

# Schroders

## Quarterly markets review

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### Overview of markets in Q1 2011

#### Highlights:

- The positive momentum from the fourth quarter of 2010 continued to propel equity markets in 2011, before a cocktail of events conspired to halt the progress. Ongoing unrest in North Africa and the Middle East, further peripheral European sovereign debt downgrades and the fallout from the Japanese earthquake and tsunami, unsettled markets and drove down global equity market indices. Although the quarter was not without its casualties, many markets managed to claw back some of the losses to remain in positive territory overall.
- Robust investor confidence favoured risk assets on the whole. Commodity prices soared, with Middle East tensions continuing to push oil prices higher. Despite periods of strength for safe haven assets, government bonds generally weakened, with investors favouring corporate bonds, particularly high yield.

#### US

US equities delivered strong gains over the quarter, with the S&P 500 producing a dollar total return of 5.9%. US stocks were supported by a positive earnings season and continuing merger and acquisition activity. Economic data remained broadly consistent with recovery, although annual headline inflation edged up to 2.1% in February from 1.6% in January. However, progress was evident in the jobs market, with non-farm payrolls rising 192,000 in February following an increase of 63,000 in January. In March, the unemployment rate dropped to 8.8%, further adding to hopes that labour market prospects have started to improve. However, US equity markets struggled to make progress over the last month of the quarter as high oil prices and the potential supply chain disruptions from the Japanese earthquake led to fears that earnings estimates could be downgraded. At a sector level, oil & gas delivered strong returns as West Texas Intermediate crude oil rose from \$91 dollars a barrel, at the start of the quarter, to nearly \$107 at the end, while autos and auto-related sectors ranked among the main laggards.

#### Eurozone

Eurozone equities got off to a strong start in 2011, with improving risk appetite driving market gains. Continued growth in core Europe and some positive results from the corporate sector propelled share prices for the most part. However, investors became increasingly uneasy in March, with further sovereign debt downgrades, escalating geo-political tensions in North Africa and the Middle East, and mounting inflationary pressures dampening sentiment. Nearing the end of the quarter, equity markets regained enough ground to ensure positive returns overall. Information technology and energy stocks registered some of the strongest gains over the quarter, while more defensive sectors such as consumer staples and healthcare lagged the wider market.

Fears of rising inflation struck a chord with European Central Bank (ECB) officials after eurozone inflation rose further than expected in March – to 2.6% from 2.4% a month earlier. Comments from ECB president, Jean-Claude Trichet, assumed a much more hawkish tone, making an imminent rate rise increasingly likely. Mandated with protecting consumers from inflationary pressures, and keeping interest rates below, but close to 2%; the ECB will be keen to ensure that the surge in headline inflation – driven by soaring food and energy prices – will not become entrenched and lead to ‘second round’ effects, such as a hike in labour costs.



## UK

2011 began with UK equities reaching two-and-a-half year highs. Throughout the first quarter, markets were supported by upbeat trading announcements and, in the main, corporate profits met the markets bullish expectations. However, there were plenty of macro-economic events to weigh on sentiment. Be it geo-political tensions in the Middle East, the re-emergence of sovereign debt concerns in Europe, or the still-live issue of a nuclear contamination threat in Japan, risk aversion has dominated the headlines. UK economic data was mixed. The Markit/CIPS UK manufacturing index showed its strongest reading since it was introduced in 1982, but inflation remained a headache (rising to 4.4% in February) and revised data showed that the UK economy had shrunk by 0.5% in the final three months of 2010. Investor confidence was not helped by ostensibly conflicting statements from UK policymakers on the timing of a rate hike, with the market now pricing in tightening sooner than previously expected. Despite heightened uncertainty, equity markets refused to sell off significantly. It took the devastating earthquake in Japan for equities to finally experience a sharp correction which, even then, was short-lived and relatively modest. Having shown remarkable resilience, we end the quarter with UK equities more or less where they started.

## Japan

Japanese equities got off to a good start in the first quarter. However, a sovereign debt downgrading by S&P, protests in Egypt, and ongoing political tensions in Libya weighed on sentiment as the quarter wore on. To make matters worse, the devastating earthquake and tsunami that hit north-east Japan in March resulted in a sharp drop in share prices. The subsequent nuclear crisis further weighed on sentiment and negatively impacted consumer spending, while the restrictions on power supply added to the woes. Towards the end of the period, sentiment improved after the Bank of Japan injected ample liquidity and doubled its asset purchase programme to 10 trillion yen, in a bid to stabilise markets.

