

Summary

- *The signals are conflicting but economic recovery is underway.*
- *Equity markets are underpinned by positive earnings revisions and positive price momentum.*
- *For clients wishing to take more equity risk through a benchmark change, now is the time to do so.*
- *Bonds are supported by falling inflation - for the moment.*
- *Commercial property prices are stabilising - it will soon be time to move back into property.*

Review of Recent Events

Interest Rates and Currencies

The second quarter saw confidence return to markets as a mix of low interest rates, the recapitalisation of banks and the introduction of government backed loan guarantees finally stabilised the financial system. This is manifested by market interest rates having fallen close to the official rates of 0.5% to 1.0% set by the central banks in all the major economies.

Markets have also been reassured by the determination of central banks to keep longer term borrowing costs down through quantitative easing. The US, UK and Europe have each, in their own way, used new money to buy longer term securities, thereby keeping bond yields down and injecting cash into the banking system.

After the shocking economic performance in the last quarter of 2008 and first quarter of this year, global growth appeared to stabilise in the second quarter. Although unemployment is still rising everywhere and consumer

demand is generally lacklustre, business sentiment has improved as manufacturing is starting to benefit from restocking. Growth in Asia has rebounded particularly strongly thanks to a massive stimulus programme in China and this is promoting a recovery in exports in the US, Japan and UK. As a result, sterling staged a modest recovery from an oversold position in March and appreciated against all the major currencies during the second quarter. Relative to the US dollar, however, sterling remains 26% below the highs seen in October 2007 and is close to its inflation adjusted fair value.

Bonds

After falling to a low of 2.95% in March, UK 10 year government bond yields rose over the quarter as fears of deflation gave way to concerns over inflation. In the event, consumer price inflation in the UK fell progressively, but there remained a worry that by potentially injecting £150bn into the money supply, the Bank of England was creating an inflation problem for the future. In addition, with the budget deficit ballooning from £35bn to £200bn, there were concerns that bond yields would have to rise to attract buyers. As a result, yields moved briefly above 4.0% in early June, until it became apparent that inflation was a very distant threat and with sterling recovering there was ample foreign demand for UK government debt,

**Price momentum is
now trending up - a
buy signal for equities**

July- Aug 2009

so yields stabilised around 3.7%.

Corporate bonds rallied from the extreme lows to which they had fallen in March and produced strong gains over the quarter. The market remained dislocated, however, with some sectors, such as retail issuers performing particularly strongly whilst the financial sector lagged behind. We used this as an opportunity to sell our Tesco bond, which had performed well and switch the proceeds into an HSBC bond. This offered a yield of 6.9%, a 1.8% improvement on the Tesco yield and 3.0% above the equivalent gilt.

Equities

Equities rallied strongly over the quarter as it became apparent that the banking sector was stabilising and the first signs appeared that the pace of economic decline was moderating. The best performing market was Asia, where we had moved overweight in March in the expectation that the Chinese economic stimulus package would boost equities in the region. The Asia fund we purchased is up 30% since then. Of the major markets, the UK produced the lowest return (9.7%) in local currency terms, though after allowing for currency movements it was better than the 6.8% achieved by international markets in sterling terms.

As the economic data became more encouraging, so analysts raised their forecasts for company earnings, reinforcing the positive environment. By the end of May, the recovery in the UK market was sufficiently prolonged for price momentum to turn up after

trending down for almost three years. We took this, together with attractive valuation levels and improving economic and earnings data as a buy signal and moved portfolios 5% overweight in equities relative to bonds.

In the UK market, the best performing sectors over the past quarter have been those that suffered most in the downturn - banks, mining and real estate. Given the risks and volatility in these sectors we maintained market weightings in these sectors, so an overall 0.3% outperformance for the quarter reflected successful stock selection rather than large industry sector bets. Our high risk Alpha portfolio outperformed spectacularly, up 22% this year, recovering past losses.

Alternative Investments

Commercial property prices continued to fall as rents declined further. The IPD property index has fallen 37% from its peak in July 2007, but appears to be bottoming. We had no property exposure over the quarter.

