

## Summary

- *UK bond returns were negative for the quarter whilst global equity returns were positive.*
- *Stronger economic growth has fuelled inflation concerns in all the major economies.*
- *Equity valuations are moderately expensive, but earnings growth remains above trend and is being revised up - equities should outperform bonds again over the third quarter.*
- *Bonds offer attractive value but yields may not fall until inflation is seen to be under control.*

## Review of 2nd Quarter

### Interest Rates and Currencies

The key theme of the past quarter has been an increase in global inflation expectations, reflected in higher interest rates and bond yields in all the major markets. The catalyst for this has been evidence that global economic growth is likely to accelerate over the balance of this year. There had been concerns that the protracted weakness in the US housing sector would spill over to the rest of the economy. However, US consumer spending and corporate investment have remained strong whilst growth in Europe and Asia has been revised up, to at or above trend levels. Whilst the UK rate of inflation spiked up alarmingly during the quarter, reported rates of inflation in the US, Europe and Japan have been benign. There have been signs though, that this may be about to change. In the past year Chinese inflation has gone from 1% to 3.4% and this, together with a gradually firming yuan is creating inflation for the importers of Chinese goods: the US, Japan and Europe. Wage pressures are mild in the UK due to immigration, but are increasing

**Inflation is the key to  
market direction in  
the near term**

in the Eurozone, as unemployment falls, and are expected to appear imminently in Japan as the job to applicants ratio rises. The response from central banks has been to raise interest rates by 0.5% in the UK and Eurozone whilst in the US rates have remained unchanged instead of being cut, as had at one time been expected. These interest rate changes have been supportive of sterling and the euro, which appreciated by 2.1% and 1.4% respectively against the dollar over the last quarter.

### Bonds

Talk of upward revision of global growth forecasts by the IMF and a gathering consensus that global inflation is on the rise made for a poor bond performance in the second quarter. During the period, 10 year UK gilt yields rose by 0.5%, representing a total return of -2.7%. This was worse than other major bond markets, reflecting not only a sharp, albeit temporary, rise in reported inflation, but also the perception that the Bank of England has been slow to respond to the inflation threat. The corollary is that short term interest rates will have to rise more than might otherwise have been necessary in order to squeeze out incipient inflation.

The good news for UK bondholders is that the yields on corporate bonds have risen more or less in line with

those of gilts. In the US, by contrast, yields on low quality bonds have risen sharply, creating large losses, as lenders to the highly leveraged property sector have suffered from falling property prices. In the UK, lower levels of leverage in property and our focus on high quality corporate borrowers (Tesco, Royal Bank of Scotland) means that we do not anticipate similar weakness. We remain watchful though.

The performance of our bond portfolios has been much in line with that of the benchmark as we had modestly increased our bond exposure at the end of the first quarter, bringing it in line with the benchmark, in anticipation of a fall in reported UK inflation. Although inflation has indeed fallen, bond yields continued to rise.

## Equities

Upgrades to global economic growth expectations and upward revisions to company earnings forecasts supported global equities in the first two months of the quarter. Even though rising interest rates caused equities to falter in June, the total equity return for the quarter was strongly positive in all markets. Pacific basin markets produced the best returns, closely followed by Eurozone markets. Both regions are overweighted in our global asset allocation. Even when translated back into sterling, which appreciated against all currencies except the Canadian and Australian dollars, only Japan delivered negative equity returns for the quarter. Interestingly, the US S&P 500 index exceeded its 2000 peak for the first time during this period.

Within the UK equity market, the large FTSE 100 companies outperformed the FTSE 250 (mid-size companies) by 6.1% as investors sought out the better value shares and those with less debt and therefore less vulnerable to increases in interest rates. Our portfolio benefited from an overweighting in the best performing sectors of mining and oil and gas but suffered from exposure to sectors that are sensitive to interest rate rises, in particular financials. The smaller companies in the portfolio tended to underperform, though our focus on shares that are undervalued, with strong growth prospects gives us confidence that this will be temporary. Positive results in the first week of the new quarter from Hephire and Northgate Information Systems have produced strong share price performance, and vindicated our strategy.

