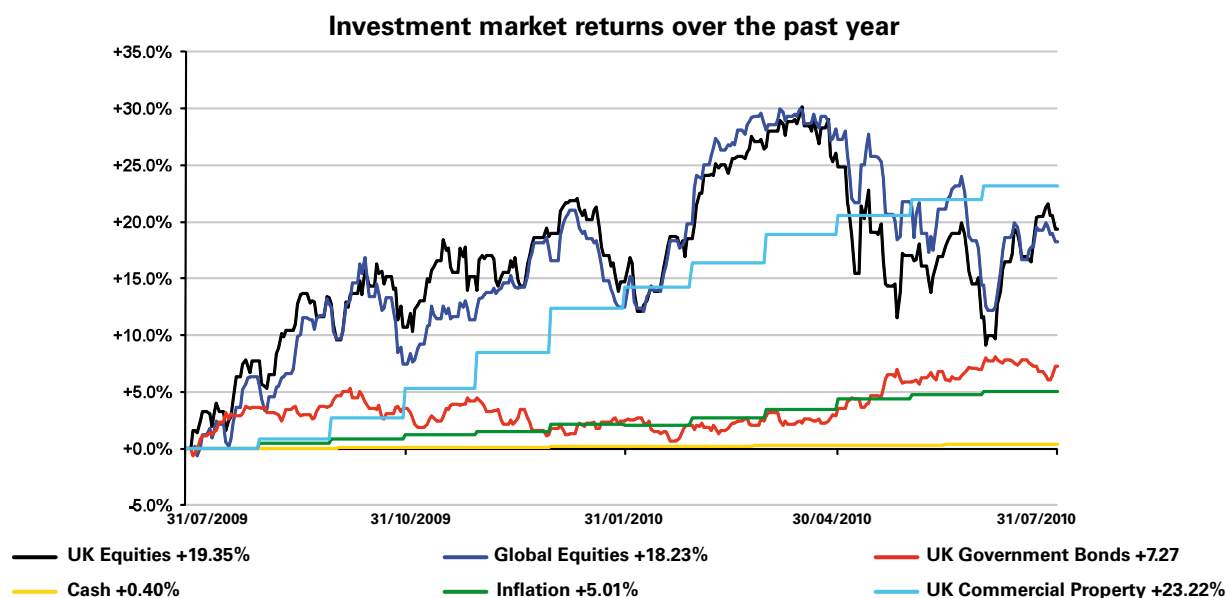


# CCLA INVESTMENT MANAGEMENT LTD

## MARKET REPORT JULY 2010

### Summary

- After a run of weak returns equity markets rebounded as confidence returned.
- Higher risk bonds attracted support, gilts eased lower.
- Activity in commercial property markets fell to low levels and prices marked time.
- Sterling improved relative to the US dollar and yen but weakened against a recovering euro.



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 a month to give a contemporaneous picture).

### Review

Global equity markets rallied in July after three months of net declines. Sentiment recovered as the most pressing concerns over sovereign debt levels faded and was further supported by data which showed that economic activity was continuing to improve, albeit at a pedestrian pace. From the standpoint of a sterling based investor the FTSE All-World Index gave a total return of +3.34% for the month. This brings the return over the past 12 months to +18.23%.

Most of the main regional markets made headway with only Japan in negative territory, at -1.20%, the fall caused by currency factors rather than a decline in the local stock market indices. Asia returned +2.46% and the US +2.1%. Europe was stronger, bouncing from the depressed levels reached in the aftermath of the Greek crisis. The main European index rose by +6.60% but some of the local markets rebounded much more – the gains in Italy, Spain, Austria and Norway were all in double figures, that from Greece a remarkable +23.86%. Despite this rally the Greek market is still -35.21% lower than it was a year ago. The UK market outshone its international peers, the FTSE All-Share Index returning +6.89%, buoyed by a recovery from BP and continued investor inflows following a budget that achieved broad investor approval. It was the large, marketable stocks which fell fastest in the down phase and it was these that rallied most swiftly as the market turned. The FTSE 100 Index gained +7.07%, more than twice the gain on the small company sector (+3.31%).

Improved investor confidence and an increased willingness to take on risk were also reflected in bond markets, although the scale of returns was less than that enjoyed by equities. Lower rated and longer dated segments of the corporate bond market gave the best returns, government bonds (gilts), recently favoured for their safe haven characteristics, lost support, with the result a modest negative outcome of -0.24%. Interestingly overseas buyers, who pushed £28 billion into the UK gilt market in March and April, were net sellers in June.