Commodities responded strongly to evidence of Chinese recovery and the copper price rose 26% over the quarter. Oil rose by 41% as OPEC reined in production and expectations of economic recovery boosted demand. Overall, the commodity index rose by 13% over the quarter, much of which we were able to capture through our purchase of a commodity fund in early May.

Our hedge fund exposure was maintained throughout the period, producing a small gain. Strong gains from equities were partially offset by losses on currencies.

Prospect Wealth Management: Performance of Model Portfolios at 30th June 2009

Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	17.6	25.8	FTSE 5-15 years
UK Equity	12 May 2006	-31.7	-28.1	FTSE 100
UK Alpha	12 May 2006	-30.8	-28.0	FTSE 100*
UK Equity Funds	30 June 2006	-28.1	-27.2	FTSE 100
International Equity	30 June 2006	-11.1	-13.0	FT All World ex-UK
Alternatives	30 June 2006	19.7	-10.3	Prospect Composite**

* Adjusted for transition date. ** IPD Property index, DJUBS Commodity index, HFRX Directional index

Total Returns in Local Currency and in Sterling Terms

3 months and 12 months to 30th June 2009

	30 th Jun	Total Return Local		Total Return Sterling	
		3 mths to 30 th Jun %	12 mths to 30 th Jun %	3 mths to 30 th Jun %	12 mths to 30 th Jun %
US dollar	1.66	-13.5	20.4		
Euro	1.18	-8.1	7.5		
Yen	159	-11.0	32.9		
Cash (3m)	Yield %				
USA	0.75	0.3	2.8	-13.2	23.8
UK	0.88	0.4	5.9	0.4	5.9
Euro	1.10	0.4	4.9	-7.7	12.8
Japan	0.39	0.1	0.9	-10.9	34.1
Gov't Bonds (10yr)	Yield %				
USA	3.48	-6.1	8.1	-18.7	30.2
UK	3.61	-2.9	17.8	-2.9	17.8
Germany	3.37	-2.3	15.3	-10.2	23.9
Japan	1.39	0.1	3.6	-11.0	37.6
Equities	Index				
USA	S&P Comp	16.1	-25.5	0.4	-10.3
UK	FTSE 100	9.7	-20.9	9.7	-20.9
Germany	DAX	19.0	-21.2	9.4	-15.3
France	CAC	13.2	-25.3	4.0	-19.7
Spain	SMSI	26.3	-18.2	16.1	-12.0
Italy	BCI Gen	22.4	-29.1	12.5	-23.7
Japan	Topix	20.9	-27.8	7.6	-4.1
Australia	All Ord	13.9	-20.3	14.9	-19.2
Hong Kong	Hang Seng	36.7	-13.7	18.3	4.6
Alternatives	Index				
Commercial Property	IPD		-2.7	-25.6	-2.5
Commodities	DJ UBS	12.5	-46.9	-2.7	-36.1
Hedge Funds	HFRX	8.9	-21.9	-5.8	-6.0

