

Summary

- *The economic fallout from the liquidity crisis has not been significant so far. The prevailing pessimism over the global economic outlook may be overdone, though it is too early to judge.*
- *UK short term interest rates remain high, squeezing the consumer sectors.*
- *Bonds are fair value but inflation pressures remain.*
- *Pacific Basin equities have risen too far too fast and profit taking is warranted. Elsewhere, lower US interest rates are supportive of equity markets.*

Review of 3rd Quarter

Interest Rates and Currencies

This has been a tumultuous quarter for all markets, though a glance at the total returns on page 3 gives little indication of the swings both in prices and in investor sentiment that have taken place over this period. Rising interest rates in the first half of this year in all markets, combined with poor lending practices in the US housing market, precipitated a crash in the US mortgage market as defaults in sub-prime mortgages reached a tipping point. Whilst the securitisation of mortgages had succeeded in spreading the risk of lending far and wide, it also meant that when defaults escalated no-one was sure who was holding the liabilities. The result was a global liquidity crisis, as banks refused to lend to one another and short term interest rates spiralled upwards.

The knock-on effects have been dramatic. Near panic in the equity market led the US Federal Reserve for the first time ever to change interest rate policy from a tightening to an easing bias in the space of 10 days. In the UK, a 1% rise in short term interest rates led to the first run on a

bank since 1866. By the end of September though, a 0.5% cut in US interest rates and the guarantee from the UK treasury for bank depositors calmed markets. The Bank of England, however, has been less accommodating than the US Federal Reserve. UK interest rates ended the quarter at 6.2%, some 0.5% higher than at the start, with the Bank refusing to cut the bank rate. Not surprisingly, sterling has strengthened against the US dollar. The pound has been weak though, against the euro and yen, as the turmoil in the UK financial sector has raised questions over the UK economic outlook.

Bonds

The environment for UK government bonds has been transformed over the past quarter from one of considerable uncertainty to buoyancy. The rise in short term interest rates, combined with a gloomy outlook for the housing sector, pointed to slower economic growth. Inflation had already fallen more rapidly than had been expected, so government bonds rallied strongly with 10 year bond yields falling from 5.46% at the start of the quarter to 5.04% at the end, for a total return of 4.6%. Lower risk 5 year maturity bonds (where we are positioned) produced a similar return, as 5 year yields fell from 5.70% to 4.99%.

Growth has been
downgraded for all
economies

Corporate bonds did not participate in the rally to the same extent and proved to be highly volatile over the quarter. The liquidity crisis led investors to avoid credit risk and even the high quality credits we hold (Tesco, General Electric) saw a 0.5% rise in their yield advantage over gilts. We reduced our exposure to corporate risk before the worst of the sell-off and by the end of the quarter the better quality credits were starting to recover. Over the quarter our bond positions produced a return of 3.5% compared to 4.2% from our gilt benchmark.

Equities

The first half of the period under review saw equity markets fall as the rise in interest rates and the liquidity crisis threatened a slowdown, or worse, for the global economy. However, the decision by the US Federal Reserve to cut interest rates transformed the outlook and US equities rose by 11% from the low point, to produce a positive return for the quarter. Although the economic news from the US was not particularly encouraging during the month of September, investors took any bad news as a sign that further interest rate cuts would be forthcoming and thus a reason to buy equities.

UK equities also rallied by 11% from their low point in August, with a strong performance from the mining sector offsetting poor performance from the financials, which reached a new low in terms of valuation for this cycle. Our UK model portfolio produced a modest outperformance for the period as we benefited from an

overweighting in mining and an underweighting in banks.

Asia produced both the best and the worst performing markets of the quarter. Japan fell by 8.6% as Shinzo Abe, the Prime Minister, stepped down after only a year in office and concerns of a global slowdown threatened to yet again delay Japan's economic revival. Hong Kong equities, by contrast, rallied by 25.3% over the quarter as Chinese growth continued unaffected by the turmoil in the Western economies. Indeed, lower US interest rates simply represented an additional stimulus to the Pacific Basin economies. Our international portfolio benefited from an overweighting in this region and outperformed modestly with a 2.4% return for the quarter.

