

Summary

- **Economic news is improving and the risk is that data is better than expected in Q4 2009.**
- **Inflation around the world remains subdued providing support for bonds at current yields.**
- **Equities have further scope for gains as momentum is positive and company earnings are upgraded.**
- **We have moved back into property following signs of a revival in the commercial property market.**

Equities Continue to Rally

Contrary to the many forecasts that the recovery from this recession would be slow and painful, the rebound in global stock markets has followed the same vigorous pattern seen coming out of previous recessions. The major equity markets are now up an average of 50% from the lows seen in March and momentum remains strongly positive for equity markets, pointing to further gains to come. Our equity portfolios are fully participating in this move with our UK portfolios outperforming the market index.

In the month of August, all equity markets produced positive returns with the exception of Asia, where profit taking following a 90% rise in equities from the lows produced a modest fall in the Hang Seng and a -22% fall in Chinese equities. Early in August we took the view that Asian markets had become expensive and sold half our Asian exposure. We reinvested the proceeds into the UK, which at the time was the cheapest of the major markets.

Favourable Environment for Bonds

Bond markets produced positive returns in spite of some encouraging economic data and a rise in commodity prices. The perception has been growing in the UK that there is little risk of consumer price inflation picking up in the next year given the spare capacity in the economy and the rise in unemployment. As a result, 10 year bond yields fell from 3.80% to 3.56% in August, helped along by the Bank of England buying gilts as part of a £50 billion extension of its quantitative easing programme. These factors should continue to underpin gilts for a few months more.

Corporate bonds also produced strong returns, as the prospect of economic recovery reduced the threat of insolvency. Our RWE bond, for example, now has a yield just 1.1% above the equivalent maturity gilt, whilst last November the yield differential was at an extreme 3.3%. Falling corporate yields mean that our bond portfolio has

produced a 4.7% return this quarter compared to a 0.8% return from the gilt benchmark. Much of the exceptional gains from corporate bonds have now been realised, though there are still attractive returns to be gained from bonds in the financial sector, where yields of 6% are still achievable for investment grade bonds.

Total Returns in Local Currency

Last month and last 12 months

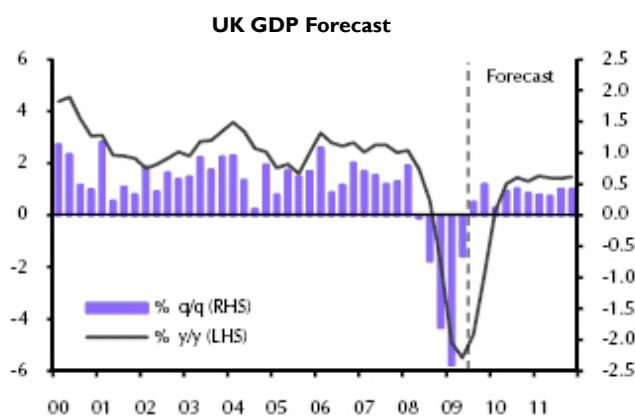
		Total Return for Market 1 month to 31 Aug %	12 months to 31 Aug %
Currencies v £	Rate		
US dollar	1.63	2.7	11.9
Euro	1.14	3.3	9.3
Yen	151	4.6	30.9
Cash (3m)	Yield %		
USA	0.59	0.0	2.9
UK	0.55	0.0	5.8
Euro	0.82	0.1	4.8
Japan	0.25	0.0	0.9
Bonds (10yr)	Yield %		
USA	3.40	1.0	7.4
UK	3.56	2.3	12.2
Germany	3.27	0.6	11.9
Japan	1.31	1.2	2.5
Equities	Index		
USA	S&P Comp	3.6	-17.8
UK	FTSE 100	7.2	-8.9
Germany	DAX	2.8	-11.0
France	CAC	7.0	-14.6
Spain	SMSI	5.5	-1.9
Italy	BCI Gen	9.4	-15.9
Japan	Topix	1.8	-21.2
Australia	All Ord	6.1	-8.2
Hong Kong	Hang Seng	-3.9	-3.8
Alternatives	Index		
Property	IPD	0.6	-22.8
Commodities	DJ AIG	1.3	-33.5
Hedge Funds	HFR	2.2	-14.4

Source: Reuters

September 2009

Improving Economic News

There is compelling evidence that the worst of the recession is now behind us and all the major economies are in the process of recovery. In both the US and the UK industrial production has started to recover from the depths of the downturn as companies replenish stocks. This process has only just begun and forward looking business surveys point to a sustained upturn. UK household spending is bottoming out, with retail sales showing signs of improvement and mortgage approvals and house prices picking up. It is now expected that real gross domestic product in all the major economies will be positive in the third quarter of this year, following positive growth in Japan and Europe in Q2.



Source: Capital Economics

The forecast for UK economic growth is shown in the exhibit above, highlighting the anaemic recovery predicted (just 1.0% growth in 2010). The concern is that consumer indebtedness and higher taxes will restrain household spending and inhibit longer term growth. Whilst this may appear realistic, the risk is that growth in the early stages of recovery surprises on the upside as interest rates remain low and companies continue to rebuild inventories. Already, forecasts for US growth, where the stimulus has been more aggressive than in the UK, are being upgraded to an above trend 3.0% rate in 2010.

If growth proves to be stronger over the coming three months, as we expect, this will provide support for a further move up in global stock markets.

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Company Earnings Upgraded

Company earnings in the current year are likely to be down by -20% in the UK and Europe but little changed in the US. Next year, forecasts are for a 35% rise in US earnings, a 30% rise in UK and European earnings and a 90% rise in Japan (albeit from a low base). The graph below shows how analysts have been upgrading expectations for company earnings in the UK and the pattern is similar in other major markets. Increases in demand at companies that have cut their cost base creates the potential for a period of rapid earnings growth and it is this that has been driving stock markets recently.

Despite a near 50% rise in the UK stock market since March, the improved earnings expectations for next year mean that the market is still cheap on a prospective price to earnings multiple of just 11 times, well below the long term average of 13 times. Whilst the overall market may be undervalued, it is noticeable that some of the cyclical sectors that suffered the most in the downturn, but have since recovered sharply, are now looking expensive. We are therefore looking for opportunities to take profits in this area.

Finally, we have bought back into property with the purchase of the Aviva Property trust, having seen the first signs of revival in the commercial property market.

Matthew Hunt



Source: Nomura, I/B/E/S



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