Source: Reuters

Macroeconomic Overview as at 30th June 2009

US	UK	Eurozone	Asia
GDP Growth			
<p>After US GDP contracted for 4 consecutive quarters, the longest downturn since 1947, data show recession ended in May. Durable goods orders rose 1.8% (-0.9% expected) including capital goods orders up 9.5%. Inventory declines mean Q3 production should rise. Consensus for 2010 GDP growth has leapt to +1.6% from -1.9% in March. However, consumer recovery will be weak in face of rising unemployment and latest weak confidence data support this. Overall recovery likely to be a long drawn out process.</p>	<p>Q1 GDP fell 2.4% qoq, worst since 1974. Weakest sectors were construction and manufacturing, both down 4.9%. Retail sales holding up well as low interest rates and inflation offset rising unemployment. Industrial production should be boosted in Q3 by re-stocking as inventories have been run down and by weakness of sterling. Managers' sentiment has improved sharply. House price decline is slowing; mortgage approvals now at 10 month high.</p>	<p>ECB sees recovery starting Q2 2010 after a record -2.5% fall in GDP in Q1. Eurozone purchasing manager surveys show business confidence has been improving since March on expectations of US demand recovery. May industrial production up for first time since August '08 showing the €85 bn German stimulus package is working.</p>	<p>Japan: after 3.8% decline in GDP in Q1, growth expected to be +0.4% in Q2. Government handouts have boosted confidence and household spending, though retail sales still fell 2.8% in May for 19th consecutive decline. Business confidence now improving sharply as exports to Asia recover.</p> <p>China: economic growth hit a low in Q1 of 6.1%, but saw recovery in Q2 with 7.9% growth. Further acceleration expected over balance of year.</p>
Employment			
<p>Unemployment at 9.5% in June, 26 year high. Job creation from the \$38 bn of infrastructure spend within the \$787 bn stimulus package is gaining momentum, Obama added \$6bn to unemployment benefits and plans to create 4m jobs in 2 years in public infrastructure and alternative energy, essential to revive consumer spending.</p>	<p>Unemployment has risen to 7.6% for the three months to May, the highest level since 1981. The rate is rising, but is still lower than in the US or in the Eurozone. Earnings excluding bonuses grew by 2.6%, slowest since 2001, but in line with inflation.</p>	<p>Eurozone unemployment rate rose to 9.5% in May, worst for 10 years. Spain is worst in region, at 18%. Austria and Netherlands are best, at 4.2% and 4.5%. German unemployment is set to hit 8.7% this year and to peak at 11.6% in 2010.</p>	<p>Japan: Unemployment at 5.2%, up from 3.8% low last November. Jobs per applicant ratio worst since 1961, so unlikely to improve soon</p> <p>China: Jobless % understated as redundant temporary workers not counted in labour force. Unemployment rising rapidly in export zones.</p>
Inflation			
<p>Core inflation remains subdued at 1.7%. Bernanke says recession easing and thus deflation is less of a threat. Fed voted not to increase its \$1.75 trillion asset purchase program but will wait for signs of effect before announcing an exit strategy. Expect dollar to remain weak as policy makers encourage exports. No threat of higher inflation in the short term.</p>	<p>CPI fell below Bank of England target to 1.8% in June, down from 5.2% last September. B of E has, like US, stopped quantitative easing for the moment to assess it's impact on the economy. Inflation trend is down for now and it appears that newly printed money is not entering the economy as the banks are hoarding the cash - unlike US & Europe.</p>	<p>Eurozone consumer price inflation turned negative in June, with fall of -0.1%, compared to inflation target of 2.0%. Lower food and energy prices explain the fall and there is little sign of a pick up in the short term. European Central Bank is attempting to boost money supply by buying bonds and other measures.</p>	<p>Japan: Falling utility prices, transport and phone charges, and year on year commodity price falls, have pushed Japan back into deflation. Wholesale prices fell 6.6% even though demand is rising. Yen set to weaken as money flows into Emerging Markets</p> <p>China: inflation remains low and interest rates have not been put up despite incipient recovery. Bank of China is tightening lending constraints to gradually rein in loose monetary policy.</p>
Balance of Payments			
<p>US balance of payments continues to improve as exports respond to demand from Asia. This will continue to reduce inventories and help manufacturing to recover.</p>	<p>Trade balance has started to improve with the May deficit the lowest for three years. Imports have fallen faster than exports, supported by the weakness of sterling. Outlook is for further improvements as export surveys are favourable.</p>	<p>Eurozone balance of payments has turned negative as the euro has strengthened against US dollar and sterling. Reflected in weakness in European economic growth as export oriented Germany now struggling. Outlook is for further deterioration.</p>	<p>Japan: exports down 44% in May and trade balance down 22% as strong yen stifles exports. Recovery expected in H2 this year.</p> <p>China: continues to run huge balance of payments surplus. has recently stopped the appreciation of the yuan currency, but will have to resume a stronger currency policy to address global imbalances.</p>

