

## Summary

- *All of Prospect's equity portfolios outperform their respective benchmarks since inception.*
- *Economic growth in the major regions is slowing whilst inflation risks are rising.*
- *Equity valuations are becoming stretched but earnings growth means equities should outperform bonds over the first quarter.*
- *UK interest rate rise likely with negative implications in the short term for bonds.*

## Review of 4th Quarter

In the fourth quarter, global equity markets continued their recovery from the correction in May/June. Falling oil and metal prices and a perception that the US interest rate cycle had reached its peak were behind the strong global equity performance and offset evidence that company earnings growth had begun to slow. Bond yields, by contrast, rose in the US, UK and Europe as inflation remained stubbornly high. In the UK in particular, strong personal and public sector consumption, together with rising house prices, raised concerns that UK inflation would remain well above the target 2.0% for some time to come.

### Interest Rates and Currencies

Short term US interest rates fell slightly over the quarter as the US Federal Reserve committee waited to see if rates at 5.0% would curb inflation pressures without exacerbating the slowdown in the housing market and tipping the wider economy into a downturn. In the UK and Europe, signs of

more robust growth prompted the central banks to raise interest rates by 0.25% during the quarter, with the market anticipating further rises in 2007.

With interest rates and economic growth moving in opposite directions, it was not surprising that the US dollar depreciated by 4.6% against sterling and by 3.9% against the euro over the quarter. The yen was the weakest currency, falling by 5.3% against the British pound as growth proved to be disappointing, with exports slowing in response to weaker growth in the US. Over 2006 as a whole, the relative strength of the UK economy and higher interest rates meant that sterling appreciated against all the major currencies (see page 3).

### Bonds

At the start of last quarter we expected to see a moderation in UK inflation as energy prices appeared to have peaked and higher interest rates were likely to restrain consumer spending. This would have been positive for UK bonds. In the event, bond yields rose as economic growth for the year proved to be higher than expected at 2.8% and house price inflation accelerated rather than slowed. 10 year gilt yields rose from 4.5% to

Equities to  
outperform bonds in  
Q1 2007

January 2007

4.7% to produce a total return for the quarter of -0.6%.

UK corporate bonds continued to perform much in line with government bonds over the quarter, as corporate balance sheets remain strong in spite of a slowdown in corporate earnings growth. The increase in highly leveraged acquisition activity by private equity investors has raised the risk for many corporate bonds that a buyout could result in a substantial deterioration in credit quality and a material fall in price. Wary of this risk, we switched out of our Severn Trent holding in November and reinvested in Royal Bank of Scotland bonds, where such risk is negligible. The **Prospect model bond portfolio** produced a return of -0.5% for Q4, in line with that of the benchmark.

## Equities

The FTSE 100 produced a respectable total return of 5% for the fourth quarter and 14.4% for the year. The real surprise, however, was in the FTSE 250 Mid Cap market. Here, a feverish degree of merger and acquisition activity caused the index to rise 12.4% in the quarter and an astounding 30% for the full year. Outside of the UK, the Pacific Basin and some continental European equity markets including Spain, Germany, and Sweden also produced double digit returns in the quarter. Eurozone economic reforms are at long last resulting in improving business sentiment, falling unemployment and, despite increased VAT in Germany, evidence that consumer spending is rising. High levels of merger activity in Europe have also supported both midsize and larger companies' shares in these markets.

Asia Pacific ex Japan equities have more than doubled since 2003. China and India continue to grow at a booming pace despite interest rate rises and high energy prices. The smaller economies in the region are benefiting as well and stock markets such as Hong Kong, Taiwan, Singapore and Malaysia have all done extremely well in 2006. Clients have benefited from an overweighting in both Europe and the Pacific Basin.

The markets that have produced the weakest returns over the quarter, the US and Japan, have also been those to have suffered the most currency depreciation against sterling. Thus, US equities rose only 1.7% and Japanese equities fell by 0.9% in sterling terms. We have been underweight in US equities as valuations are unattractive and rising interest rates and slowing corporate earnings make for an unfavourable environment for equities.

