

Summary

- *UK bond returns were negative for the quarter whilst global equity returns were modestly positive.*
- *Economic growth in the major regions has been revised up whilst inflation is expected to decline.*
- *Equity valuations are moderately expensive but earnings growth remains robust so equities should outperform bonds over the second quarter.*
- *One more interest rate rise likely in UK, now close to top of the cycle. Positive for bonds.*

Review of 1st Quarter

Interest Rates and Currencies

Expectations for economic growth in 2007 have been revised upwards for all the major economies over the past three months. This has been positive for equities, but with commodity prices picking up again inflation became a concern, prompting central banks to raise interest rates: the Bank of England by 0.25% to 5.25% in January, the Bank of Japan by 0.25% to 0.5% in February and the European Central Bank by 0.25% to 3.5% in March. In the US, the Federal Reserve left interest rates unchanged over the quarter. Fed Chairman Bernanke has a relatively positive outlook for the US economy, but is waiting to see how much damage the housing downturn and subprime lending crisis will do to overall US growth. So far, the expectation has been that while the slowdown in residential construction will have some negative impact on growth, it will not tip the US economy into an outright recession, so no change in interest rates is warranted.

The economic
environment remains
benign.

Sterling paused this quarter after a year of appreciation against the US dollar, stopping short of \$2, the level it last reached in 1992. The euro performed strongest, especially in March, as recovering business and consumer confidence provided a basis for further rate rises. The yen strengthened relative to sterling after the rate rise in February, though the yen recovery against the dollar faded shortly thereafter.

Bonds

UK 10 year bond yields rose by 0.2% to 4.94% over the first quarter, producing a negative total return of -0.3%. Consumer price inflation, although down from the high of 3.0% seen in January, did not fall as rapidly as had been expected as oil prices reversed some of their declines and house prices continued to rise. That bond yields did not rise further, given the higher level of short term interest rates, was due to the subdued level of wage rises and expectations that cuts in gas prices will lead to lower inflation in coming months. The Bank of England's pre-emptive action in raising interest rates in January also gave the bond market confidence that the Bank will not take risks with future inflation.

With this in mind and anticipating a decline in bond yields

April 2007

over the rest of this year, we extended the average maturity of the bond portfolio by selling the Treasury 2012 bond and reinvesting in the Treasury 2020. Our bond portfolio modestly outperformed its benchmark over the quarter as we had maintained a shorter maturity than the benchmark over the period of rising yields.

Corporate bonds performed much in line with government bonds, with the portfolio benefiting from the higher yields available on these securities.

Equities

In the first quarter of 2007 the FTSE All-World index of global equities outperformed global bonds and finished up with a modest positive total return of 2.2%. This occurred only with the help of an end of quarter rally, rescuing markets from a correction in February which, though less severe than that of last May and June, still highlighted the risks facing equity markets.

The cause of the sell-off was a combination of a slow-down in company earnings growth, the rise in interest rates and the related collapse in US sub-prime mortgage lending. After three years of rapid economic expansion, this combination sparked fears that the US may be heading for a sharp economic slowdown. These fears subsequently appeared to have been overdone. US consumer spending and employment growth remained strong and company earnings proved to be better than expected, leading to a recovery in global equities.

In the UK, the market has again been dominated by takeover activity. Although the FTSE 100 was only up 2.5%, the top 10 performing stocks over the quarter rose by an average of 21%. Of these, four companies were subject to corporate activity. Although none of the companies in our UK portfolio benefited from takeovers, our performance for the quarter was a respectable 2.0%.

Our sale of the property company, Land Securities, at the end of last quarter and purchase of BHP Billiton, the mining company, proved to be timely. We further added to our mining exposure with Xstrata, which has also outperformed strongly. We took profits on BT, following an 40% outperformance of the market and reinvested in Helphire, an undervalued hire company. By the end of the quarter Helphire had outperformed by 9%.

Alternative Investments

UK commercial property rose more slowly than in previous quarters, with a gain of 2.1%. The Norwich Property trust appreciated by only 0.6% as the share component of the fund (around 15%) fell in value.

Commodity prices, as measured by the DJAIG index, rose by 4.5%, with metal prices recovering from a mid-February fall. Our Schroders fund was up by 3.1% over the quarter.

Directional hedge funds produced marginally positive returns and our Valu-Trac Strategic fund moved much in line with the average for the sector.

