



- **Greek debt problems are likely to be resolved through EU intervention and an austerity programme.**
- **Economic news continues to be supportive of company earnings and equity markets.**
- **The Bank of England inflation report is positive for bonds, but underlying data is not so reassuring.**
- **Property prices continue to rise and we are participating fully through our property fund investment.**

A Healthy Consolidation for Equities

Declines in all major equity markets over the past month should be seen in the context of the 30% average rise in equities over the past year and an improving underlying economic environment around the world.

The catalyst for the equity weakness has been a combination of renewed evidence that China is taking steps to slow its economy (good in the longer term), President Obama's proposals to tax US banks (insignificant in the longer term) and fears of a debt crisis in the eurozone.

It is the threat of a Greek default that has pre-occupied markets in recent weeks. Despite the headlines, the likelihood of default appears low. Total Greek debt stands at 120% of gross domestic product, which although twice the limit set by the Maastricht guidelines, is not unmanageable. Italy has lived with debt at this level for years. What is unsettling markets, though, is the uncertainty over Greece's willingness to cut public spending to bring debt back under control, and whether concerns over "moral hazard" will prevent the European Union from providing the necessary short term financial assistance.

It appears that EU brinkmanship is designed to force Greece to take the hard decisions that Ireland has taken to cut back government spending, despite public resistance. In reality, there is little alternative to this solution. Default would leave Greece economically isolated, whilst departure from the eurozone, an alternative to default, would threaten the whole euro project - would others such as Spain, Portugal and Ireland then follow suit?

The most likely outcome is that Greece will implement an austerity package under EU supervision and the EU will provide the short term financing Greece needs. The corollary is that growth in the eurozone needs to be higher so that the fringe economies can grow out of their debt problems. This means that Germany will have to do more to stimulate their economy and the European central bank will have to keep interest rates lower for longer.

This should be positive for European equities in the medium term. For now, though, we have avoided much of this fall-out by selling half our European equity exposure in early January and holding cash pending reinvestment in the US.

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 | 1.62 | 1.0 | -9.4 |
| Euro | 1.15 | -2.3 | -1.7 |
| Yen | 144 | 3.9 | -9.7 |
| Cash (3m) | Yield % | | |
| USA | 0.19 | 0.0 | 1.3 |
| UK | 0.51 | 0.0 | 2.0 |
| Euro | 0.37 | 0.0 | 2.1 |
| Japan | 0.11 | 0.0 | 0.7 |
| Bonds (10yr) | Yield % | | |
| USA | 3.59 | 2.4 | -3.2 |
| UK | 3.91 | 1.2 | 2.1 |
| Germany | 3.20 | 2.0 | 4.0 |
| Japan | 1.33 | -0.3 | 0.9 |
| Equities | Index | | |
| USA | S&P Comp | -3.5 | 33.7 |
| UK | FTSE 100 | -4.1 | 30.4 |
| Germany | DAX | -5.6 | 34.6 |
| France | CAC | -4.7 | 31.6 |
| Spain | SMSI | -7.8 | 33.0 |
| Italy | BCI Gen | -5.6 | 29.8 |
| Japan | Topix | -0.6 | 16.4 |
| Australia | All Ord | -5.5 | 41.2 |
| Hong Kong | Hang Seng | -7.8 | 57.0 |
| Alternatives | Index | | |
| Property | IPD | 3.7 | 8.6 |
| Commodities | DJ UBS | -7.3 | 16.5 |
| Hedge Funds | HFR | 1.8 | 27.5 |

Source: Reuters

February 2010

US Economic News is Positive

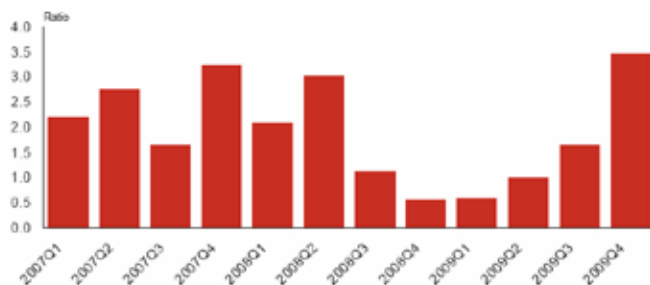
Our preference for the US is not so much based on valuations, which are relatively expensive, but on the undervaluation of the dollar against all currencies except sterling. Moreover, the economic news from the US has been encouraging of late and indicates scope for further company earnings upgrades. The employment trends are clearly improving (see adjacent graph), with few net job losses and a fall in the unemployment rate from a peak of 10.2% to 9.7% in January. Growth in gross domestic product in the fourth quarter of 2009 was 5.7%, the fastest in 6 years and industry surveys point to the highest level of manufacturing activity since August 2004.

In previous months we have seen that US company earnings have been rising due to cost cutting, but now we are also seeing evidence that revenues are improving (see chart below), following the pattern of past economic cycles. This indicates that even though this recovery may be hampered by a lack of bank credit, the earnings cycle is still trending upwards. We are therefore maintaining our overweight position in equities, with an emphasis on the US and UK markets, on the basis that we are still in the early stages of this cycle and company earnings have much scope for recovery.

Bond Rally to be Shortlived

UK government bonds rallied last month as investors sought a safe haven in the face of the eurozone debt worries. The recent Bank of England inflation report also

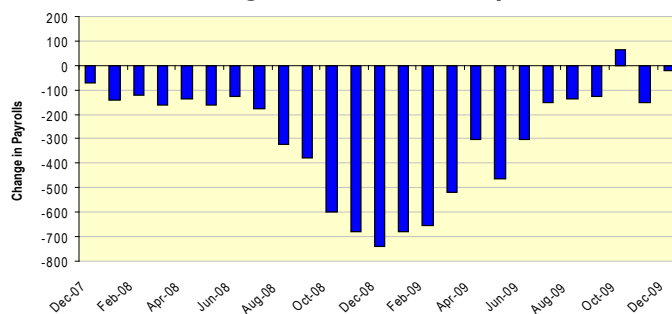
Ratio of Positive to Negative US Revenue Surprises



Source: Nomura

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Change in US Non-Farm Payrolls



Source: Reuters

provided support for the bond market by stressing the fragility of the UK recovery and suggested that inflation is likely to fall back to below the 2% target. The current 3% level of inflation is thus just a blip, partially caused by the VAT rise. Whilst this should be reassuring for bond markets, the fact remains that real yields (i.e. after inflation) are just 1% and price momentum is falling.

In our opinion the primary risk for equity investors is that economic recovery proves to be stonger than the Bank expects, as the inventory cycle turns up. As a result, inflation may be higher than is currently expected. Clearly, the Bank expects to keep interest rates at current low levels for a protracted period and will err on the side of promoting economic growth rather than controlling inflation. This is not conducive to lowering bond yields and so our portfolios remain underweight in bonds.

Property Continues to Rise

Commercial property prices, as reflected in the IPD property index, are on an accelerating trend and have now risen 9% since our purchase in September last year. We remain invested in property through the Aviva Property Trust and expect further gains.

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