

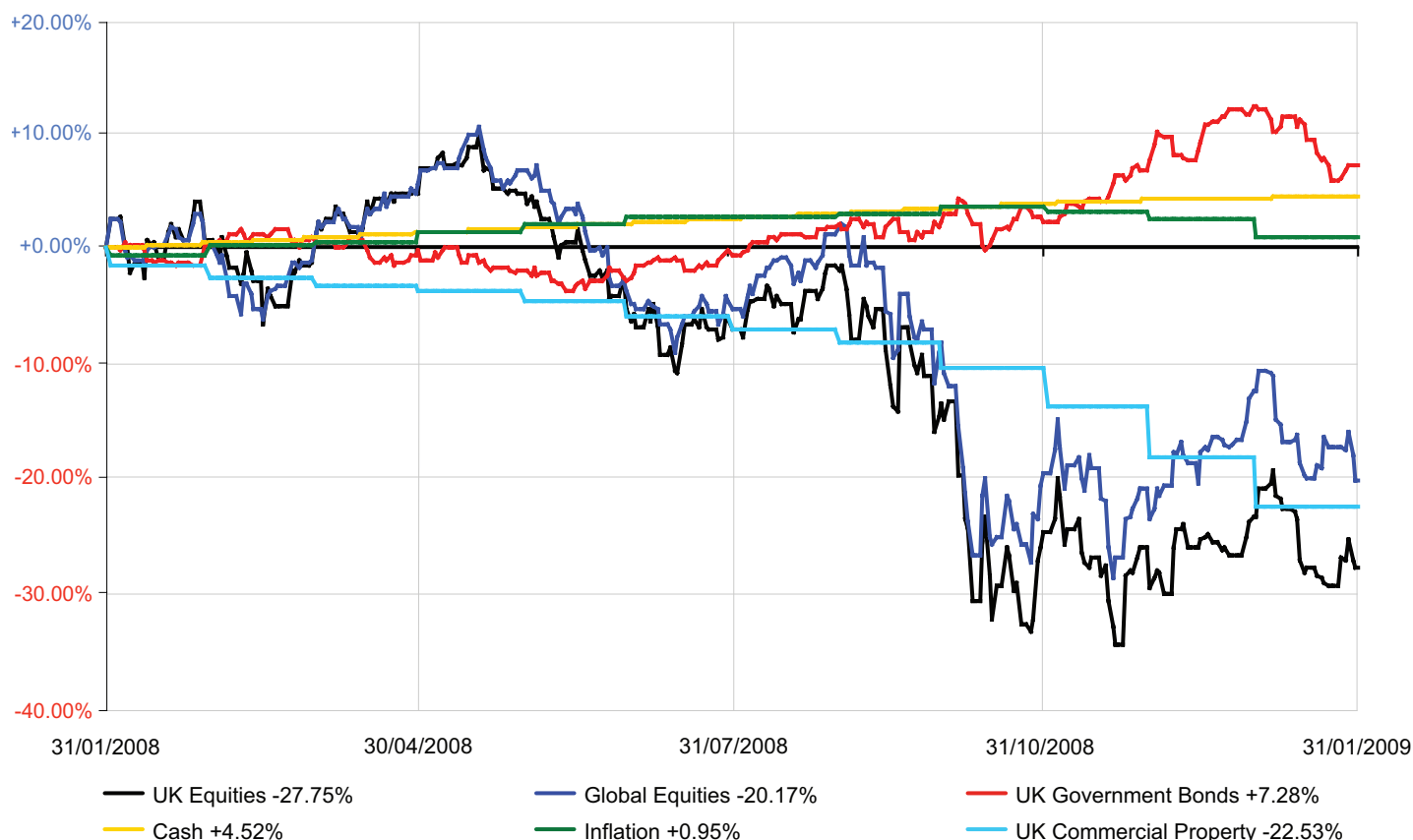
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT JANUARY 2009

Summary

- After sharp rallies at the end of 2008 equity markets fell back at the start of the New Year.
- Bond markets also retreated with government bonds easing back in line with corporate issues.
- Property fell again and is the worst performing asset class over the past three months.
- Sterling was stable relative to the US dollar and rallied against the euro.

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

Having rallied in December equity markets wilted at the start of the New Year in the face of disappointing economic news and adverse developments in the financial sector. Data from around the world economy showed that the rapid fall in activity levels that occurred at the start of the third quarter continued unabated into the new year with all major countries and all areas of activity affected. In investment markets prices reduced to reflect the realities of a recession the impact of which seemed likely to be deeper and longer lasting than had been discounted even a few months before.