## Alternative Investments

UK commercial property continued to perform well this quarter with a return of 3.4%. There is some evidence now that rental income may be rising, which may give some support to expensive valuations.

Commodity prices as measured by the DJAIG index rose by 5.4% in Q4. Our commodity fund was up 7.9%. Grain performed strongly due to drought in Australia and North America, but copper fell by 17% over the quarter. The gold price rose by 6.5% in dollar terms.

Our hedge fund was up 9.2% on the quarter.

### Prospect Wealth Management: Performance of Model Portfolios

Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	1.54	1.97	FTSE 5-15 years
UK Equity	12 May 2006	7.08	5.22	FTSE 100
UK Alpha	12 May 2006	13.72	5.41*	FTSE 100
International Equity	30 June 2006	8.63	7.24	FT All World ex-UK
Alternatives	30 June 2006	6.37	4.66	Prospect Composite**
50% Bond / 43% Equity/ 7% Alternative	30 June 2006	4.73	4.18	Composite

\* Adjusted for transition date. \*\* IPD Property index, DJAIG Commodity index, HFRX Directional index

## Total Returns in Local Currency and in Sterling Terms

3 months and 12 months to 31<sup>st</sup> December 2006

	31st Dec	Total Return Local		Total Return Sterling	
		3 mths to 31 <sup>th</sup> Dec %	12 mths to 31 <sup>th</sup> Dec %	3 mths to 31 <sup>th</sup> Dec %	12 mths to 31 <sup>th</sup> Dec %
<b>Currencies v £</b>	<b>Rate</b>				
US dollar	1.96	-4.6	-12.4		
Euro	1.48	-0.7	-2.0		
Yen	233	-5.3	-13.1		
<b>Cash (3m)</b>	<b>Yield %</b>				
USA	5.26	1.3	4.6	-3.4	-8.3
UK	5.22	1.3	4.6	1.3	4.6
Euro	3.66	0.9	2.5	0.2	0.5
Japan	0.48	0.1	0.0	-5.2	-13.0
<b>Bonds (10yr)</b>	<b>Yield %</b>				
USA	4.70	0.8	2.1	-3.9	-10.5
UK	4.74	-0.6	-0.9	-0.6	-0.9
Germany	3.96	-1.1	-1.9	-1.8	-3.8
Japan	1.69	0.3	-0.4	-5.0	-13.4
<b>Equities</b>	<b>Index</b>				
USA	S&P Comp	6.6	15.4	1.7	1.1
UK	FTSE 100	4.9	14.4	4.9	14.4
Germany	DAX	10.4	21.6	9.7	26.1
France	CAC	6.3	20.1	5.6	17.8
Spain	SMSI	10.9	36.9	10.1	34.2
Italy	BCI Gen	9.2	19.5	8.4	17.1
Japan	Topix	4.7	2.8	-0.9	-10.6
Australia	All Ord	11.4	23.4	12.3	16.3
Hong Kong	Hang Seng	14.5	37.3	9.4	20.0
<b>Alternatives</b>	<b>Index</b>				
Commercial Property	IPD	3.4	17.7	3.4	17.7
Commodities	DJ AIG	5.4	2.1	0.5	-10.5
Hedge Funds	HFRX	6.2	10.4	1.2	-3.2

