PROSPECT
WEALTH MANAGEMENT

Investment Prospects

Summary

- ***Recession in the UK now looks probable in the second half of 2008.***
- ***Absent a political shock, we expect lower oil prices and lower UK interest rates by year end.***
- ***Bond markets appear vulnerable to higher inflation in the short term.***
- ***UK, European and Japanese equities are now cheap, but momentum remains negative.***
- ***Commodity prices appear due for a correction after a 50% rise in the past year.***

Review of 2nd Quarter

Interest Rates and Currencies

The second quarter saw an easing of the global credit crisis thanks to the US Federal Reserve cutting interest rates to 2.0% and banks in the US and Europe raising new capital from shareholders and sovereign wealth funds.

The respite for the markets was brief though, as a a 40% rise in the price of oil threatened to tip a fragile global economy into recession. At the same time that a lack of credit availability was slowing Western economic growth, central banks were faced with an unexpected inflation surge as energy and food prices soared. Given a choice between higher growth and lower inflation, UK and European central banks erred on the side of lower inflation and promised to squeeze the economy to ensure that higher food and energy prices did not lead to excessive wage growth. With public sector unions grumbling over pay, it was not surprising the European Central Bank raised interest rates by 0.25% to 4.25% as a warning that higher wage demands would only result in recession and job losses. With the Bank of England taking a similarly tough line, the sterling / euro exchange rate was little changed over the quarter and UK and Eurozone economies began to show signs of a rapid slowdown.

Interest rates to fall by year-end

The US focus has been on sustaining growth through a policy of low interest rates and tax cuts. This has so far allowed the US economy to avoid recession and stemmed the outflow of dollars such that over the second quarter the dollar maintained its value against sterling and the euro. The yen has been the weakest currency, giving back a small part of the large gains made in the first quarter on concerns that slowing Western growth would hurt Japan's important export sector.

Bonds

The rise in the oil price pushed up inflation expectations over the 3 months to end June and UK 10 year government bond yields rose by 0.8% to 5.1%, producing a negative return of -4.9%. Our bond holdings were in shorter dated maturities than the benchmark, limiting the impact of the rise in bond yields. Over the quarter, we reduced our bond exposure in favour cash in recognition of the risk that the inflation outlook could deteriorate further.

July 2008

Corporate bonds generally outperformed gilts over the period as the credit crisis eased. We took this opportunity buy a high quality holding in the financial sector, where yields have risen sharply in recent months and at the time of purchase provided a 7% yield, 2% higher than that of gilts. Overall, our bond portfolio produced a return for the quarter similar to that of the benchmark at -4.2%.

Equities

Equity markets in general produced marginally better returns than bonds over the quarter. Japan, where we are overweight relative to the benchmark, provided the best return in sterling terms, +2.3%, in spite of a -6.4% depreciation in the yen. As we had expected, the Pacific Basin markets have not decoupled from the West, as exports to the faltering Western economies remain a key component of overall corporate profitability in these markets. Europe similarly produced a negative return of -4.3%, as exports began to suffer from the strength of the euro against the US dollar.

The UK proved to be one of the better performing markets over the quarter, largely because of the high proportion of energy and mining companies in the FTSE 100 index. The rise in the oil price and the recovery in some metal prices (such as copper), meant that the oil services, energy and mining sectors produced the best returns for the period. Returns continued to be highly polarised, though, as the building and financial sectors continued their precipitous fall, being exposed to the toxic mix of falling house prices, constrained credit availability and high real interest rates.

Having reduced our UK mining sector exposure in the first quarter at levels close to the highs seen to date, our re-investment into the undervalued media and retail sectors meant that the UK portfolio suffered underperformance in the second quarter. As the outlook for the building sector deteriorated with the change in interest rate expectations, we sold our holding in Persimmon, the house builder, prior to the shares halving in value. We have also sold our holding in Cattles, moving our exposure to the financial sector modestly underweight. Underperformance in the UK portfolio was partly offset by outperformance in the international equity portfolio.