## Alternative Investments

UK commercial property rose more slowly than in previous quarters, with a gain in the IPD index 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, were unchanged, even though metal prices recovered from a mid-February fall. Our Schroders fund was up by 4.6% over the quarter.

Directional hedge funds produced positive returns in line with equities and our Valu-Trac Strategic fund lagged due to bond and commodity exposure in the fund.

### Prospect Wealth Management: Performance of Model Portfolios at 30th June 2007

Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	-1.2	-1.0	FTSE 5-15 years
UK Equity	12 May 2006	12.4	11.8	FTSE 100
UK Alpha	12 May 2006	17.3	12.0	FTSE 100*
UK Equity Funds	30 June 2006	20.0	13.5	FTSE 100 TR
International Equity	30 June 2006	16.9	13.8	FT All World ex-UK
Alternatives	30 June 2006	9.3	10.7	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 30th June 2007

	30 <sup>th</sup> Jun	Total Return Local		Total Return Sterling	
		3 mths to 30 <sup>th</sup> Jun %	12 mths to 30 <sup>th</sup> Jun %	3 mths to 30 <sup>th</sup> Jun %	12 mths to 30 <sup>th</sup> Jun %
<b>Currencies v £</b>	<b>Rate</b>				
US dollar	2.01	-2.1	-7.9		
Euro	1.48	-0.7	-2.5		
Yen	247	-6.3	-14.5		
<b>Cash (3m)</b>	<b>Yield %</b>				
USA	5.30	1.3	5.4	-0.8	-2.9
UK	5.86	1.4	4.7	1.4	4.7
Euro	4.11	1.0	3.0	0.3	0.4
Japan	0.72	0.2	0.3	-6.2	-14.3
<b>Bonds (10yr)</b>	<b>Yield %</b>				
USA	5.03	-1.7	6.2	-3.8	-2.3
UK	5.46	-2.7	-1.0	-2.7	-1.0
Germany	4.56	-2.8	0.2	-3.5	1.8
Japan	1.87	-1.4	2.5	-7.7	-12.4
<b>Equities</b>	<b>Index</b>				
USA	S&P Comp	6.4	20.2	4.2	10.6
UK	FTSE 100	5.6	17.1	5.6	17.1
Germany	DAX	16.5	43.2	15.7	39.6
France	CAC	8.2	25.0	7.5	21.9
Spain	SMSI	1.8	33.4	1.1	30.0
Italy	BCI Gen	2.2	19.6	1.5	16.6
Japan	Topix	3.8	13.0	-2.7	-3.4
Australia	All Ord	6.7	29.1	9.7	35.7
Hong Kong	Hang Seng	10.7	36.9	8.4	25.3
<b>Alternatives</b>	<b>Index</b>				
Commercial Property	IPD	2.1	12.4	2.1	12.4
Commodities	DJ AIG	0.0	2.9	-2.0	-5.2
Hedge Funds	HFRX	7.6	13.9	5.4	4.8