Momentum in the commercial property market, which had been slowing for some months, finally paused in July. Activity levels fell away as buyers retreated to the sidelines and sellers held back in the hope of higher prices to come. Although valuations are better and expectations for the future improved, conditions in the underlying occupier market remain challenging, particularly in the non-prime areas. With the exception of central London offices, where rents are sharply higher, rental declines remain commonplace.

Currency markets were calmer after recent volatility. The euro strengthened against sterling, the US dollar and yen, sterling also enjoyed some strength and made gains against the dollar (+4.98%) and yen (+2.65%).

## Economies

News from the domestic economy was dominated by growth estimates for the second quarter which emerged at +1.1%, almost double the consensus expectation. A number of factors contributed to this, including tail end pre-election spending by the government, which boosted particularly activity in the construction sector, a recovery after the weather dislocated early months of the year and continued stock re-building. The problem is that all of these factors have a substantial 'one-off' element to them, raising the concern that, welcome though the growth spurt is, it is not representative of underlying trends and is therefore likely to be followed by more modest growth rates later in the year.

UK inflation edged lower, to +3.2% in June, compared with +3.4% in May and +3.7% in April. Inflation on the RPI measure was higher at +5.0%. Although the trend in the reported data is slightly down, the overall rate seems high for current conditions. The Bank of England has identified a number of special factors to explain the persistency of price rises above target levels, but after a time 'special factors' become less special and instead become incorporated into expectations. Our central forecast is still that inflation will ease back over the remainder of the year but it is not likely to be to the sub 2% levels which were expected even a few months ago.

In the international economy there are growing signs that the consensus approach to policy shared by the US and Europe is breaking down. In the United States the talk is of a potential further stimulus if growth rates continue to fade. In Europe the talk is of financial discipline and of removing existing support at an early date. We expect the rate of expansion in the US to reduce over the balance of the year to perhaps a little over 1%, from the 2.4% estimated for the second quarter, as the boost given by past government actions fade, inventory rebuilding ends and tax benefits come to a close. In Europe by contrast growth has been very hard to come by. Activity levels were unchanged in the final quarter of 2009 and increased by just +0.2% in the first three months of the current year. Growth should be stronger in the second quarter – estimates are in the range +0.5% to +0.7% - but this improvement is built substantially upon German export growth rather than a broad improvement in conditions across the Continent as a whole.

Other news was thin as the holiday season moved towards its peak. The Chinese economy continued to expand rapidly with exports a powerful contributor (up 44% in June, year on year). Growth in the second quarter was +10.3% but advance indicators suggested that growth rates would decline later in the year. In Europe 91 banks were subjected to stress testing of their ability to withstand difficult economic conditions. The tests were criticised in advance as being too soft and there were concerns that some weak banks were not tested at all. As a result, the news that only seven had failed had little impact on sentiment towards the sector.

## Outlook

The one consistent feature of equity markets over the past few months has been the continued high level of volatility as sentiment has swung between confidence in recovery and fears of a double dip. It is quite normal in an economic cycle to see a pause in growth at the phase when stimulus programmes lose their effect and before natural momentum has built. What is causing concern this time is that, in the developed world, the recovery so far has been weak, so there is little leeway before a 'pause in growth' becomes a fall in activity. Furthermore, higher natural momentum essentially means increased consumer expenditure, but with unemployment high, consumer debt exposure extended and credit both expensive and difficult to achieve, there are doubts over whether the consumer will be able to take on the burden of providing momentum. Our view is that the recovery will continue, but also that growth will not be strong. For this reason we favour companies with robust market positions, good balance sheets and an ability to pay high and rising dividends to investors.

Whilst there is clear uncertainty in equity markets the same is not true of bonds: fixed interest stocks are priced on a consistent view, that growth will be weak and inflation will be low. 10 year gilt yields in the UK are, as we write, less than 3.3%, below the current level of inflation. These yields only make sense if growth fades and we fall back into recessionary conditions. If this does not happen then yields have to rise substantially and it is this risk that today makes us cautious of the sector.

In the Commercial property market capital growth is expected to be modest for the months ahead, investor returns are therefore expected to depend on two factors; achieving a high and secure income and avoiding the traps in a sector where occupier conditions are still challenging away from the prime areas of the sector.

### 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](http://www.ccla.co.uk)

**Please note that the content of this report should not be interpreted as investment advice.**

CCLA Investment Management Limited (registered in England No. 2183088 at 80 Cheapside, London EC2V 6DZ) is authorised and regulated by the Financial Services Authority and is the manager of the COIF Charity Funds (Registered Charity Nos. 218873, 803610, 1046249, 1093084, 1121433 and 1132054).