

Summary

- *Economic weakness is materialising in the US, UK and Europe.*
- *Further cuts in interest rates are most likely needed if recession is to be averted.*
- *Inflation is expected to rise in coming months - bad for bonds and may constrain cuts in rates.*
- *Equities overall are vulnerable to a fall in earnings. Cyclical sectors have already seen price falls that largely discount recession and offer attractive value.*

Review of 4th Quarter

Interest Rates and Currencies

The last quarter has again seen turmoil in all markets as the liquidity crisis created by US subprime mortgage defaults continued to ripple through the financial system. The US Federal Reserve cut official rates by a further 0.5% this quarter, to 4.25%, in an attempt to bring bank interest rates down and thereby limit the impact of falling house prices and reduced credit availability. The Bank of England was more timid in its actions and waited until December to cut the official rate by 0.25%, to 5.5%, and then only when it had become apparent that the economy was indeed slowing under the influence of high interest rates and reduced bank lending. It took a co-ordinated injection of cash into the banking system by the US, European and UK central banks to finally bring bank interest rates down towards the levels targeted by the authorities at year end.

The economic damage caused by these events is only now unfolding and its extent remains unclear. In the US, residential house prices have fallen by around 6% over the

**More interest rate
cuts are on the way**

year, consumer confidence is at its lowest since the Katrina hurricane and unemployment has risen to 5.0%. In the UK, tighter credit conditions and falling consumer confidence have produced weak retail sales over Christmas. New orders for manufacturing companies have fallen sharply and more interest rate cuts are now expected. Sterling, having hit a peak of \$2.11 in early November, tumbled to \$1.98 by the end of the quarter on the prospect of economic weakness and lower interest rates.

Bonds

The fall in bond yields that started in the previous quarter continued in Q4. Fears for future economic growth outweighed evidence of higher food and energy prices and the prospect of an acceleration in wage inflation. As a result, 10 year government bond yields fell by 0.5% to 4.6%, producing a total return of 5.1% for the quarter. We maintained our cautious stance, invested in five year maturity bonds to protect against the risk of rising inflation. As is typical when slower growth threatens, short term yields fell by more than longer term yields, which worked to our advantage.

Corporate bonds were volatile but our focus on high quality credits (Tesco, General Electric and RWE, the German utility company) meant that the portfolio was

not unduly affected by the gyrations of the corporate bond sector. Over the quarter our bond positions produced a return of 4.1% compared with 4.3% from our gilt benchmark.

Equities

Equity returns were only marginally positive on average for the quarter. Markets bounced between fear of recession, induced by the dislocation of the credit markets, and hope that cuts in interest rates would sustain consumer spending and corporate investment. Reasonable equity valuations, high corporate profitability in the UK, US and Europe and the lack of an attractive alternative (bonds offer only fair value) meant there was no compelling case for selling equities.

In the UK, as elsewhere, the market was characterised by sharply divergent performance amongst sectors. Those companies exposed to the economic cycle, such as financials, general retailers and builders suffered significant price falls, even though these sectors were already undervalued. Food retailers, utilities and pharmaceutical companies, in contrast, proved more resilient as their earnings are not as vulnerable to an economic downturn. In the first half of the quarter, the mining sector performed strongly, helped by the takeover bid for Rio Tinto from Billiton. With mining stocks becoming expensive, we took profits on our holdings of Rio and Billiton at what proved to be close to the highs. Overall though, our UK model portfolio, which is biased towards undervalued companies, underperformed the FTSE 100 by 0.9% over the quarter.

International markets were up 1.0% overall in local currency terms, but rose by 7% after taking account of the depreciation in sterling over the quarter. Our overweighting in international markets thus produced a modest benefit to portfolios. Japan produced the lowest return, falling by 8%, but this loss was mostly offset by a 6% appreciation in the currency. Similarly, the US stock market fell by 3%, compensated for by a 3% rise in the dollar. Over the quarter we took profits on our Asia Pacific holdings and reinvested in Japan, where we perceive there is more attractive value to be found.