## Asia (ex Japan)

A strong performance by energy and materials stocks brought Asia Pacific (ex Japan) equities through a highly volatile quarter. The index ended the period in positive territory, despite strong headwinds from continued political unrest in the Middle East and the fallout from the earthquake in Japan. With oil touching \$120/barrel over the period, Asia's energy sector enjoyed double-digit gains, while materials stocks benefited from surging commodity prices following a series of industry takeovers. In March, market sentiment was weighed down by the earthquake and tsunami in Japan, which triggered nuclear contamination concerns across the region. Asia's markets delivered a mixed response to the crisis. Economies with the strongest ties to Japan – including Hong Kong and Taiwan – lagged. Overall, India was the region's main laggard as its telecoms licensing scandal intensified, driving down telecoms stocks by more than 22% over the quarter. Korea delivered the strongest performance on the back of a 30% increase in foreign direct investment. Chinese markets also saw gains, lead by the IT sector, which benefited from soaring sales across the semiconductor industry. While China also reported strong manufacturing data, the issue of inflation refused to abate, prompting authorities to announce a further rise in interest rates.

## Emerging Markets

Emerging markets posted positive returns (in US dollar terms) over the quarter, but underperformed developed markets as political unrest in Tunisia, Egypt and Libya weighed on sentiment, raising fears of instability in other Middle Eastern states. However, emerging markets rebounded in March against a backdrop of improving risk appetite and signs that countries such as Korea could win market share from Japanese competitors following Japan's severe earthquake and tsunami.

Regionally, Hungary was the strongest emerging market, driven by local currency strength. Fiscal risks in Hungary eased as the government unveiled its long-awaited structural reforms. Russia delivered strong outperformance, benefiting from the strength in crude oil prices. Czech equities outperformed, lifted by signs of economic recovery in key export markets, such as Germany, as well as local currency strength. Thailand outperformed as political risks began to ease, while Indonesian equities benefited from continued strength in the domestic economy. China outperformed modestly over the quarter as inflation fears began to ease, although the authorities lowered the GDP growth target in the 12th Five-Year Plan.

Elsewhere, markets such as India and Turkey were hit by concerns that high oil prices are likely to worsen inflation pressures, while Taiwanese stocks sold off due to fears that the Japanese earthquake could disrupt global supply chains. Latin markets underperformed, with Peru the key laggard, as the opposition candidate took the lead in the presidential elections. However, Brazil outperformed, aided by local currency strength, as the central bank raised the SELIC rate to 11.75% in early March. Egypt was the major laggard, down over 20% (in dollar terms) over the quarter, reflecting widespread political unrest and the closure of the local market throughout February and most of March.

## Global Bonds

In a quarter in which several opposing forces were at play, the balance ultimately fell in favour of risk assets. Indeed, while there were periods of strength for safe haven assets, government bonds generally weakened, while corporate bonds, particularly high yield, outperformed.

The main volatility came in March as investors contemplated the risks posed by geopolitical unrest in North Africa and the Middle East, and the problems facing Japan in the wake of the devastating earthquake. Eurozone sovereign issues were still never far from the headlines, however, with Portugal the latest candidate for a bailout (resulting in a sharp jump in Portuguese government yields). The core government markets – US, UK, Germany and Japan – benefited from the general uncertainty in the early part of March, but yields resumed their upward trend in the final two weeks of the quarter. The gains reflected ongoing concerns about high commodity prices and subsequent inflationary pressures, as well as a continued stream of generally positive corporate and economic data.

## Overview – Total Returns (%) – to end of Q1 2011

	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
<b>Equities (MSCI)</b>						
World Index	-0.82	4.91	2.47	8.73	14.03	7.91
World Value Index	0.26	6.06	3.59	7.27	12.50	6.46
World Growth Index	-1.88	3.79	1.38	10.16	15.53	9.32
World Smaller Companies Index	0.49	6.30	3.83	19.18	24.99	18.28
US	0.17	5.96	3.49	10.64	16.03	9.80
Eurozone	3.85	9.85	7.30	6.23	11.41	5.43
UK	-1.89	3.79	1.37	8.32	13.59	7.50
Japan	-10.05	-4.85	-7.07	-3.12	1.60	-3.85
Emerging Markets	-3.48	2.10	-0.28	13.26	18.78	12.41
Asia ex Japan	-4.32	1.22	-1.14	14.23	19.80	13.37
	3 months			12 months		
<b>Government bonds (JP Morgan)</b>	EUR	USD	GBP	EUR	USD	GBP
US	-5.62	-0.17	-2.49	-0.15	4.71	-0.91
UK	-4.00	1.55	-0.82	6.21	11.39	5.41
Japan	-8.05	-2.74	-5.00	9.66	15.00	8.83
Germany	-2.34	3.31	0.90	1.01	5.93	0.24
Corporate bonds (Merrill Lynch)	-4.54	0.98	-1.38	2.63	7.63	1.85

Source: Datastream

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