Source: Reuters

## Macroeconomic Overview as at 30<sup>th</sup> June 2007

US	UK	Eurozone	Asia
<b>GDP Growth</b>			
Q1 growth has been revised down to just 0.7%, the slowest pace in 4 years. Q2 should see growth rebound to 3.7%. The housing sector is likely to remain in recession into 2008 and be a drag on the economy. The spillover to the rest of economy should be limited though. Business investment remains strong and high employment supports retail spending.	Q1 GDP growth revised up to 3.0%, as services (banking and retailing) and government spending were stronger than expected. Business investment gaining momentum. Higher interest rates are slowing the housing market, though overall prices still haven't peaked. A slowdown is inevitable, but no US style housing collapse is expected over the next year as demand outstrips supply.	Manufacturing and services accelerated in June. Falling unemployment, dissaving by baby boomers and lower taxes are spurring household spending. Governments taking advantage of expansionary phase to raise taxes. French business and consumer confidence were high in June. Risk is that growth slows due to higher interest rates and strong Euro.	Japan: Industrial production fell in 4 of last 5 months. Machinery orders weak. Inventory correction might end soon though, making outlook better. Household spending in June rose 0.4%.  Chinese authorities unsuccessful in curbing growth, now at 11.1%. The 2008 Olympics are creating a bubble in Beijing property. Asian growth expected to accelerate in 2008.
<b>Employment</b>			
Unemployment is low, only 4.5%. Job creation in June remained strong and hours worked are rising at 2.5% annual rate. This provides a solid underpinning to the US economy.	Jobless rate has inched up to 5.7%, rising from 4.8% in mid 2005, keeping wage rises moderate. Both employment and unemployment are growing because of high immigration. Workforce is also expanding as inadequate pensions and better health make people retire later	Eurozone unemployment continues to fall, now at 7.1%, creating upward pressure on wages. Competition of products from low wage countries is easing as their wages rise, e.g. Czech Q1 wages rose 6.2% in real terms.	Japanese unemployment steady at 3.8% in May, a 9 year low. Jobs to applicants ratio rose to 1.1. Union demands for higher wages might be successful. This would trigger more retail spending and positive CPI inflation.  Chinese unemployment steady at 4.1%, wages creeping upward.
<b>Inflation</b>			
Core inflation at 2.6% in Q1 and likely to remain above target of 2.0% all this year. Recent commodity price rises together with low levels of unemployment mean inflation pressures are upward.  The Federal Reserve is likely to tolerate a rate of inflation modestly above target in recognition of the risks posed by the housing recession.	CPI fell from a peak of 3.1% in March to 2.5% in May. This is still the 13th month above the target. Recovery in commodity prices may mean that the recent fall in utility prices is temporary. A further increase in interest rates to 6.0% by year end will therefore be necessary to ensure that long term inflationary expectations do not rise above the BoF's target of 2.0%.	Though inflation is within target and the economy may cool slightly, high money supply growth and falling unemployment caused ECB raised rate to 4% in June. A further increase to 4.5% is expected by year end.	Japanese core inflation fell in June but BOJ expects prices to rise in summer as wages rise. Yen appreciation cannot be sustained until positive inflation is established which will draw money into Japanese equities.  Chinese inflation has trebled in past year: to 3.4% but is close to peak. Pacific Basin inflation is benign but rapid growth does pose higher inflation risk in 2008.
<b>Balance of Payments</b>			
Net current account position has been stable as the rise in the value of US overseas equity assets and the fall in the value of foreign holdings of US fixed income assets has offset the negative trade balance.  The risk remains that foreigners sell or diversify away from underperforming US assets, causing a further depreciation in the dollar.	Strong currency is not hurting exports as demand for British goods is strong in the recovering Eurozone. BoF rate of possibly 0.75% above the US rate by year end should drive sterling stronger against all currencies.	European balance of payments is in balance, so no pressures on currency. However, we expect increasing interest rate differentials to lead the Euro to be firm against the dollar and yen.	Chinese balance of payments surplus grew by 84% over the past year, which ultimately is unsustainable.  Yuan is revaluing too slowly for the US Congress. US sanctions on Chinese imports are a risk to world trade and global growth.

