

Schroders

Quarterly markets review

Overview of markets in Q3 2011

Highlights:

- Investor confidence plummeted during the quarter, fuelled by ongoing European political and economic turmoil, disappointing US GDP data and concerns of slowing global growth.
- Heightened risk aversion favoured safe haven assets, with US treasuries, UK gilts and German bunds benefiting from the flight to quality; while global equity markets saw some of the steepest quarterly share price declines since 2008.
- Meanwhile, volatility in the gold price reached its highest level since 2008. Usually seen as a safe haven, the yellow metal tumbled after hitting a high of \$1,920 per ounce in September.
- Copper prices, closely correlated with industrial growth and Chinese demand, also slid to a 13-month low amid a widespread sell off across commodities markets, as investors looked to stockpile cash.

US

The US equity market suffered over the quarter against a volatile global market backdrop, finishing the period in negative territory. At the start of the quarter, political wrangling between the Democrats and Republicans over a deal to avoid the US defaulting on its debt created an uncertain environment and set the scene for the quarter. Adding to the concerns, ratings agency Standard & Poor's downgraded the US long-term sovereign credit rating from AAA to AA+. These factors, combined, eroded investor confidence and saw equity markets slide. Investor caution reflected a sharp fall in consumer confidence and deteriorating economic indicators. In September, the Federal Open Market Committee voted to keep the federal funds rate in a range of 0-0.25%. The Federal Reserve currently anticipates that economic conditions are likely to warrant exceptionally low interest rates at least until mid-2013. In addition, 'Operation Twist' – designed to put downward pressure on longer-term interest rates to stimulate the economy while keeping short-term rates high to prevent an outflow of reserves – was put in place, but it failed to reignite risk appetite. Although still very weak, revised US growth data brought some relief at the end of the quarter, with estimated annualised second-quarter GDP growth being raised from 1% to 1.3%.

Eurozone

The quarter offered no relief for eurozone equity markets as deteriorating sentiment continued to fuel a relentless share price retreat. The indiscriminate sell off saw equity markets register the worst quarterly performance since 2008. Investor confidence has been particularly fragile in recent months given the lack of clear political and monetary leadership in Europe amid a deepening sovereign debt crisis, while challenges facing global economic growth have compounded the gloomy outlook. As markets speculated about the prospect of Greece defaulting, the troika of the European Union, the European Central Bank and the International Monetary Fund travelled to Athens to assess Greece's structural reforms (a key prerequisite for the country to receive its next bail-out tranche). Also during the quarter, the German parliament voted in favour of increasing the size and scope of the European Financial Stability Facility (EFSF). The new measures increase the total fund size to €440 billion and boost its powers to buy the bonds of struggling sovereigns. In a further effort to provide reassurance the European Central Bank signalled that it would offer a liquidity boost to banks. However, the rise in eurozone inflation to a three-year high of 3% means that the interest rate cut that many commentators were looking for, at the bank's October meeting, is by no means certain.



UK

The FTSE All Share index fell by 13.5% in the third quarter. Peak to trough the fall was closer to 17%, with August proving to be a particularly difficult month for investors. Sector trends continued as financials and miners had another poor quarter, while consumer goods and healthcare were among the strongest performers. The overarching factor behind much of the risk aversion and negative stock performance in the third quarter was the renewed concerns about eurozone sovereign debt contagion, along with the fear of a potential Greek default. Interspersed throughout were numerous triggers for significant market sell-offs. Poor second-quarter US GDP numbers were one such event, which swiftly saw markets pull the plug on companies' future growth and earnings estimates and raised questions of a global slowdown. As the quarter progressed, any expectations of an interest rate hike from the Bank of England gave way to the possibility of further quantitative easing. Stubbornly high inflation remains an obstacle for the Monetary Policy Committee, though the minutes from the September meeting were surprisingly dovish, meaning further asset purchases are a distinct possibility. Against this turbulent backdrop, many economic indicators held-up relatively well – indicating that, despite the negative headlines, economic activity is not in free fall.

Japan

Against a backdrop of global market volatility, Japanese equities remained comparatively resilient during the quarter, but lost ground overall (in local currency terms). The period opened with positive news that the impact on the economy from the March earthquake and tsunami was turning around, and indications in the middle of August that the economy contracted at a slower pace than expected in the second quarter brought some relief. In other news, Prime Minister Naoto Kan, who had received widespread criticism of his handling of the March tsunami and earthquake, announced his resignation after nearly 15 months in office, with Mr Yoshihiko Noda being chosen as the new Prime Minister. The move had little impact on markets. The yen was stubbornly strong throughout the quarter, which weighed on sentiment, and made the environment very tough for exporters. Towards the end of the quarter, despite predictions about continued currency intervention, the Ministry of Finance and Bank of Japan did not enter the market; however, they said that they will take action if the yen's movements become too volatile.

