

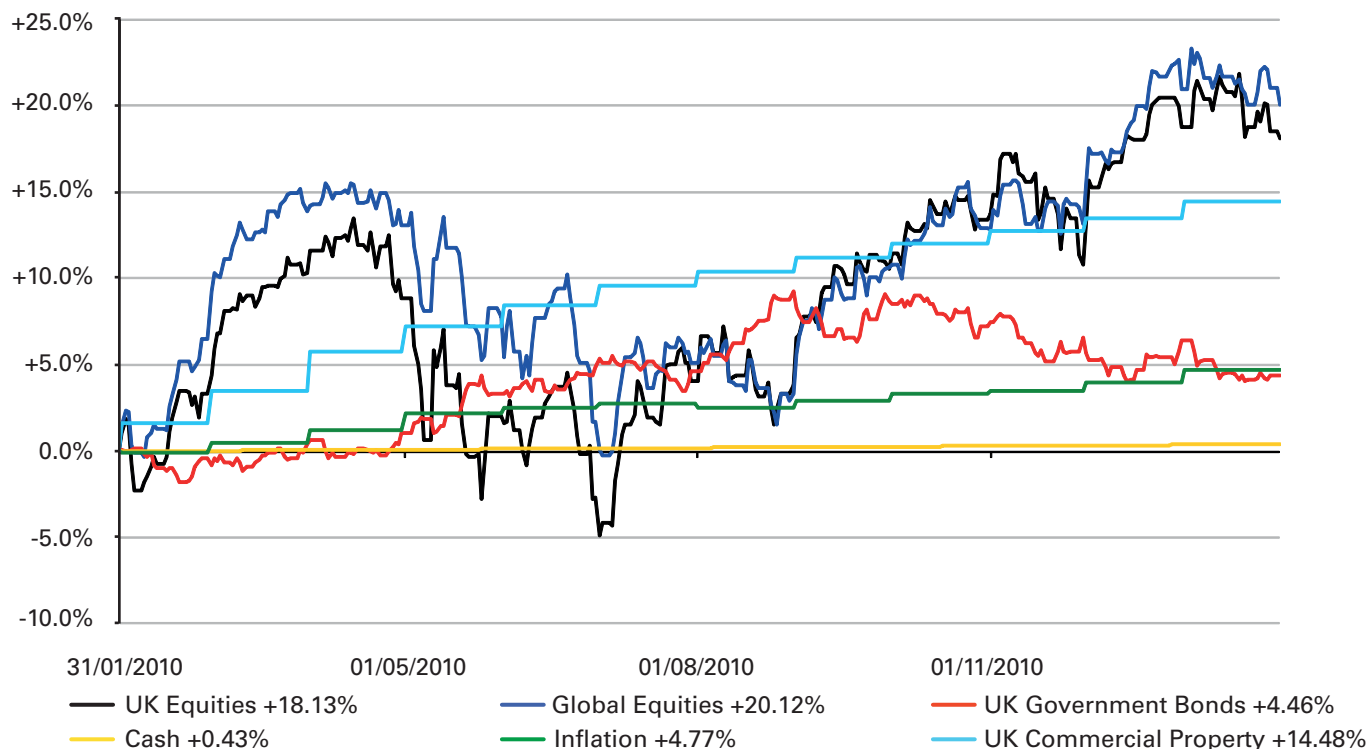
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT JANUARY 2011

Headlines

- Global equity markets were little changed on the month but on balance moved slightly lower.
- Fixed interest markets also eased, in quiet conditions corporate bonds outperformed government stocks.
- Commercial property values were little changed.
- Sterling improved against all major international currencies.

