

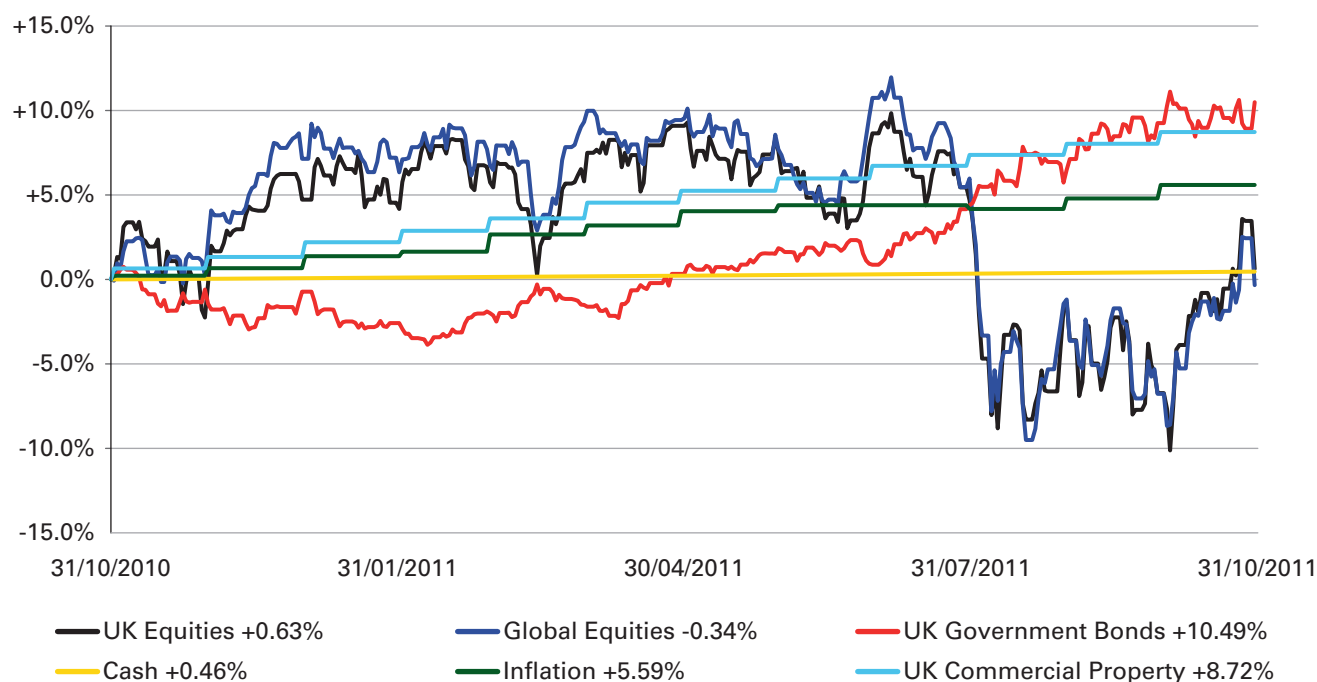
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT OCTOBER 2011

Headlines

- Global equity markets rallied sharply after a period of weakness.
- Fixed interest markets also rose but with corporate bonds leading the way as investors became less risk-averse.
- Property values overall were unchanged but this masked a divergence between solid returns for prime properties but weakness for secondary assets.
- Sterling rallied against the US dollar and yen but eased slightly against the euro.

Investment market returns over the past year



Sources: Bloomberg, IPD, FTSE All-Share Total Return Index, FTSE All-World Total Return Index, FTSE UK Govt All-Stocks Total Return Index, IPD Monthly Total Return Index*, 7 day LIBID, Retail Price Index* (*Lagged by 1 month).

Market review

Global equity markets rallied strongly over the month, although profit taking in the final few days pulled prices back from the very best levels. Having fallen back in recent months equity investment markets had become very oversold and moved higher as hopes grew of progress in addressing the many issues troubling investors. The FTSE All-World Index rose by +6.90% to a sterling based investor, a good increase but not one sufficient to turn the return for the year to date positive, it remained substantially negative at -6.98%. Almost all the regional markets rose, the exception was Japan where the translation effect of a weak yen turned a modest local currency gain negative (-3.78%). The US indices rose by +7.08%, Europe by +8.36% and Asia by +9.04%. Most European markets rose but Greece weakened again, by 5.14%, to bring the total return for 2011 to date to -49.46%. The UK broadly kept pace with its peers. The FTSE All-Share Index rose by +7.89%, the largest companies rose slightly more (+8.20%) but small companies barely moved, reflecting the liquidity driven nature of the rally and the difficulties of dealing in this segment of the market.