Alternative Investments

We still have no exposure to commercial property, where prices continued to fall, with the latest data showing an acceleration in the rate of decline.

The DJAIG commodity index rose 16.6% over the quarter, of which 12% is attributable to the rise in the price of oil. Our commodity fund produced a return of 18.2%, having captured the energy price rises and also gains in agricultural prices such as soyabeans, which have hit new highs recently.

Our hedge fund produced a return of -1.4% for the quarter, making gains from correctly anticipating the fall in bond markets but losing on equity markets overall. The volatility of the fund has proven to be low during the last quarter and this reflects our desire to reduce risk in the fund at this uncertain time.

Prospect Wealth Management: Performance of Model Portfolios at 30th June 2008

Model Portfolio	Inception Date	*Total Return Since Inception* Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	4.1	6.7	FTSE 5-15 years
UK Equity	12 May 2006	-9.3	-4.8	FTSE 100
UK Alpha	12 May 2006	-11.3	-4.7	FTSE 100*
UK Equity Funds	30 June 2006	-1.3	-3.6	FTSE 100 TR
International Equity	30 June 2006	3.6	3.4	FT All World ex-UK
Alternatives	30 June 2006	25.9	15.3	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 2008

	30th June	Total Return Local 3 mths to 30th June %	Total Return Local 12 mths to 30th June %	Total Return Sterling 3 mths to 30th June %	Total Return Sterling 12 mths to 30th June %
Currencies v £	Rate				
US dollar	1.99	0.1	0.8		
Euro	1.27	-0.6	17.3		
Yen	211	-6.4	17.0		
Cash (3m)	Yield %				
USA	2.81	0.7	5.4	0.2	6.3
UK	5.86	1.5	6.0	1.5	6.0
Euro	4.86	1.2	4.2	0.6	22.2
Japan	0.93	0.2	0.7	-6.2	17.9
Bonds (10yr)	Yield %				
USA	3.97	-3.6	13.7	-4.1	14.6
UK	5.13	-4.9	8.1	-4.9	8.1
Germany	4.63	-4.7	4.1	-5.3	22.1
Japan	1.60	-2.6	4.4	-8.8	22.2
Equities	Index				
USA	S&P Comp	-2.6	-12.7	-3.1	-12.0
UK	FTSE 100	-0.4	-11.6	-0.4	-11.6
Germany	DAX	-0.9	-17.4	-1.5	-3.1
France	CAC	-4.9	-24.0	-5.5	-10.9
Spain	SMSI	-9.0	-18.2	-9.5	-4.0
Italy	BCI Gen	-3.6	-24.2	-4.2	-11.1
Japan	Topix	9.3	-24.5	2.3	-11.6
Australia	All Ord	0.0	-11.0	4.4	1.3
Hong Kong	Hang Seng	-2.5	4.2	-3.2	5.4
Alternatives	Index				
Commercial Property	IPD	-1.9	-14.2	-1.9	-14.2
Commodities	DJ AIG	16.6	42.2	16.0	43.4
Hedge Funds	HFRX	2.8	-1.3	2.3	-0.5

