

CCLA INVESTMENT MANAGEMENT LTD

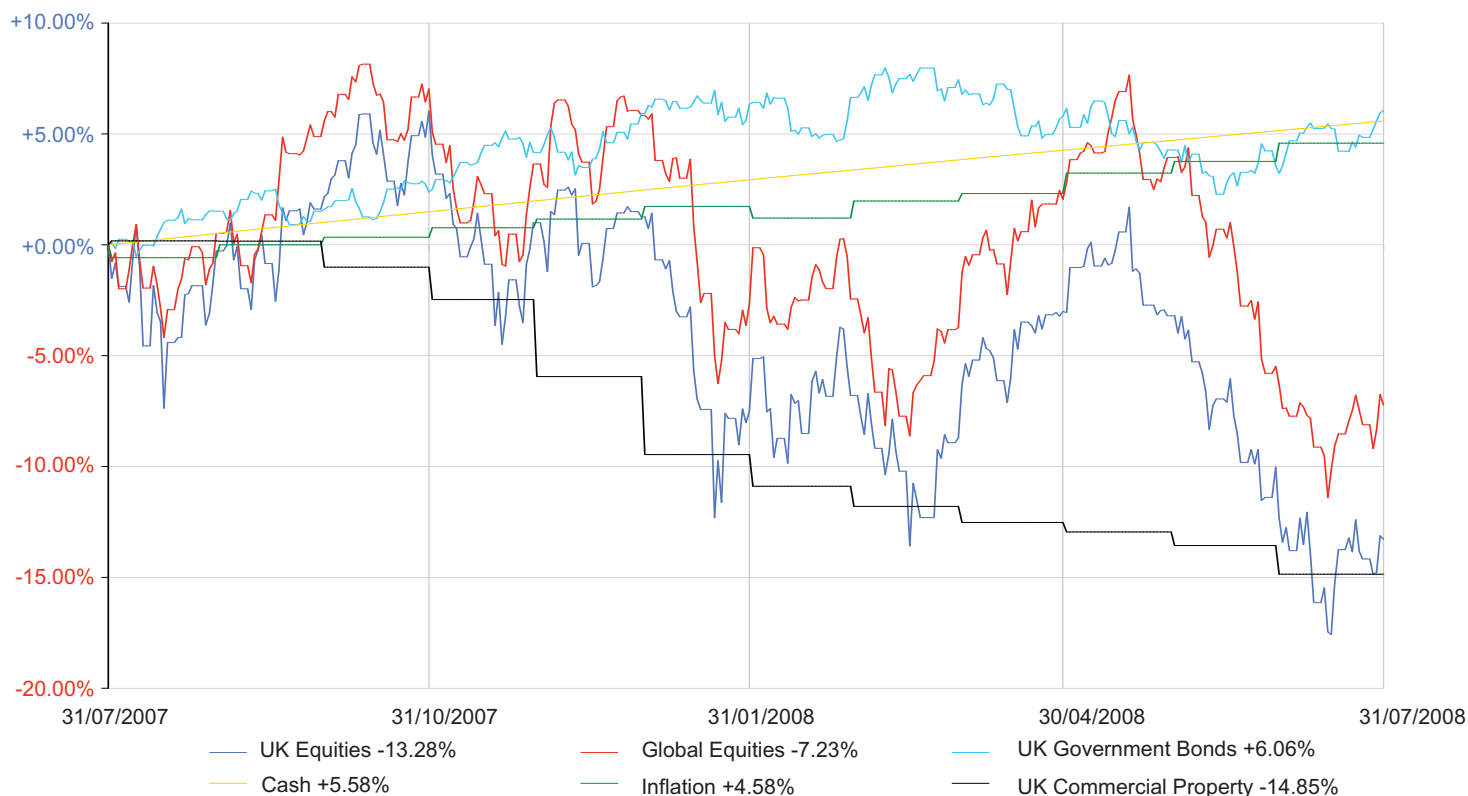
MARKET REPORT AUGUST 2008

Summary

- Trends in the economy continued to dominate investor sentiment but with inflationary fears being replaced by concerns over growth prospects.
- Equity markets eased back over the month but not at the pace seen in June.
- Bond markets rallied.
- Commercial property prices fell back.

Market returns - 1 year

Review



Source Bloomberg: FTSE All-Share Index, FTSE All-World Index, UK Govt All-Stocks Index, 7 Day Libid, RPI, IPD UK All Property Index

Equity markets fell back again in July but not at the pace seen in June. Once again sentiment was under pressure from economic trends but there was an important change of emphasis with inflationary concerns fading and worries about the risks of recession coming to the fore. Although far from a positive for investors, recession has been seen as by far the lesser of the two evils when compared to the risk of inflation or stagflation. With recession, interest rates can fall but in an inflationary environment the pressure on rates is upwards, to head off the inflationary threat. Given the frail state of the global financial system and the growing pressures on consumer spending, higher interest rates would make a difficult position worse.

