

Summary

- **US growth slowing enough to ease inflation, but not enough to threaten global expansion.**
- **Recent stability in US interest rates points to a slower pace of rate rises elsewhere.**
- **Lower raw material costs will counter softening demand and support earnings growth.**
- **Equity valuations reasonable enough to allow higher earnings to produce higher equity indices by year end.**

Calm Returns to Markets in August

Equity and bond returns were modestly positive in local currency terms in August, sustaining the recovery from the May/June correction. In the UK, equities and bonds produced similar total returns of less than 1% in August, contrasting with the substantial outperformance of equities over the past 12 months. The best performing UK equity sectors over the month were industrials, pharmaceuticals, non-life insurance and media. These sectors have been highlighted on our valuation screen as cheap for several months and we have over-weighted them in our model UK equity portfolio. As a result, our UK equity portfolio has outperformed the FTSE 100 by 1.6% over the past four months.

Sterling appreciated against all the major currencies in August. Higher short term interest rates in the UK contrasted with unchanged rates in the US and Japan, while in the Eurozone, data releases from Germany and Italy revealed that business confidence is waning.

Internationally, returns from each asset class were similar with the main theme being the lower level of market volatility brought about by reduced concern over inflation and the prospect of more stable interest rates. Equity market volatility has fallen sharply since June and with this reduction in perceived risk has come a fall in the price of gold, down 1% during August to \$627.

Lower Oil Prices and a Slower Pace of Interest Rate Rises

After a surge in the oil price on August 6, when BP said it would shut down 400,000 barrels of daily production at Prudhoe Bay due to pipeline corrosion, by the end of the month the oil price had fallen to \$69/bl, a two month low. The imminent resumption of BP production, the ceasefire in Lebanon, rising oil inventories, and the anticipation of the

usual autumn dip in demand are all factors now dampening oil prices. Not surprisingly, oil was the worst performing equity sector globally in August.

The expectation of a US housing led slowdown has eased demand pressure for commodity prices in general, as can

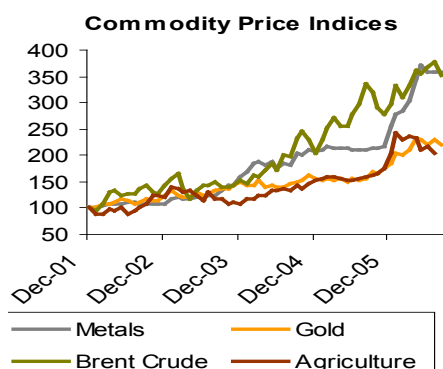
Total Returns in Local Currency

Last month and last 12 months

		Total Return	
		1 month to 31 st Aug %	12 months to 31 st Aug %
Currencies v £	Rate		
US dollar	1.90	-2.1	-5.5
Euro	1.49	-1.8	-1.7
Yen	223	-4.3	-10.5
Cash (3m)	Yield %		
USA	5.33	0.5	3.9
UK	4.87	0.4	4.5
Euro	3.23	0.3	2.1
Japan	0.33	0.0	0.0
Bonds (10yr)	Yield %		
USA	4.73	2.4	-1.3
UK	4.52	1.1	1.3
Germany	3.76	1.7	-2.2
Japan	1.63	3.0	-1.0
Equities	Index		
USA	S&P Comp	2.3	9.6
UK	FTSE 100	0.3	15.3
Germany	DAX	3.3	23.6
France	CAC	3.3	20.2
Spain	SMSI	3.1	24.7
Italy	BCI Gen	4.0	16.5
Japan	Topix	4.1	29.7
Australia	All Ord	2.9	18.8
Hong Kong	Hang Seng	2.8	19.7
Alternatives	Index		
Property	IPD	1.3	20.1
Commodities	DJ AIG	-4.3	-0.3
Hedge Funds	HFR	0.6	5.5

September 2006

be seen in the chart. Corporate profit growth is still expected to be lower this year than last, but has been revised upward slightly as declining raw material input prices give some support to margins and counter the pressure on revenues from slowing global growth. Lower



inflation expectations allowed the US Federal Reserve to leave interest rates unchanged in August, which is positive for corporate earnings as well as for bond markets. 10 year US bond yields have fallen from 5.25% in July to 4.75% currently, producing a total return of 4.8%.

It is now likely that there will be no further US interest rate changes this year and the Fed may even start to lower rates next year. Similarly, the Bank of Japan is unlikely to raise rates in the face of slowing export sales. In contrast, despite weaker economic data in Europe, the European Central Bank has indicated they will again raise rates in October. In the UK, the Bank of England's surprise interest rate hike on August 3 had a dampening effect on consumer confidence, but consensus forecasts are for another rate hike in November. However, if unemployment continues to rise and oil prices fall further, we expect that UK interest rates will be left unchanged.

Equity valuations are reasonable despite declining growth

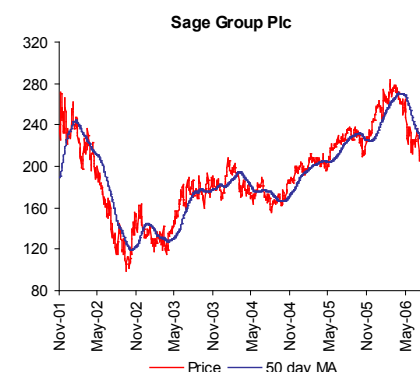
The cashflow yield on the major equity markets indicates that equity index valuations are not expensive relative to historic levels. Additionally, the PE ratio for UK equities is 12.4, which is not excessive relative to the earnings growth expectations of 11% this year and 7% next year. We therefore expect a higher FTSE 100 by year end.

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The US is more expensive than other markets, as it has been for several years. Today the US is valued at more of a premium relative to the other markets than in 2001 and 2002. Given that current and next year's earnings per share (EPS) growth for the US is forecast at 16% and 11%, versus 12% and 10% for Europe, the dearer valuation for the US has some justification.

Sage Performs Strongly in August

Sage sells accounting and business software to the small business community. The company is the market leader in the UK, France and Germany and the number two in the US. Although organic sales growth is only 5%, this has been supplemented by regular acquisitions. In a fragmented market there is scope for this to continue and Sage has recently made an offer for Emdeon Practice Services, whose customers are physician groups



in the US. The result is earnings growth of 10-15% pa and since two thirds of revenues come from upgrading existing clients it has a very secure and predictable revenue base. This combination of security and growth has in the past attracted a high valuation. However, the company has recently been trading at the low end of its historic valuation range and yet is starting to receive upward revisions to earnings forecasts from analysts. During August the share price started to rise and has outperformed by 4.5% since we first purchased the stock in June. We anticipate further outperformance.



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