



Summary

- **Fourth quarter economic growth for last year was much worse than expected - but that is history.**
- **Access to credit is growing and will accelerate as Central Banks print money.**
- **Corporate bonds have rallied but opportunities still exist to invest at 6.0% yields.**
- **We are starting to move overweight in equities relative to bonds.**

The Economic News Is Grim

The headlines continue to offer unrelenting evidence of recession. Unemployment everywhere is rising rapidly: in the US, jobs are being lost at a rate of 600,000 per month and the overall rate of unemployment has reached 7.6%, double the low of 3.8% seen in 2000. In the UK, unemployment has almost reached 2 million or 6.3% of the workforce and is predicted to be heading towards 3.5 million by the end of next year. The preliminary data point to US economic growth having fallen in the last quarter of 2008 at an annual rate of -4.0%, whilst in the UK the equivalent figure was close to -6.0%, the worst since 1980. Even Asia, which has not experienced the banking problems of the West, is suffering through a collapse in demand from developed countries. In Taiwan, for example, exports in December were 42% below the level of a year earlier and a similar picture is emerging throughout Asia. In Japan, the effect has been to produce a shocking -12% annualised fall in growth in the fourth quarter of last year. Although the solution is likely to be large scale government programmes aimed at stimulating domestic demand, this takes time to implement and in the meantime China has seen an estimated 20 million additional people out of work.

But The Pace of Decline is Slowing

Although the economic news is bad, it appears the pace of decline is now slowing and there are reasons to be cautiously optimistic that the policy initiatives put in place by governments will bear fruit in the coming months. In the US, whilst the first stage of the Obama relief programme has been watered down by the Republicans, a \$900 billion package has nevertheless been passed and we are now seeing action to guarantee bank loans and revitalise the housing market. This is likely to be only the first of a progression of steps that must ultimately involve recapitalising the banking system. In the meantime, better than expected retail sales in January and an excess of new building permits compared to housing starts offer some positive recent signs on the economy.

In the UK, the Bank of England is forecasting a robust recovery in 2010 after a fall of -6.0% in economic output from the middle of 2008 to mid 2009. It is not unreasonable to expect that a combination of zero interest rates, low commodity prices and government efforts to support the provision of credit to the economy will promote recovery

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market	
		1 month to 31 Jan %	12 months to 31 Jan %
Currencies v £	Rate		
US dollar	1.45	0.8	37.0
Euro	1.13	-7.8	17.8
Yen	130	1.6	62.0
Cash (3m)	Yield %		
USA	1.32	0.1	3.1
UK	1.95	0.2	5.5
Euro	2.06	0.2	4.3
Japan	0.68	0.1	0.8
Bonds (10yr)	Yield %		
USA	2.85	-5.2	10.1
UK	3.70	-5.4	11.4
Germany	3.28	-2.5	9.5
Japan	1.29	-1.0	3.0
Equities	Index		
USA	S&P Comp	-8.3	-37.7
UK	FTSE 100	-6.4	-26.3
Germany	DAX	-9.4	-33.7
France	CAC	-7.1	-35.5
Spain	SMSI	-7.6	-34.3
Italy	BCI Gen	-2.8	-41.1
Japan	Topix	-7.4	-39.4
Australia	All Ord	-4.3	-33.5
Hong Kong	Hang Seng	-7.3	-40.7
Alternatives	Index		
Property	IPD	-2.4	-23.2
Commodities	DJ AIG	-3.8	-40.6
Hedge Funds	HFR	1.7	-26.7

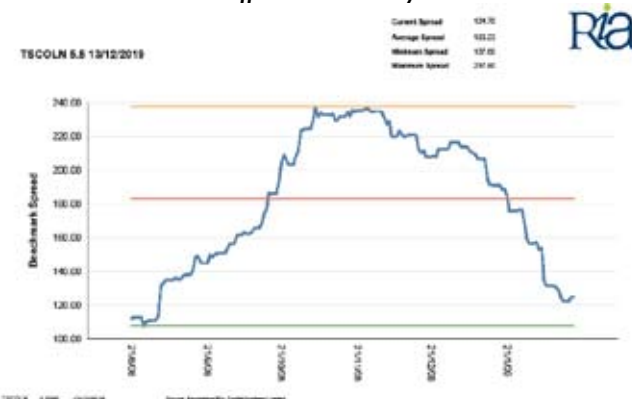
Source: Reuters

in due course. Already, we are seeing that government guarantees are encouraging lending and companies are raising capital in increasing numbers through rights issues. The Bank of England will shortly be printing money to enable it to buy corporate debt directly. This should bring corporate bond yields down and will potentially increase massively the credit available to industry.

Corporate Bonds Rally

The prospect of governments turning on the monetary printing presses alarmed the government bond markets and, as the table on the first page shows, yields rose in January, producing negative returns. We had taken profits on some of our government bonds at favourable levels, but retained all our corporate bond holdings. With the fall in equities last November, corporate bond yields at that time rose dramatically until, around 6 weeks ago, this sector started to attract press attention as offering attractive value. The result has been a flood of money into this asset class and in recent weeks the better quality names, such as Tesco and the utilities, have seen prices rise sharply and yields are now almost back at pre-crash levels relative to government bonds. The chart below shows how the yield on the Tesco 5.5% 2019 bond has moved

Tesco 5.5% 2019 Yield Differential over 10 year Gilt Yield



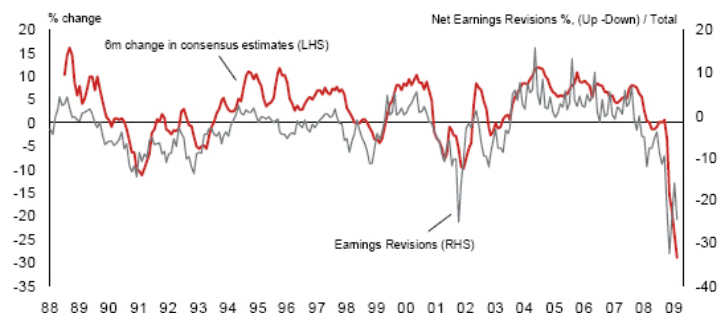
relative to gilts over the past six months. There remain opportunities to buy some corporate bonds, typically those of a credit rating “BBB”, at attractive levels (above 6.0% yield) and we are looking to take advantage of this.

Equities Forming a Base?

Global equities have been trading within a 20% range

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Global Change in Consensus Estimates vs Earnings Revisions Balance



Source: I/B/E/S, FTSE Nomura research

since October last year as governments respond to deteriorating economic news with policy initiatives that offer the prospect of recovery in due course. The chart above shows that expectations for global company earnings (the red line) have fallen by 30% over this period, closely matching the fall in equity markets. However, we have recently seen an upturn in the number of earnings upgrades vs downgrades (grey line), which has typically preceded market turnarounds in the past. This, combined with the attractive valuation of equities provides support to our view that we are close to the low point for equities in this cycle. We are therefore now moving overweight in equities relative to bonds.

Clearly, there remains enormous uncertainty for equity markets, not least because the financial sector remains very fragile as governments are prevaricating over the recapitalisation of banks in the UK and the US. Our strategy is therefore to focus on companies that have strong balance sheets, offer potential for growth in earnings even in the current environment (e.g. infrastructure development) and will be early beneficiaries of a cyclical upturn (retailers). At the same time, our portfolios remain well diversified in recognition of the unpredictability of outcomes over the next few months, whilst avoiding shares that are manifestly expensive (such as consumer goods).

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