

Summary

- *Equity market valuations now as cheap as at any time in the past 30 years.*
- *The bank bailout plan appears well-conceived, but will market interest rates fall?*
- *Economic recession in the West appears inevitable, but the likely severity is unpredictable.*
- *Global inflation to fall sharply and more official interest rate cuts are on the way.*
- *Bond markets are vulnerable to rising government deficits.*

Review of Recent Events

Interest Rates and Currencies

With stock markets around the world down 20% in the week to 13th October, the threat of widespread bank failures and talk of global recession, if not depression, what has gone wrong? At the end of August inter-bank interest rates were nudging down, commodity prices were trending lower (good for inflation) and stock market volatility was receding. The economic news at this time was deteriorating, but expectations were that growth in the Western economies would be positive in 2009 despite one or two negative quarters.

The decision on September 15th by the US Treasury to allow the investment bank, Lehman Brothers, to go bankrupt, threw the global banking system into chaos. Banks stopped lending to one another and a new liquidity crisis rapidly turned into a solvency crisis as investors questioned whether banks' capital would be sufficient to cover both the losses of a severe recession and the losses on property related securities. The confluence of a

deteriorating economic outlook and a collapse in lending between banks led to a downward spiral. AIG, the world's largest insurance company had to be rescued by the US Treasury and is now breaking itself up to repay debts. The five major US investment banks have all been either liquidated, taken over or turned into commercial banks. Major banks in Europe, the UK and Iceland have failed and been rescued by government intervention.

Although central banks have recently cut interest rates by 0.5%, this has so far had no impact on the all important inter-bank lending rate, which in the UK stands at 6.2%, far above the 4.5% base rate. The US dollar and yen have appreciated sharply against sterling and the euro as capital has flowed towards the largest and safest economies. This has had a significant positive impact on our international equity holdings.

Bonds

The 28% fall in commodity prices during the third quarter implied that inflation in subsequent months would decline sharply, even though UK inflation was not expected to peak until this month. This was positive for UK government gilts, which had an added boost from a flight to safety as investors removed deposits from banks and sought the safety of government assets. As a result,

**Equity valuation now
compelling**

10 year UK gilt yields fell by 0.7% to 4.45%, producing a total return of 6.7% for the quarter. The corporate bond market, in contrast, suffered from the threat of deteriorating economic growth and corporate bonds did not participate in the gilt rally to the same extent. Returns on corporate bonds have varied widely, with the high quality borrowers, such as the utility, RWE, being little affected, whilst borrowers in the financial sector have seen yields rise significantly.

Equities

All equity markets fell in the third quarter as the seizure of the credit markets increased uncertainty over the outlook for the global economy. The US was the best performing market in sterling terms, as an 8% fall in the stock market was offset by a 12% rise in the dollar, to produce a net positive return for a sterling based investor. In the first 10 days of the current quarter however, markets have been in freefall, losing a further 19% on average as the global banking system has faced the possibility of collapse. To place this in context, the fall since the end of September 2007 in the US stock market is now the most precipitous seen in the last 80 years (including 1932).

Not surprisingly, different UK equity sectors produced very different returns over the third quarter. The traditionally defensive sectors such as pharmaceuticals and consumer staples performed the best, producing positive returns for the quarter, whilst oil and mining stocks fell by 20% and 44% respectively. We were overweight in the pharmaceutical sector and had moved underweight in mining and oils. As markets fell,

we moved our position in mining and banks back to a neutral position as these sectors appeared to have been oversold. As the situation deteriorated further, we again reduced our position in UK banks. The performance on UK equity portfolios has swung wildly over the quarter, from a strong outperformance at the end of August, to a small underperformance at the end of the quarter.

International equities outperformed the UK due to favourable currency movements. We had no exposure to emerging markets, which have suffered significantly greater declines over the past quarter than the developed markets.

Alternative Investments

Commercial property prices continued to fall at a rate of more than 1% per month and we maintained our policy of avoiding this asset class.

The DJAIG commodity index peaked in June and has fallen significantly since then. We sold our commodity holdings early in August after a 19% decline in the quarter. Since then, the index has fallen by a further 24% as all commodity prices (including gold) have turned down.

Our hedge fund produced a return of -4.2% for the quarter, outperforming the benchmark and avoiding the volatility of the equity markets with little net exposure to equities. The loss was largely attributable to a short position in bonds, which continued to outperform, despite being overvalued, because of the flight to safety.

