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Quarterly markets review

Overview of markets in Q4 2010

Highlights:

- Global markets were influenced by both positive and negative sentiment during the quarter, but a combination of better-than-expected macroeconomic data and improved prospects for the US economy drove equity market gains overall.
- The quarter was not without its troubles with re-emerging sovereign debt concerns weighing on sentiment in November. However, a second round of US quantitative easing and a more positive outlook for global growth, brought optimism back to the markets.
- Improved risk appetite favoured more cyclical areas of the market, with the materials and energy sectors, in particular, benefiting from soaring commodity prices.

US

Equity markets in the US made good progress over the quarter, driven by a strong rebound in December. At the start of the period, US stocks benefited from expectations that the US Federal Reserve would unveil another round of quantitative easing in order to help maintain the economic recovery. While the Federal Reserve duly obliged, announcing a further \$600 billion of US Treasury purchases in early November, the equity market's response was rather muted as some investors had expected a greater level of intervention. Equity market sentiment was then dampened by resurgent sovereign debt concerns in Europe, following Ireland's bailout by the European Union and International Monetary Fund. Consequently, US equities struggled to make headway for most of November. However, economic data releases remained broadly encouraging, with an upward revision to third-quarter economic growth and an improvement in consumer confidence. Encouragingly, US equities ended 2010 on a very strong note as the Obama administration agreed a deal with Republicans to extend Bush-era tax cuts, while hopes of healthier rates of economic growth in 2011 also boosted confidence in the outlook for the S&P 500.

Eurozone

Eurozone equities ended the year on a high, posting positive returns for the fourth quarter. Fairly resilient macro-economic data and improved global growth expectations fuelled risk trading by investors, particularly in December. Materials stocks benefited as commodity prices soared, and the industrials and energy sectors were also strong performers. Banks were the notable laggards, with a cascade of issues contributing to share-price weakness – not least, the more stringent tier-one capital ratio requirements (in the wake of Basel III) and the uncertainty surrounding the future of Ireland's debt-laden banks. However, as investor shrugged off earlier concerns about European contagion risk, equity markets in peripheral European countries, such as Spain, Italy, Portugal and Ireland, also managed to take advantage of the end-of-year momentum in December. German export-led expansion continued to support robust manufacturing data, while business confidence showed further improvement and retailers benefited from an uptick in demand. The European Central Bank kept rates unchanged at 1.0% and confirmed ongoing measures to provide further lending support.

UK

Following a solid performance in the third quarter, the fourth quarter began with the equity rally intact. Better-than-expected macroeconomic data and further quantitative easing in the US drove equities higher. UK-specific factors, including the Comprehensive Spending Review (CSR), were largely positive for the market. The CSR was well received by investors, as both the cuts and public sector job losses were lower than feared. Company earnings continued to impress, and a more



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positive consensus on the outlook for the UK economy gained traction. Still, headwinds remained, ensuring volatile conditions as investors focused on short-term news flow, be it positive or negative. One notable headwind was the resurfacing of sovereign debt concerns in Europe, which produced plenty of negative headlines and brought risk aversion back to the fore. However, amid the gloom equity markets refused to sell off significantly. If we compare the market reaction to the Greek crisis in May against the Irish crisis in November, the differences in the severity of the sell-off are stark. Indeed, November proved to be a blip with December proving the swansong in terms of equity returns during the quarter. Just before Christmas, the FTSE100 rallied though the 6000 mark – its highest level in over two years.

Japan

Japanese equities rose on the back of the brighter global economic outlook this quarter. Despite a poor start, the market was boosted by an unexpected loosening of monetary policy by the Bank of Japan, following the Fed's announcement of further quantitative easing. In spite of heightened geopolitical tensions between North and South Korea, and financial difficulties being experienced amongst some of Europe's debt-laden economies, Japanese markets continued to focus on the positive newsflow. Furthermore, markets were cheered in December by the much-anticipated 5% cut in corporation tax, as part of Prime Minister Kan's fiscal reform plan. The move, designed to enhance Japan's international competitiveness, is the latest attempt by the government to kick-start growth. However, some doubts persist about how the corporation tax shortfall will be funded into the next fiscal year.

