Market review

January 2012

Review of markets over the fourth quarter

MSCI World Index total return
Fourth quarter 2011
11.3% in EUR
8.0% in GBP
7.7% in USD
7.5% in JPY
7.9% in Local
Source: MSCI, 31 December 2011.

Global stock markets comfortably outperformed government bond markets during the fourth quarter of 2011, although equities did start from a very low base at the end of September. Investors responded to positive news on the US economic recovery and to actions taken in Europe to resolve the debt crisis. Government bond yields of major economies ended the year near historic lows as investors wait for signs of a sustainable global economic recovery and more details on the European fiscal pact. The yield on the ten-year UK Gilt fell to a record low of 1.96% on 29 December. The MSCI World Index rose by 7.9%, while the JPMorgan Global Bond Index increased by a marginal 0.8%. Emerging markets underperformed developed markets, gaining just 4.9% (all in local currency terms).

Market activity during the fourth quarter was dominated by developments in Europe. But uncertainty over the strength of both the US and the Chinese economies also influenced investor behaviour.

The European debt saga is set to continue well into 2012. Last October at the EU leaders meeting in Cannes, it was announced that more austerity measures were needed in Greece, the recapitalisation of European banks, and a plan to leverage the European Financial Stability Facility (EFSF) to guarantee government bonds. The summit, however, failed to prevent the crisis from deepening. Peripheral government bond yields reached euro era highs, and European banks became less willing to lend to each other. The credit ratings of Portugal and Belgium were downgraded, and rating agencies announced a review of all European countries. At the December EU summit in Brussels all of the EU countries, with the exception of Britain, agreed to a new compact to increase fiscal integration. The details are still to be finalised but the compact would see countries penalised for breaching certain fiscal criteria. Initially markets were unimpressed with the plan and yields on ten-year Spanish and Italian bonds rose sharply, but they have since fallen.

The ECB lowered its benchmark interest rate, both times by 25 basis points (bps), at its November and December meetings, taking the rate to 1.00%. But of greater note was the ECB's offer of unlimited three-year loans to banks and a loosening of collateral eligibility rules. The banking sector welcomed these loans, borrowing EUR 489 billion (EUR 200 billion more than expected). It is unlikely, however, that the ECB will be as generous towards EU sovereigns. ECB president, Mario Draghi, stated the ECB's Securities Market Programme, which purchases government bonds to lower yields, was "neither infinite nor eternal", suggesting no dramatic increase in the size of the purchases. Meanwhile, French president Nicolas Sarkozy called for banks to use the cheap ECB loans to purchase the government debt of ailing countries. Whether banks choose to follow Sarkozy's advice, or use the loans to shore up their own balance sheets to meet the new capital requirements that will be introduced this year, is still to be seen.

In the third quarter of 2011 the US economy grew by 1.8% quarter-on-quarter on an annualised basis. This is not the rate of growth expected after a large recession, but the US is still faring better than many other developed economies. The Bluechip consensus forecast for 2012 GDP growth in the US is 2.2% and compares well to the expected 0.9% growth in the UK or the 0.1% contraction in the eurozone.

Data releases in the months to December point to stronger growth in the fourth quarter. The Institute for Supply Management's manufacturing index rose to 53.9 in December, its highest level since June and above expectations (a figure above 50 indicates expansion). The new orders component of the index rose to 57.6, which may translate into continuing demand for the manufacturing sector.

US consumers are upbeat, as the University of Michigan consumer confidence survey rose to a six month high in December of 69.9. The pick up in the consumer outlook may be down to the modestly improving labour market and lower inflation environment. The US unemployment rate dropped from 9.2% in June to 8.5% in December, but is still high in historical terms. Meanwhile, the slowdown in inflation to 3.4% year-on-year (y/y) from 3.9% in September means less pressure on real incomes. However, the stronger growth in retail sales during September and October started to slow in November suggesting that the boost from holiday spending may not be as strong as expected.