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

Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	6.9	12.8	FTSE 5-15 years
UK Equity	12 May 2006	-22.5	-17.1	FTSE 100
UK Alpha	12 May 2006	-24.9	-16.9	FTSE 100*
UK Equity Funds	30 June 2006	-16.4	-16.0	FTSE 100
International Equity	30 June 2006	-7.8	-6.7	FT All World ex-UK
Alternatives	30 June 2006	15.8	-3.3	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 September 2008

	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	1.78	11.8	14.8		
Euro	1.26	0.1	13.5		
Yen	189	11.8	24.3		
Cash (3m)	Yield %				
USA	4.33	0.7	5.2	12.6	20.8
UK	6.22	1.5	6.0	1.5	6.0
Euro	5.18	1.2	4.7	1.3	18.8
Japan	1.01	0.2	1.0	12.1	25.6
Gov't Bonds (10yr)	Yield %				
USA	3.83	2.2	11.0	14.2	27.4
UK	4.45	6.7	9.8	6.7	9.8
Germany	4.03	6.0	7.0	6.1	21.4
Japan	1.48	1.5	3.5	13.5	28.7
Equities	Index				
USA	S&P Comp	-8.2	-21.4	2.6	-9.7
UK	FTSE 100	-12.0	-21.2	-12.0	-21.2
Germany	DAX	-8.2	-23.3	-8.1	-13.0
France	CAC	-8.1	-26.5	-8.1	-16.6
Spain	SMSI	-8.6	-23.6	-8.5	-13.3
Italy	BCI Gen	-13.2	-31.8	-13.2	-22.6
Japan	Topix	-17.2	-31.5	-7.4	-14.9
Australia	All Ord	-11.7	-25.0	-18.2	-23.0
Hong Kong	Hang Seng	-17.7	-31.4	-7.6	-21.2
Alternatives	Index				
Commercial Property	IPD	-3.5	-17.0	-3.5	-17.0
Commodities	DJ AIG	-28.1	-3.8	-19.7	10.5
Hedge Funds	HFRX	-10.5	-8.9	0.1	4.6

Macroeconomic Overview as at 30th September 2008

US	UK	Eurozone	Asia
GDP Growth			
Durable goods orders fell 4.5% in August. Recession expected to be long and deep regardless of rescue package. Home sales fell 2.2% MOM in August to a 17 year low, Bernanke says housing market is set to fall further. Equity market volatility weighed on September consumer sentiment, which should otherwise have firmed on lower fuel prices. Misery index (unemployment + inflation) is worst since 1991 and likely to deteriorate.	Q2 GDP growth was revised down to 0%, 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 since 1990. Retail sales sharply down on year. Will worsen as unemployment rises. A recession looks inevitable, tempered by modest export growth as sterling weakens.	Q2 Eurozone GDP growth contracted and the EC cut its Eurozone 2008 GDP growth forecast from 1.7% to 1.3%. Business confidence has deteriorated and will take a big hit from Fortis collapse. Consumption and investment are suffering, though French and Italian consumer confidence temporarily improved slightly on lower fuel prices. Exports will be hit by the strength of the euro and by the global slowdown.	Japan: 2008/9 growth revised downward by 0.5%. Q2 GDP growth fell 2.4% annualized, probably in recession. August industrial production fell 3.5%. Household spending fell by 4% in response to higher prices and job losses. Consumer sentiment at a 26 year low. China: steel output falling, demand rose only 6% last month, down from 13% in first 7 months, as auto production and construction slow.
Employment			
Employers cut jobs for 8 consecutive months to August. Unemployment rate 6.1%, a 5 year high and likely to increase as jobless claims are rising sharply. Financial sector shedding most jobs. Wage pressure should ease.	Jobless rate jumped from 5.2% in May to 5.5% in July, heavy job losses in banking and house building sectors., Expected to get worse. Rising unemployment will weigh on consumer sentiment already under pressure from falling property and shares.	Eurozone unemployment rate remained at 7.3% in July, up from the low of 7.1%. German unemployment is at 7.6%, a 16 year low, and still expected to fall further, but at a slowing pace.	Japan: Japanese jobless rate rose to 4.2% in August. Wage growth is lower than core inflation. Government pledged to cut taxes for low income earners. China: Jobs fell for past 7 months. Wages may stop rising as economy cools.
Inflation			
CPI eased by 0.1% to 5.4% in August, on lower fuel prices. Core inflation (ex food & energy) rose by 0.2%. Nevertheless, inflation now close to a peak as commodity prices have fallen precipitously and dollar remains strong as a safe haven.	Inflation accelerated to 4.7% in August, but will peak in October around 5.0% as recession sets in and the impact of lower commodity prices is felt. Forecasts are for inflation to fall to 2.0% in 2009 in spite of weak sterling against the US dollar.	Eurozone CPI inflation of 4% (2 x target) Euribor interbank rate is highest since introduction of the Euro. European banks need a US style rescue plan, e.g. €250 bn but apart from Germany, fiscal deficits cannot afford it. Eastern Europe: Poland and Czech exporters suffering from strength of their currencies against the euro and dollar.	Japan: August Tokyo core inflation of 2.4%, the highest in a decade is hitting consumption volumes. Sluggish growth, no wage pressure and falling oil price makes Bank of Japan unlikely to raise rates for rest of year. China: Inflation falling fast. Central Bank has lowered lending rate from 7.47% to 6.9%.
Balance of Payments			
Pace of improvement will slow as global demand for US exports weakens with widespread economic contraction and a stronger, less competitive dollar. The US dollar is now only modestly under-valued on the basis of purchasing power parity, offering less scope for dollar appreciation.	Current account deficit should continue to decline as sterling weakens against dollar and yen and euro remains strong against sterling.. Expectation is that UK interest rates will decline sharply as inflation falls and this will prevent sterling from recovering.	European balance of payments remains in balance, so no pressures on currency. Inability of Europe to coordinate banking system rescue may undermine the currency if this leads to deteriorating economic environment.	Japan: Japanese current account surplus together with falling US rates should continue to be supportive of yen. China: Slower US growth will reduce the Chinese surplus but yuan forecast to appreciate against the USD as real interest rate remains positive, compared to negative for US.