To a UK investor the FTSE World Index returned -1.85% for the month to give a twelve month return of -7.23%. The UK market was weaker and returned -3.60% as measured by the FTSE All Share Index. Large companies performed similarly, with the FTSE 100 Index lower by 3.69% but smaller companies were worse. The sector declined by -4.47% and is now 35.45% lower than it was twelve months ago. The trends in international markets were similar. In Japan the return was -2.92%, in Asia -1.88%, in Europe -1.80%. Interestingly the United States, at the centre of the credit crisis and the area where the economy is showing most signs of falling growth rates, performed best and declined by just 0.34%. As ever the range between the best and worst performing markets was wide although there were few that showed substantial positive returns. The Philippines returned +10.50%, Pakistan -16.24%. There were notable casualties in Europe too, Norway, which rose strongly last month on a strong oil price, followed the price of crude lower and returned -9.30%. Ireland was also weak (-19.00%) as concerns grow about economic prospects. Whilst the trend in equity markets was overwhelmingly weaker, bond returns were positive with the lowest risk and shortest dated issues giving the best performance. Sterling rallied against Yen and Euro but slipped back relative to the US dollar. Commercial property values

were marked down again but in an environment of very subdued trading activity. Evidence continued to mount that rental growth rates were slowing and in extreme cases, moving into reverse.

Economic data was once again consistent with a reducing rate of expansion. Housing data from the US and the UK continued to be bleak, with falling prices and increased stocks of unsold properties. At the moment the sector is being squeezed by reduced loan availability and higher loan costs, the combined effects of which are that, although house prices are lower, they are not more affordable. Housing markets have become extended in many more countries and several of these are seeing prices fall back, Ireland and Spain lead the list but trends are weakening in France too.

Industrial production declined in Europe by 1.9% with all countries suffering. An important contributory factor was the strength of the Euro which reduced competitiveness in international markets. Currency strength however could not be blamed in the UK but nevertheless output declined here too. In Japan the jobless total rose to 4.1%, a 4¹/₂ year high, lacklustre domestic demand and a sharp fall in exports prompted the government to accept the risk of a short term recession whilst maintaining forecasts of growth for the year as a whole.

Although fears of inflation reduced, the pressure of past increases continued to be reflected in data. UK factory gate inflation rose above 10% for the first time in twenty years, pushed partly by fuel and raw material costs which were 30% higher. Eurozone inflation also rose to a new high with one result an increase in official interest rates, although the ECB, already suffering political pressure, was quick to point out that the move was not necessarily the start of a trend.

Many commodity prices in fact declined sharply over the month, as expectations of future consumption growth fell and speculative activity reduced. As it had on the way up, oil took the headlines on the way down with crude prices down \$25 per barrel, 17% below the peak. But oil was not the only price to fall and the CRB index gave up half the increase gained so far this year.

In markets the main focus was once again on the Financial Sector and in particular on its troubles. In the United States there was a crisis of confidence in Fannie Mae and Freddie Mac, two agencies which underwrite many of the mortgages issued in that market. Merrill Lynch, just weeks after interim results, announced further write-downs of its loan book, a fund raising of \$8.5 billion from the issue of new shares and the sale of over \$11 billion of credit exposures, much at very depressed prices. Two regional banks were forced to close. The news was poor in the UK too as the HBOS rights issue failed to attract shareholder support with 92% left with the underwriters. Bradford & Bingley tried again to raise funds after two previous deals fell through whilst Alliance & Leicester accepted a takeover approach from Santander, just seven months after refusing an approach at twice the price level.

Not all the news was poor however. A particularly encouraging development was the increased volume of bid activity as InBev bid for US brewer Anheuser-Busch, BA began talks with Iberia, WPP approached Taylor Nelson Sofres, interest was renewed in Yahoo and Continental Tyre entered takeover discussions. Corporate activity such as this is evidence that increasingly depressed share prices are seen as offering good value longer term opportunities.

Outlook

Signs of bottom fishing by corporate buyers is encouraging but specific transactions, driven by their own logic, do not on their own signal a more positive trend in markets. Economic news will be testing for some time to come and whilst the imminent threat of higher interest rates has retreated, economic growth is under real pressure and will decline further from here.

The summer months, with activity reduced, tend to follow existing trends rather than set new ones. Greater clarity should be available in the autumn as the third quarter profit announcements are made and prospects for the New Year are clearer. Until then volatility is likely to remain elevated.

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