Asia (ex Japan)

China's war on inflation continued into the last days of the year as a Christmas-day hike in interest rates brought the region's soaring equity prices back down the earth. After hitting a 29-month high in mid-December – on the back of the continued strength of materials stocks – Asia Pacific (ex Japan) equities saw their quarterly gains pared back by China's efforts to counter its fastest rate of inflation in more than two years. The news came as India's government moved to withdraw various economic stimuli in an effort to tame soaring prices, while Singapore's economy grew 12.5% in the fourth quarter (driven by strong manufacturing growth). Taiwanese equities delivered the region's strongest fourth-quarter returns as the country's export-driven economy benefited from improved engagement with China. While Asia Pacific (ex Japan) equities ended the quarter in positive territory, fears of more aggressive monetary policy by regional authorities weighed on risk appetite. Strong commodity prices and soaring demand for oil drove energy and materials stocks to the forefront of the index's gains.

Emerging Markets

Emerging market equities posted further gains in the final quarter of 2010, although they underperformed global equities as developed world markets began to anticipate a stronger US economy in 2011. Nonetheless, for the year as a whole, emerging markets markedly outperformed those in the developed world. In Asia, Taiwan and South Korea delivered very strong returns as both markets benefited from hopes of healthier global demand for Asian exports in 2011. However, China underperformed as the authorities raised interest rates to 5.81% in an attempt to contain inflationary pressure. In Latin America, Peru and Mexico were the standout performers, with the former benefiting from a robust outlook for copper, and the latter performing well on the back of expectations that the second round of quantitative easing would improve the macroeconomic environment in the US – Mexico's major trading partner. In the EMEA markets, returns diverged sharply. Russia delivered the best performance, buoyed by the robust oil price and expectations that crude oil prices could rise further in 2011. South Africa also performed strongly, with US dollar returns lifted by strength in the local currency. The Czech Republic, Hungary and Turkey retreated over the period, driven by a sharp sell-off in November following the sudden escalation of European sovereign debt fears.

Global Bonds

Two themes governed investor sentiment in the fourth quarter: a second round of quantitative easing in the US and the ongoing debt crisis in the eurozone. The former (otherwise known as QE2) prompted gains from higher yielding securities given the prospect that cash rates would remain lower for longer. The debt crisis, on the other hand (reignited by problems in Ireland), weighed on sentiment towards the European periphery – particularly impacting government bonds in Ireland, Spain and Portugal. Investors also began to take some profit on US, UK and German government bonds, after a strong rally and further evidence of economic recovery, ensuring that corporate bonds outperformed their government bond counterparts during the quarter.

Overview – Total Returns (%) – to end of Q4 2010

	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
Equities (MSCI)						
World Index	10.98	9.06	9.77	20.14	12.34	15.87
World Value Index	9.83	7.92	8.62	17.39	9.77	13.22
World Growth Index	12.10	10.15	10.87	22.88	14.89	18.50
World Smaller Companies Index	16.39	14.38	15.12	35.36	26.57	30.55
US	12.97	11.01	11.73	23.47	15.45	19.08
Eurozone	3.97	2.16	2.83	3.29	-3.42	-0.39
UK	7.93	6.05	6.74	16.36	8.80	12.22
Japan	14.11	12.13	12.86	23.62	15.59	19.23
Emerging Markets	9.26	7.36	8.06	27.48	19.20	22.94
Asia ex Japan	8.60	6.72	7.41	28.26	19.93	23.70
	3 months			12 months		
Government bonds (JP Morgan)	EUR	USD	GBP	EUR	USD	GBP
US	-0.95	-2.67	-2.04	13.46	6.09	9.42
UK	-1.08	-2.80	-2.17	11.45	4.21	7.49
Japan	3.90	2.10	2.76	25.81	17.64	21.33
Germany	-2.63	-4.32	-3.70	6.36	-0.54	2.58
Corporate bonds (Merrill Lynch)	0.15	-1.59	-0.95	17.13	9.52	12.96

Source: Datastream

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