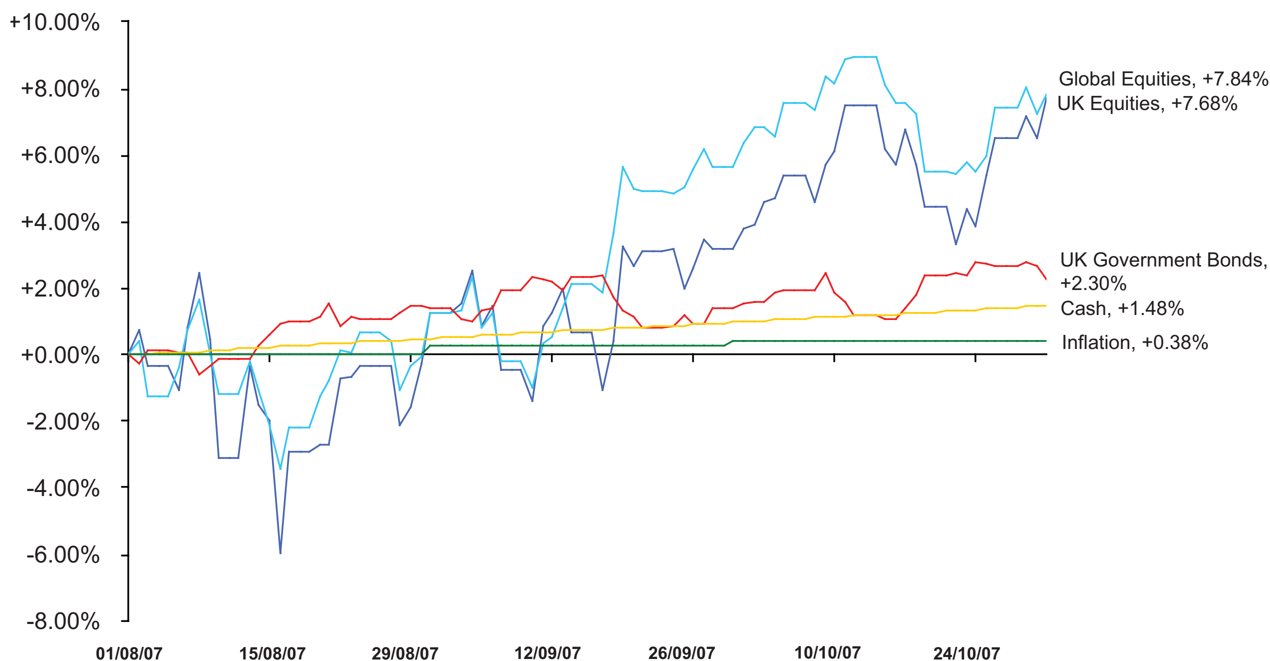
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT NOVEMBER 2007

Summary

- Global equity markets continued to rally during October on the expectation of lower US interest rates but remained volatile
- Conditions in money markets remained tight and investment markets were shaken as further losses at banks with exposure to subprime mortgages and related assets came to light
- The Federal Reserve delivered the expected rate cut on 31 October, but central banks in the UK, Europe and Japan left rates on hold in the absence of evidence showing that the credit crunch has had much of an impact on the broader economy
- Expectations of growth have been revised down but only slightly in the wake of recent developments and the global economy is likely to continue to expand at a fairly robust pace in 2008
- Although day-to-day sentiment is likely to remain frail in the short term, this provides a broadly positive background for global markets

Market returns 1 August-31 October 2007



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

Global equity markets continued to rally over October but not without some more turbulence along the way. The principal factor driving the market higher was a growing belief that the US central bank, the Federal Reserve (the Fed), would deliver a further reduction in interest rates when it met on 31 October, after cutting rates by 0.5% at its September meeting, and would continue to ease policy over the coming months. The rally came despite some lacklustre corporate earnings results, from financial services companies in particular, and a further spike in the oil price. Oil ended the month at over $90 a barrel, raising concerns that global growth could be affected and inflationary pressures could begin to build again in leading economies.

