

Schroders

Monthly Markets Review

Overview of markets in May 2010

Highlights:

- The MSCI World index delivered a negative return in May against a background of heightened concerns about eurozone sovereign debt (although markets recovered some ground towards the end of the period). Investor confidence was also impacted by a unilateral move from the German financial regulator to ban the naked short selling of various securities, while concerns about policy tightening in China contributed to a fall in commodity prices.
- The ongoing instability in the euro area prompted European Union finance ministers, central bankers and the International Monetary Fund to hammer out a rescue package to the tune of €750 billion. However, fears of contagion risk and the uncertainty surrounding the implementation of required austerity measures continued to plague markets.
- Elsewhere, uncertainty surrounding the US financial reform bill weighed on the financials sector. Fears of a politicised crackdown on banks and financial markets unsettled markets, sending share prices reeling and currency markets into disarray.
- Disappointing US jobless data revived fears that the economic recovery could prove short-lived, driving investors into safe haven assets. In addition, eurozone consumer confidence levels hit a one-year low, but better-than-expected German manufacturing data injected some much need optimism.

US

US markets were buffeted by turbulence in May as mixed data on the domestic economy was compounded by concerns over the progress of the global recovery. While US GDP growth slowed in the first quarter, upbeat consumer spending figures reassured the market that the recovery was largely on track. It was, however, international pressures that caused the S&P 500 to post its worst May performance since 1962. Sovereign debt problems in Europe and monetary tightening in China thrust the index deep into negative territory despite an optimistic start to the month. On May 10, the index recorded its strongest one-day gain in more than a year on news that the EU had agreed a loan package to support its troubled economies. The euphoria proved short lived, however, as Spain saw its credit rating downgraded by month end, with the US markets joining global markets in a fresh loss of faith in the recovery. Domestically, further details of US banking-sector reforms weighed on Wall Street and left financials among the index's chief laggards.

Eurozone

Eurozone countries battled their way through another turbulent month as sovereign debt concerns remained centre stage in May. The ongoing instability in the euro area prompted a hastily convened summit in Brussels, where European leaders agreed to a €750 billion stabilisation scheme, with contributions from European Union members, eurozone countries and the International Monetary Fund. European central banks also started to buy eurozone government bonds under the emergency rescue package. Following an initial relief rally, scepticism about the effectiveness of the rescue package soon re-emerged, as the action failed to quash fears of contagion risk to eurozone peripheral nations. Share prices tumbled, with banks in particular coming under pressure as investors worried that escalating sovereign debt could infect the financial system. Mid-month, the German short-selling ban sent the euro tumbling to fresh four-year lows against the dollar, and the Fitch downgrading of Spanish sovereign debt in the last week of the month, did little to improve sentiment.



Consumer confidence levels in the region fell to their lowest levels in over a year. However, manufacturing data remained broadly positive. Indeed, figures for March revealed that German exports have increased at their fastest monthly rate since 1992, a fillip for the country amid the ongoing fiscal and political uncertainty in Europe.

UK

Markets were dragged lower by weakening sentiment in May as the eurozone's ongoing sovereign debt crisis sparked losses across all sectors. Renewed fears that problems in Greece could affect other European countries drove the FTSE All-Share down significantly over the month. This weakening sentiment continued to overshadow a corporate sector recovery, where in general, company results for the year ending in December have exceeded market expectations by some distance, the majority reporting strong cash generation and major decreases in balance sheet risk. By sector, financials fared badly on European sovereign debt exposure concerns, while oil & gas fell away on associated economic fears amid falling energy prices. Within oil & gas, fallout from the Gulf of Mexico oil leak sparked a sell-off in integrated UK oil major BP, which now accounts for around five percent of the FTSE All-Share index. The UK elections in May proved somewhat of a sideshow compared to the European sovereign debt crisis, but amid the growing intolerance of poor public finances globally, investors in the UK will be looking to the new coalition government to move quickly to address the burgeoning public debt.

Japan

The Japanese market was in negative territory in May against the background of heightened global risk aversion. However, data releases over the month generally showed the domestic economy continuing to recover. Exports increased by 40.4% year-on-year in April, boosted by brisk demand from Asia, while Japanese GDP grew by 1.2% in the first quarter compared with the previous three months. On the other hand, deflationary conditions continued, with data released showing core consumer prices falling by 1.5% year-on-year in April.

