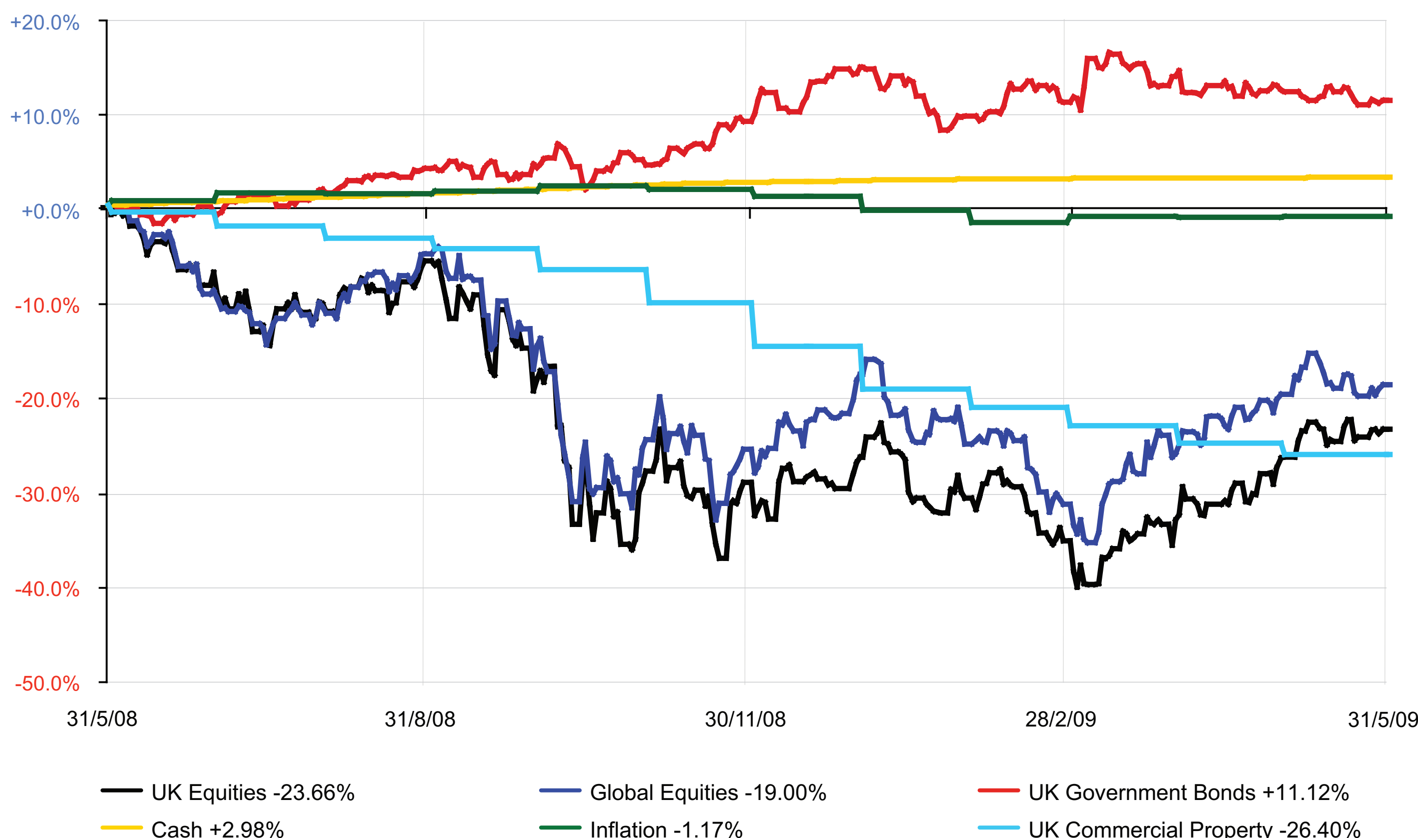
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT MAY 2009

Summary

- Equity markets extended their rally over the month.
- Gilts gave negative returns but corporate bonds performed better, with the lower rated areas of the market performing best.
- Property markets remained under a cloud.
- Sterling rallied, particularly relative to a weak dollar.