Prospect Wealth Management: Performance of Model Portfolios at 31st March 2007

Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	0.6	1.5	FTSE 5-15 years
UK Equity	12 May 2006	8.1	6.7	FTSE 100
UK Alpha	12 May 2006	14.9	6.9*	FTSE 100
UK Equity Funds	30 June 2006	15.4	8.1	FTSE 100 TR
International Equity	30 June 2006	10.9	8.5	FT All World ex-UK
Alternatives	30 June 2006	7.8	4.7	Prospect 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 31st March 2007

	31st Mar	Total Return Local		Total Return Sterling	
		3 mths to 31 st Mar %	12 mths to 31 st Mar %	3 mths to 31 st Mar %	12 mths to 31 st Mar %
Currencies v £	Rate				
US dollar	1.97	-0.5	-11.7		
Euro	1.47	0.7	-2.7		
Yen	232	0.6	-11.8		
Cash (3m)	Yield %				
USA	5.23	1.3	5.0	0.9	-7.3
UK	5.52	1.3	4.6	1.3	4.6
Euro	3.87	0.9	2.8	0.2	0.1
Japan	0.62	0.1	0.1	0.7	-11.7
Bonds (10yr)	Yield %				
USA	4.65	1.6	6.5	1.1	-5.9
UK	4.94	-0.3	0.3	-0.3	0.3
Germany	4.06	0.2	1.6	0.9	-1.1
Japan	1.66	0.7	2.9	1.3	-9.2
Equities	Index				
USA	S&P Comp	0.7	11.5	0.2	-1.6
UK	FTSE 100	2.5	9.3	2.5	9.3
Germany	DAX	5.4	18.3	6.2	15.1
France	CAC	2.3	10.6	3.1	7.7
Spain	SMSI	5.0	28.9	5.8	25.5
Italy	BCI Gen	1.3	13.8	2.0	10.7
Japan	Topix	2.2	0.0	2.8	-11.7
Australia	All Ord	7.1	22.2	9.2	21.9
Hong Kong	Hang Seng	-0.1	28.9	-1.0	13.1
Alternatives	Index				
Commercial Property	IPD	2.1	15.5	2.1	15.5
Commodities	DJ AIG	4.5	4.0	9.2	-3.5
Hedge Funds	HFRX	0.5	4.3	0.0	-7.9