Macroeconomic Overview as at 30th June 2008

	US	UK	Eurozone	Asia
GDP Growth				
	Economy on brink of recession. June consumer confidence fell to lowest since 1980. House prices down 15% yoy and higher food and energy prices discourage discretionary spending, which is set to fall after tax rebates have been spent. Auto sales under pressure. Bank losses are deepening. Manufacturing margins squeezed between high input prices and weakening demand. The bright spot in the economy remains exports, thanks to the weak dollar.	Q1 GDP growth was revised down to only 0.3%, with weakest services growth in 12 years: construction, banking, retailing. Mortgage approvals are down 64% from peak levels a year ago. Rising fuel and food prices, lack of credit and house prices forecast (by HBOS) to fall 9% this year, pushed consumer confidence to worst level since1990. Retail sales sharply down on year. Will worsen as unemployment rises. A recession looks likely, tempered by strong export growth.	Eurozone manufacturing and services contracting. Record oil prices and an ECB rate rise pushed German business confidence to a 2 year low. A weakening of the euro to the dollar, yen and sterling that began this quarter should buoy exports a little. Ireland going into recession for first time in 20 years.	**Japan:** Strong exports to Asia & Emerging markets compensate for US exports (down 18% YTD). Business confidence at 5 year low, as rising commodity prices weigh on manufacturing margins, and consumer finance firms face higher financing costs. **China:** Industrial profits Jan to May grew at 20.9%, ½ the pace of a year ago, because of record oil & coal prices, environmental costs and a strong yuan. Exports slowing. Chinese trade surplus peaked, now down 11% yoy.
Employment				
	Employers cut jobs in 6 consecutive months to June. Unemployment jumped from 5% in April to 5.5% in May. Household income growth, after falling from 6.4% to 4.4% yoy over the past 2 quarters, picked up in April on tax rebates, but is expected to weaken going forward. Service sector weak,	Employment showing signs of weakening. Expected financial services and construction industry job cuts worsening. Expectation that job cuts will restrain public sector wage demands. However, Shell tanker drivers won a 13.2% wage rise after a 4 day strike.	Eurozone unemployment remained at its 15 year low of 7.2% in May. If unemployment stops falling, unions might cool their recent high wage demands.	**Japan:** Japanese jobless rate unexpectedly rose to 4.0% after dipping to 3.8% in March; firms slow to hire as margins worsen.Low jobs/ applicants ratio keep wages and spending down. **China:** Urban wages grew 12% in 2007, then 18% yoy in Q1 2008, but only 3.4% in real terms.
Inflation				
	Inflation expectations are at the highest since 1995. High fuel costs causing preference for Americans to buy US made products, giving them pricing power. Recent dollar firmness as Fed shifts focus to fighting inflation. High oil price, flows out of equities, possible delayed rate rise as Fed supports economic growth post the tax cut could cause dollar to fall.	Inflation rose to 3.3%, 11 year high. Bank of England expects that inflation will exceed 4% this year, hurt by the weakness of sterling, which is accentuating food and fuel price rises. B of E expected to keep rates on hold until October. B of E Governor King said 'curbing inflation will require economic growth to slow and living standards to drop'.	ECB forecasts inflation, now 3.7%, will average 3.4% in 2008 and ease to 2.4% in 2009. Raised interest rates 25bps on 3 July to 4.25%, a 7 year high, the first change in a year. Euro eased, bonds and equities rallied in response to ECB suggesting no near term further rises. Eastern Europe: not tough in fighting inflation., e.g. Despite 10% wage inflation Hungarian central bank did not raise rates because currency is at 5 year high.	**Japan:** Inflation has fallen back from 1.2% to 0.8%. Yen has weakened against dollar and Euro since March, but could strengthen, especially against dollar as global equity risk appetite wanes. **China:** Inflation eased to 7.7% from Feb peak of 8.9%, on gov't food price controls - still far above the 4.8% target. Inflation pressure remains as gov't is raising fuel and electricity costs. Pace of yuan appreciation slowed as exports weaken.
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 is declining as sterling weakens and boosts exports, particularly to Europe, due to strength of euro. High real interest rates in UK put a floor on sterling so additional stimulus from weak currency likely to be limited. Deficit should improve as UK consumer demand weakens.	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 falling US rates should continue to be supportive of yen. Weak US asset markets mean the carry trade is being unwound - positve for yen. Slower US growth may reduce the Chinese surplus but yuan forecast to appreciate against the USD ~7%/yr in 2008 and 2009 as PBC raises interest rates to counter inflation.

