



Summary

- **Economic growth expectations continue to be revised upward.**
- **Bond markets fall as inflation risks rise. Bank of England likely to raise interest rates to 6% by year-end.**
- **Equity market valuations not excessive given the rate of earnings growth anticipated.**
- **Commodity outlook remains positive.**

Strong global economic growth

Expectations for economic growth around the world continued to be revised upwards during the month of May. The result was a further rise in bond yields in all the major markets, producing another negative month of returns for bonds, whilst equity markets continued to rally. In the US, there is no sign that consumer spending is being affected by the slowdown in the housing market. Commercial and public sector construction is compensating for a downturn in home building, whilst business investment is picking up. The latest employment data show that unemployment is close to a 5 year low and wage growth remains healthy. With this background there is little chance of a cut in US interest rates and bond yields have risen by 0.25% over the past month.

Spanish equities bounced from the previous month's setback, demonstrating that a slowdown in the overheated property sector is not necessarily bad for equities. German equities rose 6.6% last month, making Germany the best performing European equity market over 12 months, with a rise of 41%. The market reforms instigated by the Merkel government are showing up in accelerating economic growth and higher corporate profitability. The expectations are that the new French President, Nicholas Sarkozy, will follow in Merkel's footsteps and introduce market orientated reforms in France, making Europe still one of the most attractive regions for equity investment. Even though inflation is close to target, at 1.9%, accelerating economic growth means that the European central bank raised interest rates to 4.0% this week and further rises are on the cards.

UK bond yields rise

It was no surprise that the Bank of England raised interest rates to 5.5% in May, after consumer price inflation hit 3.1% in April. Even though reported inflation is expected to be back down to 2.5% this month, there is evidence that

companies are finding it easier to pass on higher commodity prices to the consumer and business investment is still rising strongly. The perception that the Bank has been slow to address the inflation threat is reflected in the 0.5% rise in bond yields over the past 3 months. As a result, another 0.25% rise in the bank rate is likely in July and it is probable

Total Returns in Local Currency

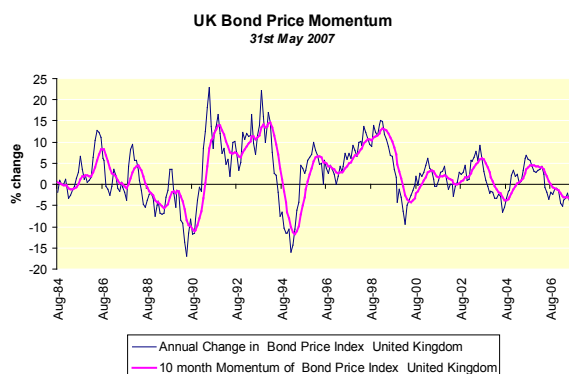
Last month and last 12 months

		Total Return for Market	
		1 month to 31 May %	12 months to 31 May %
Currencies v £	Rate		
US dollar	1.98	0.9	-5.6
Euro	1.47	-0.5	-0.9
Yen	241	-1.0	-12.7
Cash (3m)	Yield %		
USA	5.27	0.5	5.3
UK	5.75	0.5	4.7
Euro	4.05	0.3	2.9
Japan	0.64	0.1	0.3
Bonds (10yr)	Yield %		
USA	4.89	-1.6	7.0
UK	5.25	-1.2	-0.5
Germany	4.41	-1.7	0.7
Japan	1.75	-1.0	2.5
Equities	Index		
USA	S&P Comp	3.4	22.7
UK	FTSE 100	3.0	19.6
Germany	DAX	6.6	41.1
France	CAC	2.7	27.4
Spain	SMSI	6.2	40.1
Italy	BCI Gen	-0.5	22.9
Japan	Topix	3.3	12.2
Australia	All Ord	3.4	32.7
Hong Kong	Hang Seng	1.8	33.8
Alternatives	Index		
Property	IPD	0.7	13.9
Commodities	DJ AIG	0.1	2.8
Hedge Funds	HFR	4.0	12.7

Source: Reuters

June 2007

that short term rates will be at 6.0% by the year end. Whilst bond yields may still edge a little higher, the good news is that wage growth in the UK remains moderate and higher interest rates appear to be cooling the property market, as mortgage approvals have just hit a 10 year low. Further interest rate rises should drive inflation down and encourage a recovery in bond prices. As the chart below shows, UK bond price momentum looks as though it is close to a low point for this cycle and is poised to rise, a positive indicator for future price movements.



Source: Valu-Trac

UK equity performance mixed

The rise in bond yields has done nothing to dampen the level of takeover activity. This is because company earnings continue to be revised upwards on average, thereby keeping the earnings yield on equities well above the real bond yield and supporting the case for equity investment. As a result, the two best performing UK equity sectors this quarter have been electrical equipment and construction materials and in both cases key constituents are subject to takeover bids. Our main UK portfolio has not participated so far this quarter in the takeovers and as a result is lagging the market by 1%. However, the portfolio has benefited from exposure to Vodafone, where a combination of increasing investment in developing markets and rumours of a takeover bid have propelled the shares to outperform the market by 10% this quarter. The shares are starting to look expensive and we now have them under review. The key disappointment has been the pharmaceutical sector, and particularly Glaxo. The shares have underperformed following revelations

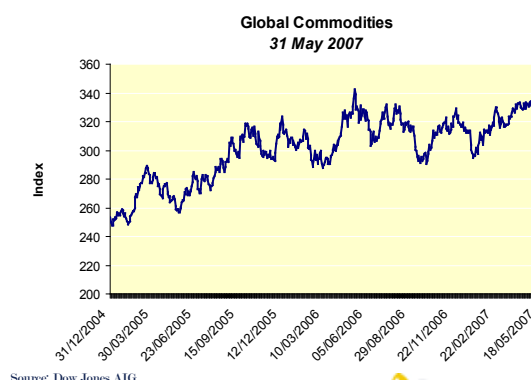
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that one of its core diabetes drugs has unexpected side effects. However, the company has an excellent pipeline of cancer drugs and we expect the shares to recover in the coming months. Our international equity portfolio, where we are overweight in Europe, is compensating for the UK by outperforming the market average by 1.2% this quarter. It has been reassuring to see the Legg Mason US value fund recover most of the underperformance seen in the last six months as stocks such as Google and Amazon have produced better than expected profits after a prolonged period of underperformance.

Commodities

Some metals prices, such as copper, have fallen from the highs seen last month, but the fundamentals remain sound. Inventories are still at record lows and global economic growth is being revised upward. Energy prices have risen this quarter ahead of the US driving season and the hurricane months. Most significantly perhaps, is the positive outlook for agricultural commodities. Oilseeds are in a long term uptrend as biodiesel demand rises and grain prices are rising on weather related concerns. Our commodity fund has risen by 3.7% this quarter and we anticipate further positive returns.

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