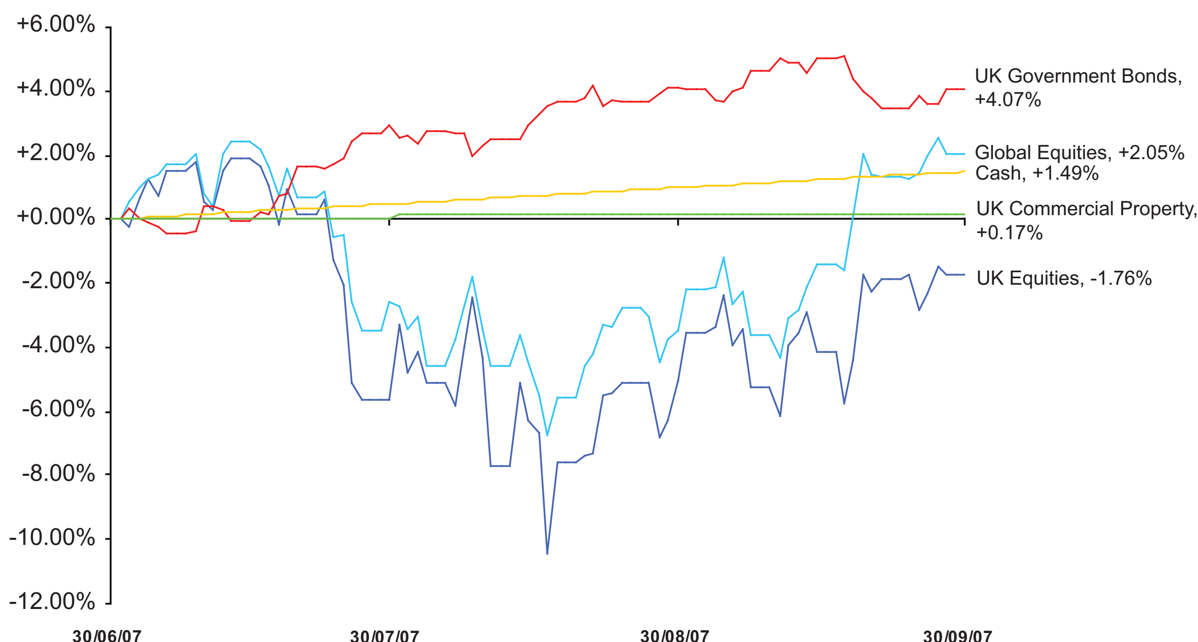
CCLA INVESTMENT MANAGEMENT LTD

MARKET REPORT OCTOBER 2007

Summary

- Volatility within markets returned to more comfortable levels in September
- On 18 September the US Central Bank, the Federal Reserve, cut interest rates by 0.5% to 4.75%. This move was designed to help forestall some of the adverse effects on the broader economy that might have otherwise arisen from the disruptions in financial markets and to promote moderate growth over time
- The rate cut helped global equity markets to rally, continuing the bounce back from August's lows
- Bond markets fell back a little on concerns that inflationary pressures may increase as a result of easier monetary policy
- Emerging equity markets hit fresh all-time highs prompting concerns that a new investment bubble may be forming. The UK and European markets have been slower to recover and ended the third quarter slightly down
- Data suggests that the global economy remains in reasonable shape, providing a positive background for markets

Market returns - Q3 2007



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

Equity markets fell back early in the month following disappointing employment numbers from the US, which raised concerns about slowing growth in the world's largest economy. However markets were subsequently supported by the growing expectation that the US Federal Reserve (the Fed) would cut interest rates at its meeting on 18 September. In the event, the Fed did not disappoint, cutting rates by a full 0.5% to 4.75%. This was the first reduction in rates since the Fed started to tighten monetary policy in 2003. The market was reassured by trading statements from a number of major financial services companies. While results from the sector were mixed, reflecting difficult conditions during the summer's market turmoil, there were no major surprises related to exposure to the sub prime mortgage market in the US. This raised hopes that we have seen the worst of the problems relating to sub prime, which should in time lead to improved conditions within credit markets.

Over the month, the oil price surged to elevated levels due to a combination of factors. The most important of these was the US rate cut, which raised expectations for growth and hence increased demand for oil in the US. The price of other key commodities also rose with gold jumping to over $700 an ounce. If the rise in commodity prices is sustained this will put upward pressure on overall inflation and may feed through to core inflation through higher costs.