Alternative Investments

UK commercial property values, as measured by the IPD index, were unchanged over the period, though the expectation is that the index will decline in coming months. The Norwich Property Trust fell by 6.4% as investment outflows exceeded inflows and the fund moved to pricing on a bid basis, cutting 5% from the price.

Commodity prices, as measured by the DJAIG index, rose by 6.2% as both metal and agricultural commodity prices rose. Our Schroders fund, overweighted in agriculture, was up by 9.3% over the quarter.

This was a volatile quarter for hedge funds, but our Valu-Trac fund produced a positive return of 1.3%, which compared favourably with the HFRX hedge fund index return of -3.0% over the same period.

Prospect Wealth Management: Performance of Model Portfolios at 30th September 2007				
Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	2.3	3.2	FTSE 5-15 years
UK Equity	12 May 2006	10.5	9.4	FTSE 100
UK Alpha	12 May 2006	14.6	9.6	FTSE 100*
UK Equity Funds	30 June 2006	15.9	10.9	FTSE 100 TR
International Equity	30 June 2006	19.7	16.2	FT All World ex-UK
Alternatives	30 June 2006	9.8	11.7	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 September 2007

	30 th Sept	Total Return Local		Total Return Sterling	
		3 mths to 30 th Sept %	12 mths to 30 th Sept %	3 mths to 30 th Sept %	12 mths to 30 th Sept %
Currencies v £	Rate				
US dollar	2.05	-1.8	-8.7		
Euro	1.43	3.4	2.8		
Yen	235	5.3	-6.1		
Cash (3m)	Yield %				
USA	5.11	1.5	5.4	-0.5	-3.8
UK	6.22	1.5	5.1	1.5	5.1
Euro	4.63	1.0	3.4	4.5	6.3
Japan	1.00	0.2	0.4	5.5	-5.7
Bonds (10yr)	Yield %				
USA	4.59	4.7	5.1	2.7	-4.0
UK	5.04	4.6	0.6	4.6	0.6
Germany	4.34	2.8	-1.3	6.4	1.4
Japan	1.68	2.2	1.7	7.6	-4.5
Equities	Index				
USA	S&P Comp	2.1	16.0	0.2	5.9
UK	FTSE 100	-1.3	12.2	-1.3	12.2
Germany	DAX	-1.2	33.1	2.2	36.9
France	CAC	-4.9	11.7	-1.6	14.8
Spain	SMSI	-1.7	15.7	1.6	19.0
Italy	BCI Gen	-3.5	9.0	-0.2	12.1
Japan	Topix	-8.6	1.5	-3.8	-4.6
Australia	All Ord	5.4	32.6	8.2	43.9
Hong Kong	Hang Seng	25.3	57.7	23.7	44.2
Alternatives	Index				
Commercial Property	IPD	0.2	8.5	0.2	8.5
Commodities	DJ AIG	6.2	17.0	4.3	6.7
Hedge Funds	HFRX	-2.9	11.4	-4.7	1.7

