

Schroders

Quarterly Markets Review

Overview of markets in Q2 2010

Highlights:

- The MSCI World Index ended a volatile quarter in negative territory, after the positive momentum, driven by strong earnings results in the first quarter, gave way to revived fears of a recovery slump.
- Concerns that Europe would lead the world into a double-dip recession spurred share price declines across the globe, and marked a sharp reversal in the risk trading that fuelled positive returns in the first quarter. The market volatility sent investors fleeing from equities into the safe haven assets, such as gold and US Treasuries.
- In Asia, downwardly revised Chinese data further compounded the global equities sell-off, propelling the 10-year Treasury yield below 3%. Crude oil suffered its first quarterly decline since the end of 2008, and iron ore has fallen 27% since its peak in April, due to slowing Chinese steel production as demand has weakened in the wake of tighter monetary policy.
- European leaders hammered out a rescue package, while individual countries unveiled sweeping austerity packages to help rein in sovereign debt. The euro continued to slide against the dollar and German consumer confidence levels weakened. However, investors welcomed better-than-expected manufacturing data.
- In the US, reports of sluggish growth in the first quarter dampened risk appetite – new home sales tumbled after a tax credit expired and unemployment continued to dampen household spending, but unemployment figures registered a slight improvement from May to June.

US

A slump in consumer confidence towards the end of the quarter was compounded by falling retail sales and signs that the US recovery was still yet to bed down. Equity markets gyrated throughout the period as upbeat developments in the domestic economy were dampened by concerns emanating largely from a crisis-hit Europe and an overheating China. Over what proved a turbulent three months, US markets struggled to gain momentum, and the S&P 500 registered its worst quarterly performance since the fourth quarter of 2008. At a sector level, banks came under significant pressure on the back of government plans to reform the sector. Meanwhile, the wheels appeared to come off the rebound in the automobile industry, as a slowdown in consumer activity sent the sector's stocks into sharp decline.

By the last days of June, the optimism of early April had all but faded as the Federal Reserve surprised the market with a statement that weakened its previously confident stance on the progress of the recovery. After revising down first-quarter economic growth figures, the US joined the rest of the world's key economies – including China, Japan, and the eurozone – in seeing the pace of its recovery appear to ease. Official US jobless figures showed that the rate of unemployment had fallen from 9.7% in May to 9.5% in June, a gradual improvement where analysts had expected a marginal rate rise. Non-farm payrolls also fell less than anticipated, down by 125 000 in June versus an expected 130,000. Elsewhere, lawmakers put the final touches on financial regulation legislation.



Eurozone

It has been a turbulent quarter for eurozone equities as the downgrading of Greek, Portuguese and Spanish government bonds sparked fears that peripheral eurozone countries would find it increasingly difficult to manage, and rein in, their mounting fiscal deficits. The downgrades also sparked wider concerns about regional banks' sovereign debt exposure – particularly Spanish banks, following the Bank of Spain's seizure of ailing domestic savings bank CajaSur. German consumer confidence plummeted and the euro tumbled as sentiment weakened. The growing unease prompted nations to ramp up efforts to tackle the problems. European leaders agreed to a €750 billion stabilisation scheme and individual countries unveiled sweeping austerity packages. The measures were endorsed at the June meeting of G20 leaders who discussed deficit-reduction targets, along with the need for the banking community to adopt more rigorous capital requirements to instill up confidence and support sustainable economic growth.

UK

Despite a strong corporate earnings season, markets were dragged lower by weakening sentiment in a volatile second quarter as the eurozone's sovereign debt crisis and evidence of slow economic growth in the UK sparked losses across all sectors. Fiscal deficit concerns in Europe continued to weigh on markets through May and June amid fears that problems in Greece could affect other European countries. This continued to overshadow a corporate sector recovery where, in general, company results for the 2009 exceeded market expectations by some margin. In fact, the majority of companies reported strong cash generation and significant decreases in balance sheet risk. Despite a brief rally, share prices fell sharply again in June, with the FTSE All-Share index closing the quarter down 13.5% in sterling terms.

Small caps (-6.4%) outperformed their larger counterparts (-14.5%) over the quarter. By sector, European sovereign debt concerns weighed on the financials sector in particular; while reduced risk appetite put downward pressure on oil & gas prices. At a stock level, the fallout from the Gulf of Mexico oil leak sparked a sell-off in integrated UK oil major BP. The UK elections in May proved something of a sideshow in the wake of the sovereign debt woes. In June, the new coalition government's emergency budget, which held few surprises, received a muted response by markets.

