PROSPECT
WEALTH MANAGEMENT

Investment Prospects

- **We expect further rises in equity prices over the next two months as economic news improves.**
- **Portfolios are positioned to take advantage of equity strength, especially in the US.**
- **Government bond yields are rising on inflation disappointment and deficit worries.**
- **Corporate bonds offer only modest scope for further outperformance.**

Equities at New Highs for this Cycle

One year on from the cyclical low point and equity markets are hitting new highs for this cycle. The catalyst is increasing evidence that the global economic recovery is established and slowly gathering pace. Company earnings on average are being upgraded following better than forecast results and central banks and politicians have navigated around the debt storms of Dubai and Greece.

We have taken advantage of equity strength by maintaining a maximum overweight position in equities. In addition, we reduced our European exposure by almost half and reinvested in US equities just before the resurgence of Greek debt fears prompted a sell-off in European markets last month. As can be seen from the table, the US has been one of the best performing markets recently.

Economic Growth Improving

Whilst central bankers still caution us over the risks ahead, the economic news has been relatively encouraging. This is particularly so as severe weather has almost certainly dampened economic activity in the northern hemisphere in the first two months of this year. Despite this, in the US the number of people employed only fell marginally in February, whilst consumer spending and industrial production both grew faster than expected. In the UK, industry surveys point to the fastest growth in export orders in 15 years, a reflection of the benefits to come of the depreciation in sterling now that global growth is picking up. Mortgage lending has also increased and the unemployment rate was unchanged at 7.8% in January, one of the lowest rates of unemployment amongst the major economies. European growth has been lagging that of the US and UK recently, due to the strength of the euro, but even here we have seen positive signs of increasing domestic growth in Germany in January.

Worries that Greece would default and cause a domino effect across some of the more indebted countries of Europe proved to be exaggerated, as we had predicted in last month's newsletter. France and Germany have committed to provide short term support to Greece in return for a credible austerity programme that should reduce Greece's budget deficit by around a third over the next two years.

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market 1 month to 28 Feb %	12 months to 28 Feb %
Currencies v £	**Rate**		
US dollar	1.53	5.0	-6.2
Euro	1.12	3.2	0.9
Yen	135	6.7	3.0
Cash (3m)	**Yield %**		
USA	0.19	0.0	1.2
UK	0.50	0.0	1.8
Euro	0.55	0.0	1.5
Japan	0.20	0.0	0.8
Bonds (10yr)	**Yield %**		
USA	3.62	0.0	-1.9
UK	4.04	-0.8	0.2
Germany	3.11	1.1	3.0
Japan	1.31	0.3	0.9
Equities	**Index**		
USA	S&P Comp	3.1	54.2
UK	FTSE 100	3.8	45.5
Germany	DAX	0.1	51.0
France	CAC	-0.5	42.9
Spain	SMSI	-5.4	40.4
Italy	BCI Gen	-3.5	46.5
Japan	Topix	-0.6	21.3
Australia	All Ord	1.6	50.4
Hong Kong	Hang Seng	2.7	66.3
Alternatives	**Index**		
Property	IPD	1.4	10.5
Commodities	DJ UBS	3.7	26.4
Hedge Funds	HFR	0.1	27.4

Source: Reuters

March 2010

Equity Outlook Still Positive

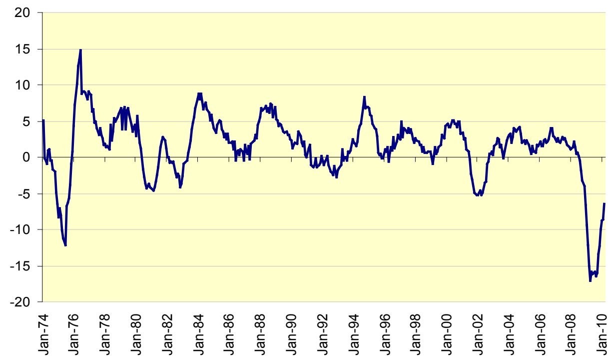
With debt worries receding and the probability of stronger economic data in the next two months as there is some catch-up from weather disruption, we expect further strength from equities. In the UK, a likely May general election would add to volatility, but it is not obvious that the outcome will have a major impact on the UK stock market. Whatever the result, an austerity budget will most likely follow whose effect can only be judged once the details are known.

The weakest sector in the UK equity market this quarter has been insurance, which has proven to be a drag on our portfolio performance. Insurance stocks are now amongst the cheapest in the market, particularly since Prudential announced an audacious bid to double its size by buying the Asian assets of the troubled US insurer, AIG. If we are right about the outlook for equities, insurance companies, who hold much of their assets in equities, should recover strongly. We have used this opportunity therefore to buy Prudential for the Alpha portfolio.

Weak Sterling Negative for Bonds

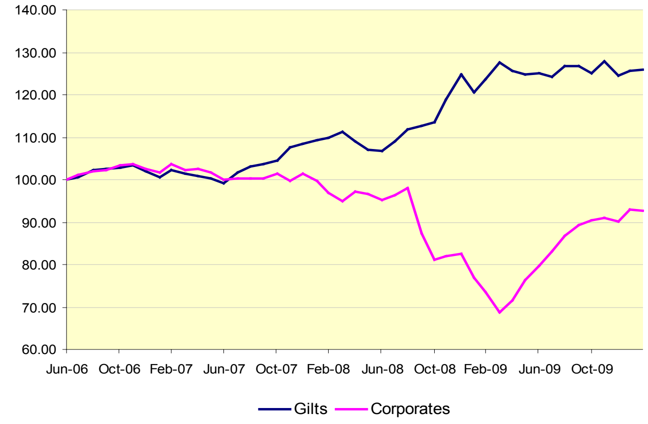
Sterling depreciated against all currencies over the past month in response to several factors: UK inflation reached 4.1% in February, the UK (a high deficit economy) suffered from Greek contagion and the chances of a hung parliament increased. Whilst depreciation is helpful to exporters, it also has inflationary implications. The Bank of England expects inflation to fall as the effect of the VAT

Industrial Production for US, UK, Europe, Japan



Source: Valu-Trac

Performance of Corporate Bonds vs Gilts



Source: Financial Express

rise in January recedes, but we remain concerned that both growth and inflation may surprise on the upside. We saw only too clearly how vulnerable UK government bonds are to bad news on inflation and the deficit as 10 year yields rose from 4.0% to 4.3% (producing a -2.3% loss) in the space of a week in mid February. We remain underweight in bonds and have a short average maturity to protect the value of portfolios against further rises in yields.

Corporate bonds have continued to outperform government bonds but now yields have fallen to a level that is looking expensive. The scale of the move for single A rated bonds is shown in the chart above. Over the past year, average 10 year maturity corporate bonds have produced a 32% gain whilst gilts have produced just a 1% return over the same period. As a result, a good quality utility bond, such as the RWE 6.375% 2013 in our portfolios, only offers a yield 0.8% higher than that on gilts. At these levels, corporate bonds do not offer a particularly attractive return for the credit risk being taken and at an appropriate time we will switch some of the corporate bonds back into gilts. This will lock in the substantial outperformance we have had from corporate bonds relative to gilts over the past year.

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