

# Schroders Monthly Markets Review

## Overview of Markets in October 2007

### Highlights

- Global equities endured further volatility in October, but markets generally ended the month in solid positive territory. Emerging Asian markets provided very high returns, while Japan was the weakest performer.
- Bond markets seesawed in October, but provided positive returns overall.
- Consumer confidence dipped in the US, even though economic growth and payroll numbers in were much better than anticipated.
- In mid-October worries about banks' exposure to risky investments were revived. The US's largest bank, Citigroup, announced a big decline in profits and huge writedowns linked to areas including sub-prime mortgages and leveraged loans. This sparked a new rally in government markets and a sell-off in credit markets.
- The US Federal Reserve cut interest rates at the end of the month, but warned that the risk of rising inflation is now on par with downside risks to economic growth. Investors had already factored in more cuts, leading to further falls in the dollar.
- Crude oil and gold prices soared to near \$100 per barrel and just under \$800 per ounce respectively.

### US

It was another choppy month for US equities as investors were weighed down by renewed concerns about the fall-out from the global credit squeeze, although the market ended the month higher. Share prices were initially buoyed by the closely-watched jobs report, which rebounded strongly in September. Of greater significance was the upward revision in August's surprising fall, easing fears that the housing slowdown and credit crunch were spreading to the wider economy. However, as October progressed, sentiment was dented by disappointing earnings in the banking sector as well as downbeat corporate forecasts, sparking a fresh bout of concerns about the extent of the slowdown in the economy. There was further bleak data from the US housing market with starts falling to their lowest levels since 1993 while existing home sales continued to slide in September.

The US Federal Reserve cut interest rates by 25 basis points at the end of the month, bringing the Fed Funds Rate to 4.25%. The move was widely expected, but the accompanying statement was slightly more hawkish.

Economic growth numbers for the third quarter came in surprisingly strong at an annualised 3.9% against expectations for 3.1%, and 3.8% in the previous quarter.

The US Institute for Supply Management's manufacturing survey came in a little below expectations in September while the non-manufacturing index was in line with consensus forecasts. Both indicators remain consistent with a slowdown in growth, rather than a recession.

### Eurozone

Eurozone markets provided strong returns overall in October, but not without volatility. Financial and mining stocks led the way higher early in the month as credit concerns eased and metals prices hit record

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levels. However, worse-than-expected third-quarter results from certain banks, hit by their exposure to US sub-prime, dragged markets back down mid-month.

The losses were then reversed as soaring oil prices lifted energy stocks and markets began to price in a further cut in US interest rates. Also dominating investor thoughts during the month was the appreciating euro, which reached record highs against the US dollar, while a hefty rise in European inflation took economic pundits by surprise. European Central Bank left interest rates unchanged in October, as expected, with the accompanying remarks from its governor, Jean-Claude Trichet sounded a little more dovish.

Overall, autos and telecoms were the best performers in European markets, while forestry & paper, and IT stocks underperformed.

The flash estimate of the composite Purchasing Managers' Index (PMI) continued to ease in October, largely due to the fall in the manufacturing PMI, while services rebounded. However, both indicators remained above the 50 level, indicating that activity is still expanding.

## UK

October was a strong month for the UK, with the FTSE All-Share rising to within a hair's breadth of its all-time high on two separate occasions. A pronounced rally in the first half of the month helped banking stocks to make up some of their lost ground, while record commodity prices pushed oil and mining shares higher. One of the main drivers for UK equities, however, was a sharp pick-up in bid talk after a quiet summer. Even so, there were clear signs that investor sentiment could still be easily swayed. There were lingering concerns about the continued fallout from the credit crunch and the US housing market, but these were later joined by fears that the UK economy could equally fall foul of a major housing setback. These concerns kept nerves on edge and, while the FTSE All-Share made strong gains, it couldn't break through its peak.

Turning to the economy, preliminary economic growth data beat expectations at 0.8% quarter on quarter in the third quarter, suggesting that the economy held up well during the credit crunch. The above-trend growth, along with resilient retail sales growth, is likely to reinforce expectations that the Bank of England will continue to leave rates unchanged in next month's Monetary Policy Committee (MPC) meeting. On the other hand, buoyant retail sales growth was largely due to discounting amongst retailers. The downward pressure on prices was also reflected in the latest inflation data, with headline consumer price inflation (CPI) remaining at 1.8% in September while the core measure (excluding energy, food, alcohol and tobacco) was just 1.5%.

The Bank of England kept rates on hold, as widely expected.

## Japan

The Japanese market made little progress against a background of ongoing concerns over US sub-prime, slowing US growth and a strengthening currency.

Financials had mixed fortunes over the month, at first experiencing a belated rally in reaction to strong gains in other Asian financials combined with news of Citigroup's offer to buy 32% of Nikko Cordial to buoy sentiment for the sector as a whole. The rally was short-lived, however, as announcements of record losses by two major US financial institutions ignited concerns over US sub-prime loans. Stocks in the sector fell back to levels not seen since August. Elsewhere, exporters struggled due to a strengthening yen and sharp falls in US stock prices reflecting concerns over the US economic outlook. Despite this, reports that Japan's trade surplus had surged to a record high in September clearly illustrated that Japan is no longer reliant on the US for its export growth.