Economic Forecasts as at 30 June 2009

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2009 %	2010 %	2009 %	2010 %	2009 %	2010 %	2009 %	Nominal %	Real %	2009 %
US	-2.8	1.6	9.5	10.5	-1.4	2.2	-13.5	0.25	1.65	-3.1
UK	-3.7	1.1	7.7	8.5	1.7	2.3	-14.0	0.5	-1.2	-1.5
Eurozone	-4.4	0.6	9.5	10.5	0.4	1.2	-5.8	1.0	0.6	-1.0
Japan	-6.1	1.0	5.0	6.0	-1.1	1.0	-6.8	0.1	1.2	1.0
China	7.2	7.6	5.0	5.5	-0.5	1.5	-4.0	5.3	5.8	7.4

Source: The Economist and Bloomberg

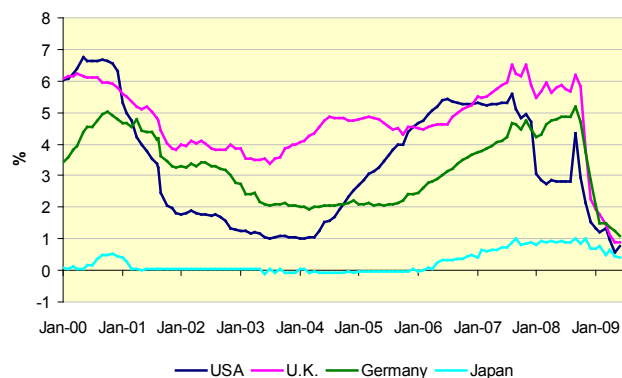
Market Outlook

Interest Rates & Currencies

The decline in global industrial output to the end of March was similar in pattern and magnitude to that of the Great Depression in the 1930's. What is different today though, is the response from governments and central banks. In the '30's, interest rates did not fall below 3%, yet now we have official rates in all the major economies below 1.0%. In the '30's, money supply collapsed, yet now it is growing strongly in the US, UK, Europe and Japan. Finally, government spending in the US in the '30's remained below 4% of gross domestic product. This year, we expect the government deficit to reach a massive 14% of GDP in both the US and UK.

These unprecedentedly aggressive policies do appear to have stabilised the global financial system and economy for now. Forward looking indicators of business confidence are uniformly positive in all the major economies. Industrial production has picked up in the US and exports are underpinned by the strength of demand from resurgent Asian economies. This is particularly so in the UK, where exporters have

3 Month Interest Rates
January 2000 - June 2009



Source: Reuters

benefited from the 20% depreciation in sterling against the dollar over the past 18 months. Despite the rapid rise in unemployment around the world, consumer spending has held up reasonably well as low interest rates and inflation, combined with tax cuts have boosted disposable income.

The hope now is that a process of stock replenishment and new investment will encourage growth, allowing governments to withdraw their stimulus and reduce their debt levels. The risk of doing this too soon and killing the nascent recovery, as Japan did in the 1990's, is only too well understood. For this reason, we expect that interest rates will remain at current low levels for a prolonged period.

The key risk is that banks will be unwilling to provide sufficient credit to support the recovery, in spite of the central banks' efforts to provide liquidity through quantitative easing. There are encouraging signs in the US and UK that banks are again prepared to take on risk, for example, with the rescue of the medium sized US bank, CIT. However, credit growth overall remains weak and we must expect that recovery will be a slow process.

Sterling has moved back above its long term equilibrium against the US dollar, as the chart opposite shows. The Bank of England is likely to want to maintain the competitiveness of sterling, to support an export led recovery, so we see limited scope for sterling to rise further in the short term.

UK Bonds

Over the next quarter, two key influences are likely to support the gilt market. Inflation is likely to fall further, as unemployment places downward pressure on wages, and the Bank of England is likely to extend its purchase of UK bonds under the quantitative easing programme, beyond the £125 billion already purchased.



In the medium term, however, we expect yields will rise as the Bank sells its bond holdings to withdraw the excess monetary stimulus and as the economic recovery raises expectations for higher inflation. The table below shows that the real bond yield in the UK of just 0.3% is well below the long term average of 2.0%, making gilts unattractive on valuation grounds. We are therefore maintaining an underweighting in gilts.

Corporate bonds remain relatively attractive even though yields have fallen from the extreme levels seen in March. The financial sector, where much of our exposure is positioned, is particularly cheap and offers considerable scope for price appreciation as company earnings improve and the risk of default fades. We will therefore maintain our corporate bond position and reduce gilt holdings in the event we raise our allocation to equities.

