

## Summary

- **Hedge fund liquidations and a deteriorating global economic outlook drive equities to new lows.**
- **Gilt prices rise as inflation peaks, but corporate bond prices fall sharply again.**
- **UK, European and Japanese equity valuations now match the levels seen at previous turning points.**
- **Government policy highly supportive of markets but price momentum has yet to turn up for a buy signal.**

## Equities & Commodities Fall Further

Following the rescue of the global banking system in September, October offered only an intensification of market volatility as hedge funds faced large scale redemptions and were forced to sell equities into a falling market. The result was heavy losses for all equity markets and a continuation of the precipitous fall in commodities, with the AIG index down a further 21% in October. Currency moves were equally extreme. Capital flowed to the safety of the US dollar and the Japanese yen was bought by investors looking to repay borrowings in yen that were becoming increasingly costly as the currency spiralled upwards. The yen appreciated against sterling by a staggering 20% in October, making for a 51% appreciation over 12 months. This currency move offset the fall in Japanese equities, making Japan the best performing equity market over the month for a sterling investor.

The global economic news deteriorated at an alarming rate in October. In the US, the rate of job losses accelerated and consumer confidence hit its lowest level since records began in 1967. Not surprisingly, US retail sales were the weakest for three decades and manufacturing confidence is now at the lowest level since 1982. In the UK, the picture is similar. Unemployment increased by 0.5% to 5.7%, the biggest rise since 1991 and a CBI survey showed business confidence at its weakest since 1980. Perhaps the most telling data is from the car industry. General Motors of the US announced a 45% fall in car sales in October compared to the prior year and in the UK car sales were down 23% year on year. Most striking, though, was the decline in sales of Volvo trucks in Europe from 42,000 in October 2007 to just 115 last month. With this background, it is not surprising that the International Monetary Fund has reduced forecasts for economic growth next year to -0.3% for the US, -0.5% for the Eurozone and -1.3% for the UK.

## Inflation to Fall - Positive for Gilts

Although UK inflation was reported at 5.2% for September,

the trend from here should be down. The Bank of England belatedly recognised this with an unexpectedly large 1.5% cut in interest rates, which has succeeded in bringing down interbank lending rates from 6.0% recently to 4.4% at the time of writing. Yields on gilts have also fallen since the end of October as expectations for lower inflation have

## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 31 Oct	12 months to 31 Oct
		%	%
<b>Currencies v £</b>	<b>Rate</b>		
US dollar	1.61	11.0	29.5
Euro	1.26	0.2	13.9
Yen	158	19.5	51.7
<b>Cash (3m)</b>	<b>Yield %</b>		
USA	2.93	0.4	4.9
UK	5.84	0.5	6.3
Euro	4.71	0.4	4.5
Japan	0.85	0.1	0.8
<b>Bonds (10yr)</b>	<b>Yield %</b>		
USA	3.97	-0.8	8.6
UK	4.51	-0.1	8.9
Germany	3.88	1.6	7.7
Japan	1.49	0.0	2.7
<b>Equities</b>	<b>Index</b>		
USA	S&P Comp	-16.7	-35.3
UK	FTSE 100	-10.5	-32.3
Germany	DAX	-14.1	-35.3
France	CAC	-13.1	-37.5
Spain	SMSI	-16.4	-40.5
Italy	BCI Gen	-14.8	-42.6
Japan	Topix	-20.1	-45.2
Australia	All Ord	-13.5	-36.8
Hong Kong	Hang Seng	-22.1	-53.5
<b>Alternatives</b>	<b>Index</b>		
Property	IPD	-2.4	-18.9
Commodities	DJ AIG	-21.3	-26.6
Hedge Funds	HFR	-13.8	-26.0

Source: Reuters

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out-weighted concerns that the government will have to borrow substantially more to support the economy over the coming year. Corporate bonds, on the other hand, have not shared in the rise in gilt prices. Forced sales by hedge funds and concerns that company defaults will rise have pushed corporate bond yields to a level above gilts that was last seen in the 1930's. This represents an attractive opportunity to buy high quality corporate bonds at yields of between 6.0% and 7.5% for maturities of less than 10 years. The graph below shows how sharply prices of corporate bonds have fallen relative to gilts over

**Gilt Prices Rise whilst Corporate Bond Prices Fall**



the past month. We look to take advantage of this move in the coming weeks.

## Where Now for Equities?

The speed and extent of the downturn in the global economy points to a sharp contraction in company earnings in the coming year, perhaps by as much as 30%, representing a slowdown worse than that seen in the early 1990's. UK, European and Japanese stock markets already discount a decline in earnings of this magnitude. Within each market, however, different industry sectors are at varying stages of recognising the threat to earnings. In the UK, forecasts for retail and housebuilding companies, for example, already assume a substantial fall in earnings, which explains why their share prices have been relatively resilient over the past month.

Historically, the low point in stock markets has coincided with valuation levels similar to those seen at the end of October, when the cash flow yield for the UK hit 9.5%, almost double the long term average. It is not unusual for the stock market to rise, even though company earnings

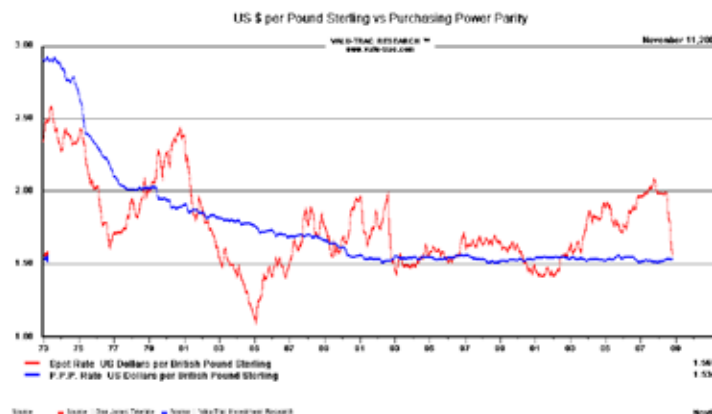
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are still falling, as investors look ahead to economic recovery. Even though the point of recovery may appear distant, the policy actions being taken are increasingly supportive of the global economy and markets. The UK and Europe have considerable scope to cut interest rates further and it is likely that UK rates will fall to 2.0% by mid 2009. This should also promote a weaker sterling, helping UK exporters. As the chart below shows, the recent fall in sterling has only taken it back to the long term equilibrium level against the dollar. There is plenty of scope for further depreciation.

Governments around the world are also embracing fiscal stimulus, borrowing to support strategic industries (banking, insurance, autos) and cutting taxes to help the consumer. There may be unwanted consequences in the future of creating higher levels of government indebtedness, but in the short term this massive intervention should succeed in underpinning the global economy.

With equity valuations attractive and government policy supportive, we only need to see price momentum turn up for all the indicators of a new bull market to be in place. This has yet to happen, but we are watching closely and beginning to increase equity exposure in those sectors that are particularly distressed.

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