

# Schroders

## Monthly markets review

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### Overview of markets in July 2010

#### Highlights:

- Following a volatile second quarter, revived risk appetite supported global equity gains in July. Fears of a recovery slump gave way to improved sentiment about the strength of global growth, following some better-than-expected economic data and well-received results from the European bank stress tests.
- European economic data was broadly positive, with a weaker euro driving export-led growth in Germany. Manufacturing data surprised to the upside, as did business and consumer confidence indicators. Although there remained some scepticism about the credibility of the bank stress tests, the results have at least dampened any immediate concerns about peripheral eurozone sovereign debt profiles. Sentiment was similarly positive in the UK as investors increasingly taking the view that the bad news has now been reflected in market valuations; while British manufacturing output continued to grow strongly in July.
- Economic indicators in the US and Japan were more mixed. US domestic demand faltered and higher unemployment in Japan weighed on sentiment; contrasting with solid corporate earnings and general relief in the wake of European bank stress tests.
- Commodities outperformed on the back of rising oil and base metals costs, signaling that, despite lingering concerns about slowing growth, the global economic recovery remains on track.

#### US

Financial markets in the US had a strong month overall in July. Economic data did not point to any break out in the pace of the recovery. Employment growth remained subdued, with the housing market mixed at best. External demand, not least related to capital investment in China and India, has given a boost to manufacturing; but growth in domestic consumer spending is still slow, and consumer price inflation has fallen from the mid-cycle peak seen in the winter quarters of 2009/2010, leading investors to discuss the threat of deflation. Bonds were positive across most areas of the market, particularly in high yield. Given the weakness of the equity market previous months, there was an increasing tendency to accept that most of the negative news is already priced in. In respect of corporate earnings, consistent if slow growth – combined with cost-cutting and low interest rates – is bearing fruit. Sectors relating to manufacturing, metals and mining, agriculture and property tended to perform best. Healthcare was among the worst performing, as were gold-related stocks.

#### Eurozone

Equities in the euro region posted positive returns in July, as fears of a double-dip recession subsided and optimism about the outcome of European bank stress tests drove share prices higher. Although, commentators remained sceptical about the credibility of the stress tests, the results helped to dampen any immediate fears about sovereign debt contagion in Europe. Financials drove the equity market gains, and the wave of confidence also supported share-price growth for telecom services stocks. Germany continued to drive industrial growth in the region, and the German manufacturing purchasing managers' index was revised upwards for June. German IFO was also stronger, rising to 106.2 versus an expected 101.5. Despite the removal of their long-term (12-month) loan facility, the European Central Bank (ECB) continued to provide substantial funding to support the banking system, through the introduction of 3-month and 6-day loan facilities. Interestingly, the higher uptake of 6-day loans suggested that banks continue to rely on the funding, but over the shorter-term. As expected, the ECB held interest rates at 1.0%.



## **UK**

The UK equity market was broadly positive in July. Following the negative sentiment that characterised much of the preceding months, investors increasingly took the view that the bad news from the period was now reflected in market valuations. At the same time, although weakness remains evident in some important sectors, notably property, the run of data in July was generally more positive. Second quarter growth was significantly higher than expected, while inflation eased down at both producer and consumer levels. Bank of England governor Mervyn King confirmed that he expected interest rates to remain below 'normal' for a long period. Bond yields tracked lower, reflecting greater confidence in the EU aid programme, with key European peripherals able to secure market funding. In equities, banks improved on the better economic outlook and the likelihood of less stringent regulatory reform. Mining stocks benefited from firmer prices. Personal consumer goods proved the best performing sector, helped by good results from Burberry and corporate activity. Integrated oil major BP, which accounts for nearly five percent of the FTSE All-Share index, saw a strong recovery in the month, rising in value by nearly a third, as it finally capped the leak in its well in the Gulf of Mexico.

## **Japan**

Risk appetite returned to the Japanese markets in July amid better-than-expected second quarter earnings reports, positive US economic data and relief over the results of the European stress tests. Comments by Federal Reserve Chairman Ben Bernanke, that rising wages in the US would spur household spending, eased concerns that a slowdown in US growth would hurt Japanese equities. Economic data in Japan was mixed. The Bank of Japan left policy rates steady at 0.1% and GDP outlook was revised up, broadly in line with expectations. Encouragingly, gains in commodity prices signalled that global economic growth remained on track. However, unemployment increased again in June from 5.2% to 5.3%, beyond market expectations.

