

# Schroders

## Quarterly markets review

---

### Overview of markets in Q4 2011

#### Highlights:

- Equities made gains in the fourth quarter, but failed to prevent most major markets posting an overall loss for the year. Once again, events in the eurozone dominated market movements.
- After heavy selling in the third quarter, investors regained their risk appetite in October. However, political and economic turmoil in Greece and Italy and growing fear that the debt crisis would spread, saw volatility return in November.
- Hopes for the December EU summit supported equities, but, in what has become a familiar pattern, initial relief that a deal had been struck soon gave way to scepticism regarding the substance and efficacy of the agreement to take a step closer to fiscal union. An encouraging bout of US economic data in the final month of the year helped.

#### US

The US equity market was relatively volatile over the quarter, but proved the best performing region overall. The downward revision of third-quarter GDP growth to an annual rate of 2%, from an earlier estimate of 2.5%, weighed on sentiment in November; however, moderately positive economic indicators, better-than-expected employment and manufacturing data and some good corporate earnings buoyed investor sentiment as the quarter progressed; and have provided some hope of a continued recovery in the US, albeit at a slow pace. The coordinated action taken by the Fed and five other major central banks to ease the dollar funding pressure, coupled with further encouraging data in December (a rebound in US consumer confidence and continued growth in the US services sector), boosted US stocks and saw equity markets end the year as a whole in positive territory.

#### Eurozone

The constant trickle of newsflow triggered vast swings in sentiment was borne out in equity markets during the fourth quarter. It was a tale of two halves in October and November; with markets getting off to a strong start in October before the rally gave way to an equally aggressive share price retreat, as confidence in the region plummeted in November. However, as we entered the festive season, a decent pick up in sentiment drove share price gains, pulling equity markets firmly into positive territory over the quarter as a whole.

The European Central Bank (ECB) cut interest rates by 25 basis points (bps) at the beginning of November, with a further quarter percentage point cut in December. Stronger composite PMI data in December, up to 48.3 from 47 in November, offered some indication that the slowdown in Europe has been less severe than feared, while inflation showed signs of subsiding as Eurostat's flash estimate for December registered a fall to 2.8% from 3% November.

As European politicians struggled to reach an agreement on a credible, long-term solution to the ballooning sovereign debt crisis; banks welcomed the ECB's liquidity boost (designed to help ease funding pressures) with take up of the central bank's €489 billion worth of three-year loans attracting strong demand. While the move averted an interbank lending freeze, much of the money has been parked back at the ECB's overnight deposit facility (a record high of €452 billion in December). It, therefore, remains to be seen whether the extended credit lines will help to improve bank lending and ease fears about bank stability and peripheral government debt.



## UK

The FTSE All Share index rose by 8.4% in the fourth quarter. This statistic masks a highly volatile period for UK equities where daily market moves of 5% in either direction were not uncommon. The theme of the fourth quarter was a familiar one: 'risk-on' or 'risk-off' – with the market driven solely by perceptions of major macro-economic issues. The ongoing debt crisis in the eurozone dominated, and any whiff of a resolution sent share prices soaring. However, such positive days were the exception rather than the rule in an overall environment of growing risk aversion. Almost all of the positive returns in Q4 came in October, which delivered the fourth best monthly return of the last ten years. Largely driven by hopes of a comprehensive solution to the sovereign debt crisis in Europe, sentiment was also boosted by the Bank of England's (BoE) unanimous vote in favour of a £75 billion extension to its asset purchase programme. In November the BoE published a very dovish Inflation Report, in which inflation was projected at just 1.5% versus the 2.0% target over the policy horizon; a signal that a further expansion of the asset purchase program may well become warranted. Elsewhere, economic data was generally poor and consumer confidence dipped to a near three year low in December. The overall rally in the fourth quarter was not enough to lift the full-year number out of negative territory.

## Japan

Japanese equities struggled to find momentum over the quarter. At the beginning of the period, the yen hit record high levels against the US dollar, prompting the Japanese government to intervene to push the currency lower. Japanese exporters have struggled with the persistently strong yen, which has been driven higher as risk-averse investors seeking safe havens amid the continued turmoil in the eurozone and concerns about the global economic outlook. However, the government indicated its willingness to again intervene in currency markets if the yen rises too sharply, offering further support to export-led companies. In addition, the Bank of Japan expanded its credit and asset purchase programme by five trillion yen, bringing the total programme up to 55 trillion yen. Towards the end of the quarter, the Bank of Japan's Monthly Report of Recent Economic and Financial Developments indicated that domestic demand remained reasonably firm, due to rising investment by businesses, resulting from reconstruction following the Great East Japan earthquake. Private consumption, housing and public investment also held up.

## Asia (ex Japan)

Robust consumer data from the US and an easing of panic over eurozone debt lifted Asian equities in the fourth quarter but failed to rescue them from their first annual decline in three years. Signs of a slowdown in growth across the region were underscored by China's decision to lift the reserve requirement ratio on banks, marking the end of a two-year tightening cycle. Meanwhile, manufacturing activity expanded in India and China in December, suggesting the slowdown in the region's two largest economies may be stabilising. GDP growth in Taiwan and Singapore, however, contracted in the fourth quarter as both were hard hit by fluctuations in export demand. As a result, they were among the worst-performing markets in the index. The ASEAN countries of Thailand and Malaysia were the standout performers of the quarter, delivering double digit gains following a cut in interest rates in Thailand and the Malaysian central bank's decision to leave its base rate unchanged. From a sector specific point of view, financials led the index after monetary easing – particularly in China – triggered a rebound among banks and real estate stocks.