Measures of Market Valuation

As at 30 June	BONDS				
	Inflation forecast %	10 yr bond yield		10 yr bond yield	
		Nominal %	Real %	3m chg %	12m chg %
US	2.8	3.5	0.7	0.8	-0.5
UK	3.3	3.6	0.3	0.5	-1.5
Eurozone	1.6	3.4	1.8	0.4	-1.3
Japan	1.9	1.4	-0.5	0	-0.2

	EQUITIES					
	Valuation			Earnings growth		Volatility
	P/E '09 %	ERP* %	Div Yield %	2009 %	2010 %	%
S&P 500	15.5	3.0	2.8	-12	25	13
FTSE 100	13.5	3.8	5.3	-35	22	21
EURO Stoxx 600	13.0	4.3	4.6	-10	25	21
Topix (Japan)	39.4	1.1	1.8	-65	60	29
Asia ex-Japan	16.7	2.5	3.3	-10	22	14

Source: Bloomberg, Nomura

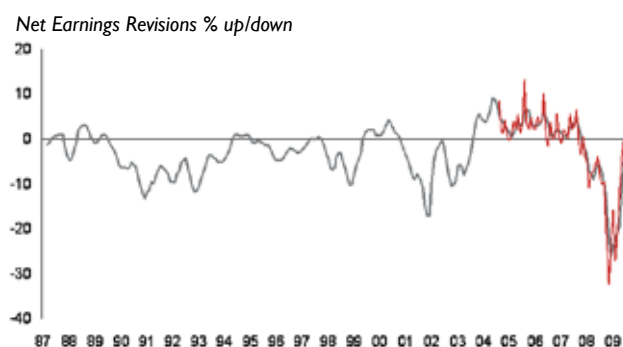
* Equity Risk Premium = (earnings / price) * 100 - 10yr bond yield

The inflation forecast is the average of the past 5 years' inflation.

Global Equities

Pacific Basin markets have been propelled steadily upwards from the low point in March as the aggressive Chinese stimulus package was seen to be delivering renewed growth. Western markets, in contrast, have oscillated within a narrow range as investors struggle with conflicting economic evidence. This is likely to continue for some months as the indebted consumer faces rising unemployment and may want to reduce borrowings rather than spend, especially as bank finance is still hard to come by. Offsetting this is a recovery in business confidence as exports stabilise

World Earnings Revisions Balance



and companies anticipate the rebuilding of depleted inventories.

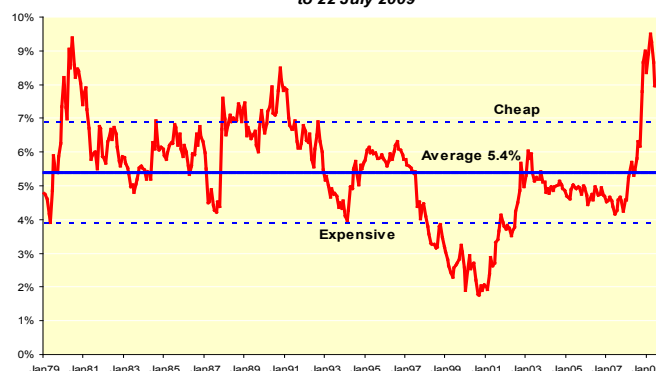
Despite these conflicting influences, Western stock markets still have the potential to rally from current levels. Share prices are primarily driven by expectations for interest rates and company earnings and the trends for both are positive for equities. Interest rates in all the major economies should remain low and stable, which is supportive of valuations. Company earnings, as can be seen from the table on the previous page, are expected to recover in 2010 from the depressed levels expected for the current year. This is despite expectations for overall economic growth being insipid in 2010. The latest earnings reported in the US for the second quarter of

this year have been better than expected and, as the graph opposite demonstrates, forecasts for company earnings worldwide are being revised sharply upwards. Streamlined operations, lower borrowing costs and the return of pricing power, mean that companies can restore profitability despite lower revenues.

