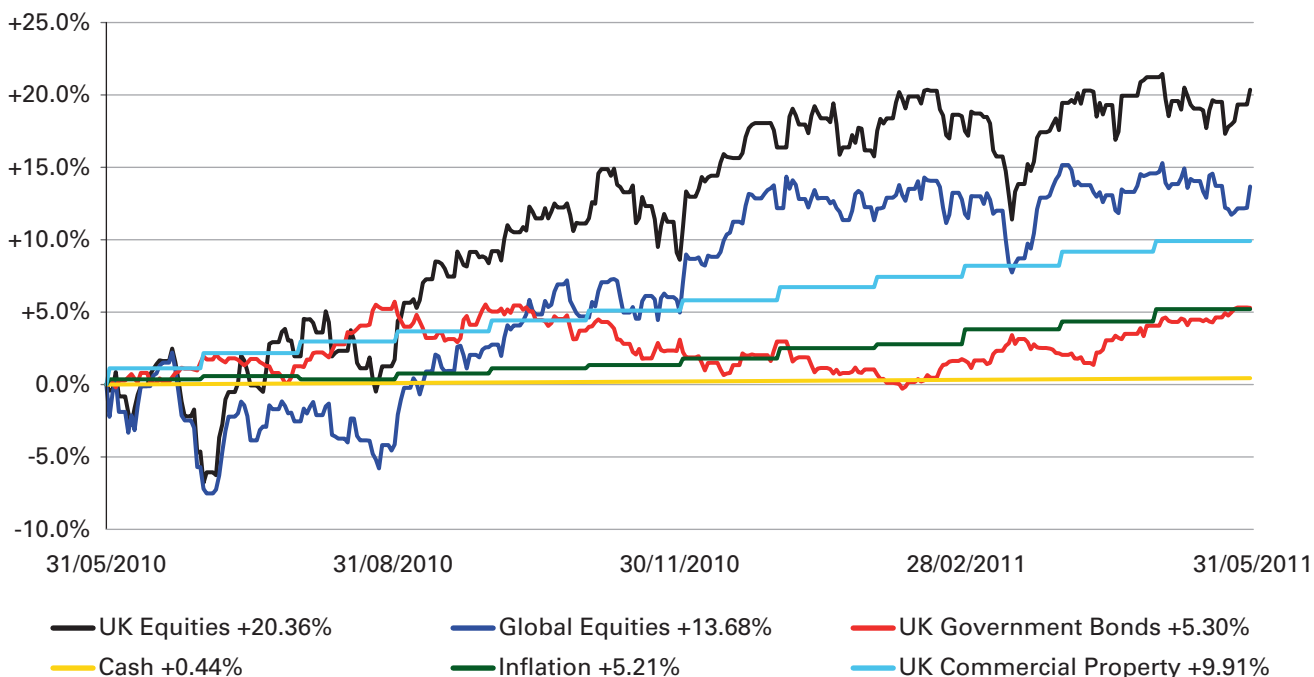


### Headlines

- Equities weakened over the month although a late rally recovered much of the ground lost.
- Fixed interest markets benefited from the increased level of investor caution, higher quality, shorter dated stocks were preferred.
- Commercial property returns were slightly positive due to the contribution from income.
- The ebb and flow in currency markets continued as sterling reversed last month's pattern and rallied against the euro, but lost ground against both dollar and 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

With a background of dull economic news and worries about the financial stability of Greece, global equity markets fell slightly over the month. The FTSE All-World Index in sterling terms gave a return of -0.79% to bring the return for 2011 to date to +1.33% and for the past 12 months to +13.68%. Of the regional markets only the US was able to edge into positive territory, +0.22%, but with the gain substantially due to currency factors. Elsewhere the trends were negative. Japan returned -0.37%, Asia -0.83% and Europe a more substantial -2.31%. Of the individual country markets Greece was comfortably the worst performer, declining by -10.88%. Finland also performed poorly with a -7.79% return but this was due not to economic concerns but rather to poor results from Nokia, the dominant stock in the local stock market index. Trends in Asia were mixed with no real standout performances.