Over the month the FTSE All World Index returned -9.06% to sterling based investors. For the first time in many months currency effects were not substantial, the decline in the index in dollar terms was -8.69%.

In the domestic equity market the return on the FTSE All Share Index was -5.83%. In a reversal of recent trends large companies underperformed the market as a whole and the FTSE 100 Index returned -6.35%. Another reversal was the relative decline in 'value' companies – typically those on lower earnings multiples or higher yields. Having performed sharply better than the higher rated growth sector for the latter half of 2008, this segment of the market fell back by a substantial -11.68% whilst growth stocks declined by just -2.46%.

Overseas markets followed the same broad path of retreat. In the US, returns were -8.54% for a sterling based investor, -8.29% in local currency. The performance from Japan was broadly similar at -7.24% as was that from Asian markets (-7.65%). Local European returns followed a very similar trend but were made worse by the pound's rally against the euro and ended the month -13.64% down. The weakest European market was Germany which fell by -17.17% but Finland and Italy were also weak.

The UK government securities market fell back as 'safe haven' buying reduced and investors focused instead on the huge volume of stock that will be offered to the market in the next year and the prospect that finding buyers for the new supply will force yields higher. Corporate bonds also fell back but less so. In a market which lacked consistency, the best support was given to the most highly rated and shortest dated issues – continuing the cautious theme which has dominated the past few months.

Index data on the property market is still awaited but anecdotal evidence suggests strongly that the price weakness that was evident in the final period of 2008 continued unabated. Despite substantial weakness over the past year valuations remain above price levels actually being achieved in transactions and, no longer able to view the disparity as an anomaly, valuers are moving their estimates down to reflect the harsh reality of the market. A concern is that falling rent levels, already seen in parts of the office market and now appearing in the retail sector, could reduce further the prices which buyers are willing to pay, thereby triggering another bout of weakness.

The economic background to the period was consistent with the news flow which has challenged investors for much of the past year. In financial markets concerns remained about the stability of the banking sector. Dresdner Bank received support from the German government to allow the merger with Commerzbank to complete. In the US it was the turn of Bank of America to seek assistance. Bank of America took over Merrill Lynch in an opportunist deal as the financial sector storm broke, however, having reviewed the acquired business thoroughly, it has reported bad debts on a scale far larger than any thought likely at the takeover and has had to seek Federal help to support its balance sheet. The financial sector debate in the UK has been darker, pondering not whether the UK's banks are too big to fail but rather whether they are too big to rescue. In terms of liabilities UK banks have similar scale to their US counterparts but the economy of course is far smaller. If government resources are stretched by the rescue measures already outlined, how do they provide support if the crisis worsens again?

Published data has catalogued with unpleasant consistency the slide into recession of the world economy. Manufacturing output has fallen sharply as factories try to stop a build up of unwanted stock and unemployment has begun to rise as companies cut costs in the face of falling demand. Inflation trends have benefited from falling input prices. In Europe the rate fell to 1.6% but it declined by only 3.1% in the UK despite a 27% fall in wholesale electricity prices, the culprit was food costs which remained high.

Preliminary estimates suggest that UK GDP declined by 1½% in the final three months, the largest quarterly fall in output since the early 1980s. Industrial production, which accounts for 18% of total output, is reported to have contracted by 4% while service sector output, which accounts for 65% of output, fell by 1% compared with the previous quarter.

Growth in the economy has been heavily dependent on the financial sector. Since the start of 2003 until mid 2008 overall economic activity has increased by 12% despite a -5% contraction in industrial production over the period. Over the same time the financial services sector grew by 40%, and has thus been a dominant contributor to the growth enjoyed by the economy as a whole in recent years.

Outlook

The momentum behind the slow down in economic activity will mean that data will continue to deteriorate in the months ahead, unfortunately this is to be expected given the extended nature of the cycle and the dreadful shock given by the crisis in the banking system. Governments have taken huge and heroic steps to moderate the downturn and put down foundations for recovery, but the effect of their actions will take time to come through. For those looking for recovery the focus should be on the second half of 2009, later for some areas.

Equity markets have been hit by distressed selling and by fears of economic melt down. Having fallen sharply and with investor sentiment at rock bottom levels, there are no real expectations of growth or recovery, but these will come in time. Valuations are low by historic standards and reflect already a severe and lasting downturn. At some point they will begin to reflect something better and when that happens prices will rise.

James Bevan

Chief Investment Officer CCLA



CCLA INVESTMENT MANAGEMENT LTD
80 Cheapside, London EC2V 6DZ

Client Service T: 0800 022 3505 F: 0844 561 5126
www.ccla.co.uk

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