Source: Reuters

Macroeconomic Overview as at 30th September 2007

US	UK	Eurozone	Asia
GDP Growth			
Housing market remains weak, with existing home sales down 13% yoy. Declining home values and stricter credit standards are impacting consumer confidence. Durable goods orders fell by 4.9% in August. Though high long term loan rates are hurting car sales, overall consumer spending has not fallen as employment remains strong. Growth is expected to slow to 1.8% in 2008.	Q2 growth was well above trend at 3.1%, with manufacturing and services better than expected. Retail sales have risen for past five months. House prices starting to fall, mortgage lending is slowing. Consumer is highly indebted and probably going into a credit squeeze induced slowdown in 2008. Government spending now slowing. However, corporate balance sheets are strong so business investment should support growth of at least 1.7% in 2008.	ECB thinks current 4% rate is accommodative enough for Eurozone growth to stay on trend despite US subprime turmoil. French consumer spending picking up on Sarkozy's tax cuts. However, German business confidence at a 19 month low on concerns over higher borrowing costs, the strong Euro and high oil price. German GDP growth set to slow to 1.9% in 2008 from 2.5% in 2007.	Japan: Industrial production rebounded 3.4% in August after July earthquake. Trade surplus soared on auto and steel exports to China and Europe, making up for weak exports to US. For first month in three, household spending rose in August, esp. autos and clothing. China: Authorities unsuccessful in curbing GDP growth, now at 11.9%. Stock market volatile but rebounded, unaffected by rise in stamp duty.
Employment			
Overall jobless claims are falling & 100,000 new jobs created in September. Job losses mainly at mortgage banks and construction firms. Jobless rate steady at 4.6% as other firms retain staff until there is evidence of an economic slowdown. With strong balance sheets, companies can afford to hire.	Jobless rate has fallen to 5.4%, with many financial services jobs being added. It is unlikely that the recent market turmoil will materially affect the strength of jobs in the short term at least.	Eurozone unemployment now at 6.9%, lowest since 1995. French tax reform will encourage growth and reduce unemployment further. Wage growth stable at 2.2%, above inflation. Strong demand for labour in engineering and services brings H2 wage rises.	Japanese unemployment rate rose to 3.8% in August from 9 yr low of 3.6% in July. In July wages had biggest drop since 2004. Higher wages essential to trigger more retail spending and positive CPI inflation. Income disparity increasing. Chinese unemployment steady at 4.1%, wages rising.
Inflation			
Core inflation fallen from 2.6% in Q1 to 2.1% currently and is likely to remain around the target of 2.0% for the rest of this year, assuming a slowdown in consumer spending. Recent commodity price rises together with low levels of unemployment mean inflation pressures cannot be ignored. 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 has fallen from a peak of 3.1% in March to 1.8% in August. This is well below expectations and reflects immigration and the inability of companies to pass on price rises. However, manufacturers input prices rose 3.2% in September as commodity prices rose and output inflation was driven up to 2.7% by high food prices. The Bank of England remains wary of the inflation risks.	Though strong Euro reduces import inflation, strong wage growth and high capacity utilization are inflationary for Eurozone. Accelerating German inflation makes more likely another ECB rate rise by year end. Sarkozy asks for 2 years to boost growth in order to bring French public debt, now 66% of GDP, below the 60% target. This also has inflationary implications.	Japan: Falling wages and food prices down 0.1% as producers absorbed cost rises mean that inflation will remain at 0% despite the desire by the Bank of Japan to promote reflation. China: Inflation is picking up pace, from 1% a year ago to 6.5%, on rising food costs. Central bank continues to raise interest rate, but the real rate is too low to stem inflation. A rise in Chinese mortgage rates could slow the property market.
Balance of Payments			
Balance of payments should improve as consumer demand slows and a weak dollar stimulates exports. With the US dollar substantially under-valued on the basis of purchasing power parity, this is positive for the dollar in the medium term.	Current account deficit of -3.3% of GDP reflects strong sterling and stimulative fiscal policy. This may change as the public finances become stretched and growth slows. This is a negative combination for sterling over the medium term.	European balance of payments remains in balance, so no pressures on currency. However, we expect increasing interest rate differentials to allow the Euro to remain firm against the dollar and sterling.	Japanese current account surplus together with potential for higher rates should be supportive of Yen. Slower US growth may reduce the Chinese surplus and limit demands in the US for trade sanctions.

Economic Forecasts as at 30th September 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	2.0	1.8	4.5	4.6	3.8	2.0	-1.3	4.8	2.8	-5.7
UK	2.9	1.7	4.7	5.4	2.5	1.8	-2.7	5.8	4.0	-3.3
Eurozone	2.7	1.8	8.5	6.9	2.3	1.8	-0.6	4.0	2.2	0.0
Japan	2.4	2.1	4.3	3.6	0.3	0.0	-2.5	0.5	0.5	4.4
China	10.5	9.6	4.2	4.1	1.3	6.5	-0.7	7.3	0.8	10.7