Source: Reuters

Macroeconomic Overview – 31st March 2007

US	UK	Eurozone	Asia
GDP Growth			
Bernanke says risks to growth are multiplying, but 'the economy is likely to expand at a moderate pace over coming quarters', 2.5-3% in 2007 and 2.75-3% in 2008. Consumer confidence at a 6 month low and business investment flattening. Rising mortgage defaults (foreclosures +12% YOY), unsold new homes at a 16 year high, and falling house prices threaten consumption. Employment and wage growth remain strong though.	2006 full year growth revised up to 2.8%. Q4 GDP grew at 3% annualized, same as Q3, and less than forecast, on lower than expected healthcare services expansion. Feb manufacturing output grew by 2.2% (Jan 2%) UK house prices starting to moderate after 3 interest rate rises. Retail sales volume has risen since mid 2006, but another rate rise is likely to rein in consumer spending in the second half of 2007.	GDP growth slowed in Q1, as strong euro and slowing US growth cools export demand. 2007 GDP growth forecast revised up to 2.2% (1.9% in Dec). In March European retail sales rose and are expected to improve in Q2. Retail sales improved in France and Italy on price cutting. French and German business optimism is high, based on strong exports and falling unemployment.	Chinese industrial production grew faster than expected in January and February, Chinese retail sales +15% YOY. Chinese gov't lowered banks' foreign short term debt quotas after a 16% rise in 2006. Japanese household spending rose for 2nd month and sales at large retailers up YOY for first month in 5, compensating for slowing exports and business investment.
Employment			
Labour market strong, 4.5% Feb jobless. Initial jobless claims fell in March as companies hold on to skilled workers. Nonfarm payrolls rose strongly in March. Fed forecasts US unemployment at 4.5-4.75% in 2007 and 2008.	Jobless rate has stabilized at 5.5%, rising from 4.7% in mid 2005. Strong private sector job creation compensates for public sector job cuts. Wage inflation under 4%. Engineering Employers' Federation settled for 3.5%, public sector 1.9% wage rise.	Eurozone jobless fell to 7.3% in February, with the first month of job creation in the retail sector. IG Metall union rejected a 2.5% wage rise, demanding 6.5%.	Japanese Feb unemployment remains at 4%, an 8 year low. Japanese wages rose by 0.2% in January. Many Japanese companies will raise wages this year in response to union demands, but the end of tax breaks means that this may not translate to higher spending.
Inflation			
Bernanke has 'not abandoned inflation bias' but he has adopted a 'neutral / flexible policy'. The Fed forecasts inflation of only 1.75-2% in 2008. Fed more likely to lower than to raise rates by year end. Trade weighted dollar has fallen 3% since mid-January, and as other interest rates (Yen, Yuan, Euro) rising, there is downward pressure on the dollar.	Consumer Price Inflation rose to 2.8% in Feb, the fastest in a decade, driven by 3.8% services inflation. A BOE rate rise in May should cool inflation and bonds should rally. Sterling to remain stable against the dollar, but likely to weaken against the Euro.	Though CPI is only 1.8%, which is below the 2% target, the ECB is concerned over inflationary pressure from rising wages and oil prices. Consensus expects an interest rate rise to 4% in June. Euro at \$1.32, near peak of \$1.36 (31/12/04). Could hurt Euro exports.	Chinese inflation is low (1.7%) as industry transfers to hinterland. Yen to weaken as a steep fall in wages and poor industrial production figures point to weak growth. Next interest rate rise not expected until H2. Unwinding of yen carry trade has begun, but will be gradual.
Fiscal Policy			
Federal budget deficit has reduced by 11.5% for H1 2007. Democrats call for Bush's tax cuts to expire by 2010.	March Budget reduced both income and corporate income tax by 2%, in an attempt to win back support lost to the Conservatives. Taxes have risen hugely under Brown, while the gap between rich and poor has increased.	As lower unemployment reduces welfare benefits and adds tax revenues, Eurozone budget deficits improve. Merkel to increase Private Public partnerships for infrastructure development from 4 to 15% of GDP.	Asian budgets vary from surplus of 1.9% in S. Korea to deficit of 5.9% in Japan. Chinese deficit (now 2.4%) will grow as it gives benefits to large numbers of unemployed rural migrants and pensions for elderly.
Balance of Payments			
IMF less worried over imbalances than a year ago. Current account deficit has shrunk below \$200 bn and should improve this year, as the slowdown reduces imports while exports rise as demand for goods in rest of world has not yet slowed.	January trade deficit is lowest in a year, as imports fell and exports of goods & (especially) services to North America recover, up 8.8% YOY, despite strong £. January Sales to the EU fell 3.6%, but subsequently rose .	Balance of Payments is in slight surplus. Surplus could increase as it depends very much on price of oil, which could go weaker since Iran returned British hostages and as Euro strengthens.	China's March trade surplus doubled YOY. China must let its currency appreciate or US will file WTO complaint over piracy of films, music. US/China protectionist trade war a risk to global growth.

Economic Forecasts as at 31st March 2007

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2007 %	2008 %	Yr ago %	Current %	Yr ago %	2007 %	Latest %	Nominal %	Real %	2007 %
US	2.6	2.9	4.9	4.5	3.6	2.3	-2.2	5.25	2.95	-5.9
UK	2.7	2.6	4.7	5.5	2.0	2.0	-2.5	5.25	3.25	-3.1
Eurozone	2.3	2.2	8.5	7.4	2.3	1.9	-1.5	3.75	1.85	0.0
Japan	2.2	2.3	4.3	4.0	-0.1	0.4	-4.9	0.50	0.1	3.8
China	9.8	9.7	4.2	4.1	0.9	2.7	-1.7	6.39	3.69	7.6

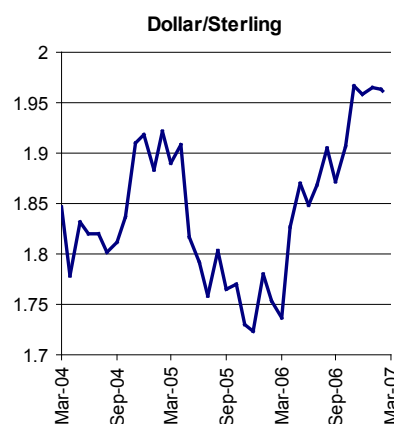
Source: Lehman Bros, The Economist and Bloomberg

Market Outlook

Interest Rates & Currencies

We expect the UK economy to continue to expand at an above trend rate of growth, despite the recent rise in interest rates. It is still the consumer that is driving the expansion, with average earnings rising at around 4.0% and unemployment stable at 5.5%. There are, however, signs that higher rates are starting to bite. Industrial production growth and capital investment have slowed and there is also evidence that house price inflation is falling. This explains why the Bank of England did not raise interest rates this month, even though inflation, at 2.8%, is well above the target level of 2.0%. It is still possible that interest rates will be raised by a further 0.25% to 5.50% if the Bank decides to avoid any risks with future inflation, but that is likely to be the high point for this cycle.