Alternative Investments

UK commercial property suffered its first quarterly fall in value since 1992 as commercial property funds sold property to meet retail investor liquidations. With rental yields still low by historic standards, we sold our holding of Norwich Property Trust on the view that the fall in the property cycle has further to run. For now, the proceeds are being held in cash.

Commodity prices were volatile, with metals down sharply (copper -17%) whilst oil was up 21% and agricultural commodities also rose. Our Schroder commodity fund again outperformed, rising by an impressive 11.0% compared to the 4.7% rise in the benchmark.

Our hedge fund experienced extreme volatility but by the end of the quarter had produced a 1.5% positive return, which compared favourably with the benchmark return of just 0.5%.

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

Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	6.5	8.1	FTSE 5-15 years
UK Equity	12 May 2006	9.3	9.2	FTSE 100
UK Alpha	12 May 2006	10.4	9.4	FTSE 100*
UK Equity Funds	30 June 2006	12.8	10.7	FTSE 100 TR
International Equity	30 June 2006	17.5	16.9	FT All World ex-UK
Alternatives	30 June 2006	11.9	9.0	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 December 2007

	31 st Dec	Total Return Local		Total Return Sterling	
		3 mths to 31 st Dec %	12 mths to 31 st Dec %	3 mths to 31 st Dec %	12 mths to 31 st Dec %
Currencies v £	Rate				
US dollar	1.99	3.1	-1.3		
Euro	1.36	5.4	9.1		
Yen	221	6.3	5.5		
Cash (3m)	Yield %				
USA	4.69	1.3	5.4	4.5	4.0
UK	5.87	1.6	5.3	1.6	5.3
Euro	4.48	1.2	3.7	6.7	13.2
Japan	0.87	0.3	0.5	6.6	6.0
Bonds (10yr)	Yield %				
USA	4.03	5.7	10.2	9.0	8.7
UK	4.57	5.1	6.2	5.1	6.2
Germany	4.32	1.3	1.1	6.8	10.3
Japan	1.51	3.4	3.4	8.4	9.1
Equities	Index				
USA	S&P Comp	-3.3	5.7	-0.2	4.3
UK	FTSE 100	0.4	7.4	0.4	7.4
Germany	DAX	3.3	24.6	8.9	36.0
France	CAC	-1.0	3.8	4.4	13.3
Spain	SMSI	3.3	8.4	8.9	18.3
Italy	BCI Gen	-2.7	-2.7	2.5	6.1
Japan	Topix	-8.4	-11.1	-2.6	-6.2
Australia	All Ord	-1.3	18.5	0.5	29.8
Hong Kong	Hang Seng	3.0	42.2	5.9	40.0
Alternatives	Index				
Commercial Property	IPD	-8.4	-5.3	-8.4	-5.3
Commodities	DJ AIG	4.7	16.2	8.0	14.7
Hedge Funds	HFRX	0.4	5.3	3.5	3.9