Source: Reuters

## Macroeconomic Overview – 31<sup>st</sup> December 2006

US	UK	Eurozone	Asia
<b>GDP Growth</b>			
Mixed messages. November durable goods orders ex-aircraft fell by 1.1%. Manufacturing slowing. But consumption growth accelerated in Q4, helped by lower energy prices. December retail sales of +2.5% at low end of forecast range. Negative impact of housing slump expected in Q1 2007, but employment and wages still growing above trend.	Q3 growth was 0.7% qoq (2.8% annualised). Though this is the fastest rate in 4 years, after a slowdown in 2005, growth is expected to continue around the 10 year historic trend (2.5% pa). Retail spending was strong in the Xmas sales on positive wealth effect of rising house values, which are forecast to rise 7% in 2007. Yet consumer confidence is negative.	Though growth at a 6 year high, +2.8% Q3 German GDP growth disappointed, slowing from Q2. Exports were strong. September retail sales in Euro area fell 0.7% from August, but +1.4% YoY. 2006 & 2007 Eurozone growth revised upward, rest of world downward. Q4 consumption should be helped by next year's German VAT hike and lower oil price.	Japan Q3 GDP grew 2% (expected 1%) on surging exports and corporate spending, though consumption fell by 0.7%. November retail sales rose less than expected. High growth in Asia ex Japan. China growth still 10.4%, despite gov't investment curbs, higher interest rates and stronger yuan. Rising retail sales compensate for slower exports.
<b>Employment</b>			
US job creation unexpectedly strong. Unemployment rate fell to 4.4% in October, a 5 year low. Of all the factors of production, labour has suffered a falling share of US GDP over the past generation. Labour may begin to catch up this year.	UK unemployment at 5 yr high, labour force participation rate is rising on high levels of immigration. Poland, with 14.8% unemployment is expanding the UK labour force with 0.5m immigrants. This is keeping wage inflation at 3.6%, down from 4.5% at end of 2004.	Eurozone jobless steady at 7.8%, and as expected, labour cost up 2.4% yoy, have been accelerating over the past year. IG Metal union leading the way to demand higher wages after little Eurozone wage growth past 2 years. ECB fears a wage/price spiral.	Strong Japanese business spending, falling jobless. Wage growth hasn't followed, but should rise in 2007, which should support retail spending. Chinese unemployment is 4.2%. Govt target: 5% maximum urban jobless for 2006-2010, up from 4.2% target of 2001-2005.
<b>Inflation</b>			
Inflation forecasts for 2006 & 2007 revised downward since 30/09/06 as oil price stays <\$60. Central bank has signaled no rate changes, but remains wary of inflation risk.	Strong sterling exerts downward pressure on inflation. Though energy and food prices have fallen, utilities bills, housing costs (house prices up 10.5% YOY) and services prices are rising and money supply growth is too strong.	Even though inflation is coming in below expectations, strong business confidence and falling unemployment make the ECB wary. Rising interest rates could threaten Eurozone property prices.	Bank of Japan likely to raise interest rates in January. Wary of excessive capital expenditure, but CPI ex energy is still negative, due to cheap imports and weak consumption: -1.7% yoy. India inflation near 8%, January rate hike expected. Chinese money supply growth is slowing, but still high at 16.8%. Chinese Central Bank expects yuan to rise by 5% in first half of '07.
<b>Fiscal Policy</b>			
Democrat control over Congress means Bush's tax cuts may be reversed. Estate tax not likely to be repealed permanently.	Budget deficit far too high at 3.6% of GDP. UK has been warned by IMF to cut deficit. Yet targets for quality of state run services are not being achieved. Tax increases are likely.	Budget deficit overall for Eurozone is 2.6%, within policy limit of 3%. Germany (-3.3%), Italy (-4.1%) and Portugal (-6%) are worst, and Finland, with a budget surplus of 2.4% of GDP is best.	Japanese Business Federation wants gov't to lower corporate taxes, funded by higher sales tax and devolution of powers from Central gov't to regions. Indian government increasing infrastructure spending by 25%..
<b>Balance of Payments</b>			
US current account deficit forecast to narrow from 6.6% to 6.4% of GDP in 2007 on expectations of stronger yuan and yen and slowing US growth. US protectionism could rise in a slowing US economy.	UK Q3 current account deficit has widened and is forecast to widen further in 2007. Exports to US likely to fall, though to Europe could rise. .	If Euro continues to strengthen and wages rise in response to union demands, the Eurozone export competitiveness will suffer.	Chinese trade surplus widened by 2/3 in 2006 to \$168 bn despite appreciation of the yuan. Currency controls have been eased so Chinese can buy foreign securities.