Economic Forecasts as at 30th September 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	1.6	1.3	6.1	7.0	5.4	2.9	-2.5	2.0	-3.4	-4.8
UK	1.2	0.3	5.5	6.0	4.7	2.5	-3.8	5.0	0.3	-3.4
Eurozone	1.3	0.9	7.3	7.8	3.8	2.4	-0.9	4.25	0.4	-0.3
Japan	1.0	0.9	4.0	4.3	2.3	1.2	-2.8	0.5	-1.8	3.7
China	9.8	8.0	4.0	4.2	4.9	3.0	0.6	7.2	2.3	8.3

Source: The Economist and Bloomberg

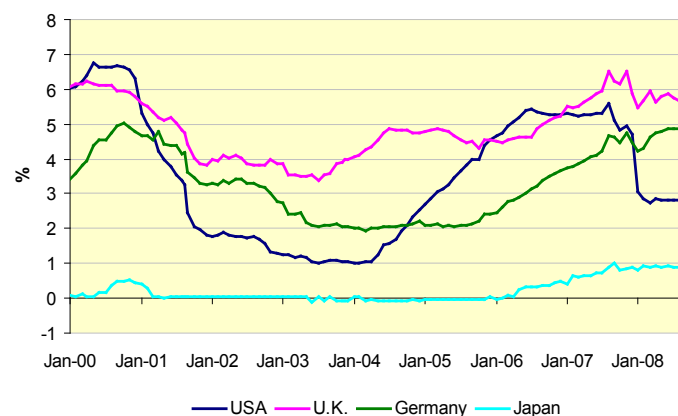
Market Outlook

Interest Rates & Currencies

The current financial crisis has been precipitated, as has so often been the case in the past, by rising interest rates. The attempt by Western authorities to squeeze the excesses out of the global economy by monetary policy (rather than effective regulation) has succeeded - but with catastrophic consequences. Rising interest rates exposed the full extent of leverage in the financial system and the over-valuation in property. Now, lending between banks has come to a standstill as depositors withdraw funds and even the largest financial institutions are threatened with insolvency. With banks hoarding cash, the banking crisis now threatens to turn an expected shallow recession in Western economies into something far worse.

The UK government's proposal to recapitalise the banks, guarantee lending between banks and guarantee deposits appears to address the issues. The unknown is whether the £400 billion the government has offered is enough to restore international confidence in the UK banking system and encourage banks to lend to the wider economy.