Macroeconomic Overview as at 31st December 2007

US	UK	Eurozone	Asia
GDP Growth			
Growth should slow from 4.9% in Q3 to just 1% in Q4 as inventories are cut. Q1 2008 growth forecast to be 1%. US home sales fell 9% to a 12 yr low in November. Home prices fell 6.1% in October, worst since 2001, with record foreclosures. Expected to bottom out in 2009. Retail sales holding up well and business spending (IT) was as expected. Stalling manufacturing, slowing corporate earnings growth and the credit crunch could depress business investment in 2008. Weak dollar supporting exports.	BofE expects growth to slow but does not expect a recession in 2008. Higher mortgage rates (average now 6.4%, 2 year fixed) and poor affordability have caused house prices to fall in November and December and have cut mortgage approvals by 37%yoy. House prices expected to stagnate this year, with negative knock-on effect on consumer spending and investment. Consumer confidence at the weakest since 1995. Government has little room to stimulate the economy but weak sterling should help exporters.	The strong Euro is finally putting pressure on exports, which is hurting business and consumer confidence. Retail sales fell in December in the Eurozone and for the past 3 months in Germany. VAT was raised in Germany and Italy in 2007. In 2008 Holland will get higher VAT and energy taxes. Hopes that spending will recover in 2008 are fading. Fears of higher inflation in Europe are cooling consumer spending.	Japan: Cabinet office cut the 07/08 GDP growth forecast from 2.1% to 1.3%. Low volume of house construction due to building permit backlog is a drag on economic growth. November factory output fell 1.6% yoy while household spending fell 0.6%. Company earnings trend remains positive though. China: 2007 growth forecast has eased from 11.9% to 11.5%, and is expected to slow next year to 9.9% on higher interest rates and a more expensive yuan.
Employment			
Jobless claims at 2 year high, consistent with slowing growth. Fewer job cuts than in previous economic slowdowns. Wage growth of 3.3% has supported consumer spending, but this will probably stall as the jobless rate has now reached the critical level of 5%.	Unemployment fell to 5.3% in October, down from 5.6% a year ago with many financial services jobs being added. However, the jobs outlook for 2008 is poor as the public sector cuts back spending and the private sector sees a slowdown in financial services and retail. Will immigration prove to be flexible?	Q4 Eurozone unemployment of 7.2% is at its lowest since 1993, giving one German union the courage to demand an 8% pay rise to cover rising food and energy prices. The payroll tax has been reduced in Germany, encouraging hiring but leaving less surplus from which to pay the unemployed in a downturn. Minimum wage to be introduced in Germany.	Japanese unemployment rate held at 4% in Oct, up from 3.6% in July. Poor business sentiment means hiring likely to slow. In November wages fell 0.2%. Weak job creation is hurting consumer sentiment, which is at a 3 yr low. Chinese unemployment fell to 4% in Q3 a level where wage inflation is likely.
Inflation			
Headline consumer price inflation surged in November to 4.3% due to high food and energy prices. Core inflation remains within the comfort zone at 2.3%. Risk is that wages rise to compensate for high food and energy and imported inflation rises following 8% fall in trade-weighted dollar in 2007. So far, little sign of this happening, but rise in gold price is a warning of global inflation pressures.	Consumer Price Inflation has been steady at 2.1%, though RPI is at 4.3% and this sets the standard for wage demands. Private sector wage growth at 4.0% is not a threat to inflation unless it spirals upwards. CPI likely to rise in coming months as food and energy prices rise by 10% - 20%. Evidence that BofE wants to devalue sterling to support export growth, but this will add to inflation. Can the government hold the line on 2.0% wage increases for the public sector? Clearly an area of risk.	Eurozone inflation may dip below 3% in December because of lower fuel prices in Germany, but ECB President Trichet expects a rise again in January on higher food prices and taxes. He is concerned about a protracted wage and price spiral. Strong euro helps to keep downward pressure on imported inflation. Inflation above 2.0% is a major impediment to cuts in interest rates.	Japan: Core CPI rose 0.4% in November, but in December the yen lost the 6% it gained against the dollar in November on news of declining industrial production and household spending. China: Inflation is rising at 6.9% even after 6 rate rises in 2007. The yuan rose 7% vs the \$US in 2007. More tightening in 2008, plus global slowdown may help to slow inflation. Risk is extra spending over Olympics.
Balance of Payments			
Balance of payments should continue to 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 is changing as the public finances are stretched, growth is slowing and interest rates falling. This is a negative combination for sterling over the medium term and should lead to improving current account.	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. Weak asset markets mean the carry trade is being unwound - positive for yen. Slower US growth may reduce the Chinese surplus and limit demands in the US for trade sanctions.

