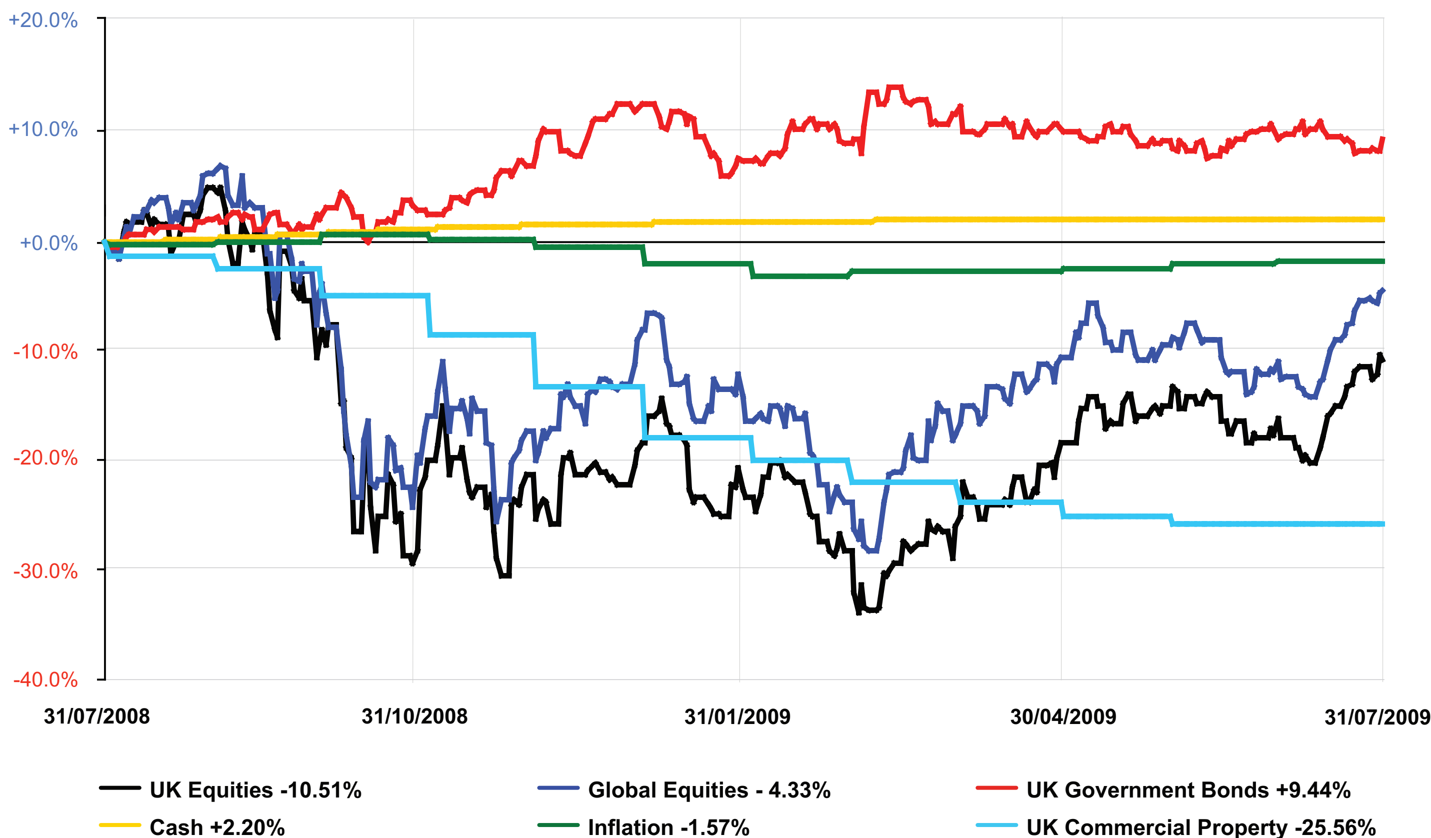
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT JULY 2009

Summary

- Global equity markets have moved higher on hopes of economic recovery and better than feared profits.
- UK government bonds have eased back but corporate bonds have advanced with lower quality issues particularly in favour.
- Property values have reduced further but the pace of decline has moderated.
- Sterling has traded within narrow ranges, gaining value relative to the dollar but losing ground against the euro and yen.