Economic Forecasts as at 30th June 2008

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2008 %	2009 %	Current %	2009 %	Latest %	2009 %	Latest %	Nominal %	Real %	2008 %
US	1.2	1.5	5.5	6.2	5.0	1.6	-2.4	2.0	-2.2	-4.1
UK	1.1	0.3	5.2	6.0	3.8	2.5	-3.3	5.25	2.0	-3.9
Eurozone	1.5	0.8	7.2	7.2	4.0	2.0	-0.9	4.25	0.6	-0.1
Japan	1.7	1.5	4.0	4.0	1.3	0.5	-2.9	0.5	-0.9	4.3
China	9.6	8.0	4.0	4.2	7.1	3.7	0.2	7.5	-0.2	9.8

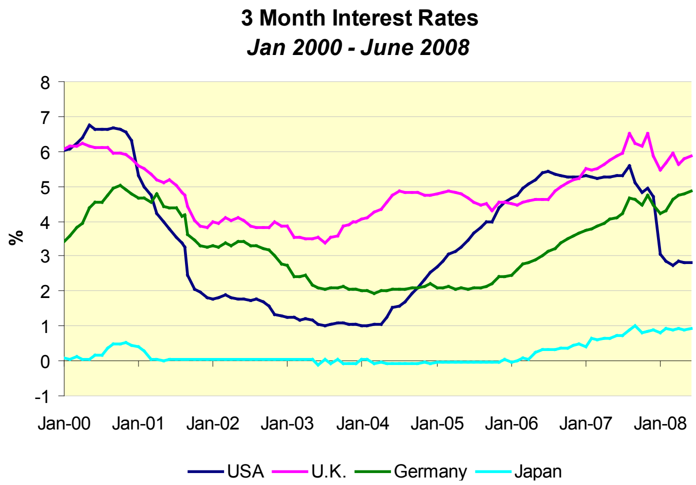
Source: Lehman Bros, The Economist and Bloomberg

Market Outlook

Interest Rates & Currencies

The path of interest rates is now being determined to an unusual degree by the price of oil and its impact on inflation. The move in the price of oil from $56 per barrel a year ago to $140 now is equivalent to a 4.5% tax on the consumer. It is not surprising therefore that in the US, consumer confidence is at its lowest since 1992, employment has declined for the past six months and there is no sign of the housing market, where prices have fallen by 15% over the past 12 months, reaching a low point. On the basis of economic growth, one would expect the trend in interest rates to be down. However, despite the grim economic environment, manufacturer's input prices have been rising at more than 6% for the past six months. The next move in US interest rates is therefore likely to be upwards if the dollar weakens further and threatens even higher inflation.

Much depends on the price of oil. What therefore is the probability of last year's move being reversed? Peter Davies, former chief economist at BP, states that there is no shortage of capacity to produce sufficient oil, regardless of the additional demand from developing countries. New refining capacity is due to come on stream in the second half of this year, which, combined with a reduction in demand as economic growth slows, should put downward pressure on prices. Already, oil inventories are above average for this time of year. What this does not allow for though, is the possibility of a shock to the supply system if, for example, Iran ceased oil production in the event of an attack on their nuclear facilities. It is this fear of a political event that is keeping prices high. If tensions are reduced, as we expect, the price of oil should fall towards $100 over the balance of this year, leading to lower inflation and lower interest rates globally.



Source: Reuters

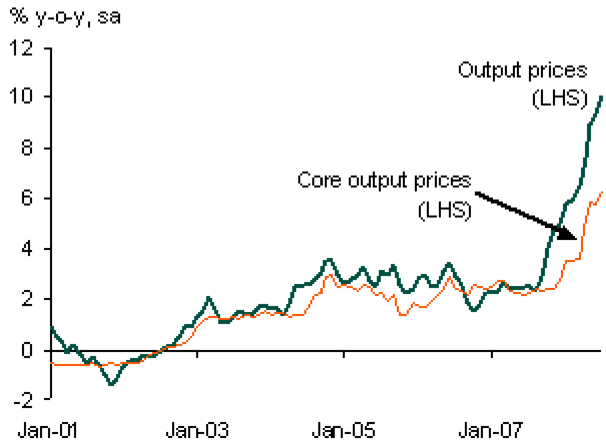
In the UK, we expect growth will turn negative in the third quarter as consumer demand slows sharply in the face of high interest rates, a lack of credit availabilty and rising food and energy bills. Unemployment is likely to rise in coming months and if this prevents price rises being reflected in wages, then the Bank of England is likely to cut interest rates in October or November. High real interest rates should continue to support sterling relative to the US dollar.