Economic Forecasts as at 31st December 2007

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2007 %	2008 %	Current %	2008 %	Latest %	2008 %	Latest %	Nominal %	Real %	2008 %
US	2.1	1.8	5.0	5.1	4.3	2.6	-1.2	4.3	-0.1	-5.3
UK	3.1	1.7	5.3	5.5	2.1	2.3	-3.3	5.5	3.4	-3.3
Eurozone	2.6	1.9	7.2	7.0	3.1	2.1	-0.9	4.0	0.9	0.3
Japan	1.3	1.7	4.0	4.0	0.3	0.3	-2.6	0.5	0.2	5.1
China	11.5	9.9	4.0	4.0	6.9	3.8	0.2	7.5	0.6	9.8

Source: Lehman Bros, The Economist and Bloomberg

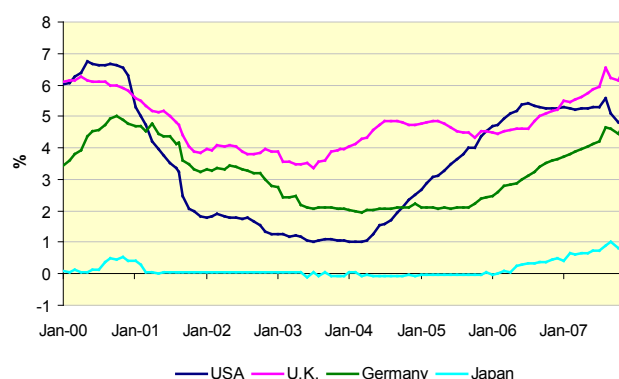
Market Outlook

Interest Rates & Currencies

The rise in interest rates that prompted the credit crisis of the last five months has started to reverse in the US and UK as central banks try to restore the efficient working of financial markets and the ability of banks to make credit available. The immediate problem of bringing bank interest rates down to the official lending rate has now been achieved, as a measure of confidence has returned to the banking system. However, the volume of credit available for lending to consumers and companies has been severely curtailed by the need for banks to take onto their balance sheets large volumes of mortgages from failed investment companies they had guaranteed.

The problem is most acute in the US, but there the Federal Reserve has been more accommodating with interest rate cuts than has the Bank of England. Lower interest rates are only part of the solution though. New capital is being provided to banks by cash-rich sovereign investors in Asia and the Middle East who see an opportunity to take significant stakes in key western assets at knock-down prices. This process may take a

3 Month Interest Rates
2000 - 2007



Source: Reuters

further six months to work through. In the meantime there are ominous signs that the period of high interest rates and the freeze in bank lending has knocked consumer confidence and industrial production. We expect that US interest rates will be cut this month to 4.00% and may fall further to avert recession.

In the UK, even though real interest rates are far higher than in any of the other major economies, the Bank of England is reluctant to cut interest rates in the face of impending higher inflation. Food and energy price rises of 10 - 20% are in the pipeline and wage demands are rising. Unless the signs of economic slowdown we have seen recently are reversed in the next few

weeks, which seems unlikely, we expect interest rates to decline to 4.75% by mid year with the first cut in February. A weakening economy and the prospect of lower interest rates should lead to further weakness in sterling against the euro and the yen in particular.

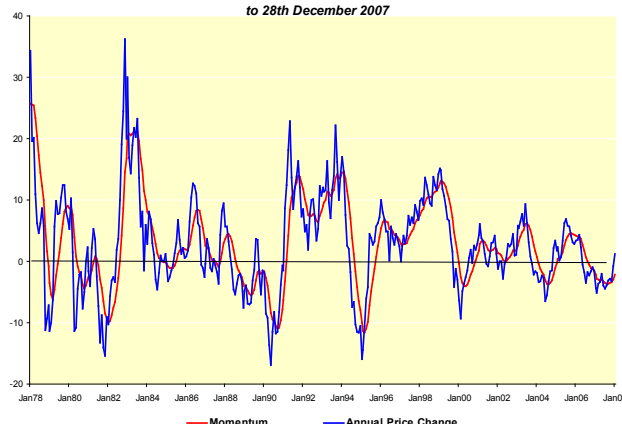
European interest rates are currently on hold as inflation is well above the ECB's 2.0% target at 3.1%. However, the strong euro is now damaging exports and European economic growth is likely to slip, necessitating a modest cut in interest rates this quarter.

