

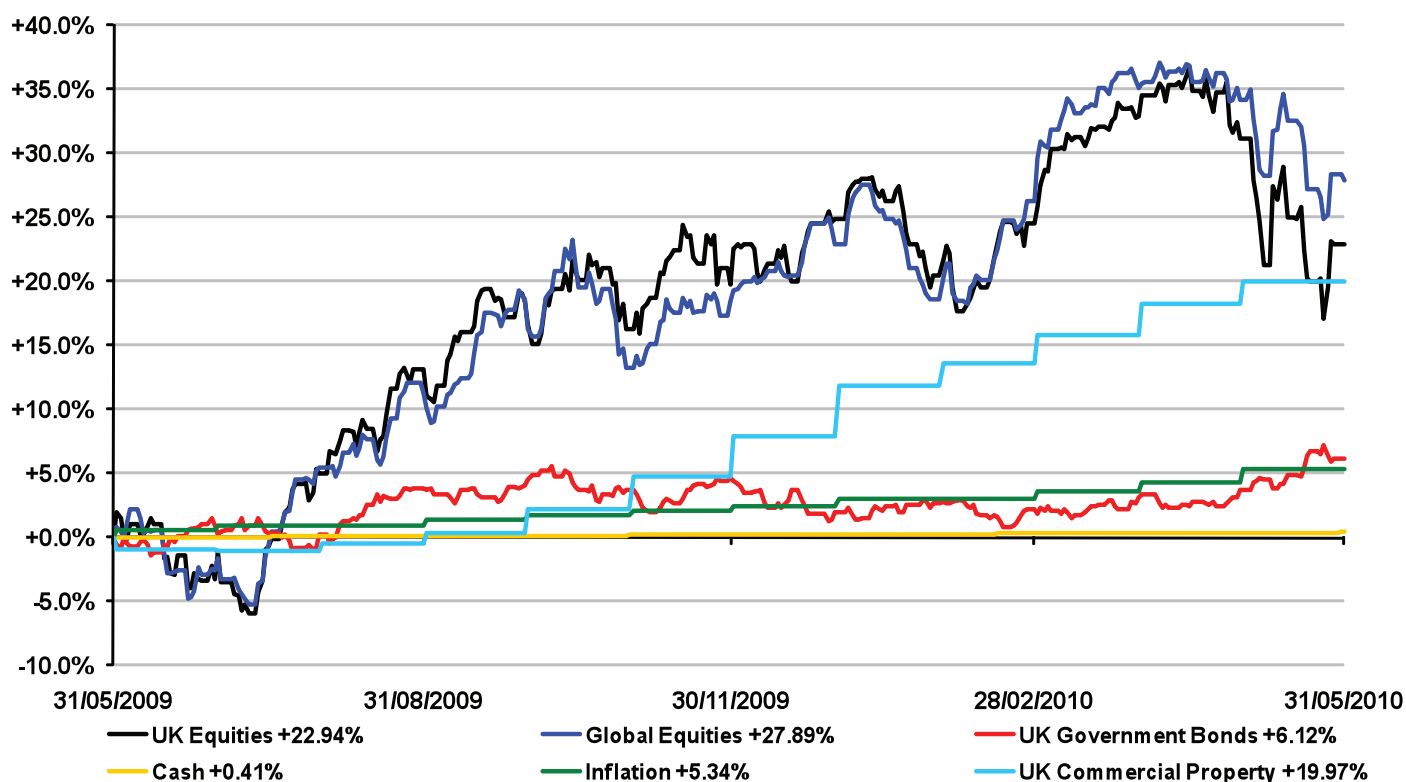
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT MAY 2010

Summary

- International equities fell sharply, European markets were the worst performers.
- Bond returns were mixed, in a reversal of recent trends government bonds were preferred to corporate issues as safe haven investments found favour.
- In the commercial property sector the pace of price improvements slowed as investors stood back from the market.
- The dominant theme in currency markets was euro weakness, sterling fell against the US 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 a month to give a contemporaneous picture).

Review

Global equity markets fell sharply in May as investors became increasingly concerned about the sovereign debt crisis and the prospects for economic growth should governments be forced to focus more on debt reduction than policies to promote growth. Over the month the FTSE All World Index produced a return of -4.65% in sterling terms, -9.49% if measured in dollars – a reflection of the cushioning effect to sterling based investors of the pound's weakness. Of the international regions Europe was the worst performer at -8.01% with all the constituent national indices moving lower. Leading the way down was Greece, down a remarkable -21.76% on the month, but Ireland, Norway, Austria and Spain all fell by more than 10%. Although sentiment in Europe deteriorated most severely other markets were also affected. Asia declined by -5.71%, Japan by -3.14% and the US by -3.21%. The UK market fell back by -6.23%, the overall trend made worse by weakness of the banking sector and the decline of BP on the drilling calamity in the Gulf of Mexico.

