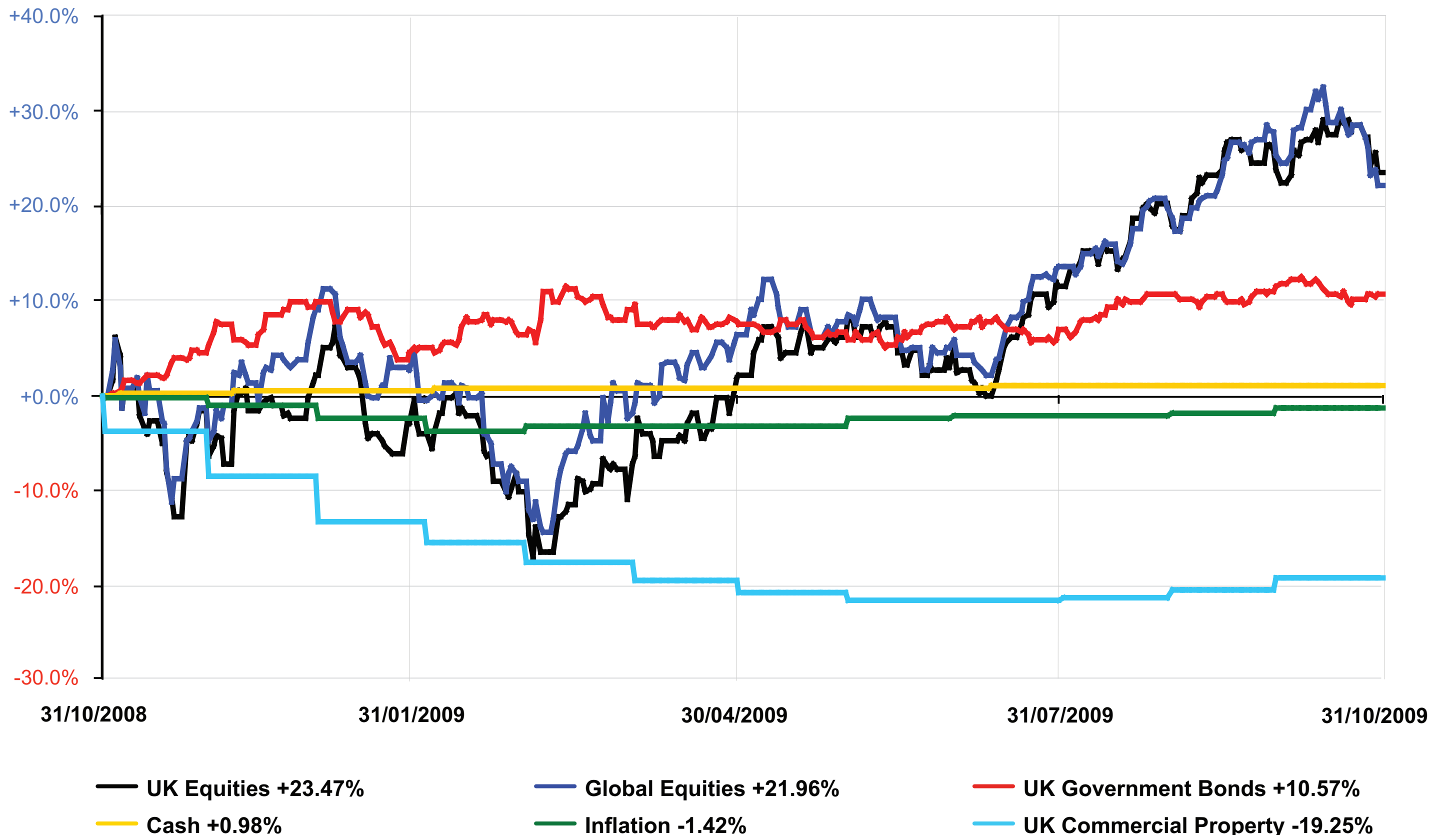
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT OCTOBER 2009

Summary

- Global equity markets fall back after an extended upward move.
- UK government bonds ease but corporate bonds continue to advance.
- Property prices move forward again despite further downward pressure on rents.
- Sterling has rallied against dollar, 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

Global equity markets fell back in October as investors locked in profits after an extended period of rising prices.