Asia (ex Japan)

Fears surrounding monetary tightening activities in China continued to hang over equity performance across Asia, while global and political strife made for a lacklustre month in the markets. Early in the period, Chinese stocks hit their lowest level in seven months as investors fretted over government measures to cool the property market and a raft of new bank shares entered the market. While Asian markets joined their global counterparts in toasting EU efforts to stabilise the eurozone economy, the optimism failed to endure as Spain's credit-rating downgrade brought the region's woes back into sharp relief. Across Asia, economic releases were largely upbeat with export activity expanding throughout the region. News that India's economy expanded 8.7% in the first quarter (compared with the same period last year) boosted sentiment, while Hong Kong also recorded a strong first-quarter rebound. Escalating tensions between North and South Korea weighed on equity performance towards the end of May, while Thailand counted the cost of violent political demonstrations that saw protestors set fire to the Bangkok stock exchange.

Emerging Markets

The MSCI Emerging Markets index was in negative territory in May, impacted by commodity price weakness and increased risk aversion. However, it outperformed the MSCI World index, with emerging markets rebounding particularly sharply in the closing days of the month. Investor confidence was impacted by a unilateral move from the German financial regulator to ban the naked short selling of various securities, while concerns about policy tightening in China contributed to a fall in commodity prices.

Emerging European markets were among the main underperformers over the period due to fears of contagion from the eurozone sovereign debt crisis. Weakness in the banking sector weighed on the markets of Hungary, Poland, Turkey and the Czech Republic, while a fall in the oil price was a negative for the energy-dominated Russian market. In other developments, the Czech central bank

cut interest rates by 25 basis points to 0.75%. The Korean market lagged, with concerns over rising tensions with North Korea having a negative impact. Brazil also underperformed given the fall in commodity prices, with the weakness of index heavyweights Petrobras (energy) and Vale (mining) weighing on the market. Peru was the best performing emerging market over the month, helped by the outperformance of gold mining stock Buenaventura. Chile outperformed, with this market viewed as relatively defensive, as did Colombia which was boosted by the outperformance of Bancolombia. The MSCI China index outperformed despite ongoing policy tightening, with the country's central bank further increasing the reserve requirement ratio for banks (by 50 basis points). Data releases over the month showed the Chinese economy continuing to grow strongly, with industrial production increasing by 17.8% year-on-year in April.

Global Bonds

Burgeoning concerns about eurozone sovereign debt caused a sell-off in risk assets during May, creating an environment reminiscent of late 2008/early 2009. The solution, at that time, came in the form of record fiscal stimulus, record quantitative easing and record low interest rates – which successfully broke the self-reinforcing deflationary spiral, but created fiscal deficits in virtually every developed economy. Eighteen months later, markets are now assessing the true cost of the bailout. Having been previously reassured by the bailouts, investors have begun to question the creditworthiness of certain countries, notably Greece, Portugal and Spain, and the risks of contagion across the rest of Europe. As a result, appetite for risk assets, including corporate bonds, has faltered and investors seem torn between selling government bonds (in light of the significant deficit and the potential for rising yields) and buying the same as a safe-haven asset.

Overview – Total Returns (%) – to end of May 2010

	1 month			YTD		
	EUR	USD	GBP	EUR	USD	GBP
Equities (MSCI)						
World Index	-1.92	-9.48	-4.64	9.46	-6.38	4.05
World Value Index	-2.00	-9.55	-4.72	9.31	-6.51	3.91
World Growth Index	-1.85	-9.41	-4.57	9.61	-6.25	4.20
World Smaller Companies Index	-2.01	-9.57	-4.73	18.24	1.13	12.40
US	-0.38	-8.06	-3.15	15.14	-1.52	9.45
Eurozone	-5.45	-12.74	-8.08	-6.78	-20.27	-11.39
UK	-3.43	-10.88	-6.11	2.43	-12.40	-2.64
Japan	-0.41	-8.09	-3.17	16.15	-0.66	10.41
Emerging Markets	-1.13	-8.75	-3.87	10.65	-5.36	5.18
Asia ex Japan	-0.71	-8.36	-3.46	10.82	-5.22	5.34
	1 month			YTD		
Government bonds (JP Morgan)	EUR	USD	GBP	EUR	USD	GBP
US	10.25	1.75	7.19	21.64	4.04	15.63
UK	5.34	-2.78	2.41	9.73	-6.15	4.30
Japan	12.19	3.54	9.08	20.75	3.28	14.79
Germany	2.29	-5.60	-0.55	6.41	-8.99	1.15
Corporate bonds (Merrill Lynch)	7.74	-0.57	4.75	21.54	3.96	15.54

Source: Datastream to 31 May 2010

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