Schroders
Monthly markets review

Overview of markets in August 2011

Highlights:

- August provided a gloomy backdrop for markets as worries about slowing global growth, a stalling recovery in the US and the sustainability of peripheral European sovereign debt levels, combined to batter investor sentiment during the month.
- Despite US policymakers reaching a compromise deal to extend the federal debt ceiling and stave off default, ratings agency Standard & Poor's deemed the cuts insufficient for the country to maintain its AAA credit rating, and subsequently downgraded the US to AA+.
- In Europe, amid escalating concerns about the state of public finances in peripheral European countries, the European Central Bank (ECB) bought Irish, Portuguese, Spanish and Italian government debt, in an effort to shore up confidence.
- Risk aversion prompted an indiscriminate sell off in equity markets and saw investors flee to safe havens, helping government bond markets outperform, while gold rocketed to a new nominal high of US$1913.50 per ounce during the month.

US
US equities struggled to find momentum in August, finishing the month in negative territory. The month started on a solemn note when Standard & Poor's downgraded the US long-term sovereign credit rating from AAA to AA+. This, together with concerns about the country's budget deficit, eroded investor confidence and saw markets slide during the month. Investor caution reflected the sharp fall in consumer confidence, along with deteriorating economic indicators. Towards the end of the month investors speculated about the prospect of Federal Reserve chairman Ben Bernanke announcing a third round of quantitative easing. However, despite indications of maintaining a low interest rate policy, no additional stimulus was proposed.

Eurozone
August proved a particularly difficult month for eurozone equity markets, as escalating investor pessimism drove down share prices. The indiscriminate sell off reflected growing fears about the sustainability of peripheral European sovereign debt levels, while weak economic indicators on both sides of the Atlantic further dampened sentiment. Preliminary eurozone second-quarter GDP disappointed, registering only 0.2% growth quarter-on-quarter, while sluggish manufacturing data and waning industrial orders weighed in business and consumer confidence.

As widely anticipated, the ECB kept interest rates on hold. The central bank also resumed its Securities Markets Programme (SMP), in an effort to stabilise markets – initially buying Irish and Portuguese debt and, latterly, Spanish and Italian government debt, narrowing yield spreads over the course of the month and staving off immediate concerns about systemic financial instability in the eurozone.

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UK
Equity markets suffered sharp declines at the beginning of the month, as a number of economic events prompted question marks over the sustainability of global growth. Poor second quarter US GDP numbers, which saw the markets pull the plug on companies' future growth and earnings estimates, fuelled whipsaw volatility. Once the markets suffer a sharp decline, forced selling and a buyers' strike ensure far heavier falls than would be justified by valuations and this time was no different. Manufacturing PMI readings confirmed that in the UK, economic activity continues to shrink. At the same time Europe's debt crisis continued to drag, despite interventions by political leaders – compounding the negative impact on banking stocks. The Bank of England left policy unchanged in August, although the Minutes showed that no member of the Monetary Policy Committee voted for a rate hike compared to two in July, with Adam Posen continuing to be the only member voting for further asset purchases. The FTSE All Share index was down circa 7% in August (in sterling terms), its worst monthly performance since autumn 2008.

Japan
Against a backdrop of global market volatility, the Japanese market produced a negative return over August. The yen was stubbornly strong throughout the month, weighing on sentiment. However, indications that the economy contracted at a slower pace than expected in the second quarter, as output and exports recovered from the earthquake in March, brought some relief. Towards the end of the month, former Prime Minister Naoto Kan – who 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.

Asia (ex Japan)
Asian equities followed most global markets into the red, after a surge of negative sentiment – triggered by signs that the US recovery was stalling and the European debt crisis was intensifying – wreaked havoc across risk assets. The MSCI AC Asia (ex Japan) endured its biggest monthly decline since October 2008 as investors fled to safety. Export-focused markets bore the brunt of the correction, with Korea and Singapore among the worst performers. India also lagged as the country's telecoms sector struggled to get past the recent phone corruption scandal and increased government regulation. With the US Federal Reserve expected to persist with its dovish stance on monetary policy, the US-pegged Hong Kong market outperformed, along with the more domestically driven ASEAN economies such as the Philippines. In August, Chinese export orders fell for the first time in two years, while manufacturing in South Korea and Taiwan contracted, signalling a slowdown in growth across the region. These developments weighed on industrial and materials stocks, which were the worst performing sectors over the month.