3 Month Interest Rates
Jan 2000 - Oct 2008



Source: Reuters

The US is now modifying its rescue package to also allow for the recapitalisation of banks, so some consensus appears to be developing as to how to deal with the crisis. Assuming this is successful, market interest rates should converge with official rates, which are currently 4.5% in the UK and 1.5% in the US.

The inflation outlook has been transformed by the 40% fall in commodity prices over the past three months and is unlikely to be an impediment to further rate cuts in the UK and Europe. As the chart on the following page shows, the Bank of England expects inflation to fall to its target 2% within two years, so further rate cuts are likely early in 2009. Even the worst case is for

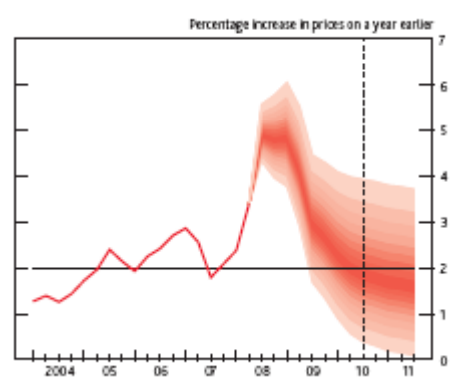
inflation to be below 4% in 2 years.

It is difficult to predict what the impact of recent events will be on the global economy. The latest forecasts for the major economies are shown in the table on page 5 and assume two or three quarters of negative growth. For this to be realised, bank lending will need to return to normality quickly to support economic activity and to limit the inevitable rise in unemployment from current levels that are still low by historic standards. Clearly, these forecasts may now be optimistic, but the outlook that is implied by recent stock and bond market moves may equally prove to be pessimistic.

UK Bonds

The transformation in the inflation outlook is already reflected in government bonds, with the yield on the 10 year gilt now at 4.3%. Given that inflation has averaged 3.3% over the past 5 years, gilts now look expensive with a real yield of only 1%. However, if economic growth slows more than expected and inflation falls to 2% over the next year, as we expect, gilts are reasonably priced.

UK Inflation Forecast - 2% within 2 years



Source: Bank of England MPC, September

The risk for bond investors is that governments find the only way out of the present financial difficulties is to print money. There is no evidence of this happening to date (quite the reverse, in fact) and independent central banks should be resistant to this temptation. Nevertheless, all Western governments will be running larger budget deficits and will have to borrow more, which typically is not supportive of bonds.

Corporate bond yields have risen to reflect the risk of recession and default so now there are attractive opportunities to achieve yields of 6.0% to 7.5% on bonds rated "A" by the major credit rating agencies. We are looking to take advantage of this by extending our exposure to high quality issues.

Measures of Market Valuation

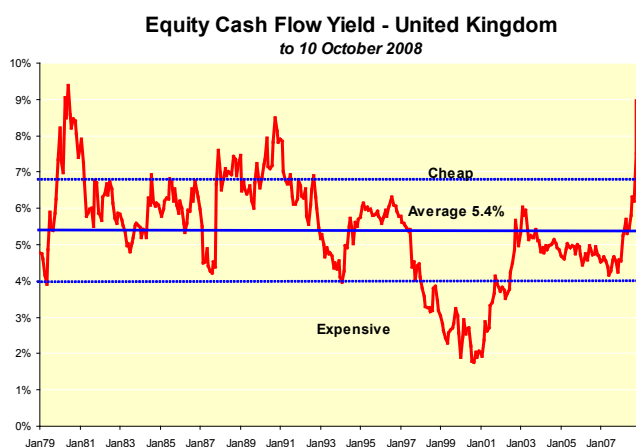
	BONDS					EQUITIES						
	Inflation forecast %	10 yr bond yield		10 yr bond yield		Valuation			Earnings growth		Volatility %	
		Nominal %	Real %	3m chg %	12m chg %	P/E '08 %	ERP* %	Div Yield %	2008 %	2009 %		
US	2.9	3.8	0.9	-0.1	-0.8	S&P 500	13.8	4.1	2.5	-5	-5	48
UK	2.5	4.4	1.9	-0.7	-0.6	FTSE 100	8.8	7.0	5.0	-7	-11	43
Eurozone	2.4	4.0	1.6	-0.6	-0.3	EURO Stoxx 600	9.0	7.1	5.4	2	-15	40
Japan	1.2	1.5	0.3	-0.1	-0.2	Topix	14.2	5.6	2.0	10	-5	34
						Asia ex-Japan	11.8	5.6	4.2	16	10	48