In Europe, exporters are now suffering from the strength of the euro, whilst consumer demand is weakening in the face of higher interest rates. Given the pace of economic decline further rate rises seem unlikely, even though inflation is now at 4.0%, double the central bank's target.

UK Bonds

Bonds are likely to remain volatile in the face of the uncertainty over the future direction of commodity prices and the extent of wage demands. Bond valuation is close to the long run average, with a real yield of only 2.6%, so if consumer price inflation in the UK rises above 4.0% in the coming months, bond yields may well rise. The chart of producer prices highlights

Producer Price Indices - Exceptional Increases



Source: ONS, Lehman Bros

the probability that this will happen, As a result our bond holdings are defensively positioned in short maturity bonds and cash. Over the medium term, weak economic growth and rising unemployment may be expected to bring inflation back towards the Bank's 2% target and lead to lower bond yields and the scope for capital gains.

Our corporate bond exposure continues to be concentrated in high quality companies offering attractive yield enhancements relative to gilts. In the present uncertain environment opportunities to purchase high quality bonds at attractive yields are likely to materialise and we remain alert to these opportunities.

Measures of Market Valuation

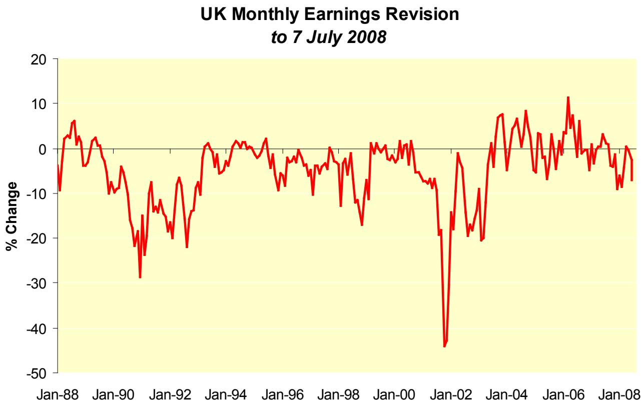
BONDS	Inflation forecast	10 yr bond yield		10 yr bond yield	
		Nominal	Real	3m chg	12m chg
	%	%	%	%	%
US	1.6	4.0	2.4	0.6	-1.1
UK	2.5	5.1	2.6	0.8	-0.3
Eurozone	2.0	4.6	2.6	0.7	0.1
Japan	0.5	1.6	1.1	0.3	-0.2
Hong Kong	3.0	3.5	0.5	0.9	-1.3

EQUITIES	Valuation			Earnings growth		Volatility
	P/E '08	ERP*	Div Yield	2008	2009	
	%	%	%	%	%	%
S&P 500	14.0	3.1	2.3	8	19	19
FTSE 100	10.6	4.4	4.1	4	8	18
EURO Stoxx 600	9.4	6.1	5.1	3	17	17
Topix	16.0	4.6	1.7	5	10	23
Asia ex-Japan	14.5	3.4	3.5	5	13	23

Source: Bloomberg, Lehman Bros. * Equity Risk Premium = (earnings / price) * 100 - 10yr bond yield

Global Equities

Three months ago, company earnings forecasts globally were recovering as the credit crisis appeared to be moving towards a resolution. Now, with inflationary pressures rising, the inability of central banks to respond to a weakening economic environment has undermined the outlook for earnings over the next year. This is most marked in the UK, where, as the chart below shows, earnings have been revised down



