CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT SEPTEMBER 2007

Summary

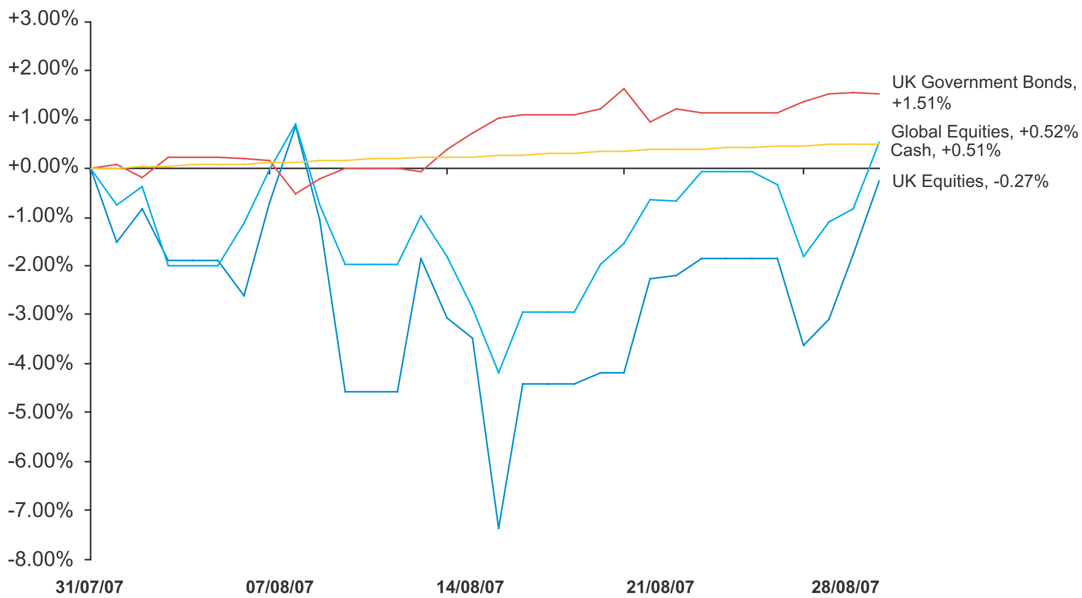
- Markets were volatile during August but ended the month little changed
- Concerns about widespread contagion from problems relating to US sub-prime mortgages have dissipated
- The global economic outlook remains broadly positive
- More volatility should be expected in the short term but the longer term outlook for markets is positive

Review

This month the focus is on the truly remarkable period in markets.

Global investment markets remained very volatile during August but equity markets actually ended the month little changed overall. The graph below shows how investor sentiment swung wildly over the month but, despite the headlines, by the close investors had recovered their composure.

August 2007 Market Returns



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

Markets came under pressure on a number of days during the month as investors showed extreme risk aversion on concerns that problems relating to exposure to 'sub-prime' mortgages in the US could have a widespread impact on the financial sector, with the potential for knock on effects on the broader global economy. In the middle of the month the high level of uncertainty within the market led to a temporary reduction of liquidity within the banking system, precipitating fears of a 'credit crunch'. This was met by a robust policy response from central banks around the world, which injected additional reserves into the banking system helping to restore some calm to markets. Sentiment was further bolstered by a statement from the US central bank, the Federal Reserve (the Fed), on the state of the all important US economy. The Fed was relatively upbeat, saying that the US economy should continue to enjoy moderate growth in the coming months, supported by solid growth in employment and incomes and a robust global economy.

Inevitably, given that the eye of the recent market storm was in the US, there is a strong US centric stance to this month's comments.

Away from the turmoil in markets, economic data from the US remained largely consistent with the Fed's views. There was considerable headwind behind the US economy going into August. Revised figures for the second quarter showed that the economy grew at a strong annualised 4% rate, significantly up on the first quarter, and releases for July remained largely positive. Although there has been some softening in the labour market, employment growth remains healthy and the unemployment rate remains low. This has continued to provide support to consumer spending with robust retail sales reported for July. Another indication of the fundamental strength of the economy comes from the rise in corporate profits over the second quarter of the year. The housing market remains the most problematic area of the US economy, with sales of existing homes at their lowest level in five years during July and the supply of homes on the market at a record 9.6 months. However, within the construction industry, strength in public and non-residential building projects has helped to offset the decline in housing.

At the Fed's August Meeting, prior to the problems in the middle of the month, the Open Market Committee voted to keep rates on hold at 5.25%. In the accompanying statement the Fed maintained its anti-inflation bias but acknowledged that the recent volatility in markets and tighter credit conditions for some households had increased downside risks. Following the problems, the market priced in a high likelihood that the Fed would cut rates by 0.25% at its September meeting, however given the recent stabilisation of markets we believe that a cut will only come when there is further clear data showing that inflationary pressures are reducing.

Elsewhere around the world there has as yet been little change in the positive economic backdrop. In the UK, growth was above trend over the second quarter and recent data suggests that the economy is becoming better balanced with the manufacturing and service sectors both performing strongly. Consumer activity has continued to hold up well despite the series of interest rate increases. Unemployment in July equalled the lowest level seen since the series began in 1993. As expected the Bank of England left interest rates on hold at 5.75% at its August meeting. In its quarterly inflation report it forecast that inflation would remain above its 2% target until 2009, assuming a further 0.25% rise in interest rates before the first quarter of next year.

Recent economic indicators in continental Europe have remained strong with further notable falls in unemployment. The European Central Bank also kept interest rates on hold at 4% in August, but Bank President Jean Claude Trichet stated that the ECB must maintain 'strong vigilance' on inflation, a strong indication that a further 0.25% rise is likely in September.

Japan recorded its tenth consecutive quarter of growth in the second quarter. The pace of growth in the Japanese economy has been held back by lacklustre consumer activity and retail sales remain weak. The hope is that strength in labour markets, which has seen unemployment fall for 20 straight months, will help to improve confidence among consumers. However, the defeat of the ruling party led by Prime Minister Shinzo Abe in elections for the upper house has clouded the outlook. Following the turmoil in the market, the Japanese Central Bank left interest rates on hold at 0.5%, deferring an increase signalled at its previous meeting. The Bank of Japan indicated that it expects the recent volatility in markets to have limited impact on the Japanese economy.

Outlook

There is growing evidence that the recent highly volatile phase in investment markets is drawing to a close. Market participants now have a clearer understanding of the scale and scope of the problems that have surfaced in a number of financial companies and concerns about widespread contagion to the broader economy have reduced. Further bad news may well emerge from some more companies over the coming weeks but this is not expected to have a significant knock on effect.

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.

For the moment, markets are likely to remain volatile and there will be shocks from bad news that will test confidence on a day-to-day basis.

We continue to see good value in equity markets and expect these to outperform bonds.

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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