



## Summary

- **Economic news has deteriorated sharply - no region is escaping the downturn.**
- **The rapid pace of decline is proving a catalyst for radical policy initiatives to promote growth.**
- **Government bonds are now looking expensive, but corporate bonds remain attractive.**
- **Equity markets are cheap but awaiting more clarity on the direction of the global economy.**

## Economic Outlook Deteriorating

The last month has seen a rapid deterioration in the economic outlook, with all the major geographic regions suffering. In the US, virtually every indicator points to a sharp contraction in activity as the turmoil in the credit markets is now impacting on the wider economy. The rate of job losses rose in November at the fastest pace in 34 years and the workweek shrank to just 33 hours, the shortest since records began in 1964. With lower employment, retail sales fell sharply and even exports, which until recently were the one bright spot in the US economy, posted a decline thanks to weakening demand around the world. Nowhere has been immune to the collapse in activity. In the UK, the picture is similar to the US. Industrial output has now fallen by 5% since the peak in February. To put this in context, output fell by 7% during the whole of the two year downturn in 1991-93. Not surprisingly, UK unemployment has risen to 1.8 million, the highest for 10 years and retail sales, which had been quite resilient up until recently, are now turning down. The Eurozone is officially in recession, with industrial output down by 5% over the past year and German business confidence at its lowest since 1993.

## Policymakers Respond Vigorously

The pace of economic slowdown since the disastrous decision to allow Lehman Brothers to go bankrupt in September is alarming policymakers. The spectre of a prolonged recession, as Japan suffered in the 1990's, or even a 1930's style depression, has drawn a vigorous response. US and UK policymakers have taken the view that deflation must be prevented at all costs. As a result interest rates were again cut in the past month, to 1% in the US, to 2% in the UK and to 2.75% in Europe. In addition, the US is starting to print money to fund programmes to support the state purchase of mortgages and to guarantee consumer loans. This drastic action, potentially highly inflationary, shows that the US Federal Reserve hopes that by acting decisively and on a massive scale, the downward spiral can be reversed.

This has succeeded in bringing down market interest rates to 2.1%, which only six weeks ago were at 4.3%. This points to the banks being increasingly willing to lend to one another (reassured, no doubt, by the \$300bn bailout of Citibank in

## Total Returns in Local Currency

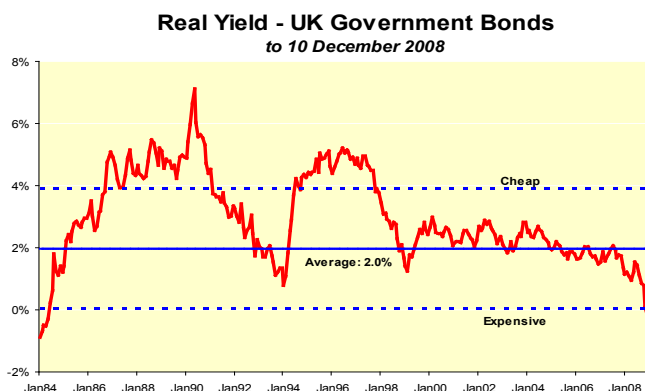
*Last month and last 12 months*

		Total Return for Market	
		1 month to 30 Nov %	12 months to 30 Nov %
<b>Currencies v £</b>	<b>Rate</b>		
US dollar	1.54	4.4	33.6
Euro	1.21	4.1	16.0
Yen	147	7.6	55.6
<b>Cash (3m)</b>	<b>Yield %</b>		
USA	2.12	0.2	5.0
UK	3.81	0.5	6.6
Euro	3.75	0.4	4.8
Japan	1.00	0.1	0.9
<b>Bonds (10yr)</b>	<b>Yield %</b>		
USA	2.92	9.3	12.8
UK	3.77	6.4	12.3
Germany	3.25	5.6	11.9
Japan	1.40	1.0	2.2
<b>Equities</b>	<b>Index</b>		
USA	S&P Comp	-7.2	-37.2
UK	FTSE 100	-1.4	-30.5
Germany	DAX	-6.0	-38.2
France	CAC	-6.0	-39.5
Spain	SMSI	-2.4	-41.5
Italy	BCI Gen	-5.1	-43.4
Japan	Topix	-3.5	-44.1
Australia	All Ord	-7.2	-39.7
Hong Kong	Hang Seng	-0.2	-49.4
<b>Alternatives</b>	<b>Index</b>		
Property	IPD	-3.8	-20.2
Commodities	DJ AIG	-7.0	-29.5
Hedge Funds	HFR	-5.1	-27.4

Source: Reuters

November), though the availability of credit to industry remains highly restricted.

The prospect of lower inflation, if not deflation, has been positive for government bonds. 10 year UK gilt yields fell to 3.8% to produce a 6.4% total return over the month. As the graph below shows, this has left bond valuations expensive, with the real yield based on the inflation average for the past 5 years below zero for the first time



in 24 years. There is now a risk that when the various measures to stimulate the global economy start to take effect, government bonds will be vulnerable to renewed inflation fears. Corporate bonds are less exposed to this risk as yields remain relatively high (e.g. 6.1% for a 10 year Tesco bond) and will benefit from economic recovery. We continue to see this as an area of opportunity and maintain our exposure to high quality corporate bonds, whilst reducing our gilt holdings.

## Equities Volatile but Range-bound

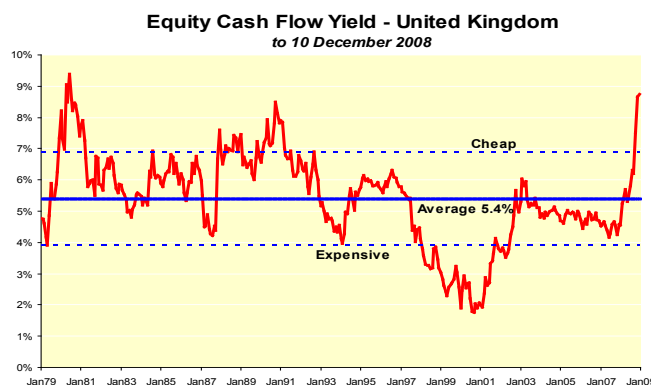
Equity markets are torn between the risk that the global recession will be prolonged and the hope that lower interest rates and government expenditure will restore growth by the second half of next year. At present, it is impossible to predict the outcome, though it is reassuring (from an equity investor's perspective) that interest rates have fallen and that government policy in the US and UK now appears to be erring on the side of stimulating growth rather than avoiding inflation. Global equities certainly offer attractive value on a longer term perspective at current prices, as is shown in the chart

opposite. In addition, expectations for the growth in company earnings have been revised down to levels from which recovery has typically been seen in the past. Thus, much of the bad news for equities should already be reflected in market prices.

## Commodities Approaching a Floor?

Whilst equity markets (both developed and emerging) are trading some 15% above their lows for this cycle, commodities have shown little sustained recovery, with the DJAIG index now 50% below its July high. OPEC are due to meet this week to discuss cutting oil production to prevent a further slide in the oil price. The incentive to bring supply and demand back into balance is high, as current oil prices are now below the cost of production in many regions. This may be a catalyst for a rally in commodities as investors look past the short term gloom to recovery. Lower commodity prices themselves represent a huge stimulus to the world economy - the fall in oil prices so far represents a \$200bn benefit to the US alone, or 1.5% of total US economic output. We are therefore looking for a suitable opportunity to reinstate our commodity exposure.

**Matthew Hunt**



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