



Summary

- **Commodity prices fall sharply as supply increases and demand falters.**
- **UK and European economic deterioration brings forward expectations of rate cuts.**
- **Bond and equity markets rally on prospects of lower inflation and lower interest rates.**
- **Shares in cyclical companies (banks, media, retail) recover from lows.**

Commodity Prices Fall Sharply

July was another rollercoaster month for markets as commodity prices peaked and the economic news proved to be generally better than expected in the US, but disappointed in the UK, Europe and Japan. We have been anticipating a fall in commodity prices, and oil in particular, but the speed with which oil, metals and agricultural commodities have fallen in unison has been remarkable, with a 12% decline in the DJAIG commodity index in the month of July alone. Lower commodity prices imply a lower rate of inflation in 2009 and mean more scope for central banks to reduce interest rates to support economic growth. This provided the catalyst for a rally in equities, with the UK stock market up 5% from the lows reached in the middle of July. It also supported the bond market, with 10 year government bond yields falling from 5.1% to 4.8% over the month for a 3% total return.

Economic Outlook Mixed

In the **US**, the current low interest rate policy (a 2.0% funding rate for banks) and tax cuts helped consumer confidence to pick up and industrial production to grow solidly. However, there are still no clear signs that the housing market is stabilising and without this there remains the risk that, with the benefits of the tax cuts now behind us, the US economy may weaken again. The consensus expectation is that we will see a further modest slowdown in the second half of this year before a recovery in 2009. This is supported by a falling rate of wage growth, which allows the US Federal Reserve more latitude in maintaining their low interest rate policy for longer.

The **UK** has seen a marked deterioration in the economic outlook, with a survey of manufacturers expectations the worst for 10 years (see chart overleaf) and a sharp fall in retail sales. With interest rates at 5.0%, demand slowing and input prices up by 30% over the past 12 months, manufacturing is beginning to struggle, in spite of a favourable exchange rate. It now appears likely that the UK will have negative growth

for the next two quarters. This makes it more likely that interest rates will be cut in October, even though inflation may have reached 5% by then.

Europe has finally succumbed to the strong euro and a collapse in property prices in Spain and France. The German

Total Returns in Local Currency

Last month and last 12 months

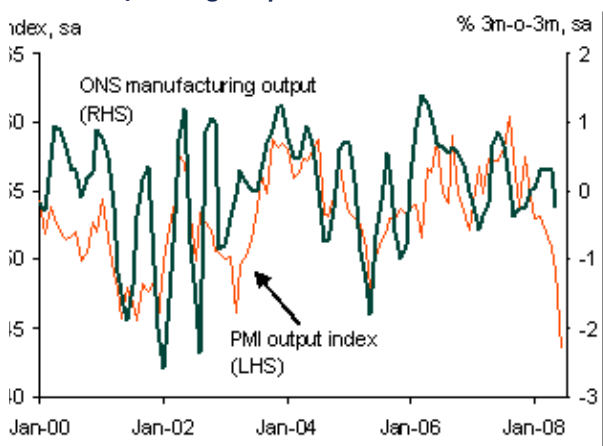
		Total Return for Market 1 month to 31 Jul %	12 months to 31 Jul %
Currencies v £	Rate		
US dollar	1.98	0.5	2.3
Euro	1.27	-0.5	16.7
Yen	214	-1.1	12.3
Cash (3m)	Yield %		
USA	2.82	0.2	5.4
UK	5.74	0.5	6.1
Euro	4.85	0.4	4.3
Japan	0.90	0.1	0.7
Bonds (10yr)	Yield %		
USA	3.96	0.5	11.1
UK	4.81	2.9	8.8
Germany	4.35	2.6	4.1
Japan	1.54	0.6	4.2
Equities	Index		
USA	S&P Comp	-0.8	-10.6
UK	FTSE 100	-3.7	-11.6
Germany	DAX	1.3	-11.9
France	CAC	-0.6	-20.7
Spain	SMSI	-1.3	-18.9
Italy	BCI Gen	-3.9	-24.4
Japan	Topix	0.6	-22.4
Australia	All Ord	-4.8	-13.7
Hong Kong	Hang Seng	3.1	0.6
Alternatives	Index		
Property	IPD	-1.6	-16.4
Commodities	DJ AIG	-12.2	23.0
Hedge Funds	HFR	-2.6	-2.1

Source: Reuters

August 2008

economy is now expected to have contracted by up to 1.5% in the second quarter and with interest rates having been raised in July, growth is likely to be negative again in the current quarter. Jean-Claude Trichet, president of the European Central Bank, last week acknowledged that conditions had deteriorated, thus removing any possibility of further rate rises. The result has been a sharp depreciation in the euro and sterling against the US dollar over the past week. Having increased our exposure to US equities last quarter, this currency move has benefitted client portfolios.

UK Manufacturing Output Index Points to Slowdown



Source: Lehman Brothers

Cyclical Equities Recover in UK

The question now is whether the anticipated fall in UK interest rates in Q4 this year will underpin equities in the face of a deteriorating economy.

In the cyclical sectors such as banking, media and retail, much bad news has already been factored into share prices with earnings projections for 2008 having been cut sharply. Lower interest rates are particularly helpful to these sectors, so it is not surprising that banks and retailers were some of the best performing shares over the past month (+12%). Despite this, share valuations remain cheap, pointing to the scope for further gains in these sectors. It is no coincidence that two companies in our Alpha portfolio (Michael Page and Collins Stewart) were subject to takeover bids in the past few weeks as attractive current valuations make companies vulnerable

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to predators. It is in these sectors that our portfolios are overweighted.

Mining companies, where we are underweighted, were amongst the worst performing sectors (-22%). Here, although share prices have fallen, earnings have not been downgraded to reflect lower metals prices, so this sector remains vulnerable.

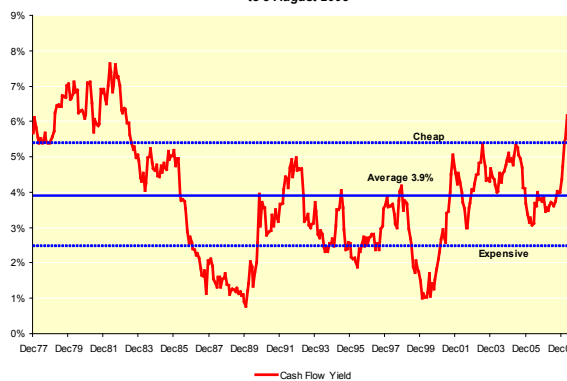
Overall company earnings have been downgraded by some 15% in the UK. We anticipate further downgrades as the economy deteriorates and the result will be continued volatility as different sectors are affected by the progress of the cycle. Our focus on undervalued shares with strong balance sheets gives us confidence we can take advantage of these developments. Fundamentally, the UK, European and Japanese markets are cheap, and though they could become cheaper in the short term, this is a good time for the longer term investor to be buying.

Japanese Equities Remain Attractive

Despite a weakening in the Japanese economy, Japan remains the cheapest equity market in valuation terms (see below) and we have increased our exposure to a 3% overweighting relative to benchmark.

Matthew Hunt

Equity Cash Flow Yield - Japan
to 8 August 2008



Source: ValuTrac



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