Japan

Japan swore in a new president as deflation continued to haunt the economy. The country's central bank introduced new measures to stimulate lending as the recovery showed little sign of gaining traction. With unemployment still high and consumer spending continuing to falter, the Bank of Japan launched interbank funding at 0.1% to support lending to the country's businesses. Concerns for the corporate sector were compounded by a strengthening yen, which has served to sharply eroded profits. In the final week of the quarter, the yen traded close to an eight-year high against the euro as waning optimism over the global economy boosted demand for safe assets. While export activity rose on the back of brisk demand from across Asia, the upswing failed to boost Japan's equity markets, which were weighed down by a rise in producer prices, along with government debt concerns emanating from the eurozone. Although markets in the region ended the quarter significantly lower, Japan was among the best-performing equity regions in the world as Europe reeled under the weight of its sovereign debt crisis. Across the sectors, heightened risk aversion left cyclical stocks, including energy and financials, trailing the wider index.

Asia (ex Japan)

Asian stocks endured their worst quarterly slump in more than a year as confidence in the global recovery was dented by headwinds from Europe and fears of economic overheating in China. While markets across the region shed value over the quarter, China bore the brunt of the declines, with the Shanghai Composite proving the world's worst-performing stock market after Greece. Investors fretted over Chinese government efforts to cool the country's property sector, while the market was bombarded by a raft of shares as the banking sector scrambled to raise capital.

The period began on a strong note, with news that the Chinese economy grew 11.9% year-on-year (yoy) in the first quarter. Across Asia, economic releases were largely upbeat with export activity expanding throughout the region. News that India's economy expanded 8.7% in the first quarter (yoy) boosted sentiment, while Hong Kong also recorded a strong first-quarter rebound. However, by

the end of June, stocks across the region were the subject of a sell-off amid signs that China's efforts to cool its economy were beginning to curb the region's growth. In the last days of the quarter, the yuan rose to its strongest level since 1993 after the People's Bank of China announced it would pursue a more flexible exchange rate by removing the currency's unofficial peg to the US dollar.

Emerging Markets

A turbulent quarter for emerging markets saw negative returns across the majority of the region's bourses. Nonetheless, emerging market equities on the whole outperformed their developed market counterparts. Sector-level performance was lacklustre; however, only the highly defensive consumer staples sector registered positive returns in US dollar terms, while the energy sector was held back by falling oil prices. Tightening measures in China and India had a detrimental impact, amid concerns about the effect on the global economic recovery. Fears about contagion from Europe's sovereign debt markets also weighed on performance. Eastern European markets were among the weakest, with Hungary, Poland and the Czech Republic suffering from fragility in the banking sector. Russia was negatively impacted by the slump in oil prices – the country's largest export. A slump in commodity prices, as well as monetary tightening, also affected Brazil, which had a poor quarter largely as a result of the weak showing from oil giant Petrobras and mining major Vale. Conversely, Peru was the best performing of the emerging markets over the quarter, helped by strength in gold stocks, such as Buenaventura.

Global Bonds

Concerns about the escalating sovereign debt crisis and a potential double-dip recession were reflected across bond and money markets during the quarter, with increased volatility and some marked fluctuations in risk appetite. LIBOR rates ticked up overall, reflecting concerns about the exposure of banks to the renewed volatility and the systemic risks posed by the sovereign debt situation. Appetite for peripheral eurozone bonds also remained weak, albeit that yields retraced to some extent from their highs after the announcement of the ECB/IMF €750 billion bailout package in early May. In contrast, core European government bonds (France and Germany), US Treasuries and gilts benefited from a search for safe havens. The performance of credit markets was also subject to considerable fluctuation, with a difficult May outweighed by positive returns in April and June, and a sharp drop in issuance levels overall.

Overview – Total Returns (%) – to end of June 2010

	3 month			YTD		
	EUR	USD	GBP	EUR	USD	GBP
Equities (MSCI)						
World Index	-3.33	-12.49	-11.28	5.93	-9.56	-2.38
World Value Index	-3.83	-12.94	-11.73	5.52	-9.91	-2.75
World Growth Index	-2.84	-12.05	-10.82	6.34	-9.21	-2.00
World Smaller Companies Index	-1.02	-10.40	-9.15	12.98	-3.54	4.11
US	-2.30	-11.56	-10.33	9.21	-6.76	0.64
Eurozone	-8.66	-17.32	-16.17	-7.78	-21.26	-15.01
UK	-4.82	-13.84	-12.64	0.32	-14.35	-7.55
Japan	-0.65	-10.07	-8.82	14.03	-2.65	5.08
Emerging Markets	1.31	-8.29	-7.01	10.05	-6.04	1.42
Asia ex Japan	5.10	-4.86	-3.54	12.91	-3.60	4.06
	3 month			YTD		
Government bonds (JP Morgan)	EUR	USD	GBP	EUR	USD	GBP
US	15.78	4.81	6.27	24.17	6.01	14.42
UK	14.13	3.31	4.75	14.96	-1.85	5.94
Japan	19.43	8.11	9.62	25.98	7.56	16.10
Germany	4.19	-5.68	-4.37	7.15	-8.52	-1.26
Corporate bonds (Merrill Lynch)	14.07	3.26	4.69	24.26	6.09	14.52

Source: Datastream to 30 June 2010

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