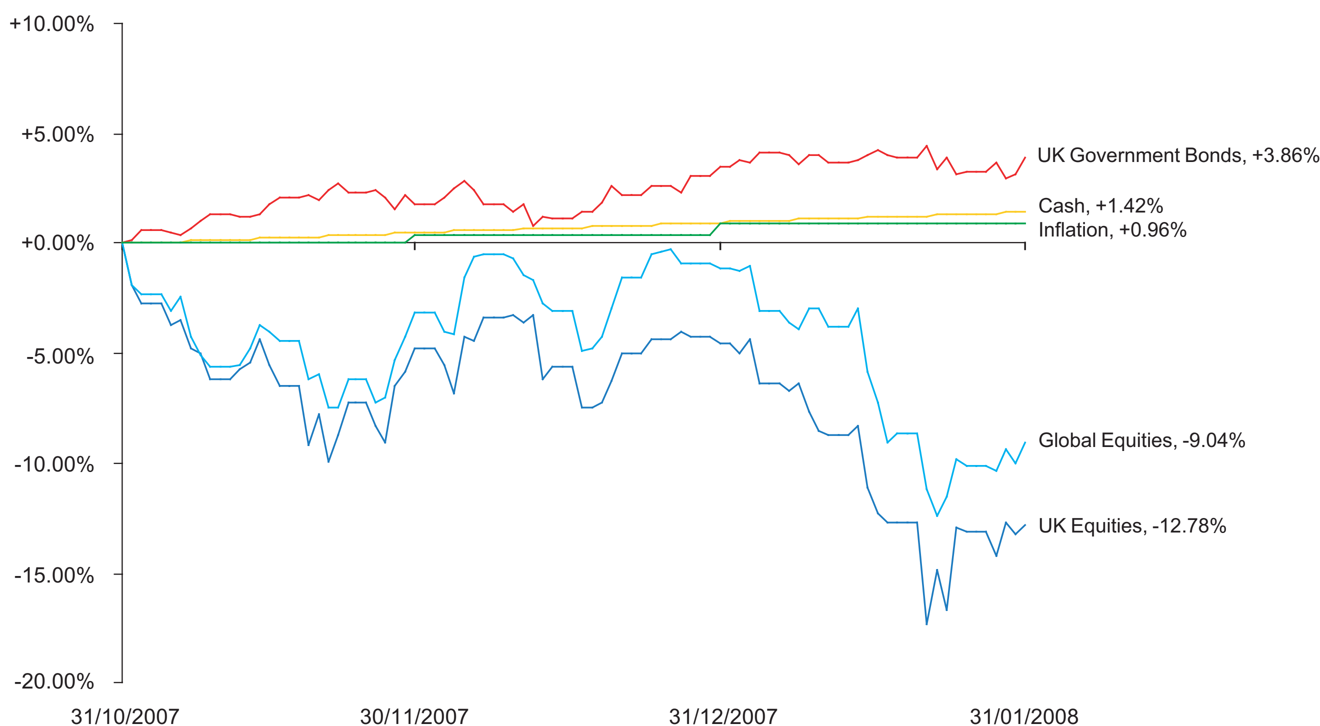
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT FEBRUARY 2008

Summary

- January was a difficult month for global equity markets, with falls seen across the board in volatile conditions
- Government bond markets benefited from the ‘flight to safety’ effect and expectations of lower interest rates, while corporate bonds did less well as spreads widened
- The commercial property market remained weak
- The fall in equity markets was largely due to fears of recession in the US
- The Federal Reserve acted aggressively to restore confidence in markets and regain the economic initiative, cutting rates by 1.25% in total to 3%
- The outlook remains clouded, and more volatility should be expected in the short term as we approach the quarterly corporate results season, but we believe equity markets continue to offer good opportunities for selective investors

Review



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

Global markets suffered a torrid start to the year, with equity indices in many countries recording their worst ever January returns. In the UK, the FTSE All-Share Index fell by more than 8% while markets in the US, Europe and Asia experienced double digit declines. Government bond markets rallied during the month, benefiting from their safe haven status and expectations of lower interest rates, while the yield premium on corporate bonds widened significantly as risk aversion increased. The UK commercial property market remained weak with IPD recording a return of -3.7% in December.

