

Schroders

Quarterly markets review

Overview of markets in Q3 2010

Highlights:

- It was a volatile quarter for global equity markets, with investor sentiment being driven by fear and greed in equal measure. Following an auspicious start in July, pessimism gripped markets in August, before renewed optimism in September put paid to earlier concerns about slowing economic growth and the prospect of a double-dip recession.
- The rebound ensured quarterly gains across regional equity markets, with Japan proving the only exception as the yen's continued strength against the dollar weighed on sentiment.
- In currency markets, fears of a stalling recovery in the US pushed the dollar to an eight-month low against a basket of major currencies at the end of the quarter. The yen, in particular, continued the surge against the dollar, reaching its strongest level since May 1995. This prompted Japanese authorities to unilaterally sell the yen – the first such move since 2004.

US

US equities made progress over the quarter, with the Dow Jones Industrials, S&P 500 and NASDAQ 100 all posting gains. Despite a poor start to the quarter, US stock markets enjoyed a strong rally in September as worries over the weakness of the US labour market and the fallout from the European debt crises began to ease. However, doubts about the durability of the US economic recovery continued to linger, pushing the dollar to an eight-month low against a basket of major currencies at the end of the quarter. Measures of economic sentiment, such as the Conference Board's index of US confidence, also turned out to be weaker than the markets had expected, thus adding to the sense of unease. The mixed economic prompted the Federal Reserve to announce at its September meeting that it was prepared to do more to help the economy, raising expectations that it may return to 'quantitative easing' at some point.

Eurozone

Relief in the wake of the European bank stress tests drove share prices higher in July, before August ushered in a more subdued period as investors contemplated the prospect of a double-dip scenario. However, September brought renewed optimism, with markets shrugging off earlier concerns of a stalling recovery to deliver positive equity market returns for the quarter as a whole. German consumer confidence hit its highest levels for more than two years, while retailers benefited from a pick-up in consumer spending as domestic growth looked to be broadening beyond the export-led industrial sector. The encouraging consumer data was also accompanied by an unexpected rise in German business confidence in September. These indicators appeared to be at odds with less robust eurozone purchasing managers' indices – which indicated a deceleration in eurozone growth. Also, in the final week of the quarter, the Irish central bank's warnings about additional funding requirements to support the country's flailing banking sector prompted renewed concerns about eurozone sovereign debt levels. Despite the mixed newsflow, the more upbeat data looked to be the driver of investor sentiment over the quarter.

UK

The end of the last quarter marked a low point for investor sentiment, as optimism fuelled by the economic recovery and the apparent runaway success of quantitative easing earlier in the year was brought back down to earth with a bump. In contrast, the third quarter saw UK equity markets posting solid gains - almost fully reversing the second-quarter declines. However, it has not all been plain sailing. The markets rode a wave of optimism following July's reports of strong company profits and better-than-expected European bank stress test results, but this was not to last



as investors' attention turned to a raft of less-than-positive macroeconomic newsflow. If there is one thing investors do not like it is uncertainty, and thin summer volumes exacerbated the impact of this sentiment. September, however, saw sentiment improve once again on the back of positive indicators, the increased likelihood of further quantitative easing in the US, and a firmer consensus on the UK economic growth outlook. Essentially, having started the third quarter with a market that had lost its bearings, much of the fog had lifted by the time we reached quarter end.

Japan

Japanese equities lagged other developed equity markets over the quarter, with the Nikkei 225 registering a minor loss (in yen terms) for the period. As has been the case for much of the year, worries about the yen's continued strength against the dollar continued to weigh on equity market sentiment, with the yen surging against the dollar in September, to its strongest level since May 1995. This prompted the authorities to intervene in foreign exchange markets – the first such move since 2004 – as Japan unilaterally sold the yen. Meanwhile, economic data in Japan remained uninspiring with the Bank of Japan's Tankan survey showing a slower pace of improvement in business confidence at the end of the quarter. The Bank of Japan remained accommodative with its monetary policy, expanding its credit lending programme to 30 trillion yen (\$357 billion) at the end of August.

Asia (ex Japan)

Asian markets posted their biggest quarterly rise this year as the region's economy remained largely resilient to signs that the global economic recovery was losing steam. While risk appetite was dented by concerns surrounding the sovereign debt crisis in the eurozone and a slowdown in US economic growth, optimism was driven by a string of upbeat developments in economies across the region. In September, Chinese manufacturing accelerated for a second month, easing fears that government efforts to cool inflation and tighten lending activity – to prevent a property bubble – were likely to trigger a significant slowdown in growth. Hong Kong equities also saw strong gains, touching their highest level in three months, following positive corporate earnings and an upbeat outlook for the local property market. Singapore, Malaysia and Indonesia all delivered their biggest quarterly gains since the third quarter of last year.

