Investment Prospects

PROSPECT WEALTH MANAGEMENT

Summary

- **Global economic growth continues to surprise on the upside.**
- **Company earnings are growing strongly, driven by cost cutting and small revenue improvements.**
- **Equities can continue to rally as valuations are not stretched and momentum is positive.**
- **Supply constraints are producing price rises and a modest threat of higher inflation.**

Can the Recovery Continue?

There is much debate at the moment as to whether the economic recovery evident around the world, together with the rally in stock markets, can be sustained. Although the US economy grew by 3.5% annualised in the third quarter there is concern that this growth has been flattered by government incentives, such as the "cash for clunkers" car scheme, which are due to be withdrawn in 2010. The prospect of higher taxes, higher unemployment and a greater propensity on the part of the consumer to save all point towards weaker consumer spending next year. With credit still in short supply as the banks seek to rebuild their balance sheets, the fear is that the global economy will dip back into recession and the recent upturn in property prices seen in the US, Europe and the UK may be shortlived.

Positives Outweigh the Negatives

However, the latest economic evidence does not indicate a "double dip" is imminent. In the **US**, the September manufacturing survey shows output is growing strongly, order books are healthier and employment is expanding rather than contracting. The overall unemployment data is deteriorating at a progressively slower rate, as the graph of the change in non-farm payrolls overleaf shows. In the **UK,** although the growth in the third quarter gross domestic product was disappointingly weak at -0.4%, the latest surveys show that both the manufacturing and service sectors are now expanding at the fastest pace since 2007. Unemployment, normally a lagging indicator, appears to have stabilised at only 7.8%, well below the 10% level prevailing in the US. It appears this reflects the desire on the part of companies to retain staff and (with the notable exception of sections of the Royal Mail), a willingness by employees to accept more flexible work patterns. Perhaps this will prove to be one of the longer lasting benefits of this recession.

The **UK** economic news has been sufficiently positive that the Bank of England has recently upgraded its UK growth forecasts to 2.1% for 2010 and 4.0% for 2011. This confidence assumes that interest rates will remain close to zero for a large part of next year and the exchange rate will remain competitive, boosting exports, in particular to the Pacific region, which is now growing at 8.0%. The key driver is the rebuilding of inventories. This appears to be

Total Returns in Local Currency

Last month and last 12 months

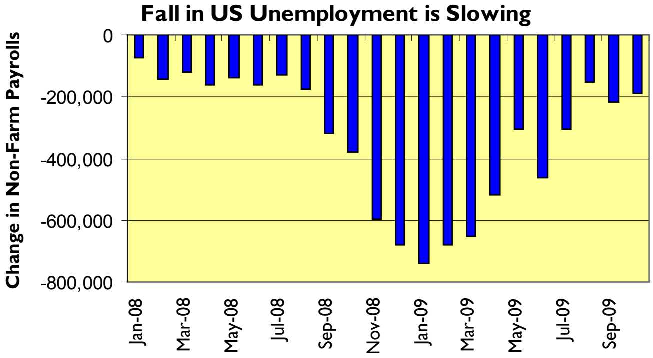
		Total Return for Market 1 month to 30 Oct %	Total Return for Market 12 months to 30 Oct %
Currencies v £	Rate		
US dollar	1.65	-3.0	-2.3
Euro	1.12	-2.1	12.9
Yen	148	-3.0	6.8
Cash (3m)	Yield %		
USA	0.27	0.0	3.0
UK	0.47	0.0	5.9
Euro	0.52	0.1	4.8
Japan	0.25	0.0	0.9
Bonds (10yr)	Yield %		
USA	3.39	-0.4	8.9
UK	3.62	0.1	12.0
Germany	0.52	0.0	9.3
Japan	1.42	-1.0	2.2
Equities	Index		
USA	S&P Comp	-1.8	10.3
UK	FTSE 100	-1.7	20.4
Germany	DAX	-4.3	13.7
France	CAC	-4.6	8.5
Spain	SMSI	-2.4	27.2
Italy	BCI Gen	-5.8	11.4
Japan	Topix	-1.5	5.9
Australia	All Ord	-1.5	24.8
Hong Kong	Hang Seng	4.0	60.9
Alternatives	Index		
Property	IPD	1.0	-16.2
Commodities	DJ AIG	3.3	0.1
Hedge Funds	HFR	1.7	14.8

Source: Reuters

November 2009

starting now in the US and UK and has been underway for several months in Europe. This process should run through the first half of 2010 and provide a strong source of growth to offset a level of consumer demand that will be constrained by low wage growth (just 1.2% in the UK in the year to September).

Fall in US Unemployment is Slowing



Source: Reuters

Equity Markets Underpinned

We expect this moderate economic recovery to be sufficient to support further upside in global stock markets. Company earnings forecasts continue to be upgraded as companies cut costs and benefit from modest growth in revenues. The chart adjacent shows how earnings in the US are being upgraded. The US is showing the strongest earnings growth, with 6 times as many positive earnings surprises as negative this quarter. In the UK and Europe the ratio is closer to 2.5 times, but the trends are nevertheless very positive and should lead to further upgrades, underpinning the gains seen to date in equities.

Market valuations are still not stretched outside the US and the Pacific Basin and price momentum in all markets remains positive (see last month's newsletter). Credit may still be hard to come by for small companies, but larger businesses are increasingly able to refinance themselves on the capital markets. What is more, they can do so at attractive rates, due to the effect of quantitative easing - increased again this month in the UK to £200bn. We therefore see further upside for global equities and maintain an overweight position.

Inflation or Deflation Ahead?

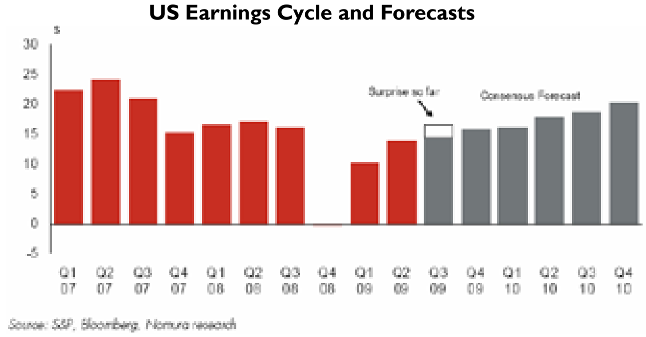
Traditional economic theory would conclude that deflation is more likely than inflation over the next year. Unemployment is cyclically high and rising or, at best stable. Wage growth is low and there appears to be large surplus productive capacity in the western economies combined with low (4%) growth in money supply, despite huge injections of cash through quantitative easing.

Why then, have we seen bond yields in the UK rise by 0.4% over the past 6 weeks? The answer is that the fall in inventories has meant that some industries are now having difficulty meeting even a modest increase in demand. With supply constrained, prices are starting to rise. Added to this are pressures on input prices in the UK as commodity prices rise (copper is up 30% since June), and by the fall in sterling over the past year against the euro and yen. The rise in the price of gold, up 18% since June, is also a warning that price pressures may be building.

Our view is that the inflation risk is real, especially as the UK authorities will have a bias towards a stimulative policy in the run-up to next year's election. Given these uncertainties, we consider bonds are unattractive relative to equities and we are maintaining our underweight position with a bias towards short dated maturities at the present time.

Matthew Hunt

US Earnings Cycle and Forecasts



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