## **Asia (ex Japan)**

Markets in Asia enjoyed their longest rally in almost a year, and ended the month firmly in the black after shrugging off signs that the global recovery continued to ease in July. Better-than-expected results of European bank stress tests boosted the mood of the market, but worries about the pace of the global rebound kept risk appetite in check. Purchasing managers' indices in China, South Korea and Taiwan registered multi-month lows, with manufacturing activity in China sinking to its lowest level since February 2009. The data followed news that US growth had slowed to an annualised rate of 2.4% in the second quarter, adding to fears that the global recovery had all but lost steam. Despite this, China's Shanghai Composite posted its longest rally since last November as optimism that the country's authorities could loosen policy coming months, buoyed confidence. Expectations of a gradual appreciation of the renminbi also boosted market gains in the region amid signs that inflationary pressures were starting to subside.

## **Emerging Markets**

The MSCI Emerging Markets index finished July in positive territory, following relatively flat returns last month, although market conditions remained volatile. Emerging markets delivered a positive return against this backdrop, but lagged developed markets – despite strength in commodity prices, which saw crude oil trade nearing a three month high on expectations for improved economic prospects. Emerging European markets were among the best performers, with Poland, Turkey, the Czech Republic and Hungary all recording double-digit growth in July. In Asian markets, South Korea, Taiwan and Thailand were the leading performers. The South Korean won and Taiwanese dollar led the gains in Asian currencies, rising to their highest levels in two months on the back of positive US manufacturing data. Latin American stocks also advanced, buoyed by stronger earnings in the region. Mexico underperformed the benchmark, hurt by a weakening demand in the US during the second quarter, as the country accounts for 80% of Mexico's exports. Russia was one of the best performing markets in the MSCI BRIC index, helped by strengthening commodity prices (particularly oil), increased manufacturing output, and strategic asset sales to China.

## Global Bonds

Sentiment in global bond markets was both calmer and more positive in July, than has been typical in recent months. In the US, there is a sense that while economic recovery is on course, it remains slow-moving. Employment reports showed little momentum and the housing sector is still weak, leading investors to increasingly discuss the likelihood of a period of deflation. Conditions in the eurozone are more subdued, with fiscal and monetary policy more stringent. Despite ratings agency Moody's downgrading Portugal, along with ongoing unrest in Greece, greater confidence in the EU aid package was reflected in a marked fall in the yields of sovereign debt in peripheral economies. The successful issue of some EUR10 billion in short-term funding indicated the return to more normal conditions. The Japanese market was flat in July, though increased Chinese buying should provide continued support. Emerging and high yield debt was among the best-performing fixed income sector, reflecting the rise in appetite for higher risk assets.

### Overview – Total Returns (%) – to end of July 2010

	3 month			YTD		
	EUR	USD	GBP	EUR	USD	GBP
<b>Equities (MSCI)</b>						
World Index	1.67	8.13	3.30	7.71	-2.20	0.84
World Value Index	2.05	8.54	3.69	7.69	-2.21	0.83
World Growth Index	1.30	7.73	2.92	7.72	-2.19	0.86
World Smaller Companies Index	1.34	7.78	2.97	14.49	3.96	7.20
US	0.60	6.99	2.21	9.86	-0.24	2.87
Eurozone	6.31	13.07	8.01	-1.96	-10.97	-8.20
UK	5.44	12.14	7.12	5.77	-3.96	-0.97
Japan	-2.62	3.56	-1.07	11.03	0.82	3.96
Emerging Markets	1.92	8.40	3.55	12.17	1.85	5.02
Asia ex Japan	-0.45	5.88	1.15	12.41	2.07	5.25
	3 month			YTD		
<b>Government bonds (JP Morgan)</b>	EUR	USD	GBP	EUR	USD	GBP
US	-5.31	0.71	-3.79	17.57	6.76	10.08
UK	-1.82	4.42	-0.24	12.87	2.49	5.68
Japan	-3.65	2.47	-2.11	21.39	10.22	13.65
Germany	-0.68	5.64	0.91	6.43	-3.36	-0.35
<b>Corporate bonds (Merrill Lynch)</b>	-5.31	0.71	-3.79	17.57	6.76	10.08

Source: Datastream to 31 July 2010

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