The question for medium term economic growth is whether the private sector can restore profitability fast enough to be able to pick up the slack that must inevitably come from lower government spending in coming years. In the 1980's the solution to a similar conundrum was "supply side economics", meaning deregulation and lower taxes to stimulate private enterprise. The result was a long bull market for equities. Now, however, the talk is of greater regulation and higher taxes, which would constrain the upside potential for equities. Other outcomes are possible though: talk of increased regulation may fizzle out and other solutions to the debt problem, such as swapping debt for equity or a return to a gold standard may be preferred to higher taxes.

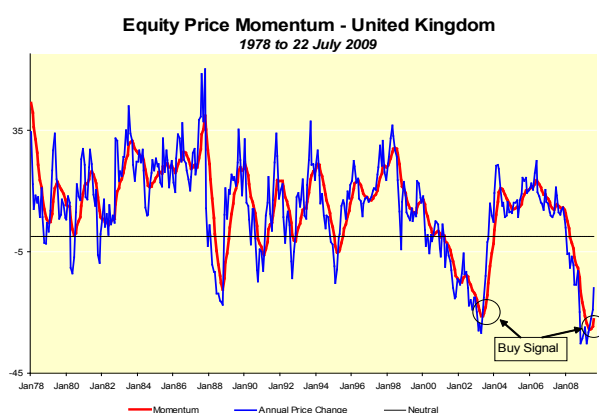
Whilst expectations for future company earnings are improving, our measure of market value, cash flow yield, which is based on latest earnings data, looks less attractive now than it did three months ago. The fall in company earnings in 2008/09 combined with the rally in stock markets over the past quarter has meant

Equity Cash Flow Yield - United Kingdom to 22 July 2009



market valuations are not as cheap as they have been. As the chart on the previous page shows, the UK cash flow yield has fallen from 9.5% to 7.6%, though even at this level it is still very cheap. Europe offers similarly attractive value. Hong Kong, in contrast, has had a huge correction, with value falling from a peak of 10% to 4.6% currently, at which level it is starting to look expensive. This is not surprising, considering the market has risen by 75% since the low in March. As a result we are now looking to take profits on our overweight position in Asia.

Company earnings growth and valuation in some markets are thus extremely positive for equities. However, the most bullish indicator is momentum. The chart below shows that the 12 month moving average of UK equity prices has now turned convincingly up. Historically this has been a good indicator that a new



Source: Valu-Trac

trend has been established and raises our confidence that this is a good time to be moving overweight both in UK equities and in equities as an asset class in general.

In summary, whilst we recognise the medium term economic challenges posed by government indebtedness, in the short term the indicators are increasingly favourable for equities and we consider this a good time to be moving overweight.

UK Stock Comments

The rally of the last quarter benefited the cyclical stocks, the retail sector (which typically performs well in the early stages of a recovery) and those sectors that had been oversold, such as the financials.

Given our contrarian style of investing, we had exposure to a number of cyclical stocks and benefited from their recovery. Invensys, the provider of industrial controls, for example, outperformed by 27% and we took profits on the holding towards the end of the quarter. Hays, the recruitment specialist, was another cyclical company that outperformed over the quarter, providing the opportunity to sell as the price ran ahead of the deteriorating outlook for recruitment.

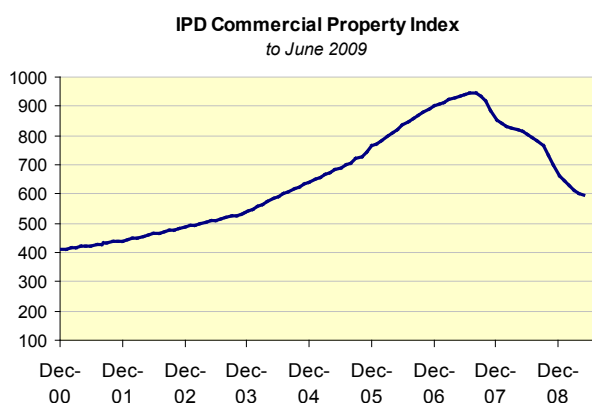
The banking sector produced some of the strongest gains over the past quarter as several of the banks recovered from the threat of insolvency. Earnings at the banks remain highly unpredictable as the level of writeoffs due in the next two years are unknown. For this reason, we have maintained a market neutral position on the sector until there is greater clarity over the future.