Fixed interest markets benefited directly from increased investor caution. Prices rose for both the government bond (gilt) and corporate bond sectors but, as would be expected in these conditions, it was the lowest risk areas which tended to perform best. Government stocks outperformed corporate bonds; better quality corporate bonds did outperform their lower rated alternatives. Fixed interest returns have lagged those from equities over the past year but have been positive, despite the low yields on offer and the sharp increase in inflation in the period.

Once again it has been the contribution from income which has dominated the returns from commercial property. Although the values of good quality locations have been steady and in some areas such as central London and the better shopping centres have seen growth, for many secondary properties valuations have eased and rents have remained under pressure.

Currency markets have continued to exhibit day to day volatility but without demonstrating a convincing trend. Sterling rose against the euro, by +1.25% but fell against the dollar and yen with declines of -1.55% and -1.16% respectively.

## Economic developments

The main stories over the month have been trends in the domestic economy and more echoes of the debt crisis in peripheral Europe.

In the UK an updated assessment of domestic growth in the first quarter of the year confirmed the pedestrian growth rate of +0.5% recorded in the original estimate. The most disappointing feature of the announcement was the data on household spending which declined by -0.6%, a fall back more consistent with a recession than a recovery. There were of course special factors which will explain some of this including a severe winter, VAT increase and high and rising fuel bills but with national wage growth of 2.5% lagging behind inflation, it is far from certain that there will be – can be – a significant bounce in spending anytime soon. This is important because the government's deficit reduction programme relies on three factors: tax increases, spending cuts and critically economic growth. If growth does not achieve the required levels then something else will have to give. For this reason, and despite another disappointing set of inflation data, expectations for the timing of the first rise in interest rates were pushed back again further into the autumn. Inflation is an embarrassment to the Bank of England but is far less of a problem than fading growth.

In Europe events have been dominated by developments in Greece, which have generated a round of anxiety which has swept up the bond markets in Spain and Italy, as well as Portugal and Ireland. The original hope with the Greek bail out at the end of 2010 was that support from the ECB and IMF would allow the Greeks to put in place a credible recovery plan and so begin a path back to market funding in 2012. This now looks to be impossible. Growth has fallen, the tax take has not improved and against a background of political resistance (there are 17 parties in the Greek coalition) privatisations have been very slow. The yield on Greek 2 year bonds is 24% compared to 0.88% in the UK and 0.45% in the US. Greek bonds have been downgraded to a rating 8 levels below investment grade – the minimum standard for most investors - and the market has adopted a when-not-if stance on default. The real problem is that the Greek debt burden is simply unworkable in any realistic situation. In time some hard decisions will be made but until then we expect more muddling through, made possible by continued ECB/IMF funding.

## Outlook

Our central expectation is for the economy to continue to expand, notwithstanding increased headwinds over the past few weeks. Growth however will be slow. Advance warnings of substantial price rises to come from the energy utility companies support the expectation that CPI inflation will exceed 5% this autumn. Despite that we expect interest rates to stay at very low levels and substantially negative in real terms. We expect a slow improvement in the underlying conditions in the commercial property market but for this to be reflected in valuations later this year and in 2012. In the meantime, excellent yields are available which are attractive for income seeking investors and for those simply seeking a solid return on their capital. We see fixed interest markets as providing poor long term value with the risk of rising yields a real one – the market is supported by its defensive characteristics rather than its fundamental attractions at current levels. Equity markets have remained volatile on a day to day basis but have effectively traded sideways for all of 2011 to date, supported by hopes of continued recovery but held back by debt fears and concerns that growth might slow as governments move from stimulatory to neutral or restrictive economic policies. We do not see an early end to this impasse but do expect higher values later in the year.



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