## Economic Forecasts as at 31<sup>st</sup> December 2006

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2006 %	2007 %	2006 %	2007 %	2006 %	2007 %	Latest %	Nominal %	Real %	2007 %
US	3.3	2.2	5.0	4.5	3.3	2.1	-2.3	5.25	1.85	-6.6
UK	2.6	2.4	4.9	5.5	2.3	2.1	-3.0	5.00	2.70	-2.6
Eurozone	2.6	1.9	8.5	7.7	2.2	2.1	-2.1	3.50	1.3	-0.3
Japan	2.8	2.0	4.5	4.1	0.2	0.5	-4.6	0.25	0.05	3.7
Asia ex-Japan	8.2	7.7			3.2	3.3				

Source: Lehman Bros, The Economist and Bloomberg

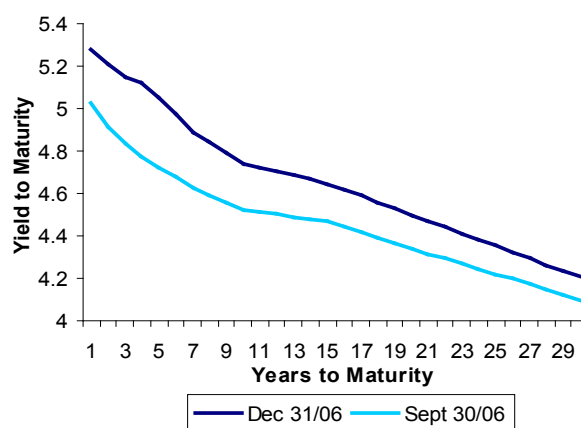
## Market Outlook

### Interest Rates & Currencies

Over the first quarter of 2007 we expect UK growth will remain robust, supported by strong consumer and government spending. There are mixed messages from the housing market, but inflation remains above target and it does look as though the Bank of England (BoE) will raise the bank rate by 0.25% during the next three months. Rates are also likely to be raised by the European and Japanese central banks in response to the latest evidence of stronger than expected domestic growth.

In the US, in contrast, rates are likely to remain on hold as expectations are that consumer spending will weaken in response to the fall in house prices. Although these rate moves are largely factored into market expectations, it is likely this will still lead to further dollar weakness against sterling and the euro. In Europe, it is likely that the European Central Bank will raise rates by more than the BoE in 2007, pointing to the euro strengthening against the pound over the coming year.

UK Government Yield Curve



### UK Bonds

The graph above shows that short term interest rates remain well above those of longer dated bonds. This points to confidence that the currently high headline rate of inflation (the Retail Price Index has risen by 3.9% over the past year) will fall as high interest rates force consumers to cut back spending. Lower energy prices and a stronger sterling are likely to help bring inflation down to the 2.1% level forecast by the economists. This should be positive for the bond market on a 6 to 12 month view. However, in the short term, another interest rate rise may be seen to reinforce the inflation risks and lead to an upward shift in interest rates of all maturities, which, as the chart shows, is what occurred in December.

At present our model bond portfolio has a duration of 6 years, one year short of that of the benchmark. We would view a rise in yields as an opportunity to increase duration in expectation that bond yields will fall later this year.

Corporate bonds offer only a modest yield enhancement over gilts given their historical relationship. However, there remains strong demand for corporate bonds from pension funds and with company balance sheets robust after several years of rapidly rising earnings, there has been no sign of corporate yields rising disproportionately to gilts. We therefore retain our exposure to corporate bonds, though wary of the risks should company earnings slow unexpectedly sharply.

## Global Equities

In March 2007 the current bull market will be 4 years old. Mindful that this is the Chinese Year of the Pig, we should be careful not to be overcome by greed this year! Certainly, there are a number of signs that point to caution at the moment. Inflation is generally

above the level that central banks are comfortable with, partly due to labour seeking to compensate for energy price rises through higher wages. Interest rates in Europe and the UK are thus likely to rise further and the direction of future interest rate changes in the US is uncertain. Economic growth, in contrast, is predicted to slow to below the trend levels that we saw in 2006, with the exception of the UK where expected growth of 2.4% is in line with trend. Any signs that the slowdown in the US housing market is affecting the rest of the economy and threatening recession would be very negative for global markets.

From a valuation perspective, the rise in markets over the past six months has left all the major stock markets on the expensive side of fair value, though nowhere near the extremes of overvaluation seen in 1999. Additionally, price momentum has been falling over the past three months in the UK, Europe and Japan, which is often a warning sign that the trend direction of the market is due to change.

