

Summary

- **Inflation concerns rise to the top of the agenda at the same time as economic growth slows.**
- **UK interest rate cuts on hold for now. The European central bank may raise rates next month.**
- **Bond markets vulnerable to deteriorating inflation news.**
- **Equities torn between improving company earnings forecasts and weakening economic news.**

Stagflation looms in the UK

The past month has seen the focus of attention switch from the credit crisis to the outlook for inflation and, particularly in the UK, to the deteriorating outlook for economic growth. Consumer price inflation in the UK hit an unexpected 3.0% in May, a rise of 0.5% on the month, and looks set to rise further in coming months - a peak of around 3.8% is likely in the fourth quarter of this year. The impact of this on financial markets has been exacerbated by a startling 20% rise in the price of oil over the past month, reaching a high of \$135, double the price of just 12 months ago.

The rise in UK inflation has been accompanied by signs of weaker growth, raising the spectre of 1970's style stagflation (a combination of high inflation and negative growth). Although growth in gross domestic product in the first quarter of 2008 was better than expected, at 2.5%, the latest indicators have been less positive. This is hardly surprising, with the consumer squeezed between high food and energy prices on the one hand and rising mortgage payments and a lack of credit availability on the other. With house prices falling by 2.4% in the month of May alone, consumer confidence is now at its lowest level since 1990.

In the US, housing continues to slump with prices down 14% in the first quarter of this year. However, low interest rates and the weak dollar are supporting the economy and the indicators over the past month have generally been better than expected.

Bond Prices Fall Back

From the onset of the credit crisis to the end of March, bond prices in the UK rose strongly, as investors sought the safety of government bonds and anticipated slow growth or recession would keep inflation muted. In the past month however, even though UK growth prospects have deteriorated, inflation has become the overriding concern. The result is that bond yields rose from 4.6% to 5.0% in May,

producing a loss of 1.9% on 10 year government bonds.

With consumer price inflation likely to move higher in the coming months, reflecting price rises already in the system and the weakness of sterling, bond yields are likely to rise further. We have limited the downside risk to investors

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market 1 month to 30 May %	12 months to 30 May %
Currencies v £	Rate		
US dollar	1.98	0.2	-0.1
Euro	1.27	-0.2	15.5
Yen	209	-1.3	15.3
Cash (3m)	Yield %		
USA	2.80	0.2	5.3
UK	5.80	0.5	5.8
Euro	4.78	0.4	4.1
Japan	0.90	0.1	0.6
Bonds (10yr)	Yield %		
USA	4.07	-2.4	11.6
UK	4.98	-1.9	7.5
Germany	4.45	-2.3	4.1
Japan	1.76	-1.1	1.7
Equities	Index		
USA	S&P Comp	1.3	-6.4
UK	FTSE 100	-0.2	-5.1
Germany	DAX	2.4	-7.4
France	CAC	0.6	-15.2
Spain	SMSI	-1.4	-11.0
Italy	BCI Gen	-0.4	-17.4
Japan	Topix	3.8	-18.7
Australia	All Ord	2.5	-4.5
Hong Kong	Hang Seng	-4.5	21.8
Alternatives	Index		
Property	IPD	-0.4	-12.7
Commodities	DJ AIG	2.7	27.9
Hedge Funds	HFR	2.0	-0.8

Source: Reuters

June 2008

by maintaining a short average maturity for our bond holdings.

By the fourth quarter of this year however, we expect inflation to be declining as energy and food prices pass their cyclical peaks. Current high oil prices are beginning to constrain demand, with US oil usage down 0.7% in May compared to a year ago. Supply, meanwhile, is slowly increasing (see the chart below), with new capacity coming onstream from OPEC expected to lead to a better supply

OPEC & Russia Oil Production Growth vs Demand



Source: Lehman Brothers

/ demand balance by year-end. On this basis, we expect the oil price to fall back below \$100 / barrel, though the precise timing is impossible to predict.

The central banks are now caught between a rock and a hard place. A rise in interest rates to counter inflation would risk turning economic slowdown into recession. The result is likely to be a period of unchanged rates before cuts resume in the Autumn. In the medium term though, a commitment to controlling inflation is positive for bond investors.

Equities Treading Water

Higher energy prices, inflation and interest rates are hardly a positive backdrop for equities. Despite this, markets showed little change over the month as company earnings forecasts continued to be revised upwards on average (see the chart opposite). As in April, performance was highly polarised, with mining and energy shares

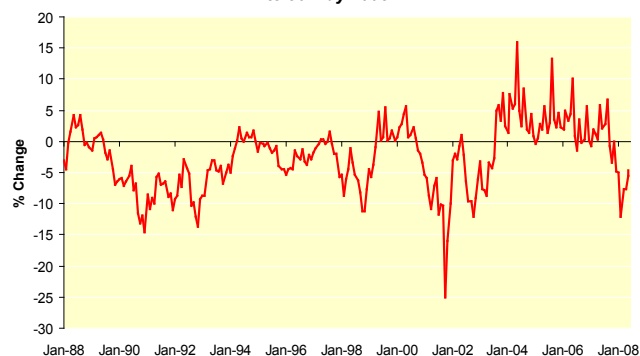
continuing to outperform whilst financials and cyclical shares weakened, as the risks of a consumer downturn increased.

Our UK equity portfolio remains focused on undervalued shares in companies with strong cash flow and a bias towards international activities. There is currently a disconnect between analysts' projections of robust earnings growth for many companies with these characteristics and the market, which is pricing these shares for an economic recession. Our policy is to bias the portfolio towards those undervalued shares that will outperform in a recovery whilst avoiding companies that would be particularly vulnerable to a housing or consumer downturn.

We have a neutral position in the financial sector, which typically is one of the last sectors to recover from a market downturn. With banks now earning higher margins following the credit crisis and the weaker ones having recapitalised their balance sheets with rights issues, we may now be close to a turning point. We will look for clearer evidence, however, that the economy will avoid recession before committing more funds to this sector. Trends in employment and default rates will be key indicators to watch.

Matthew Hunt

Global Monthly Earnings Revision to 30 May 2008



Source: Lehman Brothers

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