

CCLA INVESTMENT MANAGEMENT LTD

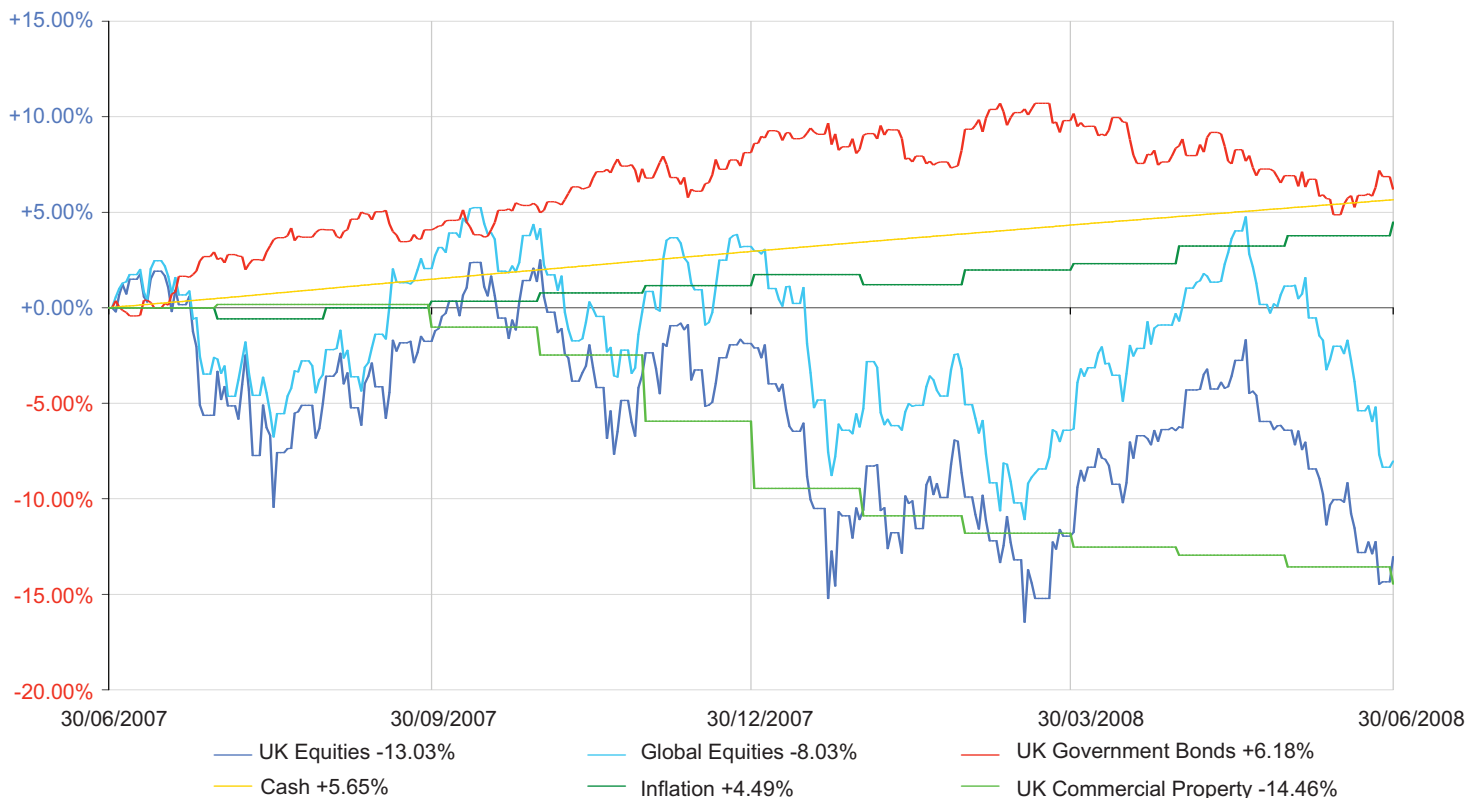
MARKET REPORT JULY 2008

Summary

- The month saw a change of investor focus away from concerns over the credit crisis to worries over the growing threat of inflation.
- Equity markets fell sharply, particularly at the end of the period, surrendering much of the ground made in the recovery.
- Bond markets eased slightly.
- Commercial property prices continued to fall, with signs that rental growth rates were coming under pressure.