Source: Lehman Bros

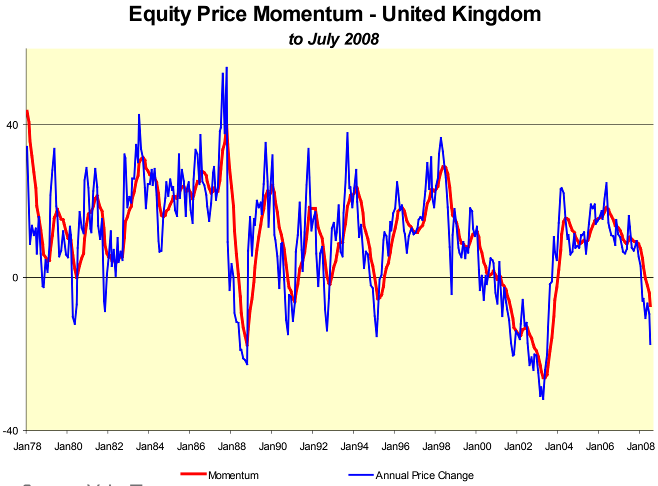
by some 10% over the past month. How much further could earnings be downgraded? Historically, economic downturns have been accompanied by an average earnings fall of around 20%, which means that a further 10% fall in earnings forecasts is possible, given the deteriorating outlook for the global economy. Part of this has already been anticipated by the share price falls which have taken most stock markets to a level 20% or more below the last cyclical high.

Market valuations, whilst starting to look cheap, are not at extremes of attractiveness other than in Japan. Further price declines would thus be needed to make most markets compellingly attractive. The positive news is that unlike the 1970's (the last time that we experienced the dangerous mix of low growth and rising inflation), inflation expectations appear manageable and the corporate sector (excluding the banks) is starting from a strong position financially.

The turning point will come when growth has slowed to a point at which inflation is percieved to be under control and interest rates can be cut. This may be several months away and in the meantime we must expect volatility. To this end we have raised the level of cash in portfolios so that we are in a good position to take advantage of opportunities as they arise.

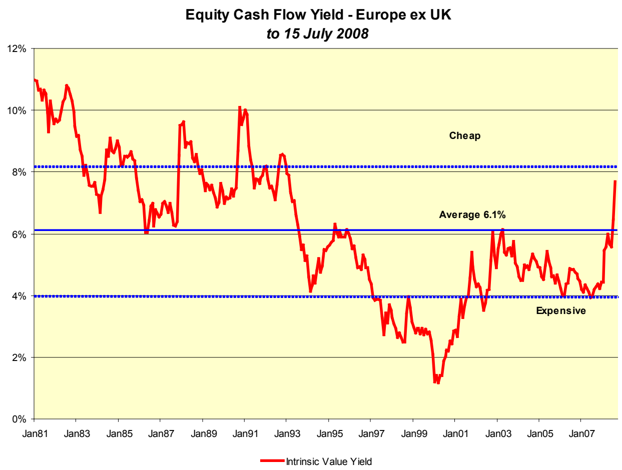
The **US** equity market, uniquely amongst the developed markets, remains expensive on valuation grounds. So far the economy has avoided recession, but with interest rates unlikely to fall further and the effect of the tax cuts dwindling, one or two quarters of negative economic growth is possible, leaving the stock market vulnerable in the short term.

UK equities are now as cheap as they were during the recession of the early 1990's. However, the squeeze on the consumer is likely to worsen in coming months as unemployment increases and energy price rises feed through to utility bills. With government finances stretched, there will be little respite until the Bank of England is able to cut interest rates. As the chart below shows, equity price momentum is still heading down, though the rate of price change is now extended and a turn in the interest rate cycle could well be the catalyst for recovery.



Source: Valu-Trac

European equities may not be suffering to the same extent as the US and UK from credit constaints, but they have their own problems. The 16% appreciation in the euro against the US dollar over the past year, together with the recent rise in interest rates, has undermined business confidence, weakened the important export sector and exacerbated declines in property prices in Spain and France. European equities have underperformed in the past year and now offer attractive value, with the highest cash flow yield of any of the major markets (see the chart below) at 7.1%.



Source: Valu-Trac

Japanese equities are similarly very cheap relative to their past valuation levels, despite recent outperformance. We remain overweight in Japan and expect the stock market and the currency to be resilient in view of a better growth outlook compared to the other developed economies.

The **Pacific Basin** has the highest expected economic growth, but equity valuations are little better than fair value. We are also concerned that Asia will not be immune to the slowdown in Western economies and current high rates of inflation will lead to higher interest rates and lower company earnings growth. We thus continue to have little Pacific Basin equity exposure.