Whilst there is reason to be cautious, it still appears to be too early to shift out of equities. Although

## Measures of Market Valuation

	BONDS						EQUITIES					
	Inflation forecast %	10 yr bond yield		10 yr bond yield		P/E '06 %	Valuation		Earnings growth		Volatility %	
		Nominal %	Real %	3m chg %	12m chg %		ERP* %	Div Yield %	2006 %	2007 %		
US	2.7	4.7	2.0	0.05	0.33	S&P 500	16.2	1.5	1.8	16.6	9.8	9.9
UK	3.1	4.7	1.6	0.25	0.65	FTSE 100	13.1	2.8	3.9	11.9	5.8	11.0
Eurozone	2.1	3.9	1.8	0.23	0.61	EURO Stoxx 600	13.0	3.8	3.2	13.0	7.9	11.1
Japan	0.5	1.7	1.2	-0.02	0.14	Topix	19.5	3.3	1.1	15.7	12.6	16.0
Hong Kong	2.0	3.7	1.7	-0.20	-0.47	Hang Seng	15.6	2.7	3.3	12.2	9.8	12.0

Source: Bloomberg, Citibank.

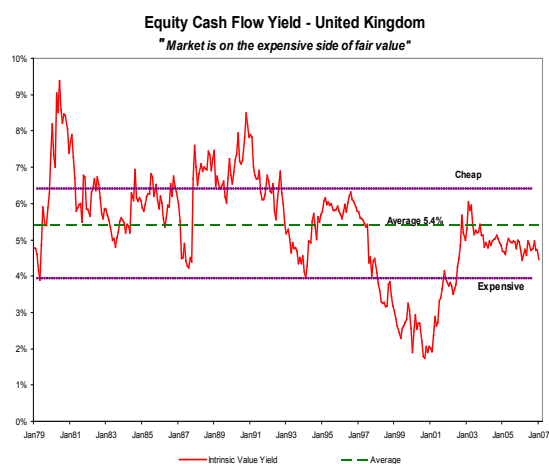
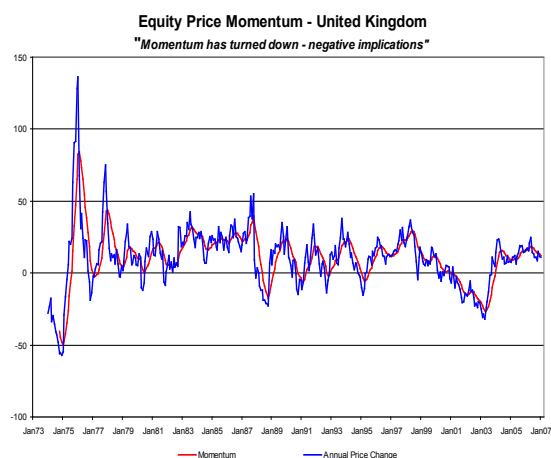
\* Equity Risk Premium = (earnings / price) \* 100 - 10yr bond yield

expectations for growth in company earnings have been downgraded in recent months, forecasts are still for growth of 5 -10% this year as lower commodity prices partially offset higher wage costs. Markets should also be supported by continued merger and acquisition activity as bond yields remain low.

In the **US**, the most recent economic indicators have been positive, with housing starts and employment stronger than expected. Whilst this is reassuring, the US stock market remains one of the most expensive globally and, when combined with a currency that is expected to weaken, appears unattractive. We will therefore continue to underweight US equities.

**Eurozone** equities outperformed in 2006 and at this point we still find them more attractive than **UK** equities. Eurozone market valuations are similar to those of the FTSE 100, but in the UK, bond yields that

to produce higher returns than those from bonds. Our portfolio is focused on larger companies and in sectors where valuations are attractive (oil, pharmaceuticals, insurance). We have moved out of the quoted property sector, which had become expensive ahead of its change of status to real estate investment trusts. In its place, we have raised our exposure to mining companies, where share prices have been depressed by short term declines in some metal prices. However,



are 1% higher than those in the eurozone provide more of an incentive to shift into bonds. Company earnings growth is expected to be higher in Europe and market price momentum is positive for the eurozone but negative in the UK. We will thus remain underweight UK equities and overweight in Europe.

