PROSPECT WEALTH MANAGEMENT

Investment Prospects

Summary

- **Equities supported by improved economic outlook and takeover activity.**
- **Bond markets fall as inflation disappoints again. Bank of England likely to raise interest rates.**
- **Equity market valuations not excessive given the rate of earnings growth anticipated.**
- **Alternatives have a mixed performance over the past month.**

Strong month for equities

April proved to be a good month for equities around the world, in spite of rises in interest rates and bond yields. Upward revisions to expectations for economic growth, strong company earnings growth, continued take-over activity and a conviction that inflationary pressures can be contained by central banks, have combined to push up equity prices in most markets. The exceptions have been Japan and Spain. Japan's emergence from deflation is proving to be protracted, as jobs and earnings growth remain stagnant. Without an uplift in consumer spending, Japan is vulnerable to a slowdown in the US economy and the stock market is likely to continue to underperform other major markets. Spain suffered a set-back after the booming property sector experienced a sharp correction in April. The overall market fall was small though, particularly in the context of the rise seen over the past year and still leaves Spain the best performing developed market over 12 months.

Stronger than expected economic growth in the US, Europe and the Pacific Basin, together with higher commodity prices, threatened higher inflation and interest rates rose as a result. In the UK, consumer price inflation rose above 3.0% for the first time in 10 years, requiring the governor of the Bank of England to write with an explanation to the Chancellor. As a result, short term interest rates rose by 0.1% to 5.62% by the end of the month and point to a rise in the bank rate this month from 5.25% to at least 5.5% and quite possibly 5.75%. The more aggressive the bank is in pushing up interest rates, the more it will reassure the bond market that the Bank is serious about bringing UK inflation down.

An economic golden age

Martin Wolf, economics editor for the Financial Times, recently described the current economic environment as a "golden age". Global growth this year is expected to be 5% (after inflation) in spite of a housing market induced slowdown in the US. Higher commodity prices are helping to lift the less developed economies whilst productivity improvements mean that growth is not leading to excessive inflation in the developed economies. Stronger consumer demand in Europe, together with the depreciation in the US

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market 1 month to 30 Apr %	Total Return for Market 12 months to 30 Apr %
Currencies v £	Rate		
US dollar	2.00	-1.5	-8.7
Euro	1.47	0.6	-1.4
Yen	239	-2.9	-13.0
Cash (3m)	Yield %		
USA	5.26	0.5	5.2
UK	5.62	0.3	4.7
Euro	3.95	0.3	2.9
Japan	0.64	0.1	0.1
Bonds (10yr)	Yield %		
USA	4.63	0.6	8.5
UK	5.04	-0.3	1.7
Germany	4.15	-0.3	2.4
Japan	1.63	0.4	4.7
Equities	Index		
USA	S&P Comp	4.5	14.9
UK	FTSE 100	2.5	10.7
Germany	DAX	7.3	25.7
France	CAC	6.0	17.7
Spain	SMSI	-1.4	26.1
Italy	BCI Gen	4.8	18.2
Japan	Topix	-0.6	0.1
Australia	All Ord	3.4	22.9
Hong Kong	Hang Seng	2.9	25.5
Alternatives	Index		
Property	IPD	0.8	15.0
Commodities	DJ AIG	1.3	3.6
Hedge Funds	HFR	3.1	5.0

Source: Reuters

May 2007

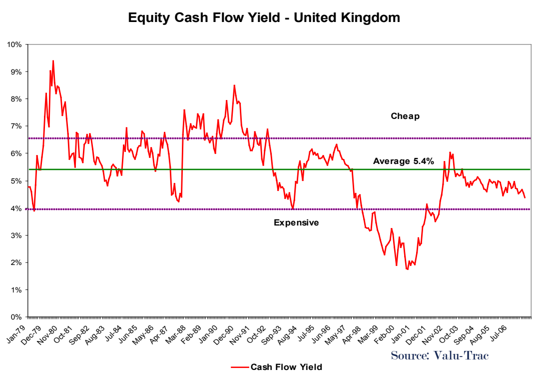
dollar, are helping to redress the global trade imbalances arising from excessive US consumption. The election of Nicolas Sarkozy, a committed reformer, to the Presidency in France should help to maintain this momentum.

In the UK, the economy shows no sign of slowing. Growth in serivces is compensating for lower manufacturing output, which fell by 0.3% in the first quarter of this year in response to the strong pound. Unemployment is stable at 5.5%, with job creation in financial services offsetting losses in manufacturing and the public sector. This, along with a still bouyant housing market, underpins consumer demand. Wage demands are moderate and we still expect inflation to fall close to the desired level of 2.0% by the end of the year.

Sell in May and go away?

This environment is remarkably benign for equity markets. However, one can never be complacent. It is worth noting that over the past 35 years the UK stock market has on average fallen by 0.2% between May and October whilst it has risen on average by 8.2% between October and April. Is now, then, the time to sell?

Certainly, the US, UK and Eurozone stock markets have become more expensive in April. It is also disconcerting that the markets are in part being driven up by takeover activity. Bond yields remain low though, whilst shares in larger companies are still relatively cheap, providing ideal conditions for the takeover boom to continue. It is remarkable that the price to earnings ratio on the larger companies in the UK and Eurozone are little changed from the bottom of the market 4 years ago, as earnings have risen in line with share prices. The graph below,



of the cash flow yield on the UK stock market, tells the same story. Value has been relatively stable in spite of the rise in the stock market, leaving UK equities only moderately expensive. We believe that sound Central Bank policy and rapid growth in Asia will sustain the global growth cycle over the next few quarters. A benign macroeconomic backdrop, moderate valuations, upward earnings revisions and low bond yields all indicate that we have not yet reached the peak of this equity cycle.

UK equity portfolios up in value

In a market that is dominated by takeovers, it is difficult to keep up with the market unless your portfolio happens to be participating in the takeovers. Our Alpha portfolio has recently benefited from the proposed merger of Thompson Financial with Reuters, producing a strong outperformance for the current quarter. In our main portfolio, although none of our holdings are currently subject to bids, we have avoided the worst performing sectors during the month of April (real estate, tobacco, utilities and healthcare equipment), with only the media sector underperforming. With Reuters now in play, other media stocks are benefiting and we have recently seen a strong performance from our holding of Reed Elsevier. We strongly believe that buying undervalued shares is a more reliable route to outperformance over the medium term than chasing the latest takeover candidate.

The other feature of the past month has been an 18% rise in the price of copper. Our portfolios are overweight in the mining sector and have benfited from the rise in metals prices, with Rio Tinto outperforming the market by 12% so far this quarter. Oil prices, by contrast, have slipped back to $61 per barrel, a fall of 10% over the past month, but oil shares have moved in line with the market. Of more significance to BP, where we have an overweight position, is the change of management and we are optimistic that Lord Browne's replacement will bring a new focus on generating value for shareholders.

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