Source: Lehman Bros, The Economist and Bloomberg

Market Outlook

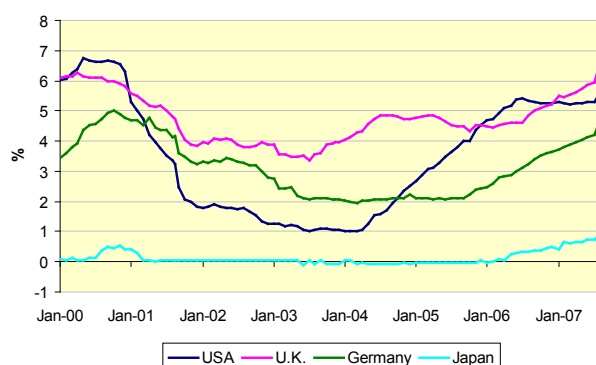
Interest Rates & Currencies

Only three months ago the direction of interest rates was clearly upwards. Robust economic growth, rising commodity prices and an end to price deflation on Asian imports, all pointed towards the risk of higher inflation. The environment changed abruptly when the liquidity crisis struck in August. This caused the US Federal Reserve to reverse interest rate policy to restore confidence and minimise the risk of recession. However, it remains to be seen whether sufficient economic weakness will indeed materialise to offset the other inflationary pressures that remain in place.

What has changed is the availability of credit to finance the riskier house loans and business transactions.

This is negative for the housing market and for private equity, but the impact on the wider economy remains uncertain. In the US, the latest employment data showed surprising growth in jobs and consumer spending remains stable. Although economists have cut their forecasts for economic growth in 2008 from 2.6% to 1.8% and pencilled in further interest rate cuts, this may well turn out to be overly pessimistic.

3 Month Interest Rates
2000 - 2007



Source: Reuters

In the UK, 3 month interest rates have risen to 6.2% thanks to the liquidity problems, but the Bank of England has refused to cut the bank rate to compensate. The result is a squeeze on the highly indebted consumer. The consumer price index has fallen below the Bank's target of 2%, but the recent 3.2% rise in producer prices showed that there are still price pressures in the pipeline and the Bank may be reluctant to reduce interest rates until there is clearer evidence of a slowdown in consumer spending. This is positive for sterling in the short term, though at \$2.04 the pound is expensive relative to the dollar in terms of purchasing power.

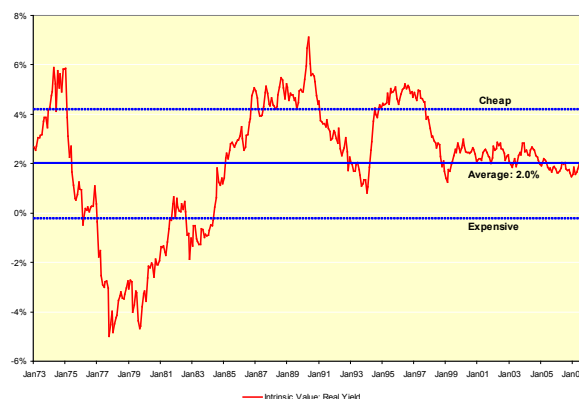
European growth in 2007 has been based on exports and investment. With the euro having appreciated against the dollar by 12% over the past year, we expect exports to slow in 2008. The slack should be taken up by consumer spending as unemployment has fallen to a new low and France is initiating a programme of tax cuts. Interest rates are therefore likely to remain unchanged, which is positive for the euro relative to sterling and the US dollar.

UK Bonds

Bonds remain fair value on our valuation chart, opposite. Although 10 year gilt yields have fallen by 0.4% over the past quarter, inflation has declined at a similar pace. Momentum is currently positive for bond prices as the Bank appears to be taking a hard line on inflation and there is an expectation that economic growth will slow under the influence of a weakening housing market.

We think inflation pressures may be underestimated and therefore have kept our bond exposure predominantly in 5 year maturities, which offer a similar yield to 10 year bonds but also greater protection in the event of disappointment over inflation.

Real Yield - United Kingdom Bonds



Source: Valu-Trac

Corporate bonds suffered from the increased aversion to risk in the third quarter. Thus, whilst government bond yields fell, producing substantial capital gains, corporate yields were little changed. This means that good quality single A corporate bonds now offer a yield advantage of 1.0% over gilts. This remains well below the 1.5% that may be seen in a recession, but it does represent an attractive level assuming the liquidity crisis is behind us.

As confidence returns to markets and it becomes apparent that the economy is not slipping into recession, so we expect our corporate bond holdings to outperform and recover the ground lost in Q3.

