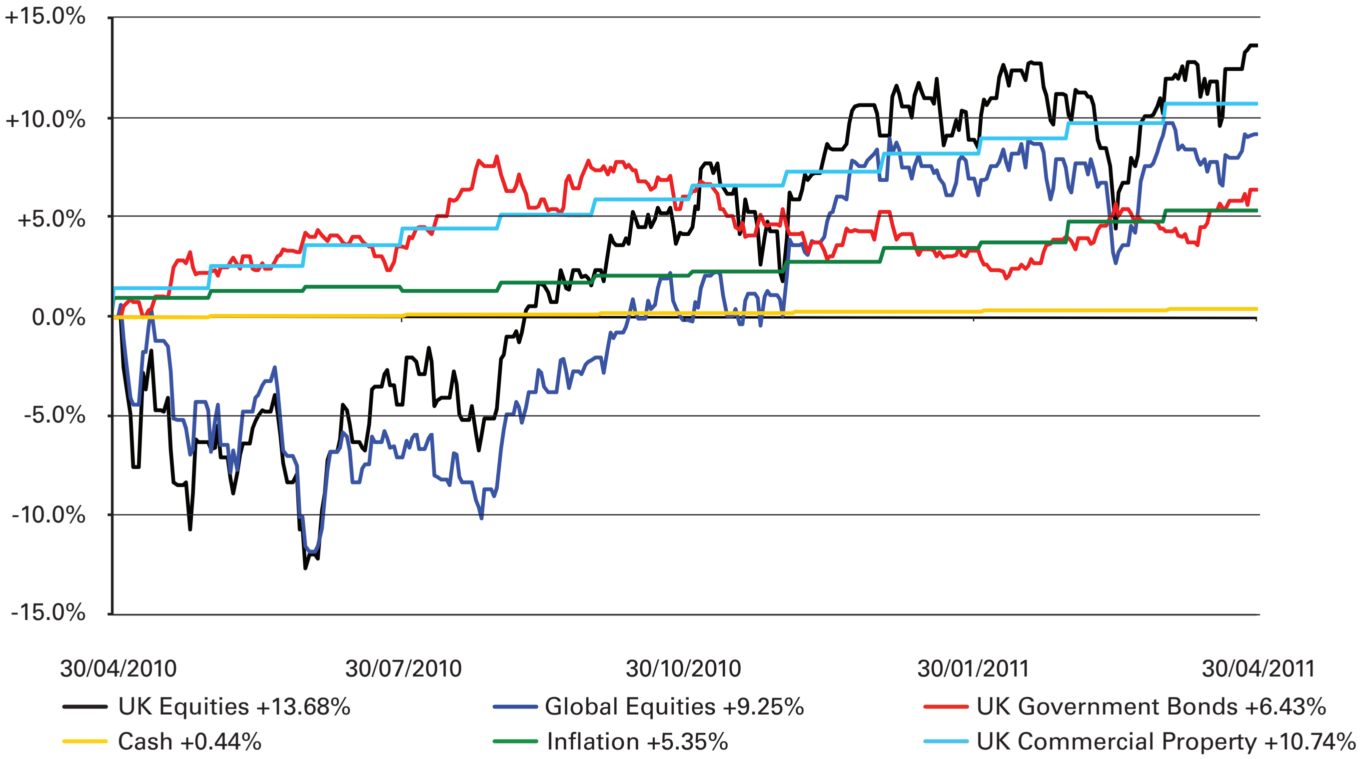
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT APRIL 2011

Headlines

- The world equity index moved higher over the month, but there were divergent trends across the regions.
- Fixed interest markets moved higher across all maturity and credit quality bands.
- Commercial property returns were dominated by the contribution from income.
- Sterling showed continued strength against the dollar and yen but again eased relative to 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* (Latest monthly return estimated by CCLA).

Market review

The FTSE All-World Index edged higher in April, although the overall improvement masked gains in some regions, weakness in others. The gain in the index over the month was +0.10%, bringing the rise over the year to date to +2.14% and for the past 12 months to +9.25%. Of the regional markets the strongest performance was from Europe, which enjoyed a relief rally on the financial support package for Portugal and in the process shrugged-off an increase in base lending rates by the ECB. The European indices gave a total return to a UK based investor of +4.39%. Asian markets moved higher, by 0.13%, but currency factors turned a local gain from the US of +3.01% into a -1.01% fall in sterling terms. The weakest performance however came from Japan, where market sentiment remained depressed by consideration of the economic effects of the earthquake. The Japanese market returned -3.48% in April and has given a return of -10.17% in 2011 to date. Against this international background the UK market performed relatively well. The FTSE All-Share Index returned +3.11% with similar strength evident across the capitalisation cohorts. The best and worst individual market returns came from Europe. Belgium topped the list, with a gain of +8.10% and there were good gains too from Germany (+6.87%) and Ireland (+6.53%). The weakest performance by far came from Greece, which fell by -8.26% as bond yields moved skywards and concerns of default rose. Over the past 12 months the Greek market has declined by -27.46%.