## Economic Forecasts as at 30<sup>th</sup> June 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	2.2	2.7	4.9	4.5	4.2	2.7	-1.4	5.25	2.55	-6.2
UK	2.7	2.5	4.7	5.5	2.2	2.5	-2.8	5.75	3.25	-3.1
Eurozone	2.6	2.2	8.5	7.1	2.5	1.9	-0.8	4.00	2.1	0.1
Japan	2.3	2.3	4.3	3.8	-0.1	0.0	-4.4	0.50	0.5	4.3
China	10.3	9.7	4.2	4.1	1.4	3.4	-1.3	6.57	3.2	8.1

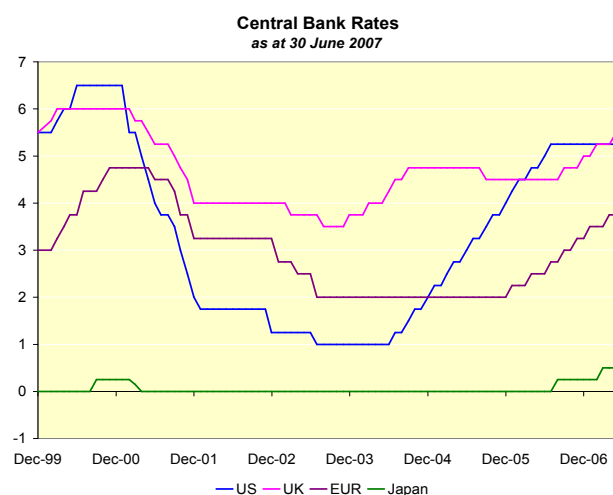
Source: Lehman Bros, The Economist and Bloomberg

## Market Outlook

### Interest Rates & Currencies

The threat of higher inflation has become the central issue in economic policymaking in all the major economies. In recent years spare industrial capacity and the benefits of globalisation have allowed the major economies to grow at an above trend rate with low inflation. However, economic growth has recently been stronger than expected and we are now seeing evidence of capacity constraints. We are also seeing a reduction in the competitive advantage of the emerging economies as, for example, salaries of Indian software engineers approach the levels of those in California. This is particularly apparent in the UK, where consumer price inflation recently reached 3.1%, well above the Bank of England's target of 2.0%.

The result is that the trend in interest rates remains upwards. The Bank of England is now perceived to have been slow to respond to the inflation threat and will probably err on the side of higher interest rates to correct any impression that they are going soft on inflation. With rates having just been raised to 5.75%, a further 0.25% rise before year end now looks likely.



This should be sufficient to bring inflation down to target as there is already evidence that underlying manufacturing costs are falling, whilst consumer spending should be reduced by higher mortgage costs and a cut-back in government spending.

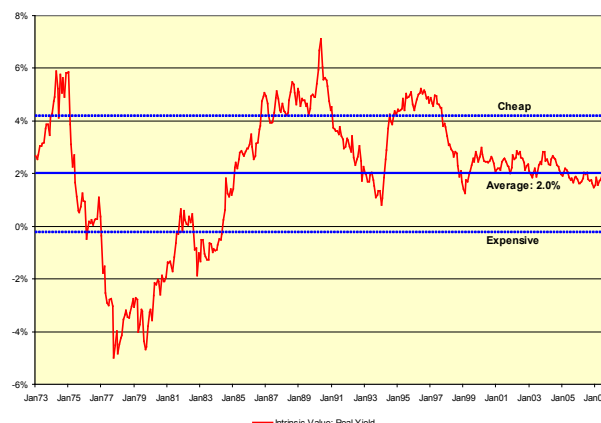
In the US, the housing recession is likely to last into 2008, but its impact on consumer spending and on business investment should continue to be limited. As long as core inflation in the US remains around its current level of 2.5%, interest rates are likely to remain unchanged as the Federal reserve balances the risks of the housing recession against the strength of consumer spending.

In Europe, the fall in unemployment and rise in wages should lead to an acceleration in the rate of consumer spending growth. This should compensate for any slowdown in exports resulting from the strength of the euro and is likely to make the European Central Bank raise rates again in September, to 4.25%, even though inflation is in line with their long term objective of 2.0%. With UK and European interest rates rising, it is likely that sterling and the euro will appreciate modestly further against the US dollar.

