



- **Equity price momentum appears to be turning down in a sell signal - a further correction is likely.**
- **We have reduced equity exposure back to benchmark weightings.**
- **With most developed economies carrying excessive debt, high volatility is inevitable.**
- **Nevertheless, the underlying economic and company earnings outlook continues to improve.**

## Sell in May.....

In our last newsletter we commented that equity markets were vulnerable to a set-back over the summer months. This has happened faster than we had expected as UK markets took fright at the prospect of a hung parliament and Greek debt worries spilled over into Spanish and Portuguese bond markets, necessitating a massive rescue from European governments and the International Monetary Fund. We have reduced our equity exposure to close to benchmark weightings over the past month to lock in some of the gains of the past 12 months.

## Political Challenges in the UK

The establishment of a Conservative led coalition brought relief, at least temporarily, to sterling and to the gilt market. However, the economic challenge facing David Cameron should not be under-estimated. The UK primary deficit (excluding interest payments) of 6.8% of gross domestic product is worse than that of Greece (6.0%) and the £6bn of cuts proposed for this year are insignificant compared to the £170bn deficit. Further tax increases and wide ranging spending cuts will be necessary and it remains to be seen whether the Liberals, who on many policy issues are poles apart from the Conservatives, will agree to push through such a painful programme. Already, Vince Cable, the Liberal Business Secretary, has demanded that some of this year's £6bn spending cuts be recycled into tax reductions for the lower paid.

The good news is that the economic backdrop continues to improve. The UK purchasing managers index for manufacturers last month hit its highest level since 1994 as exporters benefitted from the weakness in sterling. In the US, employment is now growing at an accelerating pace and should support above trend growth this year of perhaps 3.5%, the strongest growth rate amongst the developed economies. Doubtless, this positive environment helped persuade David Cameron that he had no choice but to seize the moment even at the price of making onerous concessions

to the Liberal party. Whilst this is certainly the least bad outcome for markets, it remains to be seen whether it will deliver the stability that Mr Cameron promises.

## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 30 Apr %	12 months to 30 Apr %
Currencies v £	Rate		
US dollar	1.53	-0.6	-3.2
Euro	1.15	-2.1	-2.7
Yen	143	-0.9	1.7
Cash (3m)	Yield %		
USA	0.30	0.0	1.0
UK	0.57	0.0	1.2
Euro	0.42	0.0	1.4
Japan	0.17	0.0	0.7
Bonds (10yr)	Yield %		
USA	3.66	1.8	-1.3
UK	3.92	0.6	0.3
Germany	2.97	1.4	5.1
Japan	1.29	1.3	2.8
Equities	Index		
USA	S&P Comp	1.7	39.1
UK	FTSE 100	-2.0	35.8
Germany	DAX	0.0	33.0
France	CAC	-3.7	25.4
Spain	SMSI	-2.9	23.5
Italy	BCI Gen	-5.3	20.0
Japan	Topix	1.0	20.5
Australia	All Ord	-0.8	37.1
Hong Kong	Hang Seng	-0.4	40.6
Alternatives	Index		
Property	IPD	1.1	18.2
Commodities	DJ UBS	1.9	23.5
Hedge Funds	HFR	1.1	26.5

Source: Reuters

# May 2010

## Will Debt Overwhelm Growth?

Two weeks ago the problems of excessive sovereign debt in Europe came to a head. Faced with German reluctance to bail out Greece and the resistance of the Greek public to an austerity programme, markets concluded that Greek default was increasingly likely and its bond market collapsed. Since Spain had made no commitment to address their deficit, the panic spread to the Spanish bond market. This forced European governments and the IMF to launch a €750m rescue package. The alternative would possibly have been the break-up of the eurozone.

The price of the rescue for Spain and Portugal has been a new commitment to aggressive deficit reductions. More generally, the economies of Europe will in future have to be better integrated and already moves are afoot to have the budgets of the indebted countries vetted by Brussels. If Germany and France are to underwrite other economies, they will now want a say in how they are run. Although the rescue solves the immediate problem of financing debt repayments over the next two years, it does not address the question of how the debt will be repaid. In Greece, public sector cutbacks mean the economy will shrink, leaving no surplus for debt repayment. It seems likely that only half of Greece's sovereign debt will ultimately be repaid, creating continued uncertainty for bond and equity markets.

These events highlight the central dilemma facing markets now. The extreme debt burden of most of the developed economies can best be resolved through growth. Yet

Ratio of Positive to Negative Company Earnings Surprises



Source: Nomura

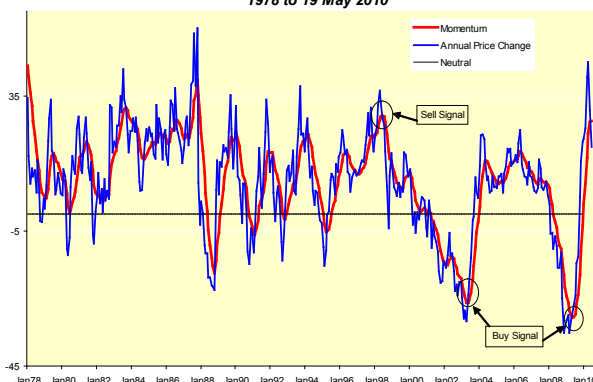
the need to cut debt limits the scope for strong growth and the political will to encourage structural reform (e.g. promoting domestic demand in Germany and labour deregulation in Spain) is missing at the moment. This growth vs austerity balancing act will be difficult to pull off and the price of failure will be inflation or default. This means we must expect increased volatility over the next couple of years, though a pro-growth bias should be positive for equities. In the short term, Europe appears most vulnerable and we are underweight European equities.

## Value Versus Momentum

As the chart opposite shows, momentum, having risen for a year, is now faltering in a typical sell signal. This supports our decision to reduce equity exposure in anticipation of a continued correction over the coming months. However, markets are not expensive thanks to strong company earnings growth, which is expected to be sustained as inventories are rebuilt (see chart above). If the economic cycle progresses as normal, this will be followed by increased capital investment, prolonging the period of growth. At an appropriate point we will therefore be looking to reinstate an overweight equity position to take advantage of the later stages of the cycle.

Matthew Hunt

Equity Price Momentum - United Kingdom  
1978 to 19 May 2010



Source: Valu-Trac

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