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

Having paused in June, global equity markets resumed an upward trend in July, buoyed by further signs of economic improvement and company results which on balance exceeded expectations.

The FTSE All-World Index produced a return of +8.19% for a sterling based investor, leaving the return over the year only slightly negative at -4.33%. The UK enjoyed similar strength over the month, the FTSE All-Share Index gave a return of +8.50% and within the market there were very similar performances across large and small capitalisation groups and value and growth market segments. In overseas markets the strongest returns came from Asia although all regions participated in the uptrend. Asian markets rose by +11.51%, Europe by +10.41%, the USA by +6.87% and Japan by +3.42%. The range of returns from individual markets was wide. Only Finland produced a negative return (-0.88%) but Portugal (+2.67%) and Pakistan (+3.10%) made little positive progress. At the other end of the range Sweden returned +17.59% and Indonesia +24.37%.

UK government securities edged back slightly as investor attention moved to areas more likely to benefit from recovery. Corporate bonds benefited from these sentiments and enjoyed good gains in all maturity and credit quality segments but the best returns came from in the areas most geared to the upturn – the longer dated and lower quality issues. The FTSE Government All-Stocks Index gave a total return of -0.76% compared to +5.38% from the iBoxx non-gilt BBB Index.

Commercial property values continued to decline although the pace of reduction moderated. The shift to higher yields which pushed prices lower in the early phase of the downturn seems now substantially to have run its course. Unfortunately a new factor has emerged to unsettle investors, rents are now falling in all sectors and most regions of the UK and although prime locations are showing resilience, secondary sites with weaker occupiers are proving vulnerable.

Economic news has continued to support the view that the worst part of the downturn has past. Manufacturing output is showing patchy signs of improvement as de-stocking comes to a close and order flow begins to normalise once again. Unemployment however has continued to increase. In the UK the number without work rose to 7.6% of the workforce, up 2.4% on the year. The young have been particularly hard hit by the downturn with the result that 17.3% of the 18-24 year old cohort is searching for work. The problem is not confined to the UK, unemployment is 9.5% in both Europe and the USA – 6.5m American jobs have been lost so far in the recession. A more positive effect of reduced activity levels is that UK inflation remained subdued. The CPI measured a +1.8% rate of price increase in the year to June, down from +2.2% in May, the RPI measure of inflation was negative at -1.6%. The OECD has published a survey of excess capacity in the world economy which shows surpluses across the developed world, ranging from 4.9% in the US to 6.1% in Japan. This available additional supply will act to keep a cap on price rises in the period ahead.

Domestic bank lending statistics show an overall decline in loans outstanding to the corporate sector with the reduction the result of an interesting interplay of factors. In part it reflects the efforts of the companies themselves which have been reducing debt by running down stocks and cutting costs. Equity and bond issues have helped relieve the burden, especially for some of the larger companies, but weakened bank balance sheets and tighter lending criteria have been a factor too and this threatens to be a particular problem for the medium and smaller company sectors where alternatives to bank facilities are fewer.

Outlook

We continue to view equity markets as good value for medium and longer term investors. Ratings are not stretched and although they are not as cheap as they have been, there is plenty of scope for further gains as ratings adjust to a recovery in profits in the year ahead. In time attention will move from expectations of recovery to an assessment of likely trend growth rates – which will be modest by the standards of recent years and this will influence the pace of progress at a point in the future.

Volatility is expected to stay at elevated levels and sharp reactions to negative or disappointing news flow are a risk investors must come to terms with. The same expectations of recovery that boost equities will support corporate bond valuations and in so doing allow that sector to outperform government stocks.

In the Property sector yields on even good quality assets are discounting falling income levels in the future. This eventuality will be true for some properties but not for all and so for income seeking investors able to take a medium term view and ride out what could still be a bumpy ride for capital values over the next month or so, the sector is increasingly looking attractive.

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