



Summary

- **US dollar appreciates against sterling and the euro on relative economic strength.**
- **Bond markets perform well as future inflation is forecast to decline from current highs.**
- **US Treasury bails out mortgage agencies but some US banks still struggling.**
- **Commodity prices continue their precipitous falls.**

US Dollar Takes Off

After being confined to a narrow range for two years, the US dollar suddenly appreciated by 9% against sterling and by 7% against the euro in the month of August. The catalyst was evidence that the UK and European economies were unexpectedly deteriorating at a faster pace than that of the US. In the UK, growth came to a standstill in the second quarter, whilst European growth was negative. This compared with robust 3.3% growth in the US over the same period, as interest rate reductions and a tax cut provided a much needed stimulus. However, this level of growth is not expected to last. Unemployment is rising and consumer demand is falling as US property prices, down 18% from their highs, continue to spiral lower.

Even though inflation rose during the month in all regions, the gloomy outlook for growth, together with further declines in commodity prices, meant that bond markets rallied. Equities produced mixed results during August, pulled between hopes of lower interest rates and fears of a weaker US economy. The fears were realised in the first week of September, with a sharp deterioration in US unemployment and renewed worries over the US banking system. The result was a sudden average 5% decline in equity markets in that week.

US Treasury to the Rescue

Faced with deteriorating confidence in the banking system, this weekend the US Treasury nationalised the mortgage agencies known as Fannie Mae and Freddie Mac. In doing so, the Treasury has lowered mortgage rates for borrowers, provided capital to support new loans for house purchase and improved liquidity in a market that is at the core of the US financial system. This controversial action should underpin the domestic property market and limit further house price declines to perhaps 10%. This is therefore another major step towards setting the US housing sector and the wider economy on the path to a sustainable recovery.

Although this bailout will help to restore confidence, individual banks still require new capital. Another major failure remains a risk and the coming weeks, when banks report third quarter earnings, will be a tense time for bond and equity markets. Corporate bonds yields have risen in all markets as a result of this risk.

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market	
		1 month to 31 Aug %	12 months to 31 Aug %
Currencies v £	Rate		
US dollar	1.82	8.9	10.7
Euro	1.24	2.4	19.1
Yen	198	7.9	17.7
Cash (3m)	Yield %		
USA	2.80	0.2	5.6
UK	5.67	0.5	6.6
Euro	4.85	0.4	4.7
Japan	0.88	0.1	0.9
Bonds (10yr)	Yield %		
USA	3.82	1.4	10.3
UK	4.48	3.0	9.6
Germany	4.17	1.8	4.9
Japan	1.42	1.2	3.3
Equities	Index		
USA	S&P Comp	1.4	-10.7
UK	FTSE 100	4.9	-7.1
Germany	DAX	-0.6	-13.3
France	CAC	2.4	-17.9
Spain	SMSI	-1.2	-18.3
Italy	BCI Gen	2.0	-23.3
Japan	Topix	-3.6	-20.7
Australia	All Ord	3.7	-11.7
Hong Kong	Hang Seng	-6.2	-8.7
Alternatives	Index		
Property	IPD	-1.1	-17.0
Commodities	DJ AIG	-7.3	17.6
Hedge Funds	HFR	-1.2	0.8

Source: Reuters

September 2008

Inflation to Fall in the UK

The August minutes of the Bank of England's monetary policy committee showed that the Bank expects inflation to fall to its target level of 2% within its two year forecasting horizon. This opens the door to interest rate cuts, perhaps as soon as next month. The latest data on industrial production and retail sales have been weaker than expected, whilst wage increases have been falling. As a result, we expect inflation to fall sharply next year, allowing for rates to fall to 3.5% in 12 months time.

UK Consumer & Retail Price Inflation Forecasts



Source: Lehman Brothers

Although the economic news is likely to deteriorate over the balance of this year, expectations of lower interest rates should underpin UK equities, helped by market valuations being cheap on a variety of measures. Company earnings are still being revised down, but the 11% depreciation in sterling over the past two months will cushion those companies with foreign earnings from the global slowdown in demand. We estimate this will benefit 70% of the companies in our UK portfolio. Additionally, client portfolios will benefit from relative currency gains on an 8% overweighting in international holdings.

Our international equity exposure does not include emerging markets, as we have perceived them in general to be expensive. With the slowdown in global demand and the collapse in commodity prices, equities in some emerging markets have seen precipitous falls - China is down 57% from its high, for example. The FTSE emerging

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markets index has fallen 32% from the peak seen last October, but even so the asset class remains expensive relative to developed markets. Whilst it is thus too early to buy in, we are alert to the opportunities in this area and are monitoring valuations carefully.

Commodity Prices Fall Further

As the graph below demonstrates, commodity prices have fallen dramatically in the space of just two months. Oil has fallen from a high of \$147 to \$104 currently as demand has slowed around the world in response to economic weakness and increased production from the Middle East. We would not be surprised to see oil below \$100 and ultimately close to the marginal cost of production, now put at \$70 per barrel. Metals are experiencing similar supply and demand pressures and further price declines are likely. We sold our commodity fund last month, realising a 30% gain over 12 months, and will reinvest the proceeds in an alternative asset class.

Matthew Hunt

Dow Jones AIG Commodity Index
January 2006 - September 2008



Source: Reuters



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