The recent market volatility is throwing up opportunities to make adjustments to portfolios with a view to enhancing performance. As cyclical stocks have outperformed, many have become expensive and it is now some of the more defensive companies that have become cheap in spite of offering attractive growth potential. We recently added Morrisons, the supermarket chain, to the portfolio as it was as cheap as it has been for many years whilst still offering earnings growth of 15% over the next two years. Cable and Wireless, the telecoms company, bought in June, is a similar example.

Alternative Investments

Commercial Property

The graph below shows that the rate of decline in commercial property prices is now moderating. With yields on high quality commercial property at around 8.5%, comparable to the trough in the last property downturn, activity is beginning to pick up. There have been several successful new issues to raise cash for speculative development (Development Securities raised £100m), which points to a stabilisation in the market and opportunity for the future. We are now poised to invest again in a suitable property fund.



Source: IPD

Commodities

Commodity prices have turned up from the recent cyclical low, as the chart opposite shows and are likely to move higher as economic recovery becomes more firmly established.

There are signs of the El Nino weather phenomenon developing over the next 12 months and if this transpires then it should produce higher agricultural prices as it leads to drought in the Southern Hemisphere. It also implies fewer hurricanes in the Gulf of Mexico, which would encourage lower oil

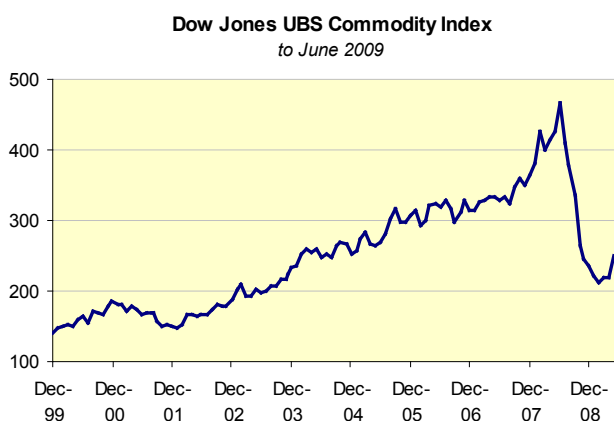
prices. In the short term, high levels of oil stocks and lower OPEC production should cap oil prices at around \$70 per barrel, slightly above the current level. Base metals prices have moved sharply higher in the last two months as China has rebuilt stockpiles. The supply and demand fundamentals for metals appear robust as mine investment has been cut back during the recession, yet now demand from Asia is again expanding. We therefore expect to maintain our holding in the Schroder commodity fund.

Hedge Funds

Our Valu-Trac hedge fund has proved adept at navigating the storms of the past 18 months, giving us confidence that their systematic approach to taking both long and short positions in all the major markets, based on value and momentum indicators, will bear fruit in the future.

At present, they have an overweight position in UK equities, are long gold, short bonds and short the US dollar currency.

Matthew Hunt 0207 413 2790



Source: Reuters

Asset Allocation For July 2009

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

		Strategic Benchmark			Q3 2009 Tactical weights %	Weighting vs Strategic Benchmark %
		Min %	Benchmark %	Max %		
Cash		0	0	10	3	+3
Bonds:	UK Government	15	25	35	8	-17
	UK Corporate	0	0	20	12	+12
	Total Bonds	15	25	35	20	-5
Equities:	UK	35	45	55	49	+4
	US	0	10	20	10	0
	Europe (ex UK)	0	4	14	6	+2
	Japan	0	2	12	2	0
	Asia / Emerging	0	4	12	3	-1
	Total Equities	55	65	75	70	+5
Alternatives:	Property	0	4	14	0	-4
	Commodities	0	3	13	3	0
	Hedge funds	0	3	13	4	+1
	Total Alternatives	0	10	15	7	-3
Total			100		100	0

Source: Prospect Wealth Management

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