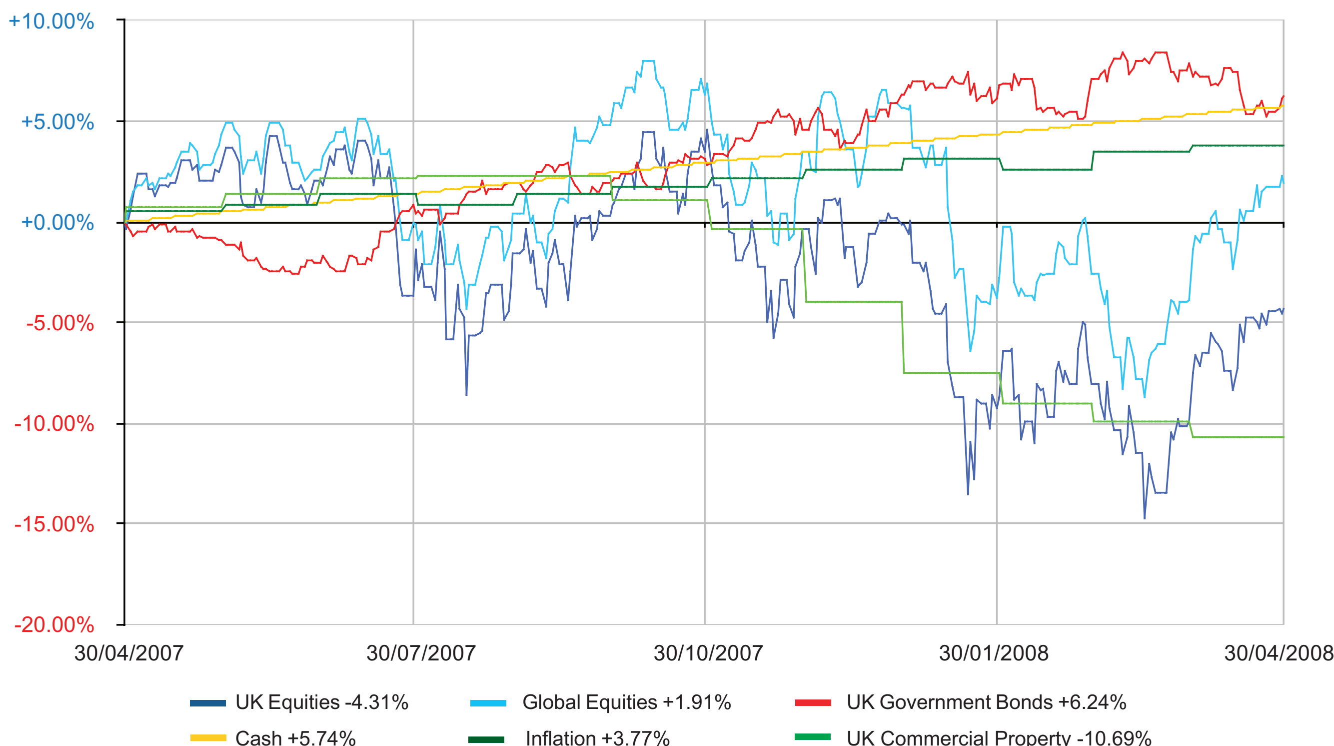
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT MAY 2008

Summary

- Equity market values bounced strongly in April as confidence grew that determined action by central banks had averted the worst risks of the credit crisis.
- UK government bonds (gilts) eased back on profit taking and concern that inflationary pressures would slow the pace of interest rate reductions. Corporate bonds performed better.
- Commercial property remained under pressure but trading activity was low.
- Investor focus has begun to shift from the specific threats of the credit crisis to the impact it will have on the economy.

Review



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

After the worst first quarter performance for five years, which saw the FTSE 100 index down by over 11%, April brought a firmer trend to equity markets. The FTSE All World Index gave a return to a sterling based investor of +6.02% for the month with all the major markets participating in the better trend. In the domestic market large companies performed best, the total return on the FTSE 100 Index was 7.05% compared with a return of just under 3% on the FTSE Small Cap Index. Turning to overseas markets, in Japan the return to a local investor was +12.05% but a sharp rally in sterling against the yen reduced the gain to +7.66% from a UK based investor standpoint. In the United States the rise was +5.24% and in Asia +8.42%. In Europe sterling investors saw a return of +4.31%, with the rise in the UK currency again reducing stronger local returns. Once again there were strong variations in returns from individual markets, Norway (+12.94%) and China (+16.62%) led the way, Indonesia (-5.42%) and the Philippines (-9.16%) were the main laggards. In bond markets UK government stocks eased back after several months of steady gains. The catalyst to the change of mood was a concern that interest rates would not decline as fast or as far as was previously hoped, due to the nagging problem of inflation. Corporate bonds did better as investors, less concerned by credit fears, bought into attractive yields. Commercial property prices continued to ease back although once again very low levels of trading activity meant that it was difficult to determine true trends from continued caution from valuers. Uncertainty on prices has had a sharp impact on lettings where activity is down almost 40% on the comparable period last year. Interestingly, despite the weakness in valuations and decline in customer interest, rents continued to move higher.