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	-0.41	-0.02
UK	2.1	5.0	2.9	-0.42	0.47
Eurozone	1.8	4.3	2.5	-0.19	0.64
Japan	0.0	1.7	1.7	-0.23	-0.07
Hong Kong	1.0	4.3	3.3	-0.45	0.40

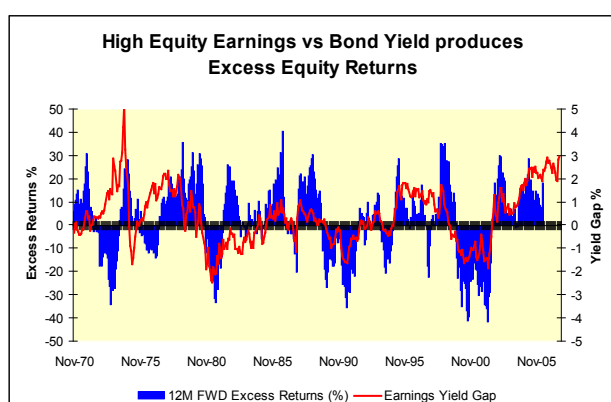
	EQUITIES					
	P/E '07 %	Valuation ERP* %	Div Yield %	Earnings growth		Volatility %
				2006 %	2007 %	
S&P 500	16.1	1.6	1.9	16.0	12	17
FTSE 100	12.2	3.2	3.7	9.0	7	20
EURO Stoxx 600	12.6	3.6	3.6	15.0	15	18
Topix	16.8	4.3	1.3	14.0	12	32
Hang Seng	19.5	1.4	2.4	12.0	9	27

Source: Bloomberg, Citibank.

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

Global Equities

The fall in government bond yields over the past quarter, at a time when company earnings continued to grow, has meant that equities have become more attractive relative to bonds. The graph below demonstrates the relationship between the equity earnings yield and bond yields and their relative returns. It shows that global equity markets are now as cheap, on this measure, as they have been for 30 years.



Source: Lehman Bros

Valuations based on price/earnings multiples are not so extreme, but as the table on the previous page shows, with the exception of the Pacific Basin, valuations are close to their long term averages of 13-14 times earnings. On this basis too, equities look attractive. This still begs the question of whether company earnings are vulnerable following the global credit crunch. With the exception of Northern Rock, the banks have weathered the storm reasonably well and their earnings overall have not been significantly impaired. Expectations for earnings in the third quarter have already been downgraded, so there is less room now for disappointment. This together with the willingness of the Federal Reserve to cut interest rates does appear to underpin the global economy and give reassurance to equity investors.

The **US** equity market remains expensive on a cash flow yield basis and though earnings growth has been

strong at around 12% over the past year, the rate of change is slowing. Whilst lower interest rates may prove to be a stimulus to earnings, we are wary of the impact on consumer spending of the recession in housing. We therefore remain underweight in US equities.

The **UK** still has a slower rate of company earnings growth than other major economies, at around 7% pa, but the rate of change is stable, as is shown in the graph below. The market is quite cheap on a price to earnings multiple of only 12.2 and the cash flow yield is close to fair value now. However, the Bank of England is pursuing a tighter monetary policy than other central

Company Earnings Revisions



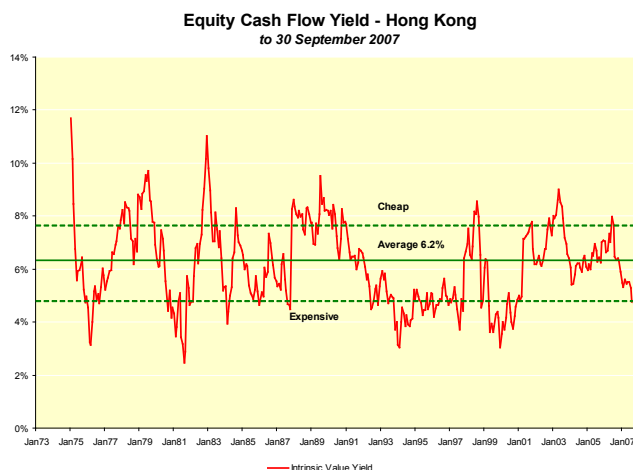
Source: Lehman Bros

banks, government spending is being reined in and sterling is over-valued against the US dollar. These headwinds are likely to lead to continued under-performance from UK equities and we remain underweight in this market.