Review

Market returns - 1 year



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

The rally in equity markets which began in mid March, came to an abrupt end in June. Investors who had come to believe that the worst of the credit crisis was over suddenly had a new cause for concern. Growing inflationary pressures caused central banks to warn that they would take any action required to prevent food and fuel costs pushing higher inflation rates which were already above comfort levels. Markets immediately changed expectations for interest rates, where once cuts were anticipated, rate increases became factored in to expectations.

The FTSE World Index returned -9.06% over the month, a sufficient decline to turn the three month returns negative (-1.80%). The domestic equity market was swept up in the retreat of equity prices with the FTSE All Share index and FTSE 100 index falling by -7.06% and -6.77% respectively. Smaller companies declined slightly more (-8.74%) whilst 'growth' stocks (-5.24%) comfortably out performed 'value' (-8.57%). This continued relative strength reflects the performance of the basic resources sector and in particular the mining stocks. Investors found no respite overseas. Of the major markets, Japan fell by -7.46% and Wall Street fell by -7.52%. Both Europe and the Far East lost more than 10% of their value. Fixed interest markets were much less affected by events and although they declined, the extent was modest. In currency markets, Sterling rallied as investors began to anticipate an environment in which UK interest rates, already high by international standards, would rise again.

Economic data continued to evidence a gentle reduction in growth rates, particularly in the UK and Europe. In the US however the data was mixed, with some signs that activity was actually stabilising, albeit with growth at modest levels. US home prices eased once more to levels about 15% below those ruling 12 months ago, but the pace of decline slowed and eight cities actually saw price increases. In the broad economy the latest 'beige book' survey suggested that conditions were 'stable' in almost half of the areas surveyed whilst estimates of the growth achieved in the first quarter were increased to 1%, making a slide into recession less likely.

In the UK conditions remained flat with none of the encouraging signs seen in the US. Housing continued to weaken with media coverage helping to talk the sector lower. At present about 180,000 mortgages are being renewed each month and those involved in this experience are finding that new borrowings are both harder to obtain and much more expensive. From the investment market standpoint however the news from the housing sector was completely overshadowed by the evidence of increasing inflationary pressures. The statistics make unpleasant reading, with producer price increases of 27.9% and prices at the factory gates 8.9% higher. The CPI increased by 3.3% but there is news of gas cost increases still to come which threaten to push the index over 4% in the months ahead. It isn't just a UK phenomenon, Euroland inflation is at a 16 year high, nor is it limited to food and fuel, iron ore prices are 96% higher. Concern that price increases could become entrenched have seen central banks in the US, Europe and the UK voice concerns and hint strongly at interest rate increases to come in the near future and certainly before the end of the year.

An important contributor to the problem has been the oil price. World oil consumption is about 85m barrels per day. At \$140 per barrel the crude oil costs consumers about \$4 trillion, up from \$2 trillion a year ago. This increase is equivalent to some 7% of world GDP. Soaring fuel costs and higher food prices are creating severe problems for a number of poorer nations which find themselves torn between importing the food and fuel their economies need and maintaining a reasonable balance of payments.

In the markets, although investor attention has moved on from the credit crisis, the 'clean up' operation continues. Recent estimates suggest the cost of credit losses to financial companies has been c\$387 billion and that new capital of c\$280 billion has been raised to repair balance sheets. This fund raising programme continued with Barclays seeking £4.5 billion from new and existing shareholders and Fortis also seeking additional new funds. Financial sector share ratings remain very depressed with investors unconvinced that the true cost of the crisis has yet become clear.

Outlook

Investor confidence, already frail, has been battered by fears that a fight against inflation, fought with higher interest rates, will exacerbate the weakening trend in world growth. At this stage the central banks are using rhetoric rather than rates but higher borrowing costs will come. Financial markets are expecting imminent action from the European Central Bank with the US Federal Reserve and the Bank of England to follow later in the year. Although investors are concerned about higher borrowing costs the most important task facing the authorities is to prevent inflationary pressures becoming embedded because if that happens the problem will last longer and require even stronger action to cure it. Until there is greater clarity on this issue markets will remain prone to strong short term price fluctuations. That does not mean however that we think there is substantial sustained downside from current levels, ratings are modest and recent share price weakness has discounted a depth of problem which is far from certain.

James Bevan

Chief Investment Officer CCLA



CCLA INVESTMENT MANAGEMENT LTD
80 Cheapside, London EC2V 6DZ

Client Service T: 0800 022 3505 F: 0844 561 5126
www.ccla.co.uk

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