UK Stock Comments

Over the past six months we have progressively reduced our exposure to the mining sector and reinvested in companies more sensitive to the economic cycle, in anticipation of a cut in interest rates and outperformance from the retail, media and services sectors.

The rise in the oil price, however, has pushed back the date of recovery in cyclical shares and prolonged the outperformance of the mining and energy stocks. Given our expectation that the price of oil is likely to fall at some stage over the next six months, we will now be looking for suitable opportunities to reduce our weighting in oil shares, which are currently trading near their all time highs relative to the market.

The financial sector has been hard hit by by the US sub-prime lending crisis, but has fallen further due to worries over the likely impact of a UK recession. Defaults on commercial property and personal loans have yet to rise and would be a further blow to the already depleted capital of the banks. However, banks are now trading close to their all time low valuations and we will look to add to our banks exposure when we see the credit cycle beginning to turn.

Opportunities are also developing in the housebuilding sector, which has been squeezed between a lack of credit availability to buyers, rising raw material costs and falling house prices. The construction industry is typically one of the last sectors to recover from a recession, but with share prices of even the high quality companies having fallen by 70%, there are bargains beginning to appear. We sold our holding of Persimmon at twice the current share price and will look to buy back into the sector at an appropriate time.

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

We continue to sit on the sidelines as commercial property prices are still falling, most recently at an accelerating pace. Although a number of big development projects have been cancelled in the major cities, thus limiting the amount of new space due to become available, rising unemployment is putting downward pressure on rents and prices. The retail sector is likely to be particularly badly affected as consumers' disposable income is reduced through the credit squeeze and rising food and energy bills. Property tends to be late in the recovery cycle so we do not expect to be taking commercial property exposure until 2009.

Commodities

The broad based commodity index that we use as a benchmark has recently hit new highs, as can be seen in the chart below. Clearly the 40% rise in the oil price in the last quarter has had an impact, but copper and other metals are also close to highs. Worries over inflation have pushed up the price of gold. Agricultural commodities, whilst coming off the highs in aggregate, are still at elevated levels.

Dow Jones AIG Commodity Index
January 2006 - June 2008

Source: Reuters

With the world economy slowing, we are beginning to be concerned that the rapid pace of commodity price increases will not be sustained. The demand for commodities from China and India, which has been the catalyst for the price rises of the last 18 months, will not go away. However, supply, both for energy and for metal commodities, is responding to the high prices and over the next year new production will be coming on stream. Similarly, the rapid rise in food prices is prompting a response in acreage planted and in changes to government policies regarding biofuels that have been so disruptive over the past 12 months. Having made gains of 50% over the past year, we are likely to take profits sooner rather than later.

Hedge Funds

Our Valu-Trac hedge fund continues to hold a short position in bond markets in the anticipation that rising inflation pressures will lead to higher yields. The fund is neutral in equity markets overall and is long sterling versus the US dollar. In commodities, the fund has recently moved short of crude oil and is long of gold.

Asset Allocation For July 2008

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

		Strategic Benchmark Min %	Strategic Benchmark Benchmark %	Strategic Benchmark Max %	Q3 2008 Tactical weights %	Weighting vs Strategic Benchmark %
Cash		0	0	10	4	+4
Bonds:	UK Government	15	25	35	10	-15
	UK Corporate	0	0	20	10	+10
	Total Bonds	15	25	35	20	-5
Equities:	UK	33	43	53	40	-3
	US	2	12	22	9	-3
	Europe (ex UK)	0	5	15	9	+4
	Japan	0	3	13	9	+6
	Asia ex Japan	0	2	12	0	-2
	Total Equities	55	65	75	67	+2
Alternatives:	Property	0	4	14	0	-4
	Commodities	0	3	13	3	0
	Hedge funds	0	3	13	6	+3
	Total Alternatives	0	10	15	9	-1
Total			100		100	0

Source: Prospect Wealth Management

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