



- Equity markets appear to have stabilised in recent weeks but we anticipate further downside.
- Economic news has been mixed and the impact of government retrenchment has yet to be felt.
- Bond markets offer little value at current yields and we remain underweight.
- Equity investment is positioned close to benchmark weightings to reflect current uncertainty.

Mixed Results

The last month has certainly met our expectations for an increased level of volatility over the summer months. Equities weakened in May but have recovered modestly so far in June even though the economic news from around the world has been mixed. The best performing asset class over the past month has been bonds. A flight to safety from the highly indebted markets of Greece, Spain and Portugal to the apparently safer UK, US and German bond markets, meant that yields on 10 year gilts fell from 3.9% to 3.5%, producing a total return of 3.0%. The return from commercial property, as represented by the IPD index, has been slowing in recent months, though it remained positive in May. Our Valu-Trac hedge fund also produced a positive return, up 3.2%, moving against the trend in the hedge fund market. By contrast, commodities continued to move in the same direction as equities and have offered little diversification benefit this quarter.

Stagflation Revisited?

Our bond investments have been positioned cautiously and have lagged behind the benchmark in the recent rally. Our fear has been that inflation would prove to be more persistent than the Bank of England has been predicting, as economic recovery leads to supply bottlenecks. The support for this view has been mixed of late. Consumer price inflation did moderate a little last month, falling from 3.7% to 3.4%. However, inflation expectations in the UK rose to 3.3% in May, a sharp increase on April's 2.5% and wage growth rose by 1.2% in the first quarter, the fastest for a year. Record low interest rates, quantitative easing and weak sterling could pose an inflation risk that is not reflected in 10 year bond yields of only 3.5%.

Other data have been moderately encouraging for the UK economy. Manufacturers continue to benefit from the weak pound and May retail sales were up a better than expected 3%. Of course, we have yet to see what impact the impending cut-back in government spending will have and whether

there is enough growth in the private sector to compensate for losses in the public sector.

In the US, the economic news has been less encouraging.

Total Returns in Local Currency

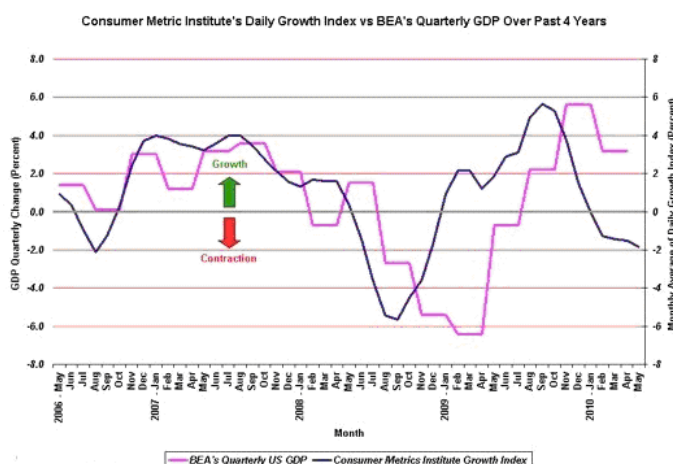
Last month and last 12 months

		Total Return for Market	
		1 month to 30 May %	12 months to 30 May %
Currencies v £	Rate		
US dollar	1.454	5.0	11.3
Euro	1.181	-2.8	-3.2
Yen	133	8.0	16.3
Cash (3m)	Yield %		
USA	0.45	0.0	0.6
UK	0.49	0.0	0.9
Euro	0.46	0.0	1.3
Japan	0.13	0.0	0.5
Bonds (10yr)	Yield %		
USA	3.30	3.3	4.9
UK	3.59	3.0	5.0
Germany	2.65	3.0	12.0
Japan	1.27	0.3	3.6
Equities	Index		
USA	S&P Comp	-8.0	21.4
UK	FTSE 100	-6.1	21.8
Germany	DAX	-2.5	25.1
France	CAC	-7.8	11.4
Spain	SMSI	-10.6	6.0
Italy	BCI Gen	-9.1	5.9
Japan	Topix	-10.7	0.3
Australia	All Ord	-7.5	24.5
Hong Kong	Hang Seng	-6.1	12.4
Alternatives	Index		
Property	IPD	1.4	22.7
Commodities	DJ UBS	-6.9	0.5
Hedge Funds	HFR	-2.6	17.2

Source: Reuters

June 2010

Growth in employment stalled in May and retail sales dropped for the first time in 7 months. Another measure of consumer sentiment, the Consumer Metric Institute Daily Growth Index, has also fallen sharply recently. As the graph below shows, this has been a good leading indicator of overall gross domestic product growth and points to a marked slowdown in the third quarter of this year.



Source: Consumer Metric Institute

Other indicators, however, such as surveys of industrial activity, have been more upbeat. Overall, the future economic direction is more than usually unclear. Are we just facing a short hiatus as re-stocking comes to an end but before new investment in extra capacity begins? Alternatively, is this the start of a more protracted downturn exacerbated by retrenchment in government spending? Politicians are painfully aware of the balancing act they must perform to reduce debt without destroying growth, but there are no guarantees they will succeed.

Equity Exposure Reduced

In recognition of these risks and with equity price momentum starting to decline in a typical 'sell' signal (see last month's newsletter), we reduced our equity exposure in May from overweight back to a position close to that of the benchmark. This has created a dilemma. Bonds are currently unattractive as the real yield (i.e. after inflation) is 0%, well below the long term average of 2.0%. The graph opposite shows how expensive gilts

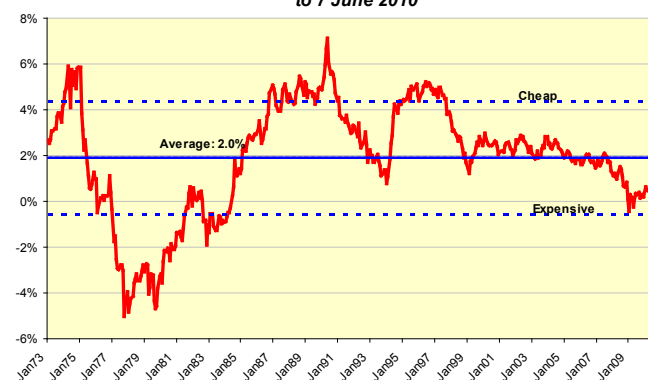
are. Alternatives, such as property and commodities, are also unattractively priced so we are holding unusually high levels of cash in anticipation of both bond and equity market weakness presenting better buying opportunities in the coming months.

BP

One such opportunity has arisen for our higher risk Alpha portfolio with the collapse in the BP share price. Now that there appears to be a lessening in the political pressure on the company with the agreement to establish a \$20bn escrow account to cover legitimate claims, there is scope for a recovery in the share price, assuming that the well is capped in the next 6 weeks. Total costs of the disaster are generally estimated to be in the region of \$35bn, which is a manageable sum for a company with assets in excess of \$200bn and cash flow estimated this year at \$70bn. If the costs are correct, then the shares should be valued at closer to 600p rather than the 350p they are currently trading at. Clearly, the risk remains that penalties may be higher than expected or that the spill will not be controlled, but on present expectations the stock is one of the cheapest in our valuation model.

Matthew Hunt

Real Yield - UK Government Bonds to 7 June 2010



Source:Valu-Trac

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