



## Summary

- **Equity valuations remain attractive and momentum has turned up - a buy signal!**
- **Bond yields have risen, but inflation is expected to remain subdued for the next year.**
- **Corporate bonds continue to outperform and still offer 5.0% yields for investment grade quality.**
- **Commodities rally strongly as positive economic surprises imply increased demand in Asia.**

## Markets Moving Back to Equilibrium

The economic news from around the world has continued to suggest an improving outlook compared to the first quarter of this year. As a result, markets have moved back from the extremes induced by the near panic in March towards an equilibrium based on expectations of a slow recovery towards trend growth rates over the next 18 months.

UK government bond yields have risen from the lows of around 3.0% reached in March to 4.0% today, producing a negative total return in May of -1.6%. This is partly explained by concerns over the huge volume of gilts to be issued to finance the budget deficit. However, it also reflects a move from an unsustainably low real yield of 0% (i.e. after inflation) to a positive real yield. As such, this is a healthy sign that the economy is stabilising rather than a warning of imminently higher inflation. This improving environment was also evident in the corporate bond market, where returns were positive in May as worries over company defaults continued to recede.

Equities produced positive returns in all markets, with the Pacific Basin, where we are overweight, generating the best returns with a 17% rise. Equities have reached a point where valuations are still highly attractive in most markets and now momentum has turned positive, pointing to the probability that a sustainable upward trend has been established. We discuss the implication of this overleaf. Commodities rebounded as stronger economic growth in Asia has reignited expectations for rising demand for base metals and energy. Our move back into commodities in early May proved to be particularly well timed.

## Positive Economic Surprises

The forward looking economic indicators for the UK have been particularly positive over the past month. The CIPS\* report, for example, suggested that services will actually show growth in coming months, pointing to a much more

\*Chartered Institute of Purchasing and Supply

rapid recovery than had been expected. The May CBI survey showed retail spending being surprisingly strong, with sales volumes up 2% on the year and retail optimism at its highest since the end of 2007. Clearly, low interest rates are supporting spending. Perhaps most surprising was that industrial production in April grew by 0.3% as manufacturing

## Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market	
		1 month to 29 May %	12 months to 29 May %
Currencies v £	Rate		
US dollar	1.62	-8.6	22.5
Euro	1.14	-2.2	11.5
Yen	154	-5.5	35.6
Cash (3m)	Yield %		
USA	0.56	0.1	2.8
UK	1.27	0.1	5.9
Euro	1.25	0.1	4.8
Japan	0.45	0.1	0.9
Bonds (10yr)	Yield %		
USA	3.46	-2.6	9.2
UK	3.74	-1.6	15.2
Germany	3.61	-3.3	11.5
Japan	1.50	-0.5	4.2
Equities	Index		
USA	S&P Comp	5.6	-31.9
UK	FTSE 100	4.7	-23.7
Germany	DAX	3.9	-26.9
France	CAC	4.1	-31.2
Spain	SMSI	4.8	-30.0
Italy	BCI Gen	4.3	-40.1
Japan	Topix	7.4	-34.6
Australia	All Ord	2.5	-28.6
Hong Kong	Hang Seng	17.4	-23.0
Alternatives	Index		
Property	IPD	-2.4	-28.3
Commodities	DJ AIG	14.4	-41.1
Hedge Funds	HFR	5.2	-22.8

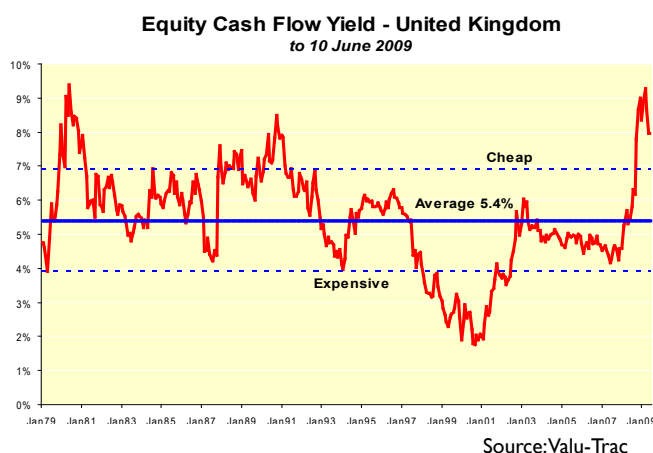
Source: Reuters

# June 2009

was helped by the weakness of sterling. The result is that forecasts for gross domestic product growth in the second quarter of this year have been ratcheted up to 0% - a marked improvement on the -1.9% fall in the first quarter.

## Tactical Benchmark Change

At turning points in the market cycle it is worth considering a tactical change to the benchmark for your portfolio. A core part of Prospect's proposition is to establish for each



client a mix of assets, represented by a benchmark, that meets their needs over the full investment cycle. Clearly though, if it were possible to buy into the stock market before a sustained rise and sell it before a sustained fall, then returns would be maximised. The problem, is how to identify the turning points.

We use two key indicators to measure value in markets and to identify turning points. Both indicators are now pointing to equities being poised to establish a new upward cycle. Clients should therefore consider whether they wish to change temporarily their benchmark to benefit from the expected cyclical upturn over the next 3 to 5 years. We have already reflected our optimism by moving up to 10% overweight in equities. Clients may, however, wish to increase this overweighting by changing the equity proportion in their benchmark. To do this, clients should contact us to discuss an appropriate strategy.

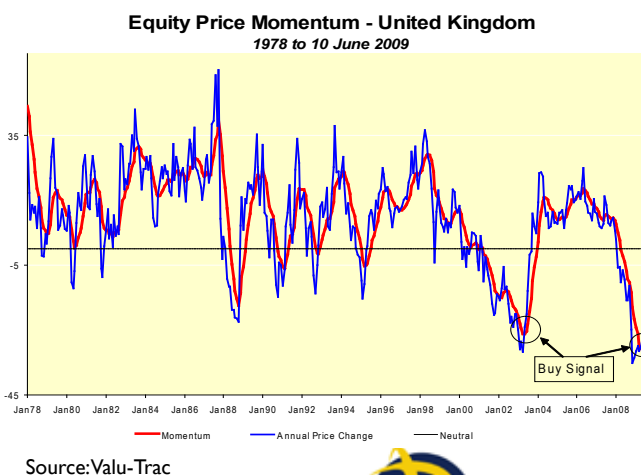
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The justification for this rare event is that market value, as shown in the chart opposite, is still particularly attractive in the UK, despite the 25% rally that we have seen since the market lows. Europe and Asia are similarly attractive, whilst in the US the recent rally has brought equities back to fair value. Globally though, there is an opportunity now to buy equities at what appears to be a cyclically attractive time.

Markets can remain under or over-valued for a prolonged period and hence the need to corroborate value with a signal that the tide has turned. The Coppock momentum indicator, shown below, has a good (though, of course, not infallible) record of identifying turning points in markets. It uses an 11 to 14 month (the time taken to overcome a bereavement) moving average to smooth out short term market movements so that when the moving average turns up, it is likely that a new trend has been established. This happened in May.

Markets do not move in straight lines and economic recovery is likely to be protracted, but current equity valuations combined with positive momentum suggest that now is an attractive buying opportunity for a two year time horizon.

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