

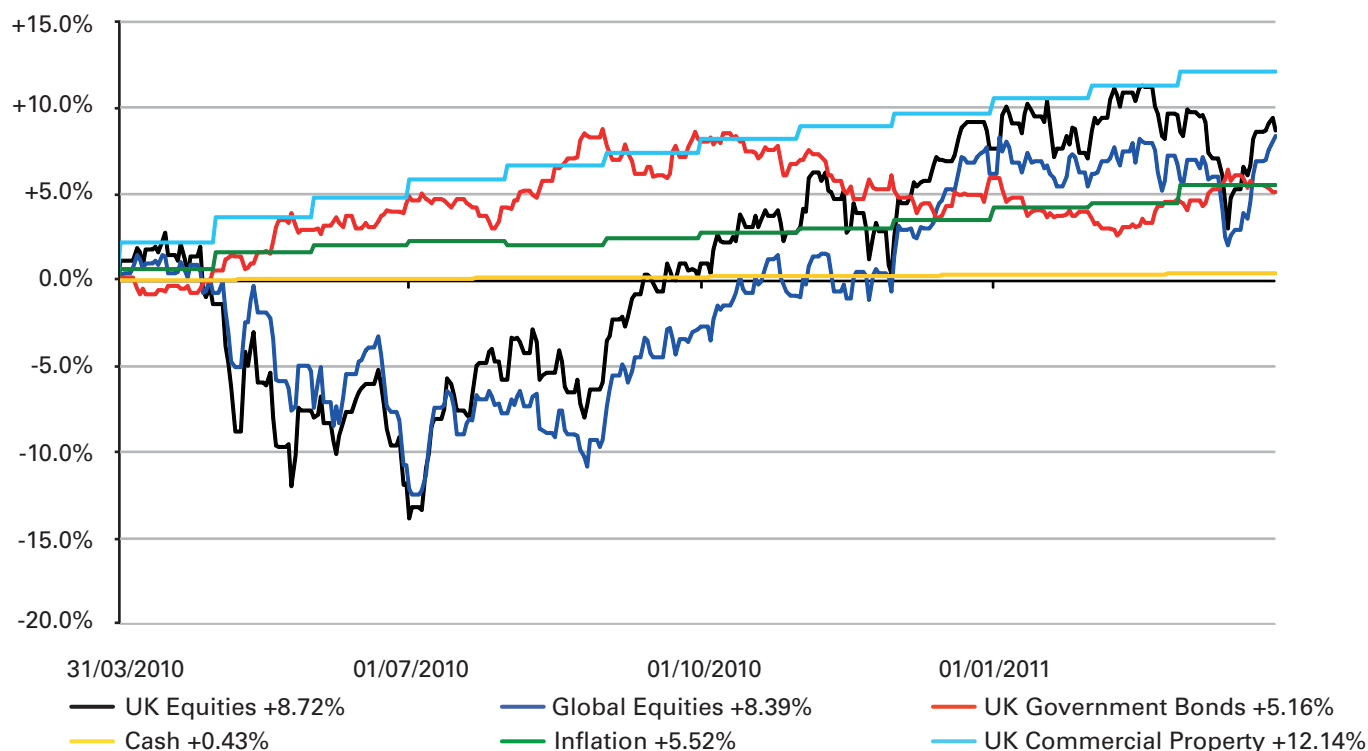
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT MARCH 2011

Headlines

- Overall global equity markets moved higher but the UK bucked the trend and eased back slightly.
- In fixed interest markets both gilts and corporate bonds strengthened.
- Commercial property returns were flat but income flows from the sector were positive.
- Sterling fell against dollar and euro, improved against a weaker 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* (Latest monthly return estimated by CCLA).

Market review

Global equity market indices rose again in March. The FTSE All-World Index gave a total return of +1.50% to a sterling based investor, over the past 12 months the return has been +8.39%. Within this overall outcome there was a wide spread of returns from the various regional indices. The best gains came from Asia, which rose by +6.83% after a poor showing in February (-3.34%). The returns from the USA, +1.52% and Europe, +1.49% were more in line with the global average but Japan fell sharply in the wake of the earthquake and the multitude of concerns that followed it. The return from Japan was -7.62%. At the individual market level Europe's best performances came from Finland (+6.02%) and Denmark (+3.71%), only Switzerland gave a negative return. The gains from Asia were altogether stronger. South Korea, +13.75%, led the way but Indonesia, India and the Philippines all returned more than +10.00% and no countries gave a negative return. Against this backcloth the performance from the UK was disappointing. In a month where sentiment was tested by poor inflation data and fears of an interest rate increase, the indices eased back with the FTSE All-Share Index producing a return of -0.81% and the other capitalisation and style based indices all producing similar results.

