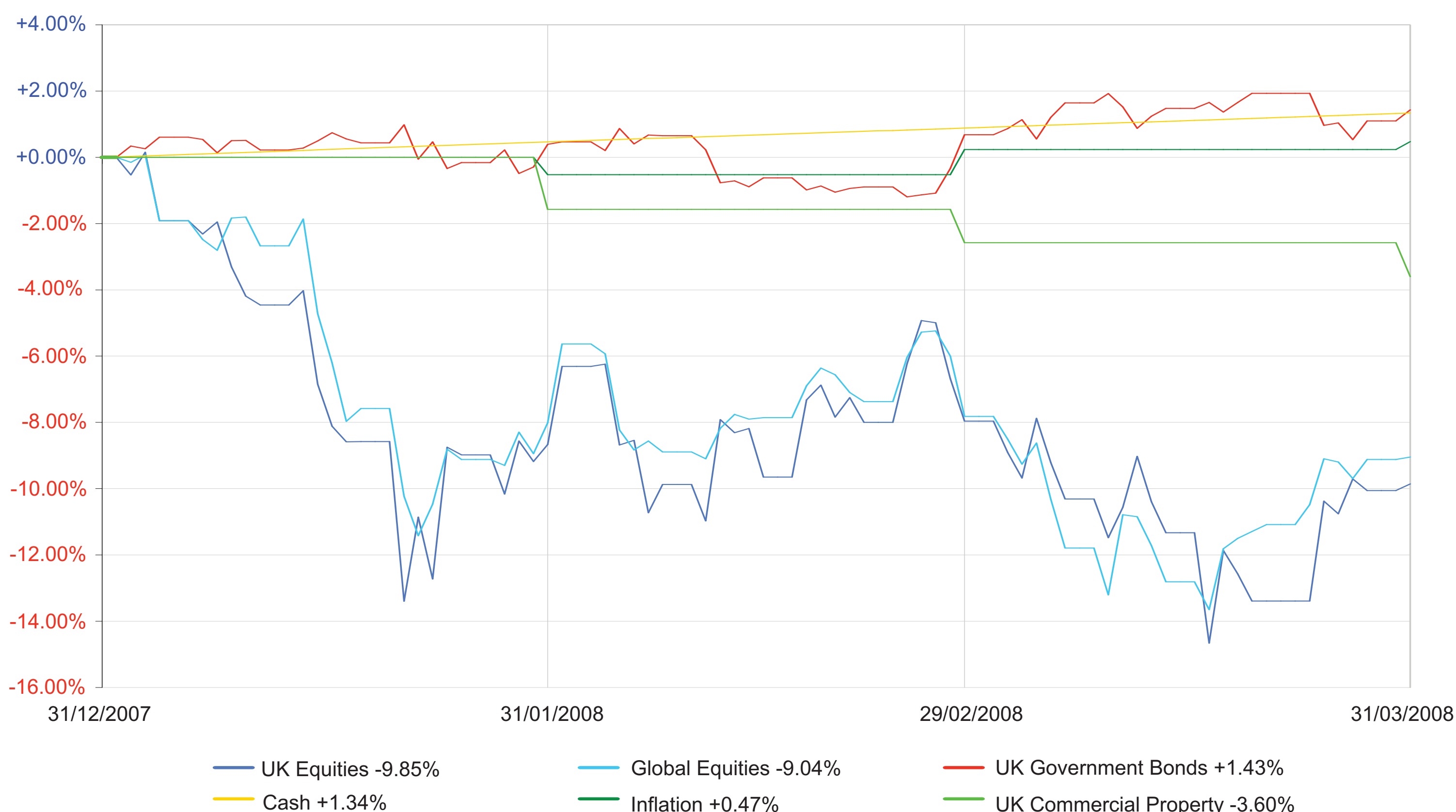
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT APRIL 2008

Summary

- Equity market values swung sharply. Although they ended the period substantially above the worst levels, they were nevertheless down on the month.
- Government bond markets continued to benefit from the ‘flight to safety’ effect.
- Values continued to decline in the commercial property market.
- There was further evidence that central banks are willing to take action to restore market confidence.
- Investor confidence remains frail and markets should be expected to remain volatile in the near term.

Review

Market returns - 3 months



Source Bloomberg: FTSE All-Share Index, FTSE All-World Index, UK Govt All-Stocks Index, 7 Day Libid, RPI

March proved to be a see-saw month for equity markets. Early weakness saw both UK and global indices down to the lows recorded in January before a sharp rally in mid – month reduced the losses to more modest proportions. The FTSE All-World Index produced a total return to a sterling based investor of -1.33%, thanks to the relative resilience of Wall St where the bounce from the lows was strong enough to leave the overall return almost in balance (-0.49%). Another positive feature was Europe, where a UK based investor saw a positive return of +1.80%, however this reflects currency factors as well as index returns. Other areas did less well; Asia Pacific fell by 3.55% and Japan by 3.66%. Away from the major indices there were some contrasting performances at the individual market level. In Europe, Spain rose by 5.38%, Finland fell by 6.12%; in Asia, Taiwan rose by 2.87%, China – only a few months ago the darling of international investors – fell by 13.82%. The China Index has produced a return of -25.68% over the past three months. Looking back over the month it is the smaller market returns which gave the truest picture of market trends.

