

Schroders

Monthly markets review

Overview of markets in February 2011

Highlights:

- Despite snowballing political unrest in North Africa and the Middle East, global markets managed to finish the month in positive territory as broadly positive corporate and economic data, and a resolution to the Egyptian stand-off, boosted investor confidence.
- However, escalating geo-political tension across the region, in the second half of the month, prompted a flight to safety and pushed oil and gold prices higher. Brent crude futures hit a two-year high on the back of the recent conflict in Libya – a significant producer and exporter of crude oil.
- The subject of inflation was never far from the headlines, with soaring commodity prices contributing to inflationary concerns during the month. China continued to apply monetary tightening measures, in a bid to cool its economic growth, while speculation of rate rises in the UK and Europe saw both the euro and sterling strengthen in the second half of the month.

US

US equities continued their strong performance in February, with the S&P 500 index producing a dollar total return of 3.4%. Small companies delivered even better performance, with the Russell 2000 returning 5.5%. US stocks were buoyed by broadly encouraging US economic data (most notably a discernible fall in the unemployment rate) and investors' expectations that US stocks could deliver good rates of earnings growth in 2011. At a global level, political unrest in the Middle East prompted investors to reallocate money from emerging markets to developed, and US stocks were among the main beneficiaries of this trend. However, equity market volatility increased in the second half of the month, reflecting fears that the rising oil price could provide a headwind to the US economic recovery. In terms of sector performance, energy stocks (particularly oil & gas drillers) performed strongly as West Texas Intermediate crude oil climbed to nearly \$97 a barrel. By contrast, auto and auto-related names struggled as higher gasoline prices weighed on sentiment.

Eurozone

Eurozone equity markets posted modest gains in February, as broadly positive economic data and some good results from the corporate sector offset concerns about escalating geo-political tensions in North Africa and the Middle East. In Germany, a rise in retail sales fed hopes that robust growth is feeding through to the domestic economy and boosting consumer spending. In the wider eurozone, bank lending to businesses increased after 16 months of contraction, and growth in manufacturing activity provided further encouragement. Although export-led growth in core European countries such as Germany continue to power the regional recovery, peripheral countries including Ireland, Italy and Spain also showed improving trends in output – suggesting that the recovery was broadening beyond core Europe. Measures of input and output prices also pointed to record rises in inflation. This was borne out in currency markets, which saw the euro strengthen in the second half of the month, amid mounting speculation that the European Central Bank (ECB) may be forced to raise borrowing rates sooner than expected as fears over inflationary pressures grew. The ECB subsequently decided to leave rates on hold in March, but hinted at the increased likelihood of a rate rise in coming months, in response to rising eurozone inflation.



UK

A robust earnings season was supportive of UK equities in February. With the strong earnings came upbeat company forecasts – though, in terms of market direction, these were at odds with economic headwinds emanating from home and abroad. While the markets were fearful of growing unrest in the Middle East and its affect on the global recovery, it was UK-specific factors that were at the forefront of investors' minds. The big question remains 'when will the Bank of England increase interest rates?' For the hawks, higher-than-expected inflation was enough to revise their expectations forward; a view also shared by Spencer Dale as he joined Andrew Sentence and Martin Weale in favour of a rate hike at the February MPC meeting. However, a surprise downward revision of fourth-quarter GDP to 0.6% from 0.5% appeased the doves, indicating that imminent rate hike fears had been overdone. Indeed, the furore surrounding the 'rate debate' obscured other data which although was largely lacklustre, included positives such as manufacturing PMI reaching an all-time high. Overall, these factors made for a volatile month but also one where UK equities delivered positive absolute returns.

Japan

Japanese markets were buoyed by a largely positive newsflow during the month, with the TOPIX finishing up 4.6% (in local currency terms). Broadly positive corporate and economic data releases, along with M&A activity, boosted sentiment early in the month – with investor's even shrugging off news of a fourth-quarter GDP contraction. Markets also reacted positively to signs of yen weakening (the trade-weighted yen hit its weakest levels in five months). However, the currency regained much of this ground towards the end of the month as rising political tensions in the Middle East saw investors seek refuge in safe-haven currencies.

