

# Schroders

## Monthly markets review

### Overview of markets in July 2011

#### Highlights:

- With the exception of Japan, global equity markets produced lacklustre returns in July, as macroeconomic issues weighed on sentiment during the month.
- In Europe, wrangling over the bail-out terms for Greece unsettled markets before policymakers reached agreement later in the month, while fears of contagion saw peripheral country debt yields surge.
- US markets were preoccupied with the threat of a ratings downgrade for US Treasuries, as the Democrat and Republican parties struggled to come to a compromise deal to extend the federal debt ceiling and stave off default.
- The uncertainty created by US policymakers' brinkmanship, along with escalating contagion fears in Europe, prompted a flight to safety. Yields on German and UK government bonds fell while gold hit a record high.

#### US

US equities made poor progress over July. Political wrangling between the Democrats and Republicans, over negotiating a deal to avoid the US defaulting on its debt, created an uncertain environment and dominated investor sentiment over the month. As a result of fears over a policy stalemate, Standard & Poor's put the US on a negative credit watch. Meanwhile, employment data remained poor due to increased economic uncertainty and the unemployment rate rose to 9.2%. Towards the end of the month, consumer sentiment and confidence readings were dampened by the sharp rise in oil prices and the longer-term problem of a poor labour market. July ended with disappointing second-quarter GDP figures at 1.3%, and the annual base revisions were broadly negative – first quarter GDP growth was revised down from 1.9% to 0.4%. In more positive news, retail sales numbers from the International Council of Shopping Centre's data and the Johnson Redbook Index pointed to increasing sales momentum during the month.

#### Eurozone

Constant wrangling over the bail-out terms for Greece unsettled markets in July. With European officials slow to come to an agreement, markets became increasingly uneasy. Fear of contagion triggered sharp falls in sentiment in Spain and Italy and saw peripheral country debt yields surge. European ministers finally hashed out an agreement towards the end of the month that will see private bondholders shoulder part of the debt burden and will increase the flexibility of the European Financial Stability Facility. July also revealed the results from the latest round of EU bank stress tests. Although markets welcomed the increased transparency, the results, once again, lacked credibility and were met with a fairly lacklustre response.

Fears of a US slowdown also weighed on sentiment, in part, with the lack of progress on agreeing a long-term US deficit reduction plan doing little to ease concerns. This was compounded by weaker-than-expected macroeconomic data, with euro area manufacturing PMI and services PMI both contracting, while the European Central Bank (ECB) survey of lending conditions indicated that demand for credit had weakened in the second quarter. Elsewhere, German and French sentiment slipped during the month but remained above the historical average. In markets, concerns about Greek debt exposure weighed most heavily on financial stocks while the euro weakened under heavy selling pressure, with investors flocking to the relative safety of the Swiss Franc as macro drivers continued to dominate. As widely expected, the ECB hiked interest rates by a further 25 basis points to 1.5% in July.



## UK

The equity rally in late June proved to be short-lived, as markets were quickly swamped by poor US jobs numbers, sovereign debt concerns in Europe and the US, and rising numbers of profit warnings from companies. Markets remained weak even after EU leaders passed a multi-faceted bailout towards the end of July. Amid these issues, news on inflation was relegated from newspaper front pages, though CPI unexpectedly eased to a three-month low. The Bank of England Monetary Policy Committee minutes noted that risks to inflation in the medium-term remained 'substantial in both directions', suggesting no near-term change in monetary policy. Data showed GDP growth almost ground to a halt in the second quarter (+0.2%). However, a number of temporary factors had a negative impact, without which GDP growth would have accelerated. Despite this, the slowdown sparked a chorus from critics calling for a 'Plan B' from the government and more quantitative easing from the Bank of England. Both are possibilities, though they remain unlikely in the near term. Against this backdrop, UK equities ended July in negative territory, but though markets remained within a tight trading range. The FTSE All Share is now only marginally positive year-to-date.

## Japan

The Japanese market finished higher this month following tentative improvements in the macro-economic environment, and some further relief after the March earthquake and tsunami. Specifically, the power shortage had not been as much of a constraint as initially feared, with companies reducing 15% of power usage. In addition, industrial production seems to be recovering much more quickly than expected from its disaster-related problems. Many factories have re-opened early, and there are now signs of improvement in supply and production figures. Domestic consumption is also recovering, with consumer confidence surveys showing that corporate and household consumer sentiment has stabilised. Meanwhile, like other markets, the Japanese market was adversely affected by heightened sovereign debt fears in the US and Europe. In addition, the strong yen made the environment very tough for exporters, with Japanese products becoming less competitive.

