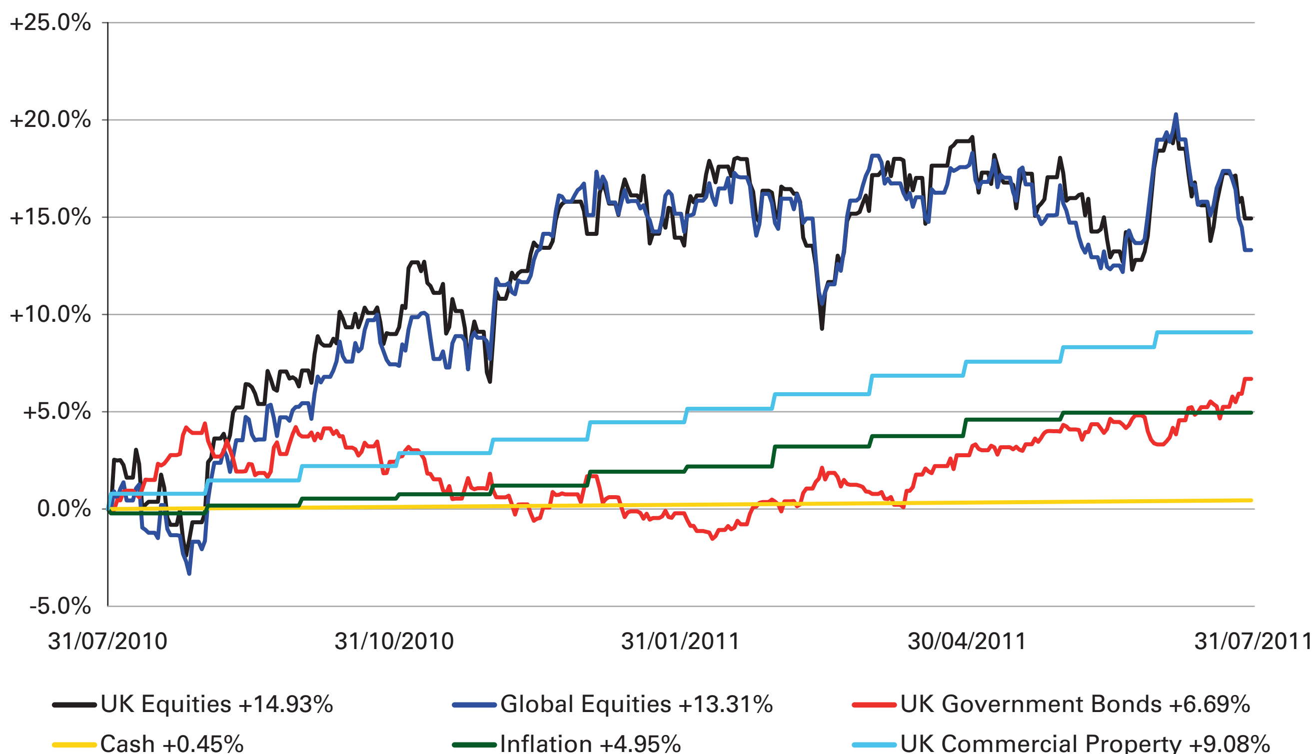
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT JULY 2011

Headlines

- All of the major regional equity markets fell over the month in local currency terms, a strong yen however pushed Japanese returns into positive territory for sterling based investors.
- Fixed interest markets rose across the board but with government bonds slightly stronger than the corporate alternatives.
- Property market returns were slightly positive, due to the contribution from income.
- Sterling rallied against the dollar and euro but fell against the strong yen.

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* (*Lagged by 1 month).

Market review

Equity markets fell consistently over the month, giving back the ground gained in the rally at the end of June. With trading volumes falling as the holiday period got underway, investors were beset by a slew of negative economic data and the continuing uncertainties caused by the debt crisis in Europe, as a result buying support fell away. The FTSE All-World Index gave a return of -3.81%, a decline which pulled the returns for 2011 to date into negative territory, at -1.56%. The return over the past 12 months remains comfortably positive, at +13.31%. Japan was the best performing of the regional markets, a modest decline in local terms was pushed into positive territory by currency factors. This market recorded a gain of +1.31%. All the other regional returns were negative. Asia declined by -1.60%, the US by -4.19% and Europe by -7.26%. All the individual European markets gave negative returns. Finland (-12.37%) and Italy (-11.27%) were the worst performers but France, Spain and Ireland all fell sharply. The UK market produced a total return of -2.20%, a decline which leaves the gain for the year to date only just in positive territory, at +0.69%. Over the past 12 months the UK index has returned +14.93%.

