PROSPECT WEALTH MANAGEMENT

Investment Prospects

Summary

- **Evidence of economic slowdown points to stable interest rates in the UK and US, in spite of higher inflation.**
- **Better than expected company earnings growth continues to support equities.**
- **Companies with sustainable earnings and pricing power, such as Tesco and British Airways, should continue to perform strongly .**

Bonds and Equities shine in July

Global stock and bond markets recovered somewhat this month, both supported by reasonable valuations. UK equities slightly outperformed bonds, with a total return on the FTSE 100 of 1.7% comparing to the return on 10 year gilts of 1.2%. The UK was one of the better performing developed equity markets, helped by a 1% appreciation in sterling against all the major currencies. As a result, the UK outperformed the US S&P500 and Eurozone equities in sterling terms by around 2% during July.

Worries shift from Inflation to Earnings

Over the last month the volatility of UK equities settled back down after a rollercoaster ride during May and June. Though volatility may have eased, the newsflow produced an eventful month. At the start of July, investors faced a surge in oil prices and renewed worries that inflation would again unsettle equity and bond markets as it had in the previous two months. Then, evidence of a US led economic slowdown took hold. Second quarter economic growth in the US slowed to 2.5%, from 5.6% in the first quarter, and was confirmed by poor retail sales and a softening housing market. These data eased concerns of worsening inflation and reduced the chances that interest rates will be raised in August. This change of outlook drove global equities up by 5% in the last week of July, leaving them only 6% off their peak of early May. A similar pattern of events occurred in the UK, where weak consumer spending was counterbalanced by strong manufacturing output, motivating the Bank of England to leave interest rates unchanged. UK Government bond yields therefore shifted lower during July, as bond investors decided that last month's inflation fears were exaggerated.

The corollory of weakening economic growth and lower inflation is that corporate earnings growth could be about to slow from their current high levels. Corporate profit as a percent of national income is at or near all time highs, not only in the UK but also in the US (where the S&P 500 is seeing its 12th consecutive quarter of double digit profit growth), Europe and Japan. The main reasons for this are the still low cost of debt owing to the high savings rate in Asia, and the slow growth in wages globally caused by the large supply of low cost labour in Asia and Eastern Europe. Though the influence of these new economies has extended the profit cycle, the laws of supply and demand have not been abolished, and at some point corporate profit levels are expected to turn down.

Total Returns in Local Currency
Last month and last 12 months

	31st July	Total Return: 1 month to 31st July %	Total Return: 12 months to 31st July %
Currencies v £	Rate		
US dollar	1.85	-0.8	-5.6
Euro	1.45	-1.0	-0.8
Yen	211	-1.1	-7.7
Cash (3m)	Yield %		
USA	5.43	0.5	3.7
UK	4.61	0.4	4.6
Euro	3.13	0.3	2.1
Japan	0.34	0.0	0.0
Bonds (10yr)	Yield %		
USA	4.99	1.7	-1.0
UK	4.60	1.2	2.1
Germany	3.92	1.5	-2.3
Japan	1.94	0.1	-4.2
Equities	Index		
USA	S&P 500	0.7	5.1
UK	FTSE100	1.7	16.1
Germany	DAX	0.2	18.5
France	CAC	1.1	15.3
Spain	SMSI	2.6	20.0
Italy	BCI Gen	0.9	1.9
Japan	Topix	-0.8	31.7
Australia	All Ord	-1.2	17.8
Hong Kong	Hang Seng	4.6	17.0
Alternatives	Index		
Commercial Property	IPD	2.1	21.6
Commodities	DJ AIG	2.8	11.7
Hedge Funds	HFR	-0.6	5.5

August 2006

Flight to Safety

The current turmoil in the Middle East, together with modest concerns over the global business cycle, has driven investors toward securities they perceive to be relatively safe. The total return for the month on the large company FTSE 100 index was 1.7%, outperforming that of the mid cap FTSE 250 index, which lost 0.6%. The sector performance in the FTSE 350 also reflected risk avoidance. Top performing UK equity sectors were Consumer Staples (Food & Drug retailing, Food Producers, Personal & Household Products, Beverages), and sectors with high dividend yields such as Real Estate and Utilities. The worst performing sectors were cyclicals, such as Capital Goods, Mining, Media and Life Insurance. Another reflection of the flight to safety is that in the US, high quality bonds have outperformed junk bonds over the past two months. On the other hand, the month did see a rebound in those risky assets that had fallen too far, namely some equity markets in Eastern Europe (Poland, Hungary) and Latin America (Brazil, Mexico, Venezuela and Peru).

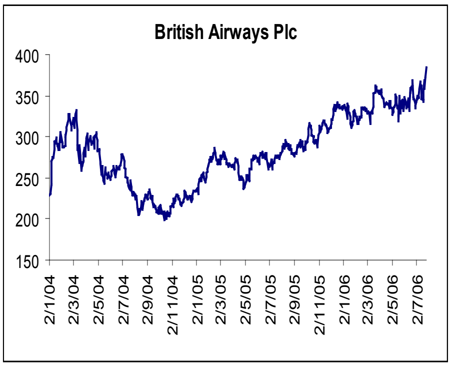
We are in an environment where the share prices of companies that report earnings below consensus expectations or where management reduce their projections for profits are severely punished. **Colt Telecom Plc** saw its shares plunge 23% after the company merely said 'conditions are challenging'. Another sobering example is market research company **Taylor Nelson Soffres**, which lost 15% of its value on the day it said its operating margin would fall by 1%. Companies on high valuations cannot bear disappointment. By contrast **Glaxo Smithkline Plc,** which is on a reasonable valuation, corrected by less than 3% when management projected slightly lower than expected earnings growth. We believe that Glaxo is on an attractive valuation given its impressive pipeline of cancer drugs and vaccines and should outperform going forward.

Desperately seeking Predictable Earnings

If corporate earnings growth is poised to turn down, a premium will be put on certainty. Investors will favour equities on moderate valuations with predictable earnings growth. These are companies with a stable earnings history, or companies that have restructured to render themselves less cyclical, with low operational and financial gearing. **Tesco Plc** is a good example of a company with such characteristics and its share price has fared very well in the last few months.

Pricing Power becomes Important as the Economy slows

The market will also reward companies with pricing power. In times of rising inflation, companies are able to pass on higher input costs. However, in an economic slowdown, pricing power of final goods and services often weakens while input costs remain high. In this environment those companies that face robust enough demand to pass on rising costs deserve a premium valuation, and if they don't already have one, are set to outperform. Despite the rise in oil prices this year, one of the top performing stocks in our model portfolio has been **British Airways Plc**, outperforming the market by some 10% year to date. A 7% increase in global air passenger traffic in the first 6 months of this year has allowed BA to pass on higher fuel costs through fare surcharges and leverage their expanded Asian routes. The airline industry is, of course, notoriously cyclical and additionally faces the challenge of a cartel investigation, so the shares require careful monitoring. For now though, demand is strong, pricing power remains intact and the uptrend of the shares looks set to continue.



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