Emerging Markets
The MSCI Emerging Markets index underperformed the MSCI World index in August, reflecting a global decline in risk appetite. Latin markets outperformed broader emerging markets over the period. Peru outperformed, aided by easing political concerns. Colombia also outperformed, with the central bank unexpectedly leaving benchmark rates on hold. Brazil lagged its regional peers but outperformed wider emerging markets. The central bank surprised the market by cutting the SELIC rate at the end of the month, citing global macroeconomic risks.

EMEA markets performed broadly in line with wider emerging markets in August. Morocco outperformed its regional and emerging peers, supported by low levels of foreign ownership and a high dividend yield. South Africa outperformed, benefiting from a series of record highs in the gold price. Russia underperformed, with sentiment hit by a decline in global commodities prices. Turkish equities lagged the wider emerging markets. The central bank cut the repo rate, despite strong domestic growth and a significant current account deficit. Hungary's market underperformed significantly, with sentiment hit by the rally in the Swiss franc.

Asian emerging markets underperformed broader emerging markets. Taiwan underperformed the MSCI Emerging Markets index, reflecting global growth concerns. Chinese markets lagged, with the annual CPI and PPI readings for July higher than expected, while industrial production growth of 14% year-on-year was below consensus. The Indian market underperformed; as in China, inflation worries weighed on sentiment. Korea’s market suffered a heavy sell-off, reflecting investors’ fears of a double dip recession in the US.

Global Bonds

Another volatile month for fixed income markets began with the good news that US lawmakers had reached a compromise over the US debt ceiling and avoided a default. However, this was immediately followed by a fresh wave of eurozone fears focused on Spain and Italy, where bond yields soared. The decision of rating agency Standard & Poor’s to downgrade US sovereign debt to AA+ further added to the prevailing risk aversion and, perversely, treasuries rallied on the news of the downgrade. Meanwhile, the Federal Open Market Committee voted to keep rates unchanged and indicated its intent to sustain a low rates policy through mid-2013 in light of weak economic conditions. In Europe, the ECB moved to buy Spanish and Italian bonds and yields fell sharply.

During this period, corporate credit suffered as thin volumes exacerbated price movements. Lower rated credit and high yield spreads widened the most aggressively amid the risk aversion. Indeed, in the high yield sector the falls of the first two weeks of August marked it out as one of the worst months for the sector in 20 years. Volatility calmed in the second half of the month and risk aversion eased somewhat. Credit yields fell, while yields on safe haven assets such as treasuries, gilts and bunds, levelled out or rose slightly. Government bonds outperformed over the month as a whole.

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

	1 month			YTD		
Equities (MSCI)	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
World Index	-7.19	-7.00	-6.25	-10.11	-3.53	-7.24
World Value Index	-7.44	-7.26	-6.51	-10.96	-4.44	-8.11
World Growth Index	-6.94	-6.76	-6.00	-9.29	-2.64	-6.39
World Smaller Companies Index	-8.41	-8.23	-7.48	-11.58	-5.11	-8.76
US	-5.72	-5.53	-4.76	-8.36	-1.64	-5.43
Eurozone	-12.95	-12.78	-12.07	-13.84	-7.53	-11.09
UK	-7.48	-7.30	-6.55	-8.74	-2.05	-5.82
Japan	-8.31	-8.13	-7.38	-15.51	-9.32	-12.81
Emerging Markets	-9.08	-8.90	-8.16	-14.56	-8.31	-11.83
Asia ex Japan	-10.03	-9.85	-9.12	-13.86	-7.55	-11.11
	1 month			YTD		
Government bonds (JP Morgan)	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
US	2.63	2.83	3.67	-0.12	7.19	3.07
UK	0.56	0.76	1.58	3.61	11.20	6.92
Japan	1.07	1.27	2.10	0.08	7.41	3.28
Germany	2.24	2.44	3.28	5.23	12.93	8.59
Corporate bonds (Merrill Lynch)	-0.08	0.12	0.93	-1.45	5.77	1.70

Source: Datastream