European equities have performed strongly over the past year, especially in sterling terms, and are now looking moderately expensive. However, earnings are growing at 18% pa and the pace of growth is accelerating. Improving productivity gains, low real interest rates and the growth of consumer demand still

make Europe attractive.

The biggest market moves recently have come from the **Pacific Basin**, especially Hong Kong. This market has gone from being the cheapest major market in the world to the most expensive in the space of one year, as can be seen from our chart. below This has all the hallmarks of a bubble, as valuations are close to an extreme even though earnings growth has been an unexceptional 13% over the past year. A catalyst for the rally has been the recent legislation allowing Chinese investors to invest outside their own over-valued market. This impact will be temporary and we



Source:Valu-Trac

have therefore eliminated our substantial over-weight position in the Pacific Basin markets.

The proceeds of the sale have been reinvested in **Japan**. Equity valuations have become more attractive as a result of an 11% growth in company earnings over the past year and a fall in the market in the last quarter. Japanese cash flow yield is now above its long term average and is competitive with Western markets. There remains political uncertainty following the resignation of the Prime Minister, but economic growth is expected to be higher than that of the US and Europe in 2008 as the Bank of Japan maintains its zero rate interest policy.

UK Stock Comments

This quarter has seen no changes to the standard model portfolio as our holdings have remained within their ranges of fair value. We have maintained our over-weighting in the mining stocks, which have now rallied by more than 50% since the middle of August. Although earnings forecasts for these companies have been raised, as lower US interest rates are expected to fuel Asian growth even further, these stocks are now starting to look expensive. We are therefore likely to realise some profits in the near future.

The financial sector, which is the largest component of the UK market, generally underperformed the market. The smaller companies dealing with lower credit risks, such as Cattles, produced the weakest returns. Although this may not be surprising in the prevailing uncertain environment, Cattles has better control over its bad debts than other banks and is well positioned to benefit from the turmoil. Those financials with Asian exposure, such as HSBC and Prudential, outperformed over the quarter, but despite this, both stocks remain undervalued. With yields of more than 5% and valuations at a cyclical low, the financials are attractive.

Media stocks have suffered recently from fears of an economic slowdown. This comes on top of concerns that new channels of communication, such as the internet, are devaluing their business models. We believe that the risks to the economy are overstated and our holding of WPP will benefit over the next year from the Olympics and the US presidential election.

Since the end of the quarter, Abbot Group, the one oil drilling company that was materially undervalued, has received a bid approach and we have realised a 22% gain.

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

UK property price rises have outpaced rent increases for a number of years, leaving property yields at historic lows. The rise in interest rates over the past year and the threat of slower economic growth are now likely to lead to a decline in property values over the next year. The scale of any correction should be moderated though, by the continued rise in rents that is being seen in all sectors. European property, in contrast, generally has lower valuations and improving economic growth is supporting a rise in property prices. We are therefore considering a move into European property, though the cost of such a transaction has to be carefully weighed.

Commodities

Agricultural commodities should continue to be well supported as key demand factors remain in place: bio-diesel and ethanol are growing energy sources and

soybean meal is required as the Chinese rebuild their hog herds. Energy prices are likely to remain high in the face of the threat of interruption to supplies as the US progressively pulls troops out of the middle East. Metals demand is greatly influenced by Chinese demand and with China growing at 11.9% currently, the risk of a major decline in prices appears limited. Whilst the short term commodity outlook is thus benign, any sign of material economic slowdown globally may be expected to produce a sharp correction in commodity prices. We remain watchful.

Hedge Funds

Hedge Funds tend to perform best in trending markets. The recent volatility, especially in the normally low risk asset class of bonds, has created difficulties for many funds. However, the wide diversification in our Valu-Trac fund, together with the ability to take short positions, gives us confidence in the long term attractions of this vehicle.

DJ AIG Commodity Index
January 2005 - September 2007



Source: Reuters

Asset Allocation For October 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	16	-9
	UK Corporate	0	0	20	8	+8
	Total Bonds	15	25	35	24	-1
Equities:	UK	33	43	53	39	-4
	US	2	12	22	7	-5
	Europe (ex UK)	0	5	15	11	+6
	Japan	0	3	13	6	+3
	Asia ex Japan	0	2	12	3	+1
	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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