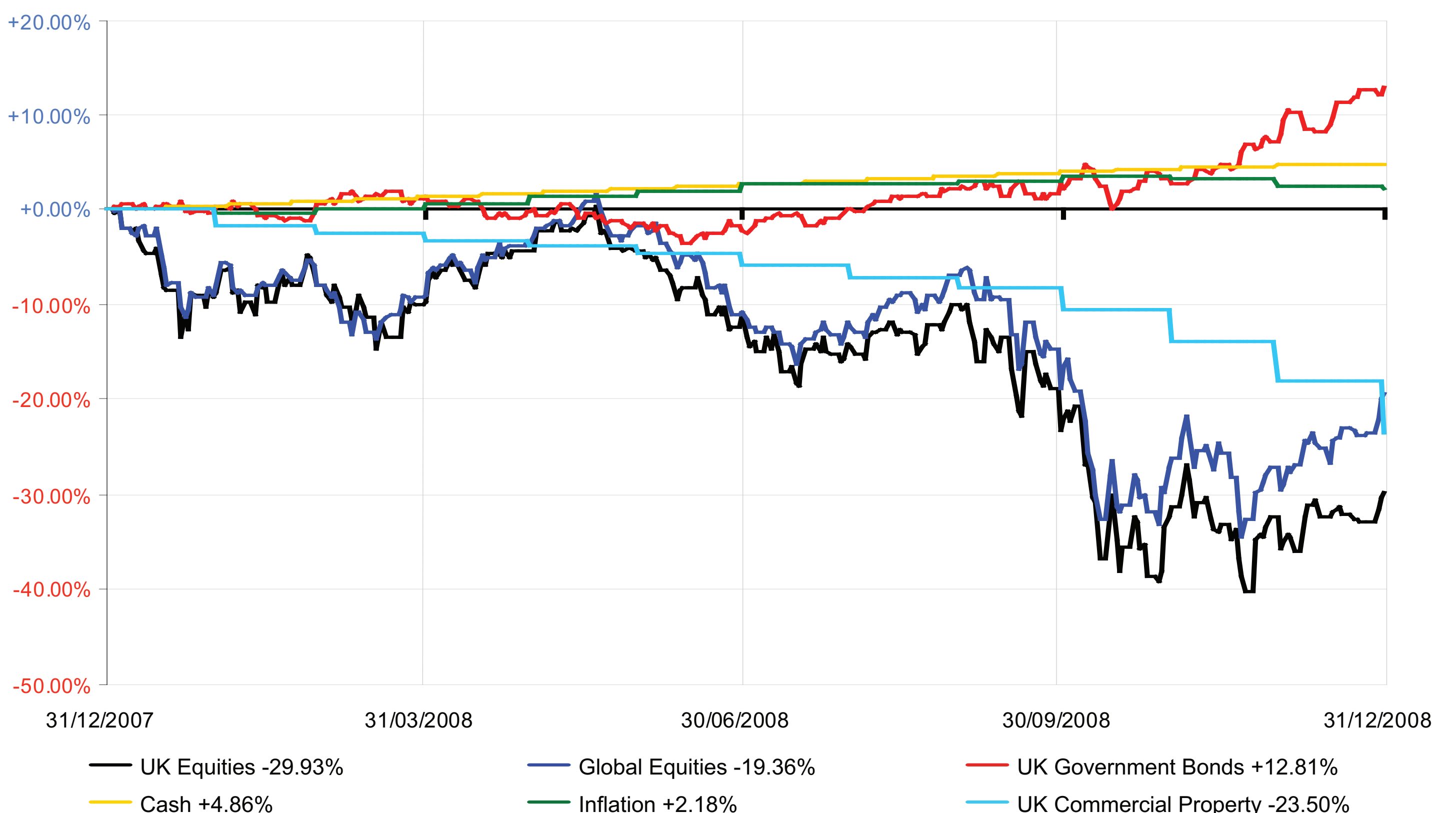
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT DECEMBER 2008

Summary

- Equities rallied in December with all the major markets making headway for sterling based investors.
- Bond markets also advanced and once again government securities performed better than corporate issues.
- Property prices fell again and sterling continued to weaken.
- Economic news was consistent with a sharp decline in activity, at home and elsewhere in the global economy.

Review



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 a month to give a contemporaneous picture).