In the US, there is a similar conflict between an inflation rate above the central bank's comfort level, at 2.7%, and an economy that has slowed in the face of a collapse in house construction and a crisis in the sub-prime lending market. Despite the problems in the housing market, employment growth is strong and consumer



spending continues to support the economy. On this basis we expect the Federal Reserve to leave interest rates unchanged over the next six months.

In Europe, economic growth is accelerating, unemployment is falling and wage demands are rising. With inflation above the European Central Bank's target of 2.0% and real interest rates the lowest after Japan, further interest rate rises appear inevitable. This points to the euro strengthening against all the major currencies and sterling appreciating modestly against the US dollar.

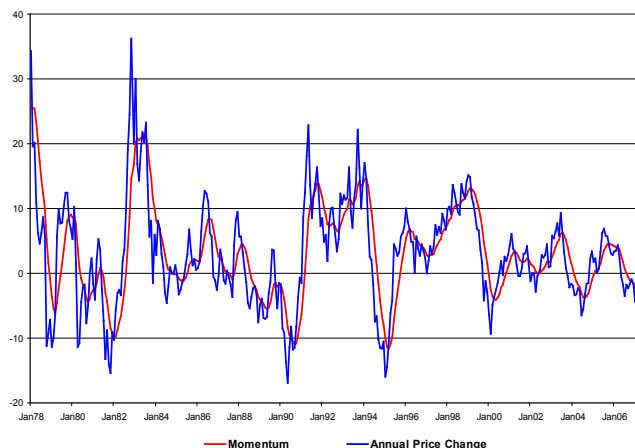
UK Bonds

The real yield on 10 year bonds has risen close to the long run average of 2.0%. Evidence of slower economic growth in the UK and the US supports our expectations that inflation will decline in the coming months. In the event that inflation is more persistent than expected, the Bank of England will raise short term interest rates further. Either way, the desired result of inflation close to 2.0% should be achieved over the course of this year.

This points to the likelihood that bond yields will decline from current levels over coming months, producing capital gains. The chart opposite shows that price momentum in UK bonds has just turned up, a positive sign that lends support to our recent decision to lengthen the maturity of our bond portfolio to take advantage of the anticipated fall in yields.

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

Bond Price Momentum - United Kingdom



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

We have just completed 4 years of a global equity bull market. This is around the average length for bull markets historically. The volatility that we experienced in May/June 2006 and again in February this year is symptomatic of a mature bull phase. However, global growth is on trend, having cooled a little and

Measures of Market Valuation

	BONDS				
	Inflation forecast %	10 yr bond yield		10 yr bond yield	
		Nominal %	Real %	3m chg %	12m chg %
US	2.7	4.6	1.9	0.05	0.33
UK	3.1	5.0	1.9	0.20	0.54
Eurozone	2.1	4.1	2.0	0.11	0.23
Japan	0.5	1.6	1.1	-0.05	-0.22
Hong Kong	2.0	4.2	2.2	0.46	-0.41

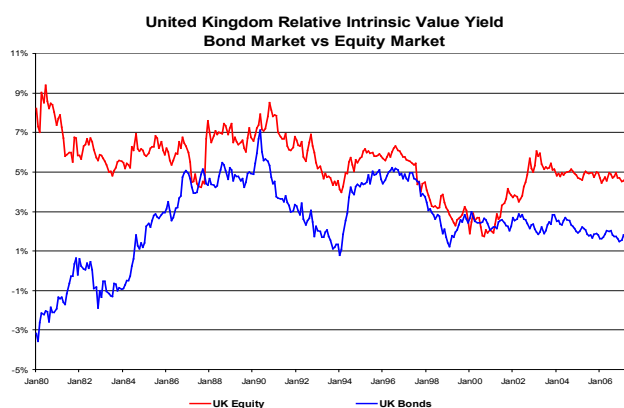
	EQUITIES					
	Valuation			Earnings growth		Volatility %
	P/E '07 %	ERP* %	Div Yield %	2006 %	2007 %	
S&P 500	15.3	1.9	1.8	17.5	7.2	16.3
FTSE 100	12.8	2.9	3.6	11.5	6.1	17.4
EURO Stoxx 600	12.5	3.8	3.2	13.5	7.7	19.9
Topix	19.5	4.2	1.1	13.5	12.8	21.7
Hang Seng	16.2	2.7	3.3	11.4	10.9	18.3

