

## Summary

- **Uncertainty over the scale of global spending stimulus ahead of the G20 Summit in April.**
- **UK quantitative easing offers the potential to make a significant difference to growth.**
- **Bonds rally in response to Bank of England's purchases of gilts.**
- **We move overweight in Pacific Basin equities after realising currency gains on yen.**

## New Initiatives Fail to Re-assure

Equities have fallen to new lows for this cycle as the economic news continues to disappoint and there is a lack of conviction that governments are really moving fast enough to support the ailing global economy. In the US, effective measures to remove bad loans from the banks, seen as a precondition to encouraging new lending, have still not been agreed, as politicians fear a popular backlash from being seen to reward failure. The price of dithering, though, is a crisis of confidence. This is well demonstrated by the fall from grace of Citigroup. Once the largest bank in the world with a market value of \$277 billion, Citigroup has now collapsed to a value of just \$5.5bn, in spite of owning \$2.2 trillion of assets, equivalent to 15% of the total gross domestic product of the US. With no scope to cut interest rates further, the US must now stimulate the economy through spending and tax cuts. The measures announced so far will make up for only 40% of the forecast lost demand this year and next, leaving the US economy exposed to a continuing recession. The opportunity to reach international agreement on a global stimulus package, however, occurs in early April, when the leaders of the G20 nations gather in London to discuss the crisis. This meeting needs to produce a co-ordinated package of spending programmes well in excess of those already announced if we are to avoid the recession dragging on through 2010.

In the UK, the Bank of England has cut interest rates as far as they can, to a low of 0.5%, and has committed to inject £75 billion into the economy by buying gilts from banks. The hope is that the banks will use the cash to make new loans. In theory, this could have a powerful stimulative effect on the economy. Capital Economics calculates that if the whole £75 billion finds its way into the economy then the multiplier effect of transactions rippling through the economy could produce a doubling in UK gross domestic product! More likely though, is that the banks will hoard the cash and only a proportion of it will reach the real economy. Either way, it will take time for this "quantitative easing" to take effect and

in the meantime the economy continues to weaken. As the chart overleaf shows, UK industrial production has dropped precipitously. The only positive in this is that equilibrium will be reached that much quicker and when it does there will be a need to rebuild inventories, providing the foundation for recovery.

## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 27 Feb	12 months to 27 Feb
		%	%
Currencies v £	Rate		
US dollar	1.43	1.4	38.9
Euro	1.13	0.5	15.9
Yen	140	-6.5	47.9
Cash (3m)	Yield %		
USA	1.20	0.1	2.9
UK	1.78	0.2	5.7
Euro	1.48	0.2	4.3
Japan	0.78	0.1	0.9
Bonds (10yr)	Yield %		
USA	3.02	-1.2	7.8
UK	3.61	1.1	11.6
Germany	3.09	1.8	10.6
Japan	1.27	0.3	2.3
Equities	Index		
USA	S&P Comp	-10.7	-42.2
UK	FTSE 100	-7.0	-31.8
Germany	DAX	-11.0	-39.6
France	CAC	-8.7	-40.1
Spain	SMSI	-10.0	-40.4
Italy	BCI Gen	-12.3	-47.4
Japan	Topix	-4.5	-41.2
Australia	All Ord	-4.5	-36.4
Hong Kong	Hang Seng	-3.1	-44.7
Alternatives	Index		
Property	IPD	-2.4	-24.3
Commodities	DJ AIG	-6.0	-50.3
Hedge Funds	HFR	0.2	-29.2

Source: Reuters

## March 2009

**Level of Manufacturing Output**



Source: Capital Economics

## Bonds Rally on Quantitative Easing

The Bank of England surprised the market by announcing that it would use the cash “printed” to buy gilts with maturities of between 5 years and 25 years. This had the immediate effect of pushing up gilt prices and thus reducing 10 year bond yields from 3.6% at the end of February to 3.1% currently, for a total return of 4.4%. Corporate bonds followed suit, so the immediate effect has been to bring the cost of borrowing down for corporates as well as the government. Bonds have also been supported by a fall in inflation expectations as core inflation fell to less than 1.0% in February. In the short term, it looks as though our caution over prospects for the bond market has been misplaced, but we continue to see very little value in bonds when real yields (i.e. after inflation) are currently negative.

## Value Shares Outperform at Last

We have progressively positioned our UK portfolio towards those companies that appear undervalued, have robust balance sheets and will benefit from early stages of economic recovery. These companies, especially those with an interest in government spending, have all outperformed the market in the current quarter. The disappointment continues to be in the financial sector. Here, the banks have suffered further writedowns and the insurance companies have fallen by almost 50% on average this year. The insurance sector has been convulsed by a debate over how short term declines in their asset values (such as corporate bonds) will affect future solvency. However, the long term nature of both liabilities and assets in insurance companies implies that solvency should not be an issue and the shares are oversold.

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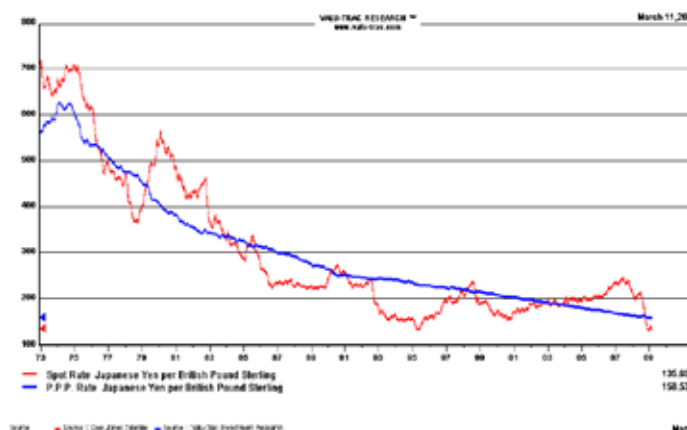
## Opportunity in the Pacific Basin

We have now reduced our overweight position in Japan and increased our exposure to the Pacific Basin, with a particular emphasis on China. Since moving overweight in Japan eighteen months ago, the yen has appreciated by 77% against sterling and, as the chart below shows, has now reached a level that is expensive relative to the long-run inflation-adjusted equilibrium rate (the blue line). It is also hard to see the yen appreciating much further when Japanese exports are collapsing (down 43% in the latest quarter to produce the first trade deficit in 13 years) and their political leadership is in turmoil. Although the Japanese stock market is cheap, we have decided to lock in the currency gains.

The Pacific Basin offers similarly undervalued stock markets but with US dollar currency exposure, which is more attractive than the yen. China, in particular, appears attractive at current levels. The leadership has committed \$600bn to stimulating their economy, a figure that as a percentage of GDP is double the fiscal boost the US has committed. With the threat of social unrest, the Chinese authorities have every incentive to support their economy and, with \$2 trillion of foreign exchange reserves, they have the means to succeed.

**Matthew Hunt**

**Japanese Yen appears overbought vs Sterling**



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