UK Bonds

UK bond prices have risen partly in response to the subdued level of UK inflation, but more due to a flight out of risky assets. This process may have further to run as banks complete the adjustment of their balance sheets and the short term impact of the liquidity squeeze fuels fears of recession. Certainly, momentum is positive for bonds at the moment, as the chart shows.

However, we still think that inflation pressures are building. The rise in the price of gold reflects the potentially inflationary consequences of central banks

UK Bond Price Momentum - An Upward Trend
to 28th December 2007



Source: Valutrac

injecting cash into the financial system to support growth. Weaker sterling and higher wage demands add to the inflationary pressures in the UK. We 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.

Corporate bond yields have risen as concerns over economic slowdown have increased. The high quality bonds we hold now yield 1.1% more than comparable gilts and at this level offer attractive value. We expect these bonds to outperform gilts providing recession is avoided.

Measures of Market Valuation

	BONDS				
	Inflation forecast %	10 yr bond yield		10 yr bond yield	
		Nominal %	Real %	3m chg %	12m chg %
US	2.6	3.9	1.3	-0.77	-0.79
UK	2.3	4.5	2.2	-0.55	-0.39
Eurozone	2.1	4.1	2.0	-0.23	0.15
Japan	0.3	1.5	1.2	-0.25	-0.27
Hong Kong	1.0	3.2	2.2	-1.04	-0.45

	EQUITIES					
	P/E '08 %	Valuation ERP* %	Div Yield %	Earnings growth		Volatility %
				2007 %	2008 %	
S&P 500	13.8	2.0	2.1	3	-5	17
FTSE 100	11.9	3.6	3.7	4	-1	20
EURO Stoxx 600	12.2	3.4	3.6	1	5	18
Topix	14.8	4.3	1.4	15	10	32
Hang Seng	16.7	1.4	2.4	6	2	27

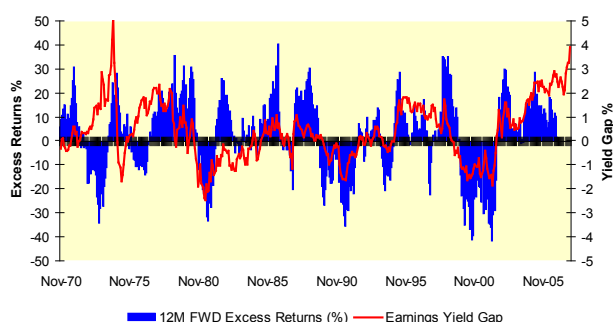
Source: Bloomberg, Lehman Bros.

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

Global Equities

Valuation measures now show equities to be close to fair value or cheap on the basis of expected company earnings. Price to earnings ratios are currently half the level seen at the last market peak in 2000, even though earnings hit a record high in the third quarter of this year. The 1% fall in bond yields over the past six months has also made the equity earnings yield even more attractive relative to bonds, leaving equities

High Equity Earnings vs Bond Yield produces Excess Equity Returns



Source: Lehman Bros

as cheap on this measure as they have been for 30 years. As the chart above shows, when equities offer a higher earnings yield than the gilt yield, it has tended to produce higher returns for equities than bonds in the following 12 months.

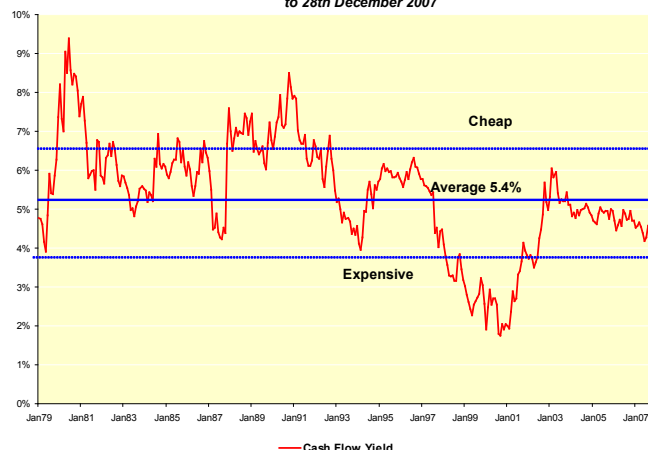
Clearly, the worry is that earnings forecasts from analysts for 2008 (see the table on page 6) will prove to be optimistic and the outcome, instead of being a modest fall in earnings in the US and UK, will be a major decline consistent with a recessionary environment. Already, cyclical shares in the construction, retail and financial sectors have fallen by around 40% on concerns this may happen. There is no doubt that profit margins are being squeezed between rising energy and commodity costs and a decline in consumer demand as house price falls knock confidence.