The better US economic position combined with heightened risk aversion towards Europe saw investors shift away from gold. Gold fell by more than USD 200 from November to December, to USD 1,564 per troy ounce. The US dollar was one of the world's preferred safe haven assets over December. Increased demand saw the USD/EUR exchange rate moved below USD 1.30 for the first time in almost 12 months.

Continued evidence of a soft landing for the Chinese economy emerged late in the fourth quarter. The HSBC Purchasing Managers' Index of manufacturing was 48.7 in December (below the 50 expansion threshold) but higher than the November figure of 47.7. Weaker external demand has hit exporters, leading to the loosening of monetary policy. The People's Bank of China reduced the reserve requirement ratio by 50bps in November. Inflation has fallen sharply since the middle of 2011, from 6.5% y/y in July to 4.2% in November, suggesting that further cuts are likely. Domestic demand remains robust.

Other emerging markets are also undertaking a loosening of monetary policy. Brazil's central bank reduced the Selic rate by 50bps at both the October and November meetings and another cut is expected in January 2012.

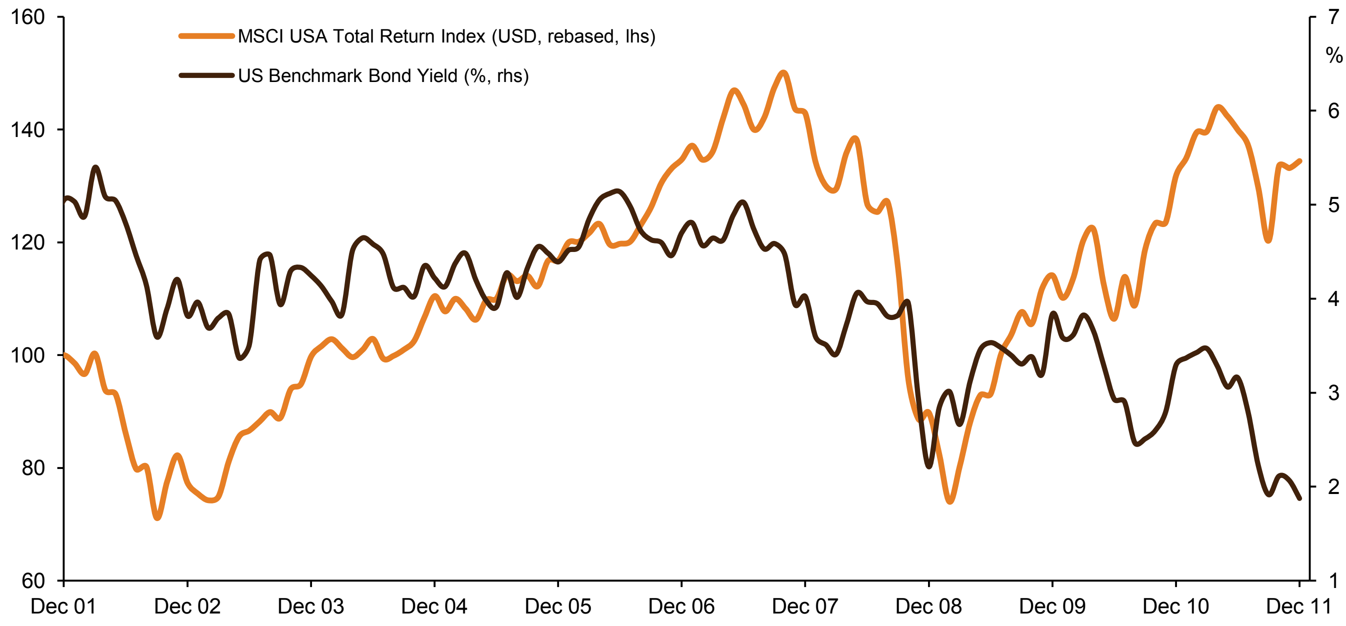
Total returns from markets in the fourth quarter (%)