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In terms of domestic developments, pessimism regarding prospects for the Japanese economy emerged as the Cabinet Office revealed a third consecutive month of economic stagnation. Low trading volumes characterised the month and indicated a degree of caution ahead of the interim results reporting season, although early results provided the stimulus for a sharp rally in the final few days of October.

The Bank of Japan kept interest rates on hold in October, as expected.

### Asia (ex Japan) Markets

Asian markets – and primarily emerging Asian markets - provided very strong returns over the month of October, despite increasing oil prices, political tension between Turkey and Iran and a profit warning from Caterpillar. Towards the end of the month, Asian markets rose strongly as the US Federal Reserve cut interest rates.

The strongest performing markets were India, China and Indonesia. India has been boosted by approximately US\$19 billion of foreign net inflows year-to-date. China was the next best performing market for the month, as the H-Share market performed well following news that HSBC would most probably be increasing its investment in Bank of Communication. The interest of local Chinese investors in QDII funds also boosted market performance this month. Indonesia's strong performance from the energy sector bolstered returns.

Across sectors, the energy and telecommunications outperformed, while the consumer discretionary and semiconductor sectors lagged.

### Emerging Markets

Global emerging markets made strong progress in October, continuing their run of good performance from the previous month. Local currency appreciation enhanced overall performance in US dollar terms, while in other developments the US Federal Reserve reduced interest rates by 25 basis points, following September's 50 basis point move.

The Indian market delivered the strongest returns among global emerging markets – despite a sharp mid-month fall on the release of proposals from the Securities and Exchange Board of India for controls on offshore derivative instruments (the market recovered strongly later in the month). The Chinese market continued its run of strong performance, helped by favourable liquidity conditions and despite further monetary tightening measures. The Chinese economy continues to grow at a rapid rate, with data released over the month showing the country's GDP growing by 11.5% year-on-year in the third quarter. The Indonesian market also delivered high returns.

In Latin America, Brazil outperformed. Mining and metals stocks performed particularly well. The macro-economic environment remains favourable despite recent inflation pressures and a pause in interest rate cuts from the central bank. Argentina, Mexico and Colombia made solid progress in absolute terms but underperformed the MSCI Emerging Markets index. The underperformance of the Mexican market reflected continuing concerns about earnings growth. In Argentina, Cristina Kirchner won the presidential election in the first round of voting, while data was released showing industrial production growing by 8.8% year-on-year in September. In Colombia, the central bank left interest rates on hold at 9.25% against a background of favourable inflation data.

South Africa was among the best performing EMEA markets, with the appreciation of the rand having a large positive impact on performance in US dollar terms.

Hungary was the weakest performing emerging market over the month, although local currency appreciation enhanced returns in US dollar terms. The country's central bank left interest rates on hold at 7.50%.

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### Global Bond Markets

Debt markets seesawed in October as the market's outlook for the global economy swung from hope to gloom. The US Federal Reserve at the end of September had cut interest rates by an exceptional 50 basis points, and bond markets fell back over the next couple of weeks as investors scaled down their concerns about the credit crisis and moved back into riskier asset classes.

However, by mid-October worries about banks' exposure to risky investments were revived. The US's largest bank, Citigroup, announced a big decline in profits and huge writedowns linked to areas including sub-prime mortgages and leveraged loans. This was enough to spark a new rally in government markets and a sell-off in credit markets. The trend intensified as other leading US banks including Bank of America and Wachovia also announced bleak earnings statements. Then, Merrill Lynch took the market by surprise by revealing that its losses were much greater than previously declared. Government markets continued to rise into month-end, while spreads in credit markets widened. There were few surprises when the Federal Reserve cut interest rates by another quarter point on the last day of the month.

### Overview - Total Returns (%) – to end of October 2007

Equities (MSCI)	1 Month			YTD		
	Local	USD	EUR	Local	USD	EUR
World Index	2.16	3.09	1.34	10.73	15.64	5.40
World Value Index	1.29	2.20	0.46	6.86	11.56	1.68
World Growth Index	3.00	3.93	2.17	14.63	19.76	9.15
World Smaller Companies Index	3.79	4.90	3.12	5.70	11.38	1.51
US	1.69	1.69	-0.04	11.34	11.34	1.48
Eurozone	3.12	4.90	3.12	12.79	23.74	12.78
UK	3.98	6.02	4.22	10.91	17.72	7.29
Japan	-0.15	-0.38	-2.07	-1.64	1.66	-7.34
Asia ex Japan	9.62	10.68	8.79	49.92	54.24	40.58
Emerging Markets	8.96	11.16	9.27	41.42	49.90	36.62

Government bonds (JPMorgan)	1 Month			YTD		
	Local	USD	EUR	Local	USD	EUR
US	0.81	0.81	-0.90	5.73	5.73	-3.63
Germany	0.71	2.46	0.71	1.60	11.47	1.60
Japan	0.48	0.25	-1.46	1.74	5.16	-4.16
UK	0.88	2.86	1.11	1.86	8.12	-1.46

Source: Datastream to 31 October 2007

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