Asia (ex Japan)

Continuing unrest in the Middle East dominated sentiment across Asia as oil rose to \$120/barrel, fuelling inflation concerns and tipping Asian equities into negative territory. Over the month, investors veered away from risk as commodity prices continued their upward trend – registering their longest monthly winning streak since 2004. Across the sectors, all, but energy and materials, posted negative returns as inflation fears took their toll on sectors likely to be worst affected by soaring consumer prices – and its possible impact on demand. As a result, the consumer-related sectors, along with technology and industrials registered the steepest declines. On a regional basis, Korea and Taiwan were the main laggards as central banks in both countries were expected to intensify efforts to curb inflation. In Korea, stocks capped their worst monthly performance in two years on worries surrounding slowing export demand and the stability of its savings bank sector, while North Korea threatened fresh military action.

Emerging Markets

The MSCI Emerging Markets index registered a negative total return (in dollar terms) over the month, underperforming developed world equities. Political unrest in the Middle East provided the main headwind, although further rate rises in China also weighed on sentiment. Regionally, the EMEA emerging markets delivered the best returns, driven by strong gains by South Africa and Russia. South Africa benefited from strength in the gold price, reflecting the unrest in the Middle East and fears of stagflation in the West. Russian markets were lifted by local currency strength as well as a sharp rise in global oil prices. However, Middle Eastern markets struggled as Egypt's stock market remained closed while Jordan suffered a 6.2% loss (in dollar terms). In the Latin markets, Brazilian equities rose as investors responded positively to news of R\$50 billion of budget cuts. Peru and Mexico also enjoyed gains with the latter benefiting from signs of economic recovery in the US. Asian emerging markets struggled to make headway with the rising oil price weighing on sentiment. Taiwan and Korea suffered the heaviest losses, with the MSCI indices down 8.8% and 6.2% respectively (in dollar terms).

Global Bonds

While February's headlines were dominated by the growing unrest in North Africa and the Middle East, the reaction within fixed income markets appeared to be relatively muted. Indeed, despite increasing pressure on global risk appetite as the month progressed, there was sustained demand for corporate bonds and for high yield securities in particular. Core government markets showed some evidence of a shift in risk appetite during the month, but 10 year yields in the US and Germany ended the month broadly flat. The extent to which investors 'retreated to quality' in the second half of the month was only sufficient to offset the rise in core yields seen earlier in the month – a rise that reflected a run of stronger than expected US economic data, continued growth in core Europe and another good set of results from the corporate sector.

Overview – Total Returns (%) – to end of February 2011

	1 month			YTD		
	EUR	USD	GBP	EUR	USD	GBP
Equities (MSCI)						
World Index	2.78	3.55	1.97	2.87	5.91	1.95
World Value Index	3.21	3.98	2.40	4.51	7.60	3.57
World Growth Index	2.35	3.11	1.54	1.26	4.26	0.36
World Smaller Companies Index	3.30	4.07	2.48	2.00	5.02	1.09
US	2.59	3.35	1.78	2.79	5.83	1.87
Eurozone	1.95	2.71	1.15	6.62	9.78	5.67
UK	3.55	4.32	2.73	3.32	6.38	2.40
Japan	3.79	4.56	2.97	1.69	4.70	0.78
Emerging Markets	-1.65	-0.92	-2.43	-6.36	-3.59	-7.19
Asia ex Japan	-4.56	-3.85	-5.32	-7.52	-4.78	-8.34
	1 month			YTD		
Government bonds (JP Morgan)						
US	-0.81	-0.08	-1.60	-2.97	-0.10	-3.83
UK	1.55	2.31	0.75	-0.33	2.62	-1.22
Japan	-0.87	-0.13	-1.65	-4.57	-1.75	-5.43
Germany	0.15	0.89	-0.64	-1.32	1.60	-2.20
Corporate bonds (Merrill Lynch)	-0.04	0.71	-0.82	-1.95	0.95	-2.83

Source: Datastream

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