Volatility remained high throughout the month as problems related to subprime mortgage lending rumbled on and investors absorbed data pointing to a marked slowdown in activity in the US. With US markets closed on 21 January for the Labour Day holiday, equity markets elsewhere around the world fell very sharply as investor concerns came to a head. The sell-off came despite the previous week’s announcement of a proposed $140 billion fiscal package from the US government aimed at supporting beleaguered consumers. Fears that the sell-off could snowball into a damaging market rout prompted the US Federal Reserve (the Fed) into slashing interest rates by 0.75% to 3.50% at an emergency meeting on 22 January, the largest single cut in rates in more than two decades. The surprise move helped to stabilise markets and towards the end of the month equities recovered some of the ground they had lost. This was largely due to expectations of further monetary policy easing from the Fed, which duly came in the form of a 0.5% rate cut on 30 January. In its statement accompanying this second cut, the Fed said that ‘Financial markets remain under considerable stress, and credit has tightened further for some businesses and households. Moreover, recent information indicates a deepening of the housing contraction as well as some softening in labour markets’. There was also support for markets towards the month from some slightly firmer US data releases, which alleviated fears of an imminent slide into recession somewhat, and news of a plan to support bond insurers, which have developed problems that, if unresolved, could destabilise the broader financial system.

Signs of increasing weakness in the US economy included poor retail sales figures for the Christmas period, a weak employment report for January, with the manufacturing and construction sectors both shedding significant numbers of workers, and more dire housing market figures. Sales of existing homes and new homes fell by 2.2% and 4.7% respectively in December adding to the large overhang in supply. This suggests that the US housing market will remain depressed for some time to come. Data from the manufacturing sector was slightly more positive. The ISM index of manufacturing activity fell below the 50 level that separates expansion from contraction in activity in December but rose back above 50 again in January. Strong durable goods orders for December were another sign that there is some resilience in this area. The first estimate of US GDP growth for the fourth quarter of 2007 came in at an annualised rate of 0.6%, way down from the robust 4.9% pace of the third quarter.

In the UK, there were a number of signs that consumers are wilting under the strain of last year's rate rises, tighter credit conditions and higher household bills. Several of the big High Street retailers reported disappointing Christmas sales and there was a steep decline in the number of mortgage approvals in January. The Bank of England voted to keep rates on hold at 5.5% at its January meeting, following December's 0.25% cut, but expectations mounted that a further reduction in rates would be delivered in February. The Bank is faced with a dilemma in setting monetary policy as inflationary pressures are likely to build in the coming months due to higher energy and food prices, while consumer activity slows.

There are signs that the European economy has begun to lose some momentum as a result of the problems in global financial markets. As expected, the European Central Bank (ECB) kept interest rates on hold at 4% for the eighth month in a row in January, despite inflation running well above the 2% target. Following the meeting, ECB President Jean Claude Trichet indicated that in order to control inflation it was more likely to raise interest rates than cut them, even if growth slows. However, his comments came before the market turmoil in the middle of the month and the two rate cuts from the Fed. Markets are now pricing in rate cuts from the ECB in the second quarter.

The Japanese economy has not been firing on all cylinders for some time and data released in January remained lacklustre. Wages have been falling for several months due to poor bonus payments and this has further depressed consumer sentiment. The yen continued to rise against the dollar over the month which had a negative effect on exporters.

Elsewhere in Asia, the Chinese government brought in price controls on basic food items to slow recent rapid price rises, which have been fuelling inflation. The Chinese authorities also implemented measures to control the amount of lending by banks and raised property taxes in an effort to put a brake on rapidly rising house prices. Early estimates of Chinese growth rates suggest that expansion in 2008 will be around 9%, below the 11% growth generated in 2007.

Outlook

The Fed has acted aggressively to regain the initiative with economic policy and there is no doubt that it is committed to taking whatever steps are necessary to stop the US economy getting mired in deep recession. However, its scope to provide further stimulus may be limited in an environment where banks are tightening their lending criteria and interest rates have fallen close to the level of inflation. Having been hit badly by subprime related losses, banks have become much more wary about lending and will be keeping the rates they charge borrowers at levels significantly above official interest rates as they attempt to rebuild their balance sheets. This means that many borrowers are faced with higher debt servicing costs despite substantial cuts in official interest rates. Growth in the US is likely to remain slow over the first half of the year, with a mild recession a possibility. We then expect to see activity accelerate moderately as the effects of the fiscal stimulus package and rate cuts totalling 2.25% since last August begin to kick in. Against a background of slowing growth, there are clear risks to consensus forecasts for corporate earnings, but based on the evidence to hand, we do not expect activity to collapse as some doom-mongers have been suggesting.

In recent months there has been much talk of the strongly growing emerging economies decoupling from the US, helping to sustain global growth at good levels despite a slowing US economy. The across-the-board falls in global markets during January suggest that this may not prove to be the case.

Despite the uncertain background, we believe there is selective value in global equities, and companies with robust balance sheets, strong free cash flow yields, and attractive businesses should be able to pay high and rising dividends which can be seen as unusually attractive in the current conditions of depressed sentiment and undiscriminating markets.

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