Source: Bloomberg,

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

Global Equities

In times of severe market dislocation, it is important to assess stock market value based on the long term sustainable growth of company earnings. Over time, markets always revert to their average valuation. The chart below shows the cash flow yield for the UK equity market, a reliable measure of value based on 5 year average company cash flows. It shows that the fall in prices over the past year has raised the value of UK



Source:Valu-Trac

equities dramatically, such that the market is now as cheap as at any time in the last 30 years. European and Japanese markets offer similarly extreme levels of value. The US has, for a number of years, been expensive on this measure and also relative to the rest of the world. However, even the US is now on the cheap side of fair value, though it would need to fall a further 30% to reach the same level of value that we find in the other developed markets.

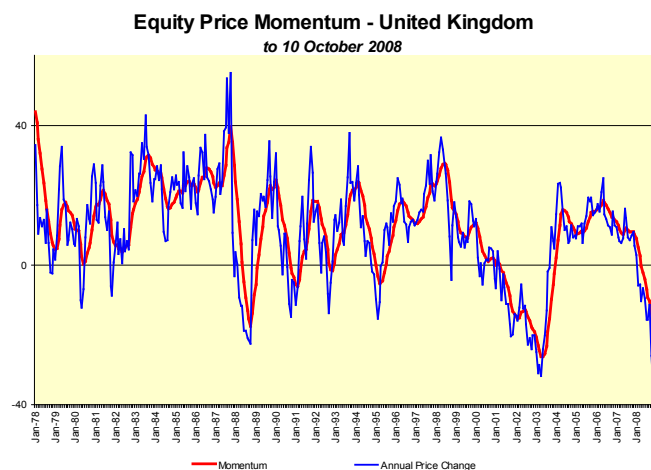
Other measures of value show a similar picture. The fall in UK equity prices has meant that the yield on the FTSE 100 has risen to 6.0%, a full 1.6% more than the yield on a 10 year government bond and the first time since 1965 that equities have offered a yield higher than gilts (see chart overleaf).

Even with UK earnings now expected to fall by 11%

in 2009, the stock market remains attractively valued. By way of comparison, the UK market is now cheaper than it was in 1990, another time of property over-valuation and one that preceded five quarters of negative economic growth.

Historically, the catalyst for a market turnaround has been a cut in interest rates that has typically coincided with a peak in inflation. Inflation around the world has either already peaked or will do so this month in response to the collapse in commodity prices. Central banks in all the major economies (except Japan) have now cut interest rates and the expectation is that further cuts will be made in coming months. This, together with a credible plan to rescue the Western banking system, should underpin stock markets that are, in any case, fundamentally cheap.

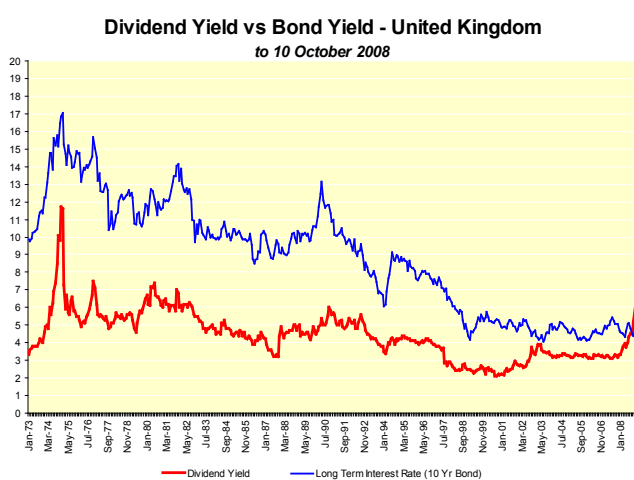
Although it looks as though we could now be at a turning point for equities, risks remain. Normally, we would look for price momentum (the 10 month moving average of the index) to turn up to confirm that a new market trend is in place. The turn in momentum will, by definition, lag the actual market move and, as the chart below shows, we have yet to see any evidence that a sustainable turn has occurred. However, the 12 month change in price (the blue line) is now as extreme as it has been in the past 30 years



Source:Valu-Trac

and provides support to the view that markets are at a low point.