Government bond markets once again made progress as investors sought respite from the equity arena. Support however was very much based on safe haven buying and it was the least risky sections of the market which did best. Government securities again outperformed corporate bonds and in the corporate area the best returns came from the shorter - dated stocks and those with the highest credit ratings. Commercial property prices continued to weaken although the pace of decline slackened. Trading levels were light however and in the absence of deal volumes it remained difficult to establish true prices in many areas. One area which did fall back was the retail warehouse sector. Previously this had been supported by attractive yields but prices eventually succumbed to the general trend to lower values.

In the currency markets the month saw marked weakness from sterling which fell in line with the dollar and lost about 4% of its value against both the euro and the yen.

Economic news over the period continued to paint the picture of a world economy where growth rates were gradually slowing. In the US, the news began to indicate that growth would turn negative and the economy would move into a recession. Evidence for this was broadly based. The ‘beige book’ summary of current economic conditions showed signs of activity levels declining quite sharply. This was echoed in the High Street, where retail sales growth turned negative and in auto sales, where the January and February combined sales totals were the worst for a decade. Here, it is not just the willingness of customers to commit to a large scale purchase that is the problem, for many it is the cost and availability of credit which has forced them out of the market. The cause of many of these problems, weakness in the housing market, continued. Prices fell again to give thirteen months of declining values and the backlog of unsold homes rose to 9.6 million. Finally, the Conference Board, a respected source of economic monitoring data, published its forward looking indicator of expectations, it was very downbeat and consistent with a fall of about 1% in overall output.

In the United Kingdom, the Budget attracted few headlines, but one piece of data that did cause comment was the projected value of government bond sales. At £80 billion this is the highest ever and illustrates how tight the government’s financial position is ahead of what is likely to be a period of lower growth. The Bank of England maintained interest rates unchanged during the period, concerned about inflation but also voicing a view that the economy needed to have a period of slow growth to work - off the excesses of the credit boom. As in the US, domestic house prices were under pressure but to a much lower degree. The Nationwide Survey suggested that home prices had fallen back for the fourth month. An increasingly important factor contributing to this is the reduced level of housing finance available. Over half of the mortgage offers outstanding six months ago have been withdrawn and the terms of those still open have been made less generous in both scale and cost. Warning signals continued to flash on inflation. Producer prices rose by 5.7% and raw materials by an extraordinary 19.3%. Perhaps the most worrying statistic though related to food prices, up by 6.6%.

In Europe the ECB held interest rates and again voiced concerns about inflation. Despite the strength of the euro, which is effectively tightening monetary policy, growth in Euroland continues to meet expectations. The main engine for that is Germany, where activity and business confidence have risen over the past three months. In contrast, the Spanish economy, dependent for construction and housing for much of its recent growth, is suffering badly.

Turning to financial sector news, the US Federal Reserve (Fed) continued to demonstrate its commitment to making sure the credit crisis did not damage the financial system as a whole. To help ease the liquidity squeeze it widened both the range of assets it would accept as collateral against borrowing and the number of finance houses to whom the borrowing facility would be available. There was also another substantial cut in interest rates to 2.25% - they were 5.25% just a year ago. More hedge funds announced they were in difficulty (Carlyle and Thornburg) but these were soon overshadowed by the spectacular and sudden collapse of Bear Stearns. In the Fed engineered ‘rescue’ shareholders were initially offered $2 per share of their holdings, compared with a price of $160 in 2007.

Outlook

The trend to slower economic growth in the world economy is well established and will continue to develop in the months ahead. Against this background, as acceptance grows of lower activity later in the year, so we should expect to see reductions in earnings forecasts coming through.

Further actions to ease the liquidity shortage are likely in the US, UK and Europe, but whilst these will help at the systemic level, for the commercial or individual borrower conditions will continue to get tougher as wider credit spreads push borrowing costs up and the availability of credit remains tight.

Emerging economies will do better, but clearly will not be unaffected by cooling conditions at their customers. Recent equity weakness in these areas suggests that investors are coming to terms with this likelihood.

However, although the backcloth may appear dull, we have to remember that much has been discounted by equity markets which have fallen back over recent months. We expect volatility to stay high near term, with substantial moves possible even on a day to day basis, but behind this value is beginning to build.

In bond markets, we think that there is insufficient attention being paid to the risks of inflation and that therefore the sector is fully valued at present. Having fallen sharply relative to their government issue counterparts, selected corporate bonds are offering good relative value.

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