## Asia (ex Japan)

Asian markets withstood global headwinds to end the month in positive territory as markets welcomed the results of Thailand's general election and Indonesian equities were boosted by a slowdown in inflation. With Indonesia and the Philippines holding fire on raising interest rates, it was these economies in the south-east region that led the index's gains. Following a decisive win by the Pheu Thai party in the country's general elections, Thailand's markets enjoyed double-digit gains on expectations that increased political stability would encourage foreign investment. The region's largest economies – India and China – were the MSCI AC Asia (ex Japan) index's main laggards, each ending the month down. India posted the steepest losses as the central bank raised interest rates more than expected, on evidence that inflation was continuing to rise. It was a similar story for China where CPI hit 6.4% in June, and second-quarter GDP growth was ahead of expectations. In the final week of July, the Shanghai Composite fell the most in six months as railway shares plunged on news of a fatal high-speed train crash in Wenzhou.

## Emerging Markets

The MSCI Emerging Markets index fell in July but outperformed the MSCI World index, benefiting from strong returns from a number of Asian emerging markets. Thailand outperformed strongly, responding to easing political risks as the Puea Thai party won the general election. Indonesia and the Philippines also outperformed strongly, with both markets supported by easing inflation concerns. Meanwhile, Korea outperformed its regional and emerging market peers, with industrial production for May coming in stronger than expected at 8.3% year-on-year. Taiwanese equities outperformed the regional index and wider emerging markets, with IT hardware component suppliers buoyed by strong results from high-profile US technology names. China underperformed as the central bank raised deposit and lending rates by 25 basis points. On the inflation front, annual CPI rose to 6.4% in June, reflecting unfavourable base effects and higher food prices. India underperformed as policymakers surprised the market by raising rates by 50 basis points.

The EMEA markets underperformed broader emerging markets in July. Russia outperformed the region and wider emerging markets, supported by a recovery in oil prices. Meanwhile, South Africa outperformed its regional peers but underperformed broader emerging markets. The market was supported by gold prices, which rose above \$1,600 an ounce for the first time. The remaining EMEA markets underperformed wider emerging markets in July, with only Jordan bucking the trend. Latin markets lagged their emerging market peers in July. However, Peru's market rallied strongly as President Humala moved to ease investor concerns by re-appointing the existing governor of the central bank, and naming Luis Miguel Castilla as Minister of Finance. Brazil underperformed as policy tightening continued, with interest rates rising to 12.5%. Chile underperformed significantly as the central bank kept rates on hold, reflecting the recent moderation in economic growth.

## Global Bonds

Risk aversion, uncertainty and fear continued to grip fixed income markets in July, as investor sentiment was dominated by negative news on both sides of the Atlantic. In early July, the eurozone debt crisis dominated the headlines, once again, and bond markets turned their attention to Portugal, Spain and Italy. Yields in these countries rose sharply as investors moved into safe-haven German and UK government bonds where yields fell as risk aversion prevailed.

In a widely expected move, the ECB raised rates by 25 basis points in early July to 1.5%, citing the need to keep inflation under control. The final part of the month was dominated by fears over the US debt ceiling, as politicians struggled to reach an agreement. This heightened fears of a US downgrade or even a default and caused a flight to quality. In this 'risk off' environment, core government bonds outperformed corporate debt and peripheral sovereign bonds. In the corporate credit space, the best performance came from the highest rated investment grade credit, while high yield underperformed.

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

	1 month			YTD		
	EUR	USD	GBP	EUR	USD	GBP
<b>Equities (MSCI)</b>						
World Index	-0.91	-1.79	-3.94	-3.16	3.73	-1.06
World Value Index	-2.12	-2.98	-5.11	-3.80	3.04	-1.72
World Growth Index	0.28	-0.61	-2.79	-2.52	4.41	-0.41
World Smaller Companies Index	-1.44	-2.31	-4.46	-3.47	3.40	-1.38
US	-1.07	-1.95	-4.10	-2.80	4.12	-0.70
Eurozone	-5.62	-6.45	-8.51	-1.02	6.02	1.12
UK	0.96	0.07	-2.13	-1.36	5.66	0.78
Japan	4.47	3.55	1.27	-7.86	-1.30	-5.86
Emerging Markets	0.51	-0.38	-2.56	-6.03	0.65	-4.00
Asia ex Japan	2.14	1.23	-0.99	-4.26	2.55	-2.19
	1 month			YTD		
<b>Government bonds (JP Morgan)</b>	EUR	USD	GBP	EUR	USD	GBP
US	2.80	1.89	-0.35	-2.68	4.24	-0.58
UK	6.74	5.80	3.47	3.03	10.36	5.26
Japan	5.91	4.98	2.67	-0.98	6.06	1.16
Germany	3.16	2.25	0.00	2.92	10.24	5.14
Corporate bonds (Merrill Lynch)	3.19	2.28	0.03	-1.37	5.65	0.77

Source: Datastream

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