For any rally to be sustained, we need to see inter-bank interest rates fall close to official rates. This will be the evidence that the government guarantees for bank lending truly have restored confidence, in particular amongst the cash-rich banks of Asia and the Middle East. The impact of the financial turmoil on the global economy is impossible to predict, but the



Source:Valu-Trac

chances are that the slowdown will be worse than the mild recession currently predicted by the consensus of economists. This is not necessarily an impediment to a rise in stock market prices though. Historically, bear markets have anticipated a downturn in the economy and a market recovery has occurred in spite of economic weakness.

Our policy now is to be modestly over-weight in equities with an emphasis on Europe and Japan. Japanese equities have weakened over the past month on fears over export weakness as the yen has appreciated and a global slowdown looms. However, we expect that the relative financial stability in Japan along with a focus on high quality manufacturing will allow Japan to weather the downturn better than Western markets.

UK Stock Comments

In the last two months, share valuations have oscillated wildly as sentiment has swung between fear of economic collapse and hopes of revival. Those companies with safe cash flows such as utilities, supermarkets and household goods have become ever more expensive, whilst cyclical companies have been hugely volatile.

We have avoided the temptation to pay high valuations for apparently safe companies, knowing that buying expensive shares does not produce strong relative returns in the medium term. Having previously reduced our exposure to oil and mining into market strength, we added to our mining holdings into market weakness, though we did not anticipate the market collapse in October and this purchase is now showing a loss. With mining companies now trading at only 4 times earnings, we expect a strong recovery in the sector even if commodity prices remain weak.

We are underweight in banks as the outlook for earnings is so uncertain in an environment not only hampered by economic headwinds but also, most likely, by increased regulation and government interference.

Given the uncertain economic outlook we hold a blend of stocks that will benefit from any anticipation of economic recovery (Hays, WPP) as well as stocks that are less cyclical but still attractively valued (Vodafone, Glaxo, Sage). In all cases though, we have ensured that we have companies that have strong balance sheets, robust business models and can withstand an economic slowdown.

Alternative Investments

Commercial Property

Commercial property prices continue to fall at a rate of around 1.0% per month and we have maintained our zero exposure to this asset class. Although property managers try to take comfort from the lack of new development and the prospective shortage of supply as the cycle turns, there is little evidence of any slowdown in the pace of price decline. Interestingly though, quoted property shares have outperformed strongly over the past two months in anticipation that prices will bottom out in 2009. As regards direct commercial property funds, we expect that prices are likely to fall sharply in January as the year end valuations seek to discount the worst. This may prove to be an opportunity to buy in at distressed levels, though we are wary of a further drop in property prices if rental income starts to fall.

Commodities

The fall in commodity prices that we predicted in our last quarterly report has happened with a vengeance, as can be seen in the graph below. We sold our commodity holdings in early August as it became evident that demand for metals was slowing around

the world just as increased production from new mines was coming on stream. Similarly, oil demand has been weakening at an accelerating pace for several months but Saudi Arabia has decided not to reduce shipments, thereby placing further downward pressure on the oil price. A measure of just how weak commodity markets are is the Baltic Dry Index, a measure of shipping contract rates, which has fallen 80% from its high in May this year. A stronger dollar has placed downward pressure on agricultural commodity prices and this is not expected to change in the near term. We will thus maintain a cash position instead of commodities for the time being.

Hedge Funds

Our Valu-Trac hedge fund has been resilient in the face of the equity market turmoil as the fund has maintained a net zero position in equities. The fund is unlikely to move into equity markets until momentum turns up convincingly. The fund is short in bonds, anticipating a rise in yields on the basis that real yields are historically low. In commodities, the fund is long in industrial metals. Importantly, the Valu-Trac fund only invests in financial futures markets rather than individual securities and therefore is not faced with the liquidity problems that have affected many other hedge funds.

Dow Jones AIG Commodity Index
January 2006 - October 2008



Source: Reuters

Asset Allocation For September 2008

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

		Strategic Benchmark			Q3 2008 Tactical weights	Weighting vs Strategic Benchmark
		Min %	Benchmark %	Max %	%	%
Cash		0	0	10	9	+9
Bonds:	UK Government	15	25	35	12	-13
	UK Corporate	0	0	20	8	+8
	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	0	-3
	Hedge funds	0	3	13	4	+1
	Total Alternatives	0	10	15	4	-6
Total			100		100	0

Source: Prospect Wealth Management

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