However, we expect that interest rate cuts will support consumer confidence in the US and UK whilst a weakening dollar and sterling should bolster exports to Europe and Asia, where growth is expected to remain positive, if slower. If this benign outcome proves to be correct, there is scope for meaningful gains from equities over the next 12 months from current levels.

The **US** equity market remains expensive on a cash flow yield basis and earnings are expected to fall this year. Despite this, there is a case for increasing our exposure to US equities. The Federal Reserve has shown its willingness to stimulate the economy and equity returns may well be better than expected once the financial sector stabilises. This will leave us only a little underweight in US equities.

UK equities offer reasonable, though unexciting value, as the graph below shows, though the cyclical sectors are now priced for recession and do look cheap. There remain strengths in the economy in the form of low unemployment, wage growth of 4% and a robust export sector. The uncertainty revolves around the Bank of England's ability to tread the fine line between stimulating the economy and managing inflation expectations. We fear they may err on the side of caution and as a result remain underweight UK equities.

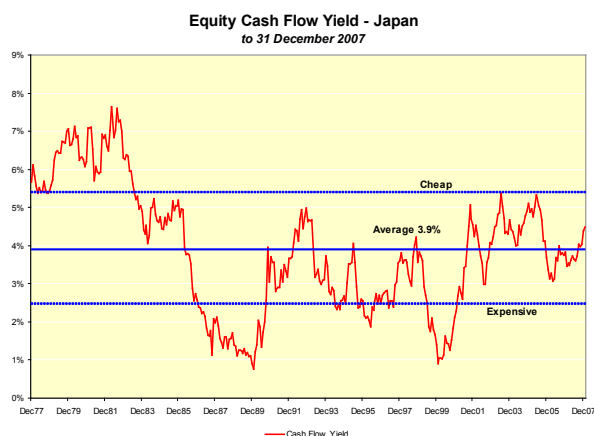
Equity Cash Flow Yield - United Kingdom to 28th December 2007



Source: Valu-Trac

The case for **European** equities, which has been so strong for the past year, is weakening a little as the strength of the euro undermines companies' ability to export. Nevertheless, prospective earnings growth is still higher than that of the US or UK as real interest rates remain low, productivity gains should be realised in France and consumer demand should remain strong.

Japanese equities have underperformed for several years and have been amongst the most volatile recently. However, Japan has good earnings growth prospects for this year and is now looking cheap



Source:Valu-Trac

relative to its historic valuations, as can be seen in the chart above and is also attractive versus western markets,. Moreover, in the event that global equity markets fall, the yen should strengthen as investors repatriate loans borrowed at low interest rates in yen. Japan thus offers an attractive diversification and we will maintain the overweight position we have recently established.

We have recently moved underweight in the **Pacific Basin** region, realising substantial gains on our holdings that had appreciated by some 50% over the past year. This region is now significantly overvalued and earnings growth is vulnerable to the slowdown in the US, despite the ongoing strength in the Chinese economy. **Emerging markets** in general are similarly vulnerable.

UK Stock Comments

This quarter has seen a radical shift in the valuations of companies as the market adjusted to the risk that consumer spending could fall sharply in the wake of tighter bank lending and high interest rates. This has provided a number of opportunities for us over the past quarter.