## UK Bonds

Depending on the measure of inflation that one uses, UK bonds are now either fair value (as shown in the chart adjacent) or, at a real yield of 3.5%, cheap (see the table below). Our expectation is that consumer price inflation will stay at 2.5% or below as low wage growth, strong sterling and a slowdown in consumer spending all bear down on inflation. This should be positive for bonds, leading to a decline in yields from current levels and capital gains. However, until we see some evidence of economic slowdown the bond market will be wary that recent inflation of 3.1% may have raised long term inflation expectations in the UK.

Real Yield - United Kingdom Bonds



Source:Valu-Trac

This seems unlikely, but price momentum has turned down again, which points to further weakness, and we will reduce our bond exposure if it appears that the Bank of England is not responding appropriately to the inflation risk.

Corporate bond yields have risen modestly relative to gilts over the past quarter, but cash flow remains strong and company earnings are being upgraded. There are no signs therefore that corporate cashflow is diminished and we expect the credit quality, in particular of the high quality bonds that we hold, to remain secure for the time being.

## Measures of Market Valuation

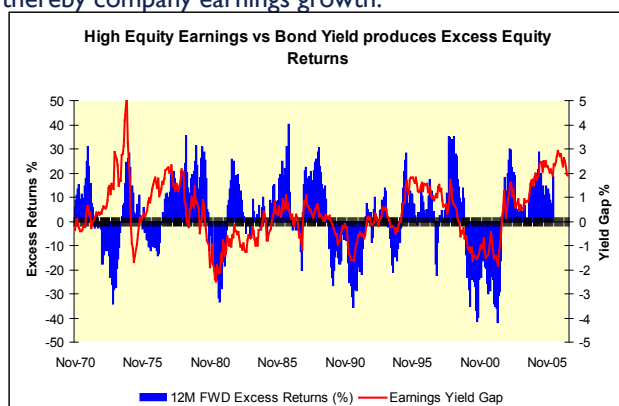
	BONDS					EQUITIES						
	Inflation forecast %	10 yr bond yield		10 yr bond yield		Valuation			Earnings growth		Volatility %	
		Nominal %	Real %	3m chg %	12m chg %	P/E '07 %	ERP* %	Div Yield %	2006 %	2007 %		
US	2.7	5.0	2.3	0.38	-0.12	S&P 500	16.0	1.1	1.8	16.0	10.0	12.4
UK	2.0	5.5	3.5	0.47	0.71	FTSE 100	13.0	2.3	3.6	9.0	8.0	11.1
Eurozone	2.1	4.6	2.5	0.49	0.47	EURO Stoxx 600	13.2	2.5	3.3	15.0	13.0	13.8
Japan	0.5	1.9	1.4	0.20	-0.11	Topix	17.8	3.7	1.1	14.0	12.0	16.0
Hong Kong	2.0	4.7	2.7	0.60	-0.03	Hang Seng	15.8	1.6	3.3	12.0	9.0	12.1

Source: Bloomberg, Citibank.

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

## Global Equities

As bond yields rose and the major equity indices appreciated over the quarter, equity risk premia (the equity earnings yield minus the 10 year bond yield) have fallen, making equities more expensive relative to bonds. The graph of global markets below shows that when the equity earnings yield is higher than real bond yields, (a positive reading on the red line) equities tend to outperform bonds. As bond yields have risen over the past quarter, so the risk premium (the red line) has fallen. The question is, have bond yields reached a level at which either they offer an attractive alternative to equities or they threaten economic growth and thereby company earnings growth.



Source: Lehman Bros

Clearly global equities in aggregate still offer an attractive risk premium, simply because earnings are still rising at an average of 10% and are being revised upwards. On this basis, the expected economic slowdown that should result from the recent interest rate rises should be seen as a healthy mid-cycle slowdown, not a prelude to a recession or a protracted stock market fall.