Source: Bloomberg, Citibank.

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

is now being revised upwards. The global economy has survived a full cycle of US interest rate rises and significant rises in Europe and the UK, in spite of a major rise in raw material prices. We are now in the late stages of interest rate rises everywhere, except Japan. Central banks have demonstrated skill in extending the length of the business cycle which, in turn, lengthens the equity market cycle. Alan Greenspan, the previous chairman of the US Federal Reserve, was so skilled at extending the business cycle that he is blamed for creating asset bubbles in both equities and property. Greenspan had to preside over the bursting of the equity bubble in 2000 and now his successor, Ben Bernanke, begins his reign having to contend with the bursting of the property bubble. Bernanke thinks (prays) this will occur with a slowdown rather than a recession.

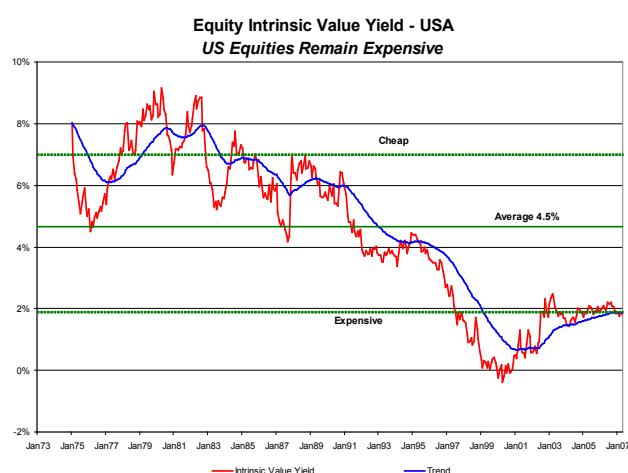
The signs are that this will indeed be the case. Unlike



2001, the US corporate sector has strong balance sheets and investment is growing, supporting robust consumer demand. Although company earnings growth is slowing, we do not have the conditions for a sustained equity market correction. As the chart above shows for the UK, bear markets tend to occur when the real yield on bonds equals the equity cash flow yield. Right now, equities offer an attractive risk premium over bonds, implying that it is too early to

leave the party.

In the **US**, the combination of doubts over the dollar, a slowing (albeit upward revised) US economy and valuation that is more expensive than other developed markets (see chart), makes it difficult for US equities to outperform. It is notable that the value of European markets has overtaken that of the US for the first time since before the first world war due to improving European profitability, currency appreciation and the



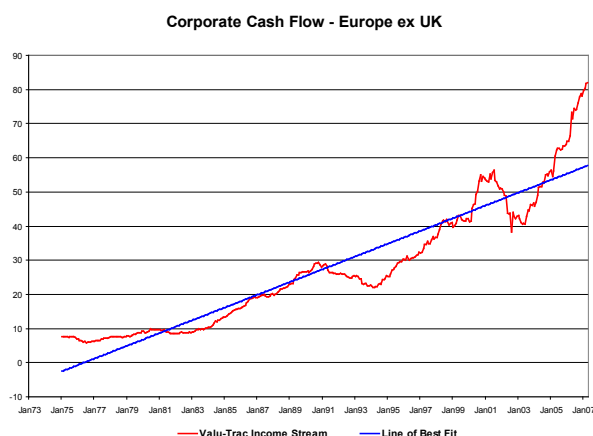
excessive regulation of US markets, which is shifting new listings to London. Since the start of the current bull market in 2003, Pan-european equities are up 160% in dollar terms versus 70% for the S&P 500. We expect this trend to continue and therefore retain our underweighting in US equities.