Fixed income markets produced a much steadier performance. Government bonds have been in the shadow of the corporate alternatives for many months now but outperformed in May as investors moved to favour safe investments. With most European bond markets out of favour, the UK gilt market saw strong inflows from overseas buyers. Coincident with this, sentiment was improved by the election of a coalition government which promised budget deficit reduction as their prime objective. The FTSE Government All-Stocks Index gave a return of +2.27% on the month. Most areas of the corporate bond market were also just in positive territory, riskier issues though edged lower.

After several positive months, valuation improvements in the commercial property market stalled in May as transaction volumes fell away. With prices significantly up from the lows and economic prospects apparently clouded by events in sovereign debt markets, buyers preferred to stand back rather than push up prices for the relatively modest amounts of prime property currently on offer.

The dominant trend in currency markets was the continued downward pressure on the euro – which fell by -8.04% against the dollar over the month. Sterling gained ground against the euro but fell back relative to the dollar (-4.82%) and the yen (-7.40%).

Evidence emerged over the month that overall world economic activity had recovered back to the levels experienced before the recession, the pattern and sources of demand however are very different. Although total output is back to the old highs, activity in the developed world remains some way below past peaks, having recovered only 60% of the output lost in the recession. Emerging economies in contrast have performed well, particularly Asia, which has more than made up the lost ground with output 10% above the pre-crisis peaks. The recovery in production has been stronger than that in services, a reflection of the manufacturing-centric economic base of China in particular, whilst government activity has been more important than private sources of growth, underlining both the role of government intervention in creating the foundation for recovery and the continued dependence on state support in many countries.

The main driver of market developments remained the debt crisis in Europe, centred on Greece but threatening to spill over into Portugal and Spain. Although slow to respond to the developing crisis due to political problems, the ECB, working with the IMF, eventually offered Greece a loan facility of €110 billion, sufficient to meet requirements for two years and so removing any need over that period to depend on external investors. In addition, to dampen concerns that other heavily indebted members of the euro bloc could also face funding difficulties, a €500 billion loan facility was created. These actions reduced immediate fears but did little to answer the long term questions over debt repayment, for Greece but also other problematical members of 'Club Med'. In reality governments unable to finance debt burdens have limited options, they can default, find somebody else to pay the debt or print money to reduce the burden via inflation. Given the huge volumes of debts in place around the developed world this latter option seems increasingly likely.

Against this background drama the various economic data releases of the month were rather overlooked. In the UK there was disappointing news on both inflation and employment. On the CPI measure of inflation, prices rose by +3.7% in the year to April, on RPI, by +5.3%. Factory gate prices rose by +5.7%, suggesting that price pressures will continue in the months ahead, particularly if duties and taxes are increased in the forthcoming Budget. An increase in the rate of VAT to 20% would push the CPI to +5%. Unemployment rose again to 2.5 million, equivalent to 8.8% of the workforce, it is estimated that another 2.8 million workers are 'under employed', either in part time work or on temporary contracts rather than a full time basis. A concern looking forward is the potential impact of government spending cuts on unemployment. In the last recession, with a government deficit only one third of current level, 600,000 public sector jobs were lost.

Outlook

The setback to equity markets over the past few weeks underlines the frailty of investor confidence; valuations are recognised as being low by historic standards and the recovery seems slowly to be gaining way, but the risks are high and are likely to remain so for some years yet, even on optimistic assumptions. Investors are attracted by potential returns but are still quick to run for cover, creating a volatile environment which many market participants find discomfiting. These conditions are expected to continue in the months ahead.

Turning to the various investment sectors, we expect further gains from commercial property but expect too that the next few months will be quiet. The main attraction of the sector is the high level of income available from well managed funds. UK government bond prices are being supported by buying from investors who are steering clear of Europe and by hopes that the new government will make swift inroads into the budget deficit. In time we expect the sheer volume of bond issuance to re-assert itself as the dominant influence on prices and cause the market to ease back. Equities have strong long term attractions but day to day fluctuations in prices could stay high.

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