As expected, the Bank of England rates left unchanged at 5.75% at its October meeting. The view of the Monetary Policy Committee was that a precautionary rate cut was not justified in the absence of concrete data showing a sharp slowdown in activity as such a move could risk stoking up inflation again. The MPC was concerned a cut could imply that the outlook for growth and inflation had shifted decisively to the downside. Since UK consumer price index inflation reached a peak of 3.1% in March it has fallen back below the Bank's 2% target. Although there have been some signs that the economy is beginning to cool, there have been few indications that the turmoil in financial markets has had much of an impact on the broader economy as yet. The economy is expected to expand at a rate just below 3%, above the long-term trend yet consistent with stable inflation.

Early in the month, a further immediate cut in US rates did not appear certain following good employment and retail sales data which suggested that the US economy as a whole is still growing well. The market had been taken by surprise in September by US employment data showing a slight drop in the number of people in jobs during August. In October, the

previously reported employment figures for July and August were revised sharply higher, transforming Augusts' job losses into reasonably healthy gains, while initial figures for September also indicated that job creation was continuing at a reasonable pace. Overall US retail sales rose 0.6% in September, following a 0.3% gain in August, indicating that the crisis in credit markets has not as yet at least had an impact on consumer activity.

What tipped the balance in favour of a further rate cut was continuing disruption in financial markets and further evidence of persistent weakness in the US housing sector. There had been hopes within the market that a line had been drawn under the US subprime mortgage debacle in September as major banks and other financial services companies announced headline grabbing provisions against losses. However, during October some leading financial companies such as Merrill Lynch and Citigroup faced the embarrassment of having to make further announcements to the market to the effect that their subprime related losses would be significantly worse than they had thought just a few weeks previously. This raised concerns over how much more is still to come in terms of losses related to subprime lending problems. Conditions within money markets remained tight throughout the month, showing that the big banks at the heart of the world's financial system remain anxious. On the US housing front, housing starts were down by 10.2% in September and sales of existing homes sales fell 8%. The supply of unsold homes is becoming a worsening problem with an estimate in September that there were enough homes on the market to meet all demand for 10.5 months, up from 9.6 months in August. This is the highest number since 1999.

As expected, the Fed delivered a further reduction to interest rates on 31 October, with nine out of ten members of Federal Open Market Committee voting for a 0.25% cut to 4.5% and one member voting for no change. However, the Fed carefully crafted its accompanying statement to manage market expectations saying that 'the upside risks to inflation roughly balance the downside risks to growth'. This indicates that the Fed will continue to make decisions based on unfolding data and a continued series of rate cuts should not necessarily be expected. Looking backward, preliminary GDP numbers for the third quarter indicate that the US economy continued to grow strongly despite the credit crunch and housing problems with strong contributions from consumer spending, non residential construction and exports. However, more recent data suggests that activity may now be softening.

In continental Europe, the European Central Bank left interest rates on hold but emphasised that it would act swiftly if required to control inflation. The rise in the euro against the dollar, combined with the global credit squeeze, has had a similar impact on the eurozone economy as a rate increase would have had. Recent economic reports from eurozone members have been surprisingly strong with impressive bounces in industrial production in France and Italy and manufacturing orders in Germany. The eurozone unemployment rate remained at 6.9% for the third consecutive month in October, its lowest level since 1993.

The Japanese Central Bank also left interest rates unchanged in October. Japanese interest rates have been on hold at 0.5% since February.

Outlook

The underlying problems of imbalances in the global economy remain, but look unlikely to trouble markets while central banks are able to provide support. Whether this benign set of circumstances can continue however remains to be seen; economic growth is robust and if inflation were to rise, the pressure to raise interest rates would be substantial.

Looking forward, equity markets are not expensive in terms of historic valuations and should be supported by companies' earnings and cash flows. However as the global economy slows, we expect that there will be an increasing worldwide focus on the quality of companies and their ability to pay and sustain good dividends.

For now bonds are buoyed by the prospect of lower interest rates but there are risks that inflationary pressures will rise, undermining returns.

We expect that commercial property prices will fall back in the face of low transaction volumes, but that over time the prospect of attractive rental growth will support prices, with superior performance associated with higher yields and yield growth.

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