Fixed interest sectors were positive across all the risk and maturity ranges. Dull domestic economic growth data was a support to this market as, following the releases, investors pushed back expectations of when interest rates in the UK would rise. Another important factor was cash inflows of funds seeking a safe haven from the turmoil in a number of European bond markets. The FTSE Government All-Stocks Index returned +1.87%, corporate bonds returned more with the strongest gains from the longer dated maturities.

Commercial property returns were modestly positive although the gains were due to income flows rather than higher valuations. Within the market there has been a growing divergence between the behaviour of good quality, income secure assets and more secondary locations, the latter experiencing downward pressure on both capital values and rents.

In currency markets sterling continued to improve against a weak dollar, rising by +4.24% on the month. It also rose against the yen (+1.82%) but fell back by -0.33% against a euro which strengthened on higher interest rates.

Economic developments

Initial estimates for UK economic growth for the first quarter of the year have emerged at +0.5%, within the bounds of what was a relatively wide range of forecasts. Growth of +0.5% in the first quarter, but a decline of a similar magnitude in the closing quarter of 2010, suggests that activity has been flat over the past six months, a disappointing outcome at this stage of the recovery. At present of course the data is preliminary and subject to revision and it may well be that estimates are moved higher as firmer data come in. In particular there is doubt about the stats on construction which accounts for just 6% of overall output but which reduced the overall growth total by -0.3%. Standing back from the detail and considering instead the broad trends, growth so far has been dependent on re-stocking, manufacturing and exports. Missing has been any significant contribution from the consumer and a concern for the government will be how to improve this critical component of demand whilst personal sector debt remains high and real wages are falling. Ahead of the GDP data release there was speculation that inflation pressures would force the Bank of England to impose an early rise in base rates. Post publication these expectations simply evaporated and although most forecasters still anticipate higher interest charges in 2011, the date pencilled-in for the first change has now been pushed back into the third quarter – or even later.

In Europe the dominant theme has been the debt crisis; Portugal's problems have attracted most of the headlines but the real drama has been with Greece. In Portugal's case it seems that the country was invited by the ECB/IMF to apply for support because rampant speculation that it would have to do so was affecting both its own financial markets and those of other vulnerable economies such as Ireland and Greece. The overall package is expected to have a total value of about €80 billion but, although the scale is similar, to have terms which are less demanding than those offered to Greece or Ireland. For Greece the problems has changed from a lack of liquidity – which the support programme has largely addressed – to fear of basic insolvency. As a result bond yields have raced upward to a point where 2 year bonds now yield over 24% (against 1.03% for an equivalent gilt) and credit markets are openly pricing-in a probability of default or restructuring. This risk opens a huge amount of uncertainty and helps explain why nervous investors have preferred UK government bonds to those issued within Euroland. If Greece does seek to restructure its debt the main blow would be taken by the ECB, which has been the only buyer of Greek bonds for many months. But the main blow is not the only blow and there is a risk that a number of banks, still struggling to rebuild their balance sheets, find themselves exposed to another set of losses on a potentially major scale. There is of course also the risk of contagion.

Outlook

We expect the UK economy to continue on a path of slow improvement, with the pace of recovery held back by reduced government spending, high unemployment and a continued squeeze on real incomes. Inflation is likely to be elevated for all of 2011 and could easily peak at over 5% in September or October, despite this interest rates will stay low and are unlikely to exceed 1% by the year end. Against this background we expect commercial property values to mark time but for good quality assets to continue to provide an attractive high income. We believe that bond markets offer poor long term value at current prices and are vulnerable to a rise in yields as safe haven buying abates. We expect equities to offer the best absolute and relative returns. One has to be impressed by the resolve of equity markets which, faced with a monstrous earthquake in Japan, a sharply higher oil price, disorder in the Middle East on a major scale, a rescue programme for Portugal, fears of default by Greece, rising inflation and moves to tighter policies in a number of emerging economies including China, India and Brazil, have simply moved higher. Recent resilience however does not mean that there are no risks; day to day volatility is expected to remain at current elevated levels.

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