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

Global equity markets were only modestly changed over the month but overall declined slightly. The FTSE All-World Index returned -0.75% to a sterling based investor, a change which brings the return over the past 12 months to +20.12%. There were mixed trends across the regions. Europe, buoyed by a relief rally, rose by +2.83% and the US also inched into positive territory, albeit by a tiny margin, with a return of +0.01%. There were negative returns from Japan, -2.24% and Asia, where markets fell back by -3.62%. At the individual country level the range of returns was more marked. In Europe there was a broad uptrend, led by some of the markets which were most under pressure at the end of 2010. The Greek Index rose by +15.13% and Spain rallied by +11.19%, only Norway and Switzerland were lower over the period. This broadly bullish picture is in contrast with the trend in Asia where the profit taking was the prevailing trend as fears increased that the Chinese authorities would take steps to control inflation – and thus limit growth. India, the Philippines, Indonesia and Thailand gave double digit negative returns and in the region as a whole only South Korea and Taiwan advanced, but neither managed to improve by even +1%. The UK market performed in line with its international peers and moved a little lower, the FTSE All-Share Index returned -0.53% over the month. Not all parts of the market fell however, small companies enjoyed positive returns and although growth stocks fell, there was good support for value companies which pushed this part of the market into positive territory.

Fixed interest markets fell overall despite a rally in the final few days of the period. Earlier weakness was the result of disappointing inflation data and related fears that official interest rates were more likely to rise in the near to medium term. The late rally followed the poor data on 4th quarter economic growth which were seen to make a near term rate increase less likely.

In commercial property, occupier trends were little changed overall although the downward pressure on rents reduced slightly and there were signs of increases in some areas – of which London is the best example. In terms of transactions the year has started very slowly, with little so far to suggest anything other than broad stability in price levels.

The inflation data and interest rate fears which pushed the fixed interest market lower helped support sterling. The domestic currency rose by +2.57% against the dollar, by +3.72% against the yen and by +0.26% relative to the euro.

Economic developments

The economic headlines over the period were claimed by the UK. Inflation moved higher again, to +3.7% on the CPI measure, +4.8% on a RPI basis. The sources of the upward pressure were numerous but a common theme was rising energy prices which pushed higher the inputs from air fares, utility bills and fuel costs. The crude oil price averaged \$60 per barrel in 2009, \$80 per barrel in 2010 and has topped \$100 per barrel this year; it has been a persistent and substantial contributor to rising prices across the economy. Inflation will rise further in the next few months and is likely to remain above 3% for all of 2011, one result of this is a rising expectation that base rates will rise, not dramatically, but enough to signal that the Bank is not ignoring the inflationary pressures. Partly offsetting these expectations was the disappointing economic growth data for the fourth quarter. Expectations were that growth rates would be down on those achieved earlier in the year but an actual decline in activity was a surprise – if not a shock – to observers. We can say of course that this was only the first estimate of activity and so open to revision, that it is only one quarter and that the period was severely affected by adverse weather. The underlying data however shows a definite softening in key sectors in October and November before the weather had its effect, it may then be that hopes of a recovery bounce in January may be optimistic. Consensus expectations for growth for the year as a whole are still clustered around +2% but to be achievable this outturn needs a robust improvement in the first quarter.

In contrast with the UK, the data from the US economy was more encouraging. Growth in the fourth quarter relative to the third was +3.2% and in line with estimates. The overall conditions were described as 'improving' but although stronger the upturn was not yet thought strong enough to be self-sustaining – a signal that low interest rates and quantitative easing measures would stay in place for the medium term. One source of strength has been manufacturing output, up for 18 months in a row and now at the highest levels reached for seven years. European data was more mixed and showed the conflicting pressures on the region. The German and French economies are both forecast to have grown by more than 3% in 2010, Ireland and Greece to have shrunk by the same amount. The difficulty in finding a single interest policy to suit both core and periphery is clear.

Outlook

Our expectation for the year ahead is one of continued economic growth but at a pedestrian pace as recovery in the UK is held back by government cut backs and tax and price rises. These are significantly deflationary in their effect on consumer activity. That said, whilst the economy as a whole will move forward relatively slowly, we expect stronger growth from the corporate sector. Company balance sheets are cash rich, cost bases have been cut and profits will increase in response to even gentle increases in demand levels. We expect interest rates to rise but only modestly; earnings on cash deposits will remain negative in real terms. More at risk are the yields on bonds which have been pushed lower by strong cash flows into the sector and have reached levels which are hard to justify in an environment of growth and sticky inflation. Against this background we expect equity markets to outperform and for bond prices to ease lower. We expect little change in property prices in the near term but are attracted to the high income yields available from the sector.



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