After a period of sharply falling prices equity markets rallied in December. Once again the returns from international investment were amplified by a decline in the value of the pound. The better trend was achieved despite rather than because of economic news. Data from around the global economy showed activity levels falling sharply as the credit crisis that had damaged the financial sector so severely, began to have an impact on the economy as a whole. In the investment markets themselves a marked difference in December relative to both October and November was the reduction in forced selling by investors who had previously had to raise cash to pay out exiting customers or to pay back bank loans. December is a month of poor liquidity because of the holidays and year-end pressures and so most investors who needed to make sales would have planned to complete them before dealing became more difficult.

Over the month the FTSE All World Index gave a total return of +3.79% to a dollar based investor but one of +10.78% for one based in sterling. This pattern of a weak domestic currency boosting returns from overseas holdings was repeated elsewhere in the world: sterling declined by -5.10% against the dollar, -9.76% against the yen and by -13.67% against the euro.

In the UK, the FTSE All Share index gave a positive return of +3.67%. Large companies, as measured by the FTSE 100 index, returned +3.52% but small companies continued to lag (+1.59%), despite several months of disappointing returns. Over the year to end December the return on the market as a whole was -29.93%, on smaller companies -48.32%.

The returns from international markets, boosted by currency factors, were stronger. European markets gave +16.67%, Japan +15.25%, Asia +16.64% and the USA +8.11%. The range of returns at the individual country level was widest in Asia where Indonesia gave +32.70% but Pakistan -41.05%. In Europe, Belgium, Germany and Spain all gave returns of more than +20% whilst Ireland rose by just +3.95%.

The UK government securities (gilts) market continued to provide steady gains, and was up +5.20% on the month. Corporate bonds did less well but generally rose, with the highest quality issues giving the best returns.

Commercial property remained weak. Capital values declined by an estimated 7% in December as the downward pressure on prices evident in the Autumn intensified. Despite this setback valuations remain above the prices actually being achieved in the market and it is likely that this gap will be narrowed in the next few months as valuers try to reflect more accurately in their assessments what is actually being achieved in transactions.

The gains in investment markets were achieved against a background of very poor economic news. In the UK, a sharp deterioration in activity in the second half of the year resulted in 2008 being the first year for 15 years that real economic growth was below 1%; activity is likely to weaken further in the first half of 2009. Over the period manufacturing activity fell at a record pace to reach the lowest level since 1992. The decline in sterling, which reached 18% in trade weighted terms, produced no gains to exporters battling to win orders in a global environment where demand was falling sharply. The Bank of England cut Base Rate to 2%, the lowest level for 57 years, but with credit conditions still very tight, much of the fall in official rates failed to be passed on to the corporate sector, indeed for many companies it was the ability to borrow that was of greater concern than the rate at which borrowings might be achieved. Consumer activity also declined. Car sales were weak and activity in the housing sector was more than 50% down in the corresponding period in 2007. In the United States the ‘beige book’ survey of economic activity showed a declining trend in all areas of the country for the second month in succession. The Federal Reserve cut borrowing costs effectively to zero and yields on 30 year government bonds fell below 3%.

The problems were not confined to the developed economies. Chinese exports fell for the first time in seven years, a fall of 2.2% that is dwarfed by the scale of the fall in imports (-17.9%). It is estimated that 10 million workers who have migrated into the cities in search of employment have lost their jobs.

Having reached a high of $147 per barrel in the summer, crude oil fell below $35. OPEC continued to cut production levels but were effectively following rather than leading market trends. Despite the aggressive calls for higher oil prices, the fact that 1.2m barrels per day of the 1.7m reduction in production so far seen has come from Saudi Arabia shows how desperate the other producers are for income.

Outlook

If 2008 was the year when the full weight of the credit crisis hit the financial sector, 2009 will be the year in which the main impact on the economy is felt. Activity levels will decline further, unemployment will rise, and the inflation rate will fall back and could be negative by the Autumn. Interest rates will fall and could easily fall to below 1%. This all sounds rather bleak and so it is important to add some balancing thoughts. First and foremost is the scale of the activity undertaken by governments to put in place the foundations for recovery, In terms of hard action, the US Federal Reserve has done more in the past year or so than Japan did in 10 years after its crisis broke. Secondly, there are some self correcting trends in the world economy – lower fuel prices and lower interest rates will feed through to consumers and although some of this boost to income will be saved or used to pay back debt, some will flow through to the High Street. Equity markets offer longer term investors cheap valuations and attractive income yields. In time investors will focus less on the current economic downturn and move on to the probable recovery in 2010 and as that happens so share prices should move higher. In the near term however day to day volatility must be expected to remain at elevated levels.

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