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

Equity markets further extended the recovery in prices that began in March as investors increasingly took the view that the economic downturn, although intense, was moderating. The other effect of this change of mood was that those investments which had previously performed well, because of their safe haven connotations, eased back. Government securities and the dollar are both examples of this development.

Over the month the FTSE All World Index gave a return of +1.28% to a sterling based investor bringing the three month gain to +18.54%. The three month gain to a dollar based investor, inflated by currency weakness, was +34.11%. In the UK the May return on the FTSE All Share Index was +4.19%, with larger companies performing slightly better and small companies lagging after exceptional strength in the previous month. In overseas markets investors enjoyed gains in local currency terms although the rally in sterling generally reduced the improvements from a UK investor perspective and in the case of the US reversed a rise to an overall negative return. The gain from Europe was +4.92%, from Japan +1.36% and from Asia +5.83%. US returns were a negative -3.10% (compared with +5.45% in local currency terms). The range of returns from individual markets was, as ever, wide with India, buoyed by a popular election result, leading the way (+25.56%) but with Singapore, Hong Kong, Austria and Norway all rising by more than 10%.

Commercial property markets did not share in the improved sentiment. Instead the dominant influences were negative and in particular participants remained concerned about weakening rental levels and threats to sector financing. Non – prime High Street rents have fallen by c.30% from their peaks whilst sector debt of c.£43 billion is due to be repaid or refinanced over the balance of 2009. There are worries about the willingness of banks to recommit on the same scale to a sector where values are still under pressure.

Government securities gave a negative total return of -0.98%, a similar outturn to April. Although not significant in themselves, these declines are indicative of the increased risk appetite of investors and thus of their willingness to invest in other assets, and of a growing concern at the scale of the volumes of new gilt issuance that will hit the market this year and for several years to come. Corporate bonds did better, supported by higher yields in a market where high income sources are in strong demand. The iBoxx Non-gilt AAA Index returned +0.18%, the BBB Index in the same series +5.7%; BBB is the lowest rating still considered to be of investment grade quality.

Economic news was patchy but there was sufficient evidence that the worst of the downturn had passed to give hope to investors. Of course a moderating downturn is not a recovery, getting worse more slowly is not getting better, but signs of a gentler decline boosted hopes that growth might resume later this year or in 2010 for countries with deeper problems. The most recent assessment of UK economic activity confirmed previous estimates that activity had fallen by 1.9% in the first quarter, but also suggested that all of this was due to destocking and that, with overall stock levels now reduced by over 50%, the scope for this trend to drag down overall output in the months ahead was much reduced. In the international economy manufacturing trends in India and China turned positive and Germany experienced growing exports in March. In Japan, where activity has been very depressed, manufacturing surged in April at the fasted pace experienced since records began 56 years ago.

Coming alongside this encouraging news flow was some very sobering news on UK government finances, with a forecast that in 2010 government spending would account for 52.4% of G.D.P. but government revenues would cover only 38.7%. A gap of this scale is extraordinary and is associated with extreme economic stress such as war time. Furthermore, less than 3% of the shortfall is due to the recession, the rest is structural and therefore can only be eliminated by tax increases and more particularly spending reductions on a massive scale. So far the government has not provided any guidance on where the axes will fall but it looks very likely that whichever party wins the general election due by May of next year, the economic programme will be one of wide ranging austerity.

Outlook

The rally in equity markets has reflected relief that the worst risks of a protracted deflationary slump have passed. Although prices have moved up substantially from the depressed levels experienced in March, ratings are not stretched but neither are they quite so much in the bargain basement area and so further sustainable progress will need to be supported by real, rather than simply hoped for, economic improvement. For government securities the picture is more of a concern. The safe haven considerations that justified a 50% relative outperformance by gilts of equities are in less demand now whilst the issuance programme is a looming threat of massive supply to the market place. It does not seem likely that we will see real weakness anytime soon but a further erosion of the relative position is likely.

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