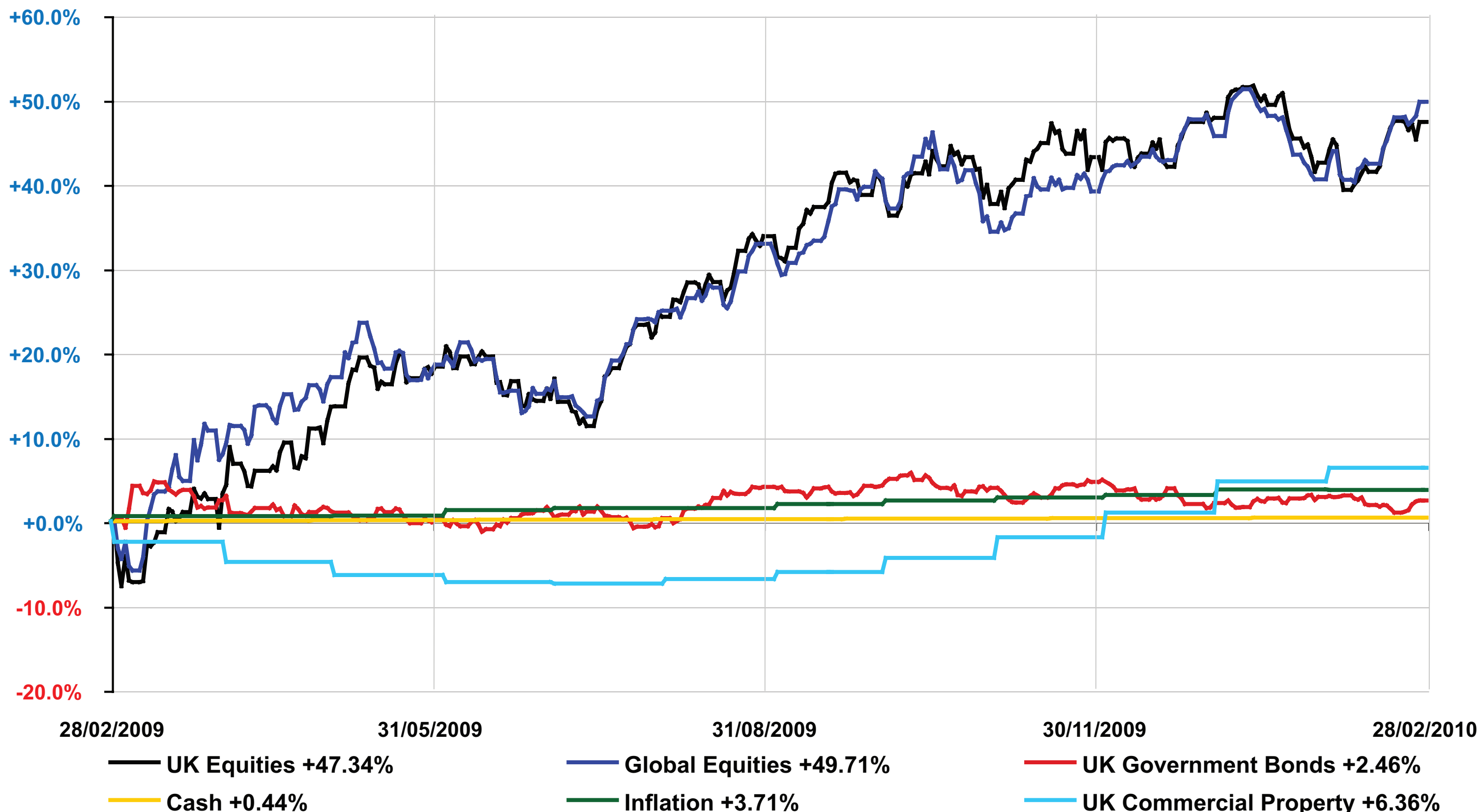
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT FEBRUARY 2010

Summary

- Most equity markets made progress in local currency terms over the month.
- Bonds eased gently, lower risk issues performed best in the corporate bond sector.
- Property edged forward once again.
- Sterling fell sharply against all major currencies.