UK fixed interest markets in contrast moved higher as concerned investors sought safe haven investments. Government bonds produced the strongest returns but corporate bonds too moved higher, particularly the longer dated issues most geared to falling interest rates. The FTSE Government All-Stocks Index gave a return of +3.20%, the iBoxx Non-gilts AAA Index +2.88%.

Low levels of transactional volumes remained a feature of commercial property markets. Overall capital values were stable but this positive overall picture was an average of strength in London and for properties with solid income flows but weakness in secondary locations.

Sterling improved relative to the dollar and euro, rising by +2.32% and +3.07% respectively. It fell however against a very strong yen, ending the month -2.45% lower.

Economic developments

Economic news has been disappointing on a broad front with the result that concerns have increased that the recent downturn in global growth, up until now described as a second quarter blip, may be something more substantial. Estimates of growth in the US in the second quarter emerged at +1.3%, substantially below the +1.8% consensus expectation. In addition, first quarter growth estimates were revised down, from +1.9% to +0.4%, with other revisions to past data showing the recession to have been deeper and the recovery far less vigorous than was previously thought. On the new data, despite two years of improvement, activity levels are still 1% below pre-recession peaks. Contemporary evidence from the 'Beige Book' survey of regional trends suggests that activity levels are flat in 8 of the 12 reporting areas, with manufacturing, a previous bright spot, weakening.

UK growth was equally dull; the economy expanded over the quarter, but, at +0.2%, only just. The 'special factors' approach to explaining disappointing UK data was present again with the suggestion that without the Spring heat wave, late Easter and Royal Wedding, growth 'might' have been up to +0.3% higher. Whether or not any or all of these factors had an effect, growth over the past 12 months has been only +0.7% and it is hard to see this as anything but disappointing. This level of growth is so low that it makes the government's deficit reduction timetable challenging. If the dull trend continues, as we expect it to, then the pressure to stimulate activity will grow. The problem, with revenue so tight, is how to afford it.

Domestic inflation showed a modest fall in June to 4.2%, from 4.5%. RPI fell too, to 5.0%. Most commentators had expected an unchanged pace of price increase over the summer before a rise in the autumn as higher energy prices start to feed into the calculation. The June dip seems to have been caused by the sales starting early, the biggest contributors to the fall were clothing and footwear.

Agreement was reached on a second financial rescue package for Greece, one which focused more on getting that economy out of a hole rather than punishing it for being in one. Interest rates were cut and loan terms were extended. There were however some heroic assumptions made on privatisation proceeds to help balance the books. Although there was a small and short lived relief rally on the news, investment markets still expect that the basic insolvency of Greece will result eventually in default. The success of this latest round of negotiations is therefore in buying time for this to be organised in an orderly way, one that minimises the effect, not on Ireland and Portugal, which will probably be involved in that process, but on Italy and Spain, which hopefully will not be. Bond yields in these two markets have risen and then fallen back in line with sentiment through this odyssey but each peak seems to have been higher and each pull – back a little less convincing. Thin summer markets and reluctant and reactionary responses from the authorities suggest that there is scope for more drama here over the next few weeks.

The stop – the - press news for the month relates to the last minute deal to prevent the debt ceiling pushing the USA towards default. That both left and right wings of Congress seem to be unhappy with the proposals suggests that it has the elements of a true compromise, but our worry is that there is much less substance to it than first meets the eye. This is because most of the spending cuts are set sufficiently far ahead to be the concern of a future Congress and will inevitably be judged against the circumstances of the time. Furthermore, although there are targets for cuts, the base from which they will be made has not been agreed. This is important because over the period ahead payroll subsidies and tax cuts for high earners are scheduled to fall away and the extent to which these are taken into account will have a major influence on the amount of true spending reductions which actually take place.

Outlook

Our expectation remains that the UK economy will continue to expand, but at a modest pace. The growth rate is likely to be too slow to prevent a further rise in unemployment over the next year. Against the background and despite a probable rise in inflation to over 5%, interest rates are clearly not going to increase in the foreseeable future.

Recent moves in investment markets have pushed yields on UK 10 year government bonds below 3%, a level at which they offer very poor value on any reasonable outcome to the current situation. We are very cautious towards this sector. We expect no progress in commercial property values near term; that will need to wait for 2012. In the meantime, however, good quality properties are providing a very high income return. Thin summer trading conditions traditionally bring heightened equity market volatility and 2011 has proved to be no exception to the pattern. Over time we expect higher values but there is a clear risk of near term weakness. We would see this as a buying opportunity for those able to look through a period of uncertainty.

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