Equities (MSCI)	Sterling	US dollar	Yen	Euro	Local
World	8.0	7.7	7.5	11.3	7.9
US	12.0	11.7	11.5	15.5	11.7
Europe ex UK	3.7	3.5	3.3	7.0	6.6
UK	9.4	9.1	8.9	12.8	9.4
Japan	-3.6	-3.8	-4.0	-0.6	-4.0
Pacific ex Japan	6.3	6.0	5.8	9.6	2.2
Latin America	9.1	8.8	8.6	12.5	9.3
Emerging Markets	4.7	4.4	4.3	8.0	4.9
Bonds					
World	0.4	0.1	0.0	3.5	0.8
US	1.1	0.9	0.7	4.3	0.9
Japan	0.9	0.7	0.5	4.0	0.5
UK	5.5	5.3	5.1	8.8	5.5
EMU Aggregates	-4.0	-4.2	-4.4	-1.0	-1.0
Currencies					
Sterling	na	-0.2	-0.4	3.1	na
US dollar	0.2	na	-0.2	3.4	na
Yen	0.4	0.2	na	3.5	na
Euro	-3.0	-3.2	-3.4	na	na

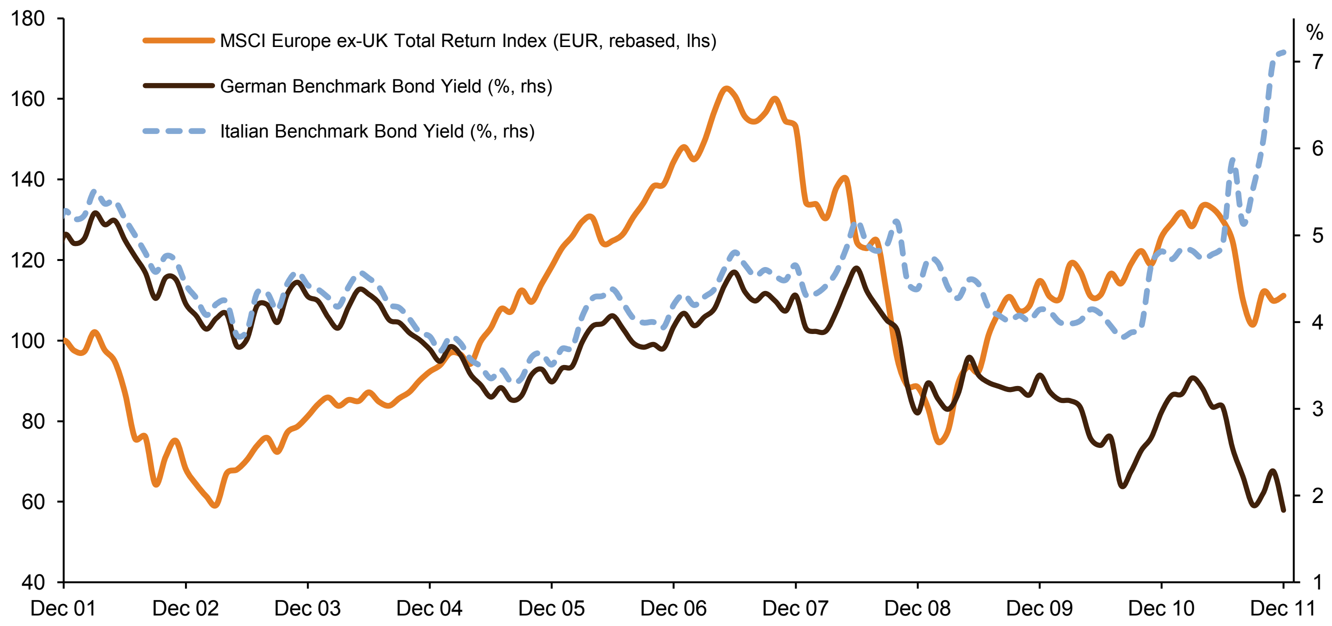
Source: JPMorgan GBI indices, MSCI, FactSet, J.P. Morgan Asset Management.

Part 2: Index and yield charts

US equities and bonds