In the UK, markets were briefly rocked when the Bank of England agreed to provide emergency funds to the country's fourth largest mortgage lender, Northern Rock, when the freeze in the money markets threatened its balance sheet. This led to a run on Northern Rock, as large numbers of savers rushed to withdraw their funds on fears of losing money. In turn, this prompted the government to issue a statement guaranteeing that all deposits would be repaid in full if demanded. In the immediate aftermath, the shares of a number of other banks and building societies fell heavily on fears that they could be similarly affected. However, while Northern Rock shares continued to fall as likely bidders ruled themselves out of the frame, the financial services sector as a whole steadied as fears of contagion subsided.

As expected the Bank of England left interest rates at 5.75%, at its September meeting, which occurred before the problems at Northern Rock became apparent. However, the Monetary Policy Committee (MPC) broke with tradition by releasing a statement along with the decision. The MPC reiterated that its mandate is to meet the government's 2% target for CPI inflation but said that it was 'monitoring closely the evolution of both credit spreads and the quantities of credit extended, alongside all other data relevant to the outlook for inflation'. The statement signalled that the Bank remains in 'wait and see' mode but is willing to act decisively should conditions in money markets deteriorate, threatening the broader economy. The Bank is concerned that a fall in financial sector activity could impact growth and that businesses could postpone investment as a result of uncertainty over the economic outlook. The UK economy is likely to slow over the coming months, as consumers feel the effect of the last five interest rate increases and the housing market moderates.

While the US employment numbers for August were disappointing, other economic data from the US was relatively firm. Surveys of the manufacturing and service sectors both showed moderately healthy growth and consumer activity and sentiment remained steady. Based on the latest reports, manufacturing seems well poised to start taking advantage of the recent decline in the dollar which makes US goods more competitive abroad. The US construction industry is also being supported by strength in non residential construction. The housing market however remains a major area of weakness. Year-on-year sales of existing homes were down 12.8% in August and the supply of existing homes for sale rose to a record 10 months' stock. The news on new home sales was even worse, with year-on-year sales down 21.2%. The Fed's decision to lower interest rates was supported by good news on inflation, with the PCE price core index rising by only 1.8% year on year, coming in under the Fed's 2% comfort limit for the third straight month.

Recent data from the eurozone suggests that activity in the region may be slowing slightly due to the stronger euro, although growth remains at around the long-term trend rate. The European Central Bank kept interest rates at 4% in September but maintained its tightening bias, citing the favourable medium-term outlook for real GDP growth. The ECB acknowledged the seriousness of the recent financial market turbulence and said that it would continue to monitor financial market developments closely.

The Japanese equity market has underperformed other major developed markets over the year to date due to the country's relatively disappointing economic performance. Recent data on the economy has remained lacklustre and stocks came under pressure during September following the resignation of Prime minister Shinzo Abe, who had been in office for less than one year. As expected, the Bank of Japan left interest rates on hold at 0.5%. The Bank said that it expects the economy to continue to grow gradually.

In contrast to other central banks, the People's Bank of China raised interest rates during September by 0.27% to a nine year high of 7.29%. The Bank has increased rates five times since March to try to curb inflation and prevent bubbles forming in the stock market and real estate. Consumer prices in China have been rising at twice the rate targeted by the People's Bank of China. Economic growth in China remains on course to reach 11% for the year.

Outlook

Equity markets have regained their upwards momentum having been shaken over the summer by volatility in credit and money markets. September's cut in interest rates by the Federal Reserve reinforced investors' belief that central banks are willing to take action to support economic activity when this is required. The Fed's move was an attempt to get ahead of the curve of deteriorating economic conditions and further moves will depend on unfolding economic data.

We expect that the US economy will continue to see some moderation in growth as problems in the housing market persist but believe that a recession in the world's largest economy is unlikely. Turning away from the US, the picture remains positive. Emerging market economies are growing strongly and in Japan and Europe growth looks secure.

We continue to see good value in most equity markets although emerging markets are beginning to look relatively expensive. We expect that equities will continue to outperform bonds in the medium term.

Developments in the property market will take time to be reflected in prices. We expect upward progress from current levels to be hard won and believe the best returns are likely to come from good quality properties with a good income yield.

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