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 moved higher in February with local currency gains magnified by a weak performance by sterling for UK based investors Over the month the FTSE All-World Index gave a total return of +6.5% in sterling terms to bring the gain over the past 12 months to +49.71%. The uplift in dollar terms was more modest, but still positive, at +1.21%. The domestic equity market also enjoyed a positive month. The FTSE All-Share Index returned +3.37%, within this the largest companies did slightly better (+3.77%) but small companies fell back with a -2.28% loss of value. International markets were generally better. The return from the US was +8.48% to a UK based investor (+3.06% in local terms), Asia returned +6.61%, Europe +2.72% and Japan +6.53% - although these two latter markets were actually slightly down in local currency terms. All the Asian markets made gains with the best returns coming from the Philippines, +12.18%. Europe was more mixed, Sweden was strongest (+7.65%) but predictably Portugal (-0.87%), Ireland (-1.12%), Spain (-2.32%) and Greece (-5.51%) fell again.

In fixed income markets gilts fell back slightly and corporate bonds declined slightly more, with the longer dated and lowest credit quality issues giving up most ground. It is interesting to note the upward pressure on UK government bonds relative to other countries in Europe. Although the rating agencies have said that the UK's AAA ('triple A') rating is secure, investment markets seem to be taking a different view. Against a current reference point of German government bonds which yield 3.14%, gilts now yield 4.07% v 4.03% for Italy - which is only rated A+.

In the commercial property sector values advanced again, albeit at a far less hectic pace than that seen in the final months of 2009. Buyers continued to show interest but were less interested in paying up for deals. Difficult economic conditions continued to put downward pressure on rental levels but the decline, rapid last year, continued to lose momentum.

Sterling lost ground, buffeted by a number of factors including weak economic data, which suggested that interest rates would stay lower for longer, a rise in inflation and by opinion polls which suggested that the election could result in a hung and therefore insufficiently decisive parliament. The pound fell by -4.68% against the dollar, -3.10% against the euro and -6.06% against the yen.

It was a busy month for economic news. In the UK the pedestrian early estimate of +0.1% economic growth in the fourth quarter was revised up to +0.4%. What was unusual about this revision however was that it relied not on data confirming that fourth quarter activity was stronger than previously reports but rather that the third quarter was worse – not something it was easy to spot from the official announcement. Actual activity levels remained weak, with little sign of the momentum historically associated with the early months of an upturn. Despite the lacklustre growth environment inflation moved up to 3.5% from 2.9% in December. The rise was described as an 'echo of the recession' in that 70% of the increase was due to beneficial data, including the cut in VAT, dropping out of the comparison.

Growth in international economies was mixed. In Europe, growth rates slowed to just 0.1% in the fourth quarter whilst the US moved sharply ahead, enjoying the best quarterly performance for 6 years. The rate of +5.9% owed a substantial amount to stock building, an expected but not long lasting feature of a change in business confidence. Typically inventory gains benefit the first few quarters of an upturn and then become neutral as storerooms become filled again. Expectations for growth in the first quarter show this normalisation in process with forecasts clustered around + 2.2%.

Stealing the headlines from recovery however were developments in Greece where a substantial budget deficit and insufficient plans to address it, caused a crisis of confidence. Although the Greek predicament is serious, it is containable; Greece accounts for less than 3% of Euroland economic activity. The real issue is that the challenges faced by Greece are also faced by Portugal and Spain and so the way the Greek problem is resolved is very important. If markets do not see the solution as credible, lasting and appropriate, concerns will widen and in so doing become much more of a threat. These events are likely to be an important part of the investment background for many months yet.

Outlook

In the months ahead the domestic investment markets will increasingly be viewed against a backcloth of UK politics and international economic developments, a situation which can only increase uncertainty and ensure that day to day volatility remains elevated. We need therefore to stand back and try to focus on investment fundamentals. Fixed income markets will be challenged by a huge flow of new issuance which we believe will be a major factor in pushing yields higher. Equities have rallied up to historic average ratings and now need to be supported by earnings growth. We expect this to result in higher prices over the balance of the year. Property valuations are enjoying more support to prices through transactional activity. We expect more steady progress in the months ahead. Sterling has weakened but remains vulnerable.

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