In sterling terms the FTSE All-World Index gave a negative total return of -4.47%, for a dollar based investor the decline was less, at -1.54% The change in the index over the past 12 months has been strongly positive, up by +21.96% to a UK based investor and by +20.72% to one with a dollar base, a reflection of the improvement in investor confidence that has occurred in the period since March. Over the month the domestic equity market mirrored the move in the world market with a negative return of -1.82% on the FTSE All-Share Index. Large companies performed similarly but smaller companies fell slightly more, at -3.66%. This section of the market has been at the forefront of the share price rally and was therefore more extended in valuation terms than the standard alternatives. In international markets the same broad trends were apparent. The US market returned -4.85%, Europe -5.36%, Japan -5.55% and Asia -3.38%. Very few individual markets managed to advance. In Asia, China returned +3.53% and both Hong Kong and Malaysia were just in positive territory. Sweden was the best performer in Europe. At the opposite end of the scale the worst performing developed market was Ireland which produced a negative return of -21.60% and is now one of the very few countries where investment markets have made no progress over the past 12 months.

The UK government bond market (gilts) gave a slight negative return (-0.27%) but corporate bonds were a little better, supported particularly by lower grade and longer dated issues. The iBoxx BBB Index returned +1.63%, the 7-10 Year Maturity Index +1.32%.

Commercial property values moved upwards again despite continued, albeit less pronounced, weakness in rental values. Transaction volumes have remained low but there are clear signs of increased buyer interest and cash flows into specialist sector funds have risen.

Sterling rallied against the dollar, euro and yen, rising by +2.94%, 2.35% and 3.38% respectively.

Economic news was mixed, as is normal at a time of trend change. International news saw the IMF upgrade expectations of world economic growth for the first time in 2 years, to an overall +3.1% rate of expansion. The improvement however is heavily biased towards developing economies, which are expected to grow by +5.1% compared with +1.3% in the more mature nations. Chinese GDP estimates certainly supported the suggestion of strong growth in the emerging economies. Third quarter growth was estimated at +8.9%, so strong that it sparked concerns of over-heating and speculation as to when the government might ease back the stimulus programme still in place.

In the major economies the best news came from the United States where data suggested that economic growth had resumed in the third quarter, ending the longest downturn in activity since the depression of the 1930s. Early stage output estimates are adjusted more often than not as additional information becomes available. In this instance however the claimed scale of the expansion achieved strongly suggests that, whilst the precise level of growth may be adjusted, an uptrend is securely in place.

Against this broadly positive backcloth the early estimates of activity levels in the UK economy were a particular disappointment. Consensus expectations of a modest expansion were shown to be far too optimistic by an outturn which suggested that output had fallen by 0.4%. Expectations are that as evidence of activity in the quarter becomes more substantial so these estimates will be revised upwards, but unless the upgrading is substantial it seems that, having endured a sharper recession than many nations, the UK is also recovering more slowly.

Whilst the focus is on the severity of the downturn it is worth noting the sad plight of Iceland where the stock market has lost 97% of its value, GDP has declined by 8.5%, inflation has risen to 11.7% and unemployment has risen from a little over 1% to 8.6%.

Outlook

The evidence is increasing that the developed economies overall have turned the corner from economic contraction to growth, helped by an end to de-stocking by industry but importantly by massive government intervention. As the need for emergency support reduces so questions grow as to when and how quickly this support will be withdrawn. Too soon and a fragile recovery will be threatened, too late and there is a risk of inflation pressures building. The indications are that the authorities will err on the side of growth, given the asymmetry of the risks so soon after a major recession.

In terms of markets, we are more cautious on fixed income investments, particularly government bonds, which we see as fully valued at current levels and increasingly exposed to upward yield adjustments as quantitative easing ends and increased issuance begins.

Property in contrast seems good value for those able to look to a multi year horizon. Yields of more than 7% when deposit rates are less than 1% are in themselves attractive, but there is the additional prospect of some improvement in capital values.

Equity markets have risen on the hope of economic revival and under the impact of easy money flows. Having risen by over a fifth in the past quarter they seem to be ahead of the game and should consolidate at, or ease back from, current levels.

We remain cautious of sterling and expect it to weaken against the major economies.

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