In currency markets sterling rallied after an extended period of weakness. It gained over 1% against the euro and over 4% against the yen.

Economic news continued to suggest that growth rates are still slowing. In the United States, the Federal Reserve cut interest rates again, to 2%. Statistics showed that the economy had managed to grow in the first quarter of the year but only just, and that due to stock building. A major problem is that lower official interest rates are not reaching the market

place as banks both widen the differentials they are willing to lend at and restrict the availability of credit . Against this difficult background the housing sector has remained under considerable pressure with average prices down 13.6% on the year but with spectacular falls in locations such as Las Vegas (-22.8%) and Miami (-21.8%).

Housing sector news has captured the headlines in the UK too. Mortgage approvals have fallen to 50% of the level reached just 6 months ago and prices continue to edge lower on all the monitoring indices. The problem is that lower prices have not made housing more affordable for the average buyer as higher mortgage costs and stricter lending terms have taken away all the benefit. Due partly to the news on house prices consumer data suggests falling confidence but the extent to which this is being reflected in reductions in actual spending is uncertain. UK consumers have so far proved to be resilient and the information from the High Street is at best equivocal, given the impact of an early Easter and a late Spring. What is clear is that more commentators have reduced their forecasts for economic growth, with the IMF now suggesting that the Government's recent forecasts are too optimistic. All commentators still agree that the economy will expand but at the more modest rates most now expect there will be pressures on the Government's spending programme.

In Europe inflationary pressures came to the surface as the rate of price rises reached the highest level for 16 years. Retail spending was again under pressure – unlike their UK counterpart the European consumer has not participated in any convincing way in this phase of economic expansion – and for the first time there were indications that currency strength was finally hitting export volumes.

Elsewhere, growth in Japan was modest and official forecasts for growth in the year to end March 2009 were reduced to 1.5% from 2.1%. In China expansion continued at a rapid pace with growth of 10.6% in the first quarter. Inflation however was uncomfortably high at 8% with the biggest concern foodstuffs, 21% higher.

The month has seen a number of important developments in the banking industry as the sector has begun the process of rebuilding balance sheets. In the UK, RBS has launched the biggest rights issue in European history to raise £12bn of new funds. HBOS swiftly followed suit with a call for £4bn. A feature of both announcements is the decision to pay the interim dividends not in cash but in shares. This followed some heavy hints from the Bank of England that generous payments to shareholders were hard to justify at a time when the banks were making use of the Bank of England's emergency liquidity window. Fund raising has not been restricted to the UK, a number of US banks have also issued equity, including Wachovia ($7bn), and National City Bank ($8bn). Loan finance has been raised on an even larger scale – over $300bn so far. The problem the banks are trying to address is that while credit losses have emerged ahead of the economic downturn, loan losses will lag it, and with these still ahead, balance sheets have to be strengthened now. Given the scale of the problems we expect to see much more fund raising in the period ahead.

Outlook

The liquidity shortage phase of the financial crisis has reached its low point as a result of the huge resources made available by the central banks of the US, UK and Europe. Still to be understood is the extent to which it will have a knock-on effect on the real economy and in so doing, amplify the scale of a cyclical downturn. Although the authorities have taken action to mitigate this risk by cutting official interest rates, the time lag before these effect economic activity must be measured in months and even then the effect will be weak. This is because, for most participants, the benefit of lower official rates has been absorbed by higher lending premiums and the reduced willingness of the banks to lend. An important factor looking forward is the extent to which higher fuel and food prices pre-empt other spending because squeezed wallets will act as another anchor on growth. Overall it is clear that investors should expect growth to slow further in the months ahead.

Emerging economies will continue to expand at significantly faster rates although even here inflationary concerns are causing the authorities to try restrain activity.

The recent rally in prices illustrates that despite the uncertain outlook there is a continuing appetite for good quality assets at sensible prices. Although we must expect volatility to continue, those able to take a long term view will find good value at around current levels.

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