Over this period we reduced our mining sector exposure. We reinvested the proceeds in companies that were undervalued at the time and offered earnings resilience either through the quality of their franchise or through international diversification. Next (fashion retailing), Carphone Warehouse (phone retailing and telecoms) and Hays (international recruitment agency) were added to portfolios during the quarter.

The portfolio now has a bias towards those companies that are exposed to the economic cycle and many are now at valuation levels that discount economic recession. Current trading, though, does not warrant this and we expect a significant recovery in shares in the construction, retailing and financial sectors as interest rates are reduced and greater clarity develops over the economic outlook for the year. Already bargain hunters have launched a takeover bid for one of our holdings, Northgate Information Solutions, which saw its share price rise from a low of 43p to a takeover price of 95p during December.

The financial sector is now trading at valuations not seen for 30 years, with major banks yielding 9% even though they are likely to maintain their dividends. Helphire and Cattles, both medium sized financial services companies, have both had recent upgrades to their earnings forecasts and yet the share prices have fallen by 30%. Such undervaluations are unlikely to last long.

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

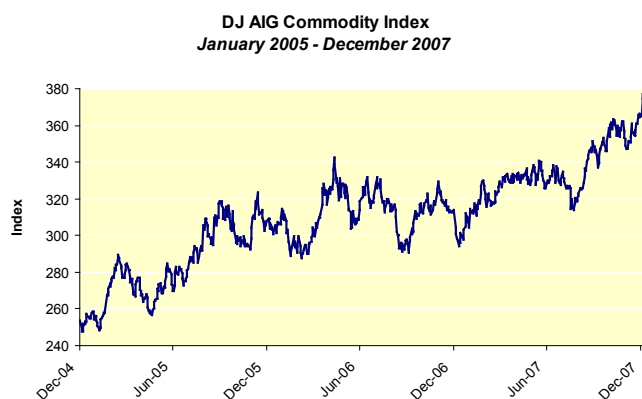
UK commercial property prices turned down in August for the first time since the early 1990's. During the final quarter it became apparent that large-scale sales of property funds by retail investors were leading to forced sales of commercial property and driving prices down sharply. Some property funds even ceased trading for up to six months to allow time to liquidate property. We took the decision to sell our holding of Norwich Property trust in anticipation of further declines of up to 20% in fund prices. We are now seeing property changing hands at yields of 7% that only recently had been purchased at 4.5%. We are currently holding the proceeds in cash but will look to purchase a quoted global property fund that is already trading at a suitable discount to net asset value.

Commodities

Agricultural commodities should be supported over the next few months by winter weather patterns, tight stocks and increasing demand for biodiesel. The slowdown in global economic activity is expected to have an impact on energy prices (the price of oil has fallen sharply since briefly touching \$100 per barrel recently) and base metals. The trends in these commodities are now clearly down. Precious metals, in contrast, may well rise further as worries over the surge in global monetary growth and its inflationary implications push up the price of gold. Our Schroders Commodity Fund currently has substantial positions in agriculture and precious metals, has a small exposure to energy and very little exposure to base metals.

Hedge Funds

Our Valu-Trac global fund has proved to be highly volatile in recent months, though has produced positive returns through the turmoil of the past five months. The portfolio can take short as well as long positions in all major markets and so has a low correlation to equity markets. The fund is currently short of bond markets in the expectation that bond yields will rise in coming months.



Source: Reuters

Asset Allocation For January 2008

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

		Strategic Benchmark			Q1 2008 Tactical weights	Weighting vs Strategic Benchmark
		Min %	Benchmark %	Max %	%	%
Cash		0	0	10	4	+4
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	10	-2
	Europe (ex UK)	0	5	15	11	+6
	Japan	0	3	13	6	+3
	Asia ex Japan	0	2	12	0	-3
	Total Equities	55	65	75	66	+1
Alternatives:	Property	0	4	14	0	-4
	Commodities	0	3	13	3	0
	Hedge funds	0	3	13	3	0
	Total Alternatives	0	10	15	6	-4
Total			100		100	0

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