Emerging Markets

The MSCI Emerging Markets index gained in value over the quarter, benefiting from declining risk aversion in September and a rebound in the price of commodities. Regionally, India stood out among the BRICs economies as data released at the end of August showed that the Indian economy expanded at its fastest pace in over two years, helping to drive the market to a double-digit percentage gain (in US dollar terms) for the quarter. Chinese equities also rose over the quarter as the country's manufacturing sector accelerated in both August and September, according to a survey of purchasing managers published by HSBC and Markit. In Latin America, Brazil's equity market registered gains as the authorities confirmed that they would not increase taxes on capital inflows. Foreign investors have poured money into Brazil, enabling Petrobras to successfully complete a record \$70 billion share offering. In Russia, markets posted gains over the quarter, benefiting, in part, from stronger oil prices. However, the severe drought prompted authorities to ban grain exports until the end of the year. The impact of the drought also forced the authorities to raise their official inflation forecasts for this year and next year.

Global Bonds

Bond markets mirrored the volatility in other financial markets during the summer months as investors continued to gauge the likelihood of a double-dip recession. July saw a notable improvement in risk appetite (albeit from a low level) as fears about eurozone sovereign debt subsided to some degree. In particular, investors appeared comforted by the results of the long-awaited European banking sector stress tests, along with some successful peripheral European bond auctions and the apparent implementation of austerity plans in these countries. Risk assets, including corporate bonds outperformed as sentiment improved, with cyclicals, basic industries and the European financial and insurance sectors benefiting in particular.

Corporate bonds made further gains during August, but they were nevertheless outpaced as a search for safe havens rewarded their government bond counterparts. Low August trading volumes exacerbated market moves. In the US, earnings season momentum helped in early August, but weak economic data and a surge in supply weighed on appetite for credit during the rest of the month. Meanwhile, 10-year treasuries outperformed as US macro news disappointed and the Federal Reserve revealed plans for treasury purchases, with the intention of stimulating growth. The outperformance of government bonds in the US was mirrored in Germany and the UK as fears about sovereign risk returned. Mixed economic data, a ratings downgrade for Ireland and continued problems within the Irish banking sector, all contributed to take UK and German 10-year government bond yields to record lows.

The third quarter ended with more muted performance from most bond markets. The exception was high yield, which benefited from a hunt for yield to which companies responded with large scale issuance. US treasuries remained well supported by indications that the Fed would take further action if needed, while attention in the eurozone continued to focus on Ireland and its troubled banking sector.

Overview – Total Returns (%) – to end of Q3 2010

| | 3 month | | | YTD | | |
|-------------------------------------|---------|-------|-------|-------|-------|-------|
| | EUR | USD | GBP | EUR | USD | GBP |
| Equities (MSCI) | | | | | | |
| World Index | 2.19 | 13.89 | 8.13 | 8.25 | 3.01 | 5.56 |
| World Value Index | 1.29 | 12.89 | 7.18 | 6.89 | 1.71 | 4.23 |
| World Growth Index | 3.08 | 14.88 | 9.07 | 9.62 | 4.31 | 6.89 |
| World Smaller Companies Index | 2.94 | 14.73 | 8.93 | 16.30 | 10.66 | 13.40 |
| US | 0.07 | 11.53 | 5.89 | 9.29 | 4.00 | 6.57 |
| Eurozone | 7.72 | 20.06 | 13.99 | -0.66 | -5.47 | -3.13 |
| UK | 7.48 | 19.78 | 13.72 | 7.82 | 2.59 | 5.14 |
| Japan | -4.99 | 5.89 | 0.54 | 8.34 | 3.09 | 5.64 |
| Emerging Markets | 6.02 | 18.16 | 12.18 | 16.68 | 11.02 | 13.77 |
| Asia ex Japan | 4.60 | 16.58 | 10.68 | 18.10 | 12.38 | 15.17 |
| | 3 month | | | YTD | | |
| Government bonds (JP Morgan) | EUR | USD | GBP | EUR | USD | GBP |
| US | -7.74 | 2.82 | -2.38 | 14.55 | 9.00 | 11.70 |
| UK | -1.99 | 9.23 | 3.71 | 12.67 | 7.21 | 9.87 |
| Japan | -3.89 | 7.11 | 1.70 | 21.08 | 15.22 | 18.07 |
| Germany | 1.95 | 13.63 | 7.88 | 9.24 | 3.95 | 6.52 |
| Corporate bonds (Merrill Lynch) | -5.88 | 4.90 | -0.41 | 16.96 | 11.29 | 14.05 |

Source: Datastream

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