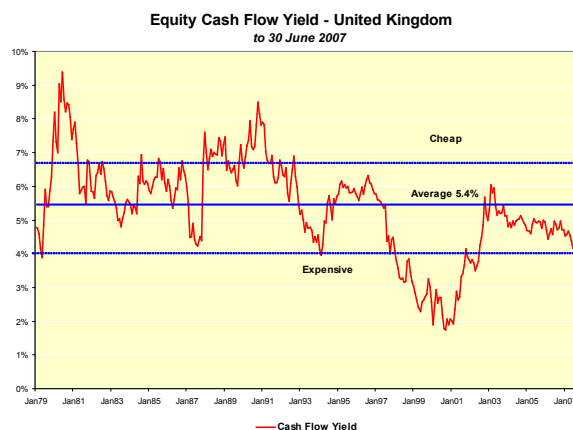
The **US** stands out from the other markets as having the lowest equity risk premium (see valuation table) and, as we pointed out last quarter, the lowest cash flow yield. Investors are also nervous that the high level of takeover activity is creating an excessively

indebted corporate sector that will not be able to withstand a rise in interest rates. Although the US equity market valuation is relatively unattractive and debt has risen, company earnings growth remains strong and we expect US equity markets to rise to reflect at least a part of that earnings growth. We remain underweight in the US on valuation grounds.

The **UK** has experienced the sharpest rise in interest rates and the greatest currency appreciation compared to other markets, so it is not surprising that UK equities produced one of the lower returns over the last quarter. However, expectations for company earnings growth have recently been revised up from 6% to 8% and companies are reporting an ability to raise prices for the first time in this cycle.

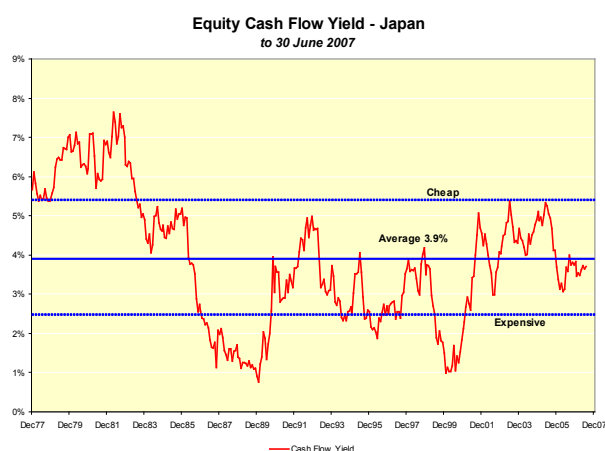
There is also no sign that the takeover boom that has fuelled the rise in value of the mid-size companies is faltering. On the contrary, takeover interest is shifting to ever larger targets in spite of the higher costs of debt. Whilst this trend is doubtless sowing the seeds of a sharper reversal at some stage in the future, in the present robust economic environment it further underpins the UK equity market.

The graph below shows that the recent appreciation in UK equity indices has left the market close to being expensive and we therefore continue to underweight UK equities.



**European** equities still look the best value of global markets, offering a similar valuation to UK equities but with much higher expected earnings growth. The euro is also expected to remain strong relative to the dollar and be stable relative to sterling. The scope for productivity gains within Europe remains enormous, especially now that we have a reform-minded president in France. The 43% appreciation in the German stock market over the past 12 months is testimony to the potential for gains if France takes steps to liberalise its labour markets.

**Japanese** equities are good value with attractive earnings growth, but the Yen may not be quite ready to turn stronger and currency losses could compromise returns. Until the Yen ends its weakening trend, we will remain neutrally weighted in Japan.



Source:Valu-Trac

We continue to favour **Pacific Basin** equities as a means of taking advantage of strong Chinese economic growth without dealing with the volatility of the Chinese stock market. We remain overweight Pacific Basin equities.

