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## Investment Review Summary October 2006

- Global equity markets have enjoyed a reasonable rebound and now stand close to their previous cyclical highs. The average stock performance, however, has not been quite so strong, reflecting the fact that market leadership has rotated towards previously lagging large cap stocks. Equity markets face conflicting forces in the months ahead. Corporate profits are likely to fall in response to weaker activity, but lower bond yields should provide some support.

- On a relative basis, we continue to favour the US equity market. The US should be more resilient to slowing growth conditions as the recent fall in the price of oil and a strengthening bond market will provide support to the US economy. The Federal Reserve board has revised down its economic forecast reflecting both the recent drop in GDP and the slide in the housing market and their prediction is for growth to be below trend for the next six months. This should, however, ease inflationary pressures and pave the way for interest rates to fall, providing further support for the economy as we move into the first quarter of next year.

- Having seen the Japanese market power ahead at the turn of the year and the Bank of Japan increase interest rates, there are some recent signs of economic weakness with both the industry activity index and overall household spending both recording falls. The Japanese authorities are therefore highly vigilant on economic growth and deflation may not yet be totally beaten. We doubt that the Japanese economy is relapsing back into recession, but the rapid growth in its economy over the last 12 months is unlikely to be repeated. More likely is a period of consolidation. Going forward, we view the prospects for Japan as positive on the basis that the necessary foundations for a broad based economic recovery are firmly in place. Corporate balance sheets are stronger and therefore profitability is likely to rise.

- Commodity prices have corrected in recent weeks. The decline in the oil price has caught many off guard and having developed in a very short period of time suggests that the bulk of the previous rise was speculatively driven. In the near term, the price of oil may rally, but given the vibrant economies of China and the US are slowing, this should mean their intake of oil also slows. A lower oil price should be positive for both growth and inflation prospects.

- The US dollar has remained under pressure, but some respite may be close at hand. We suspect that the highly economic sensitive Asian currencies will begin to perform poorly when global growth weakens and this should divert some of the attention away from the dollar. Similarly, we forecast a bout of weakness in the commodity currencies. The pull of higher interest rates is keeping sterling reasonably buoyant and a hawkish ECB is keeping the euro stable. We fear both of these currencies may drift lower unless their market fundamentals begin to improve. Finally, the yen should make ground against most major currencies provided the Bank of Japan is allowed to pursue its gradual interest rate lifting policy.