In the **UK**, the rise in interest rates and the appreciation in sterling against the dollar should squeeze company profits and earnings growth is forecast to slow to only 6% this year, the weakest of the major markets. Market valuation, using our preferred measure of cash flow yield, is on the expensive side of fair value, but not alarmingly so. Whilst UK equities are not unattractive, we consider that European and Asian markets offer better growth prospects and more attractive valuations and therefore

we continue to underweight UK equities in our asset allocation model (see page 10).

In **Europe**, company earnings should continue to grow strongly as productivity continues to improve, led by a revitalised Germany. Even though a strong euro may dampen exports, which have been the engine of growth in the past two years, falling unemployment and rising wages are likely to improve domestic demand.

The chart below shows the extent of the earnings boom in Europe and why we remain overweight there.



In the **Pacific Basin** growth continues at a remarkable pace, with Chinese corporate earnings growing at 17% whilst inflation remains below 2%. We have held a 20% overweight position in this region for the past 9 months, over which time Asian equity markets have risen by 21%, the best performing area after Europe (up 19%). Current market valuations remain attractive relative to other markets thanks to the rapid rate of company earnings growth and we retain our overweight position in Asia.

UK Equity Portfolios

Our biggest overweighting is in the mining sector, where rising commodity prices should feed through to higher earnings and dividends. Mining shares are still undervalued as investors have doubted whether

the commodity boom would prove to be durable. As the outlook for global growth improves, so does the outlook for the mining sector and we expect further outperformance. The big pharmaceutical companies have performed poorly recently, but now appear significantly undervalued. We expect Glaxo and Astra Zeneca to be revalued and in the meantime they offer a degree of protection against market volatility.

The portfolio has missed out on the recent takeover fever that has focused on the consumer sector (Sainsbury, Alliance Boots, Next) as these companies are fundamentally expensive and are vulnerable to disappointment in the event that a takeover does not materialise. In the long run, we believe it is better to buy undervalued stocks than to chase the latest takeover fad.

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

Demand for the London office market is growing as London surpasses New York as a global financial centre. This is likely to continue for at least another year as speculative development is running behind demand. In the rest of the UK, returns on commercial property are beginning to slow. The Norwich Property trust, for example, suffered losses on the sale of two properties in the past quarter and inflows to the fund are slowing. Performance will not be helped by exposure in the fund to the newly formed REITS, which we feel are significantly overvalued within the equities market.

Commodities

Since February, demand for industrial metals has risen strongly as China has sought to re-stock on key metals such as nickel and copper. Inventories are now down to only 3 days worth for nickel and 6 days for copper and this, combined with strikes at mines in Chile have forced prices up sharply. As supply is constrained by the two years it takes to bring a new mine into production, we expect metals prices to rise further.

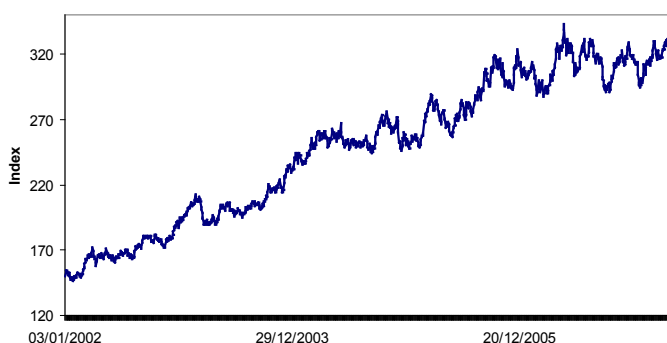
Demand for agricultural commodities remains firm, bolstered by demand for biofuels. Our exposure to commodities is through the Schroder SAS All Commodity fund, which currently has a 45% exposure to agricultural commodities, favouring corn, oil seeds and palm oil.

Hedge Funds

The Valu-Trac Strategic Fund currently is significantly overweight in bond markets as price momentum has turned up. The fund is also overweight equities, with an emphasis on Australia, Japan and the UK. In commodities, the fund has short positions in copper and oil and is long of coffee.

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

DJ AIG Commodity Index
January 2002 - April 2007



Asset Allocation For April 2007

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

		Strategic Benchmark			Q2 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
	Total Bonds	15	25	35	24	-1
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
	Total Equities	55	65	75	66	+1
Alternatives:	Property	0	4	14	4	0
	Commodities	0	3	13	3	0
	Hedge funds	0	3	13	3	0
	Total Alternatives	0	10	15	10	0
Total			100		100	0

Source: Prospect Wealth Management

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