## UK Stock Comments

Our biggest overweighting continues to be in mining stocks. This has been the best performing sector over the past quarter as the improved global economic outlook reinforced perceptions that the current mining boom is sustainable. As a result, earnings expectations for copper and iron mining companies in particular (Rio Tinto and BHP Billiton) have been revised up by some 60%. This means that even though Billiton has outperformed the market by 39% this year, the shares are still cheap on our valuation model. In addition, earnings could yet be revised up by a further 25%. We therefore retain our position in this sector, but will take profits at the first sign of economic slowdown. Oil companies, which we over-weighted in the first quarter, have similarly performed well since that time.

The interest rate sensitive sectors, namely the financials and housing related stocks (Persimmon and Speedy Hire) have suffered from rising interest rates. However, the banks we hold are not unduly exposed to the mortgage market and are currently very undervalued. We expect outperformance in due course. In the housing sector, our holdings have strong growth potential thanks to the demographics that favour housebuilding and we expect that the market will respond positively to the next earnings announcements from the companies we hold.

Vodafone produced a strong performance over the quarter as earnings reports vindicated management's strategy for developing business in emerging markets and retaining an interest in the US market. At the current price the shares are starting to look expensive and we will take a suitable opportunity to realise gains on our holding.

## 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 equity asset classes.

### Commercial Property

The IPD property index rose by 2.0% in the quarter, but this largely reflected the still buoyant London commercial property sector. Elsewhere higher interest rates and low yields are weighing on the market. Our holding in the Norwich Property Trust has suffered from exposure to the quoted property sector and we are monitoring this closely with a view to potentially underweighting this holding in the event that the UK property market shows signs of significant weakness.

### Commodities

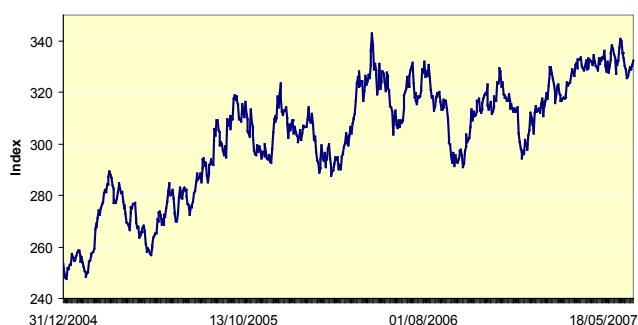
Commodities were little changed overall last quarter, but may well lift near term: crude oil will be bid up on the recent UK terror incidents, aluminium on capacity reductions and more price control as Alcan and Alcoa merge, and wheat, soybeans, corn and oilseeds ought to rise with the increasing popularity of using biofuels. A sign of the times is that McDonalds, keen to promote a progressive image, have announced they will run their delivery trucks on recycled cooking oil and palm oil.

Our Schroder commodities fund has gone overweight in energy and agriculturals with a view to taking advantage of these trends.

### Hedge Funds

Hedge Funds have been doing better lately as equity markets have trended upwards. Our Valu-Trac Strategic funds has also benefited from the trend in equities but also had a short position in bonds in the latter part of the quarter and so benefited from the rise in bond yields. This diversification is precisely what we are looking for from this type of investment.

DJ AIG Commodity Index  
January 2005 - June 2007



Source: Reuters

## Asset Allocation For July 2007

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

		Strategic Benchmark			Q3 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

"The information in this document is believed to be correct but cannot be guaranteed. Opinions and forecasts constitute our judgment as at the date of issue and are subject to change without notice. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors. Before contemplating any transaction, you should consult your financial adviser. The research and analysis in this document have been procured, and may have been acted upon, by Prospect Wealth Management and connected companies for their own purposes, and the results are being made available to you on this understanding. Prospect Wealth Management, its clients, officers and connected companies may have a position, or engage in transactions, in any of the securities mentioned. Neither Prospect Wealth Management nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such research and analysis."



**PROSPECT**  
WEALTH MANAGEMENT

22 Rathbone Street, London W1T 1LA  
T: +44 (0)20 7413 2799 F: +44 (0)20 7413 0988  
www.prospectwealth.co.uk