## Emerging Markets

Emerging market equities, as measured by the MSCI Emerging Markets index, produced positive returns over the fourth quarter of 2011, driven by a rally in October. However, they underperformed developed equities, reflecting the 'risk off' environment in equity markets as a result of the macroeconomic problems in the eurozone.

The Latin American region outperformed broader emerging markets in the fourth quarter. Peru outperformed, aided by strength in copper-related names. Mexico outperformed, with market sentiment boosted by the improving tone of US economic data releases. Brazil outperformed, supported by monetary policy easing and news that the government has abolished the IOF tax on foreign investors trading in Brazilian equities. Chile outperformed, aided by a strong domestic economy and third quarter GDP growth of 4.8% year on year. Colombia underperformed. The central bank raised interest rates in response to inflation concerns.

Asian emerging markets, as measured by the MSCI EM Asia index, underperformed wider emerging markets. However, markets such as Malaysia, Thailand, the Philippines and Indonesia outperformed, supported by their perceived relative lack of sensitivity to the problems in the eurozone. China outperformed; in general, economic data releases were indicative of a moderation in growth, rather than a hard landing, while the authorities commenced policy easing by reducing reserve requirements for the banking sector. Korea outperformed, aided by strength in a number of electronics-related names, although the market weakened following the death of North Korean leader Kim Jong Il. Taiwan underperformed, reflecting global growth concerns and weaker-than-expected third quarter GDP growth. India underperformed significantly, with sentiment hit by inflation concerns and local currency weakness.

The EMEA markets underperformed broader emerging markets in the fourth quarter. However, South Africa outperformed, with retail names supported by a better-than-expected third quarter for retail sales. Russia outperformed, aided by resilient Brent crude oil prices, although the equity market weakened in December following political unrest. The Czech Republic and Hungary underperformed, reflecting local currency weakness; Hungary raised interest rates to support the forint. Poland underperformed, with commodity-related names hit by the announcement of additional taxation on the sector. Egypt underperformed as renewed political unrest and concern over the depletion of the country's international reserves weighed on sentiment. Turkey underperformed, reflecting poor performance from banking sector names and worries over the country's large current account deficit.

### **Global Bonds**

Sentiment continued to swing regularly between fear and optimism in the fourth quarter, with the eurozone debt crisis remaining the key driver. At the same time, the new ECB President Mario Draghi surprised markets twice by lowering rates in November and December, by 25bps each time. In October, government bond yields rose across the board while credit performed strongly as some positive data from the US emerged and, then, the month's crucial European summit produced a number of measures that were warmly received by investors.

November saw a return to the risk aversion that had dominated the previous quarter. Italy's Prime Minister, Silvio Berlusconi, was forced to resign as concerns over the country's debt grew and its 10-year bond yields soared to more than 7%. UK gilts and US treasuries were November's best performing sovereign bonds as investors sought safe havens. Credit endured a torrid month, with high yield performing particularly poorly. The year ended on a brighter note as riskier fixed income assets made a December comeback. The sovereign bonds of Spain and Italy, which had proved such a drag on the index the previous month, were among the best performing assets in December, while lower rated credit and high yield also outperformed.

Overall, most major fixed income indices were in positive territory for the quarter (in local currency terms). Gilts were the best performing developed market sovereign bonds, up 5.54% (in sterling terms). Meanwhile in credit, high yield recovered much of the previous quarter's losses, with the BofA ML Global High Yield index up 5.33% in dollar terms. In investment grade credit, AA-rated corporate debt was the best performing tier in terms of rating quality over the period.

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

Equities (MSCI)	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
World	11.33	7.72	7.98	-1.84	-5.02	-4.31
World Value	11.37	7.75	8.01	-1.75	-4.92	-4.22
World Growth	11.26	7.65	7.91	-1.97	-5.14	-4.44
World Smaller Companies	11.96	8.32	8.58	-5.65	-8.71	-8.03
US	15.48	11.73	12.00	5.40	1.99	2.75
EMU	5.80	2.37	2.61	-14.08	-16.86	-16.24
Europe	8.99	5.45	5.70	-7.51	-10.50	-9.84
UK	12.77	9.11	9.37	0.74	-2.52	-1.79
Japan	-0.63	-3.85	-3.62	-11.32	-14.19	-13.55
Emerging Markets	7.95	4.45	4.70	-15.44	-18.17	-17.57
Asia ex Japan	6.76	3.30	3.54	-14.30	-17.07	-16.46
Government bonds (JPM GBI All Mats)	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
US	4.29	0.91	1.15	13.62	9.94	10.76
UK	8.82	5.29	5.54	19.86	15.98	16.85
Japan	4.04	0.66	0.90	11.39	7.79	8.59
Germany	1.93	-1.37	-1.14	9.85	6.30	7.09
Corporate bonds (BOFA ML)	5.19	1.78	2.02	11.10	7.51	8.31
Global High Yield (BOFA ML)	8.86	5.33	5.58	6.06	2.63	3.39
Euro High Yield (BOFA ML)	4.22	0.84	1.08	-2.55	-5.70	-5.00

Source: Datastream

**Important Information:**

**For professional investors and advisers only. This document is not suitable for retail clients.** This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (Schroders) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Schroders has expressed its own views and opinions in this document and these may change. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. This document is issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA, which is authorised and regulated by the Financial Services Authority.