Asia (ex Japan)

Global macroeconomic events dominated sentiment across Asia Pacific (ex Japan) markets as indices in the region endured double-digit percentage losses. During what proved a tumultuous three months – that saw US credit downgraded by S&P and the crisis in the eurozone reach fever pitch – some markets in Asia posted their worst quarterly performance in a decade. Local concerns, such as rising inflation and monetary tightening in China, largely took a backseat as investors priced in the growing likelihood of a double-dip recession in the global economy. China lagged the index on the back of signs that GDP growth had begun to slow. The country's financial stocks bore the brunt of the sell off as fears surrounding non-performing loans to local government enterprises weighed on the sector. The Philippines was Asia's best-performing market – over the third quarter and year to date – as the market benefited from signs of robust economic growth and comments from the central bank that it has the flexibility to support expansion.

Emerging Markets

Emerging markets underperformed the MSCI World index over the third quarter (in US dollar terms), reflecting rising risk aversion and local currency weakness. Asian emerging markets outperformed wider emerging markets over the quarter; the Philippines, Indonesia, Thailand and Malaysia outperformed, due to their perceived lack of sensitivity to the macroeconomic problems in Europe and the US. Taiwan outperformed modestly, aided by easing supply chain disruptions and benign inflation data. India outperformed, with the market perceived as being relatively insulated from the sovereign debt problems in the eurozone. Korea and China underperformed, due to concerns over the global growth outlook. The Latin markets underperformed, with local currency weakness providing a drag in several markets. Peru was the strongest Latin market, with President Humala signalling policy continuity while S&P raised Peru's foreign currency debt rating to BBB. Colombia outperformed, supported by its domestic investor base and robust GDP growth. Mexico outperformed, with the market benefiting from its relatively defensive status. Brazil and Chile underperformed, suffering from local currency weakness and the sell-off in commodities markets.

The EMEA markets underperformed wider emerging markets; however Morocco outperformed its emerging peers, aided by its low level of foreign ownership and high dividend yield. Turkish equities also outperformed, with sentiment benefiting from S&P's upgrade of Turkish local currency government debt to investment-grade status. South Africa outperformed, supported by strength in the gold price over the third quarter, but local currency weakness weighed on returns. Egypt outperformed modestly as political risks started to ease, but the situation remains fluid, with parliamentary elections delayed to November 2011. The Czech Republic performed broadly in line, with local currency weakness weighing on returns. Russia underperformed with rouble weakness and the sell-off in crude oil adversely affecting sentiment. Hungarian and Polish markets underperformed, due to local currency weakness, the deteriorating growth outlook in developed Europe and worries over consumer exposure to Swiss franc loans.

Global Bonds

Volatility and a flight to quality dominated fixed income markets through the quarter, as the eurozone debt crisis remained the centre of attention. Sentiment ebbed and flowed over the course of the quarter due to mixed newsflow and political developments on both sides of the Atlantic, but overall heightened risk aversion caused the outperformance of safe haven assets. The yields on US treasuries, UK gilts and German bunds fell to new lows amid the flight to quality and they were the best performing sectors as risk assets tumbled. Yields in peripheral eurozone countries continued to rise overall during the quarter, as Greece remained in the spotlight and Italy's situation worsened. Meanwhile, corporate bond indices posted losses, with lower-rated bonds and economically sensitive credit performing particularly poorly. High yield credit endured a torrid quarter, with the global high yield index down more than 8% over the period.

Overview: total returns (%) – to end of Q3 2011

Equities (MSCI)	3 months			YTD		
	EUR	USD	GBP	EUR	USD	GBP
World Index	-9.79	-16.52	-13.96	-11.83	-11.83	-11.38
World Value Index	-10.23	-16.92	-14.38	-11.77	-11.77	-11.32
World Growth Index	-9.36	-16.12	-13.55	-11.89	-11.88	-11.44
World Smaller Companies Index	-13.96	-20.38	-17.94	-15.73	-15.72	-15.30
US	-7.10	-14.03	-11.40	-8.73	-8.72	-8.26
Eurozone	-22.56	-28.34	-26.15	-18.79	-18.79	-18.38
UK	-8.57	-15.39	-12.80	-10.66	-10.66	-10.21
Japan	1.17	-6.37	-3.51	-10.76	-10.75	-10.30
Emerging Markets	-16.21	-22.46	-20.09	-21.67	-21.66	-21.26
Asia ex Japan	-14.37	-20.75	-18.33	-19.73	-19.72	-19.32
Government bonds (JP Morgan)	3 months			YTD		
	EUR	USD	GBP	EUR	USD	GBP
US	15.08	6.50	9.75	8.94	8.95	9.50
UK	14.12	5.60	8.83	10.15	10.16	10.71
Japan	14.53	5.99	9.23	7.07	7.08	7.62
Germany	8.02	-0.03	3.02	7.77	7.78	8.32
Corporate bonds (Merrill Lynch)	10.51	2.26	5.39	5.62	5.63	6.16

Source: Datastream

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