Over the next few months we still expect UK equities

this ignores the longer term contracts which mining companies are now negotiating and the earnings upgrades that have left shares in these companies significantly undervalued.

Japan was the worst performing equity market in 2006 in sterling terms. Despite this, the market is not cheap, though company earnings this year should be the highest of the major economies, bolstered by exports to the rapidly growing markets in China and India.

In the Pacific Basin, equity markets are no longer on cheap valuations after surging since 2003. However, economic growth remains high and as domestic demand in China and India expands, so the region is becoming less dependent on exports to the developed world and to the US in particular. Price momentum is positive in this region, and we retain our overweight position to the region for the present.

## Alternative Investments

Our policy is to remain neutrally weighted, other than in exceptional circumstances, in alternative assets as these are intended as a diversification to the bond and equity asset classes.

### Commercial Property

Direct commercial property in the UK performed well again this quarter, with a return of 3.42% compared to 3.72% in the third quarter. Even though there is evidence that rents are rising in the London area, the overall yield on commercial property has fallen to a new low of 4.6%, leaving property prices vulnerable to any economic slowdown.

### Commodities

The agricultural sector has largely been responsible for the positive returns that have been generated over the past quarter. Despite a recent pull-back in prices, the agricultural sector is also expected to produce a positive return in coming months. Demand for sugar and grain is rising by some 20% per annum due to their use in biofuels and a progressive decline in inventories.

Energy prices have fallen by 9% since the start of the year as mild weather in the US caused a rise in inventories. The downside over the next six months

is limited by OPEC's willingness to cut production to support prices around current levels of \$55 per barrel. In December OPEC cut 1.2m barrels a day from production and have stated they are prepared to cut more if prices do not recover. In the longer term, the increase in the cost of production should provide a base level for the price of oil at around \$40 a barrel.

Base metal prices have been weak recently and there is no sign in the short term that this trend will reverse. However, given our benign economic outlook and growth in demand from developing markets, we expect metals prices to rise in the medium term. Gold has upward price potential as production is slowing whilst China and India are considering using gold as an alternative to dollars for their currency reserves.

Our exposure to commodities is through the Schroder SAS All Commodity fund, which ensures that investment in these volatile assets is actively managed.

### Hedge Funds

The Valu-Trac Strategic Fund currently has 55% exposure to equities, with an emphasis on Pacific Basin and Europe. The fund has a short position in Japanese bonds and is short in soya beans and coffee but long in copper and oil.

The fund is designed to offer clients a well diversified portfolio with a low correlation to bonds and equities.

DJ AIG Commodity Index  
Jan 2002 - Jan 2007



## Asset Allocation For January 2007

25% Bond / 65% Equity / 10% Alternative Model

		Strategic Benchmark			Q1 2007 Tactical weights	Weighting vs Strategic Benchmark
		Min %	Benchmark %	Max %	%	%
Cash		0	0	10		
Bonds:	UK Government	15	25	35	14	-11
	UK Corporate	0	0	20	10	+10
	<b>Total Bonds</b>	<b>15</b>	<b>25</b>	<b>35</b>	<b>24</b>	<b>-1</b>
Equities:	UK	33	43	53	38	-5
	US	2	12	22	8	-4
	Europe (ex UK)	0	5	15	11	+6
	Japan	0	3	13	3	0
	Asia ex Japan	0	2	12	6	+4
	<b>Total Equities</b>	<b>55</b>	<b>65</b>	<b>75</b>	<b>66</b>	<b>+1</b>
Alternatives:	Property	0	4	14	4	0
	Commodities	0	3	13	3	0
	Hedge funds	0	3	13	3	0
	<b>Total Alternatives</b>	<b>0</b>	<b>10</b>	<b>15</b>	<b>10</b>	<b>0</b>
<b>Total</b>			<b>100</b>		<b>100</b>	<b>0</b>

Source: Prospect Wealth Management

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