Fixed interest markets rose with government bonds supported by the new quantitative easing initiative by the Bank of England. In contrast to September, when lower rated corporate bonds declined, in October they enjoyed support from investors seeking the higher income available. The FTSE Government All Stocks Index gave a return of +1.13%, the iBoxx Sterling Non-Gilts BBB Index returned +2.53%.

Transaction volumes in the property sector began to improve from the very quiet levels experienced in recent months but there was no change in the dominant sector trends. Good quality properties supported by high and secure yields remained in strong demand, sufficiently so in the London office sector to push prices higher. Secondary properties however remained friendless and there was continued downward pressure on prices as well as rents.

In currency markets sterling rallied against the dollar and yen by +3.23% and 4.73% respectively but slipped slightly against a strengthened euro.

Economic developments

The catalysts for the rally in equity prices were the proposals to stabilise the financial position in Euroland. At the headline level the proposals went further than many thought likely: a 50% 'haircut' for holders of Greek bonds, realistic minimum capital levels for Euroland banks and a massive increase in the stability fund. Taken together these indicated a level of resolve and resource commitment which had been missing in the crisis to date, the proposals therefore had a credibility that past promises had lacked. Equity investors reacted positively and pushed prices higher over several days, before giving back some of the gains to profit taking towards the end of the month. Even the most supportive commentators noted however that the proposals lacked detail and so still contained substantial delivery risks, not least of achieving all the necessary agreements in a timescale that matched the urgency of the situation. The delivery risks came to the fore with the announcement by Mr Papandreou, the Greek Prime Minister, that he would call a referendum on the rescue terms or whether Greece should remain in the euro, to be held later this year or early in 2012. This unnerved investment markets because of the uncertainties and delays it created for a programme which was, even on optimistic assumptions, far from risk free. The threats extend beyond Greece itself; a key feature of the programme was an enlarged financial stability facility, sufficient to support the Spanish and Italian bond markets whilst those governments enacted needed reforms. If the deal is less certain then attention will focus again on areas of perceived vulnerability – particularly Italy, where a weak government had made no progress in delivering the serial promises it has made.

Within Europe estimates for economic growth were reduced significantly. Activity has been lacklustre for several months but has fallen away recently due in part to the uncertainties created by the crisis. A particular problem has been credit shortages as banks have become both less willing and less able to lend. With a new head of the ECB from 1st November an immediate cut in Euroland interest rates is a clear possibility.

In the UK, estimates of economic growth in the second quarter were revised down to just +0.1% but early estimates for quarter three emerged at +0.5%, above most forecasts. Probably the best way to view the position is to consider the two periods together, which gives an average of +0.3% per quarter and suggests an economy which is expanding but only at a very modest rate. This is unlikely to improve in the near future; leading indicators based on October data suggest that there will be no uptick in the final three months of the year. Other data released in the month were consistent with the sober economic background. Unemployment rose again, to 8.1% of the workforce, as public sector job losses continued whilst inflation increased due mainly to higher heating costs entering the comparisons. On the CPI basis the rate of increase in prices was 5.2%, the RPI rose by 5.6%. We expect inflation to peak at near current levels and then to decline in the New Year. Against this dull backcloth the Bank of England has announced an extension of the Quantitative Easing programme, earmarking £75 billion to be spent over the next four months. There is no magic to this number or timeframe, if the outlook remains dull then there is a good chance that the programme will be extended - the objective is to stimulate activity, not to spend a pre-determined amount of cash.

Elsewhere other data highlighted the differences between the performances of the developed and emerging economies. The USA saw activity levels rise at an annual 2.5% rate, but only because of an unsustainable cut in consumer savings rates, actual consumer income fell by almost 2% in the period. In contrast China grew by 9.1%, which was the lowest quarterly rate of expansion for two years.

Outlook

The fragile improvement in confidence that resulted from the Euroland summit has been broken by the Greek call for a referendum which, at the very least increases something that investment markets already had far too much of – uncertainty. It is not impossible that the eventual outcome is positive – a fresh mandate for the government in Greece and action by countries such as Italy which have been unwilling or unable to act up until now, but this will take time to emerge and until then we must expect volatility to stay high.

Given recent events we should expect forecasts of economic growth to reduce in the next few weeks as analysts publish their revised expectations for 2013. This is disappointing but is not a new concern for investment markets which have factored in lower growth over the past few months. The UK is expected to grow by just 1% next year, in current circumstances Europe will grow less. We expect inflation to ease and interest rates to stay at current levels - for some time to come.

Uncertainty and growth fears could act to support prices in the fixed income market but we regard this sector as substantially over-valued. We do not expect any capital growth from the property sector, indeed there is a small risk of erosion in some areas, but high income flows mean the sector will stay attractive to income seeking investors. We remain long term buyers of equities. They are priced at levels which discount both a weaker economy and falling profits and which ignore low valuations and long term profit growth potential.

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