Fixed interest markets gave positive returns due partly to a bullish reaction to dull economic data but also due to a couple of technical factors. The government announced a pause in the issuance of longer dated stock, boosting support for existing issues, whilst maturing bonds changed the structure of some of the gilt indices, again helping the valuation of the longer dated sector of the market.

Commercial property has seen occupier markets continue to stabilise although the gap between good quality, income secure properties and secondary offerings has remained wide. Central London has continued to provide the best

performances but there have been recent signs of improvement in shopping centres, in contrast industrials have typically remained a dull sector, with more evidence of falling rents.

Sterling has eased against the dollar and a strengthening euro but has moved slightly higher against the yen.

Economic developments

In the UK the main focus of economic concern has been the rising level of inflation. In February, against an official target of 2%, the rate of change in the CPI was +4.4%, it was +5.5% on the RPI, the highest rate of increase for 20 years. Price pressures are expected to remain high for all of 2011. Indeed, with a continued push on prices from food, fuel and tax, CPI could hit 5% before declining towards the end of the year. The traditional response to this level of price pressure – and maybe the necessary response if the credibility of the inflation target is to be maintained – is an increase in interest rates. The problem is that although headline inflation is at unacceptable levels, the effect of the price rises is deflationary, not inflationary, serving to reduce household disposable incomes at a pace far above that being compensated by the growth in earnings, even before the effect of tax increases. With economic growth only pedestrian and likely to be constrained in the medium term by high unemployment and government spending cuts, and with consumers still carrying a significant burden of debt, raising interest rates is far from a risk free strategy. We expect base rates to rise, but in the third quarter, not in the next few weeks. Although this will signal a new direction for interest rates, the level is expected to be low for the medium term.

In the United States the economic position is altogether more robust. With the recovery slow to get going and unemployment in particular sticky, the US authorities elected to maintain a substantial stimulus to activity levels by means of a second phase of quantitative easing ('QEII'), gradually this has had an effect. Growth estimates for the fourth quarter of 2010 have been nudged up to +3.1%, unemployment has begun to fall and boosted by overseas demand, manufacturing surveys are at their most optimistic for 27 years. With growth now better established, expectations are that the stimulus provided by the easing programme will not be renewed; interest rates however are expected to remain at low levels.

The low interest rate, easy money policies needed in the United States to stimulate growth are fuelling inflation in a range of countries, particularly where there are exchange rate links to the dollar. In many of these nations the recession was relatively mild and the recovery swift, and with activity at levels creating a strain on available capacity, tightening programmes have already begun. So far this year Korea, Thailand, India, Hungary, Poland, Turkey, Brazil, Peru, Chile, China, Philippines, Taiwan, Indonesia, Russia, Columbia and Israel have all begun tightening policies. These will slow growth but will still leave expansion rates relatively attractive.

In Japan, estimates of the economic effect of the earthquake have suggested only a modest direct effect on output. The three worst affected prefectures accounted for only 4.1% of GDP and so even if 25% of output were lost for four months – a slower recovery than that achieved after the Kobe earthquake – the effect would be relatively modest on the economy as a whole. Indeed, looking into the future, the rebuilding and replacement effort for the lost infrastructure in the region would be stimulative, potentially adding more than 1% to overall GDP in 2012.

Outlook

Our central expectation remains one of continued economic expansion, but at only a moderate pace. Expectations for UK economic growth are clustered around +1.5% for this year, rising slightly in 2012 and beyond. We expect domestic interest rates to rise but to remain low and well below the rate of inflation. Economic growth, high levels of new bond issuance and persistent inflation is a combination of factors that we expect to lead to higher yields on fixed interest stocks – and so lower prices – in the months ahead. We expect property values to continue to trade broadly sideways, but for income flows on good quality properties to keep overall returns positive. Equities seem better placed, certainly for the medium term, although there are some near term risks which could hold up progress in the immediate future. These include a sudden move higher in bond yields, deterioration in economic growth rates or profit results which fail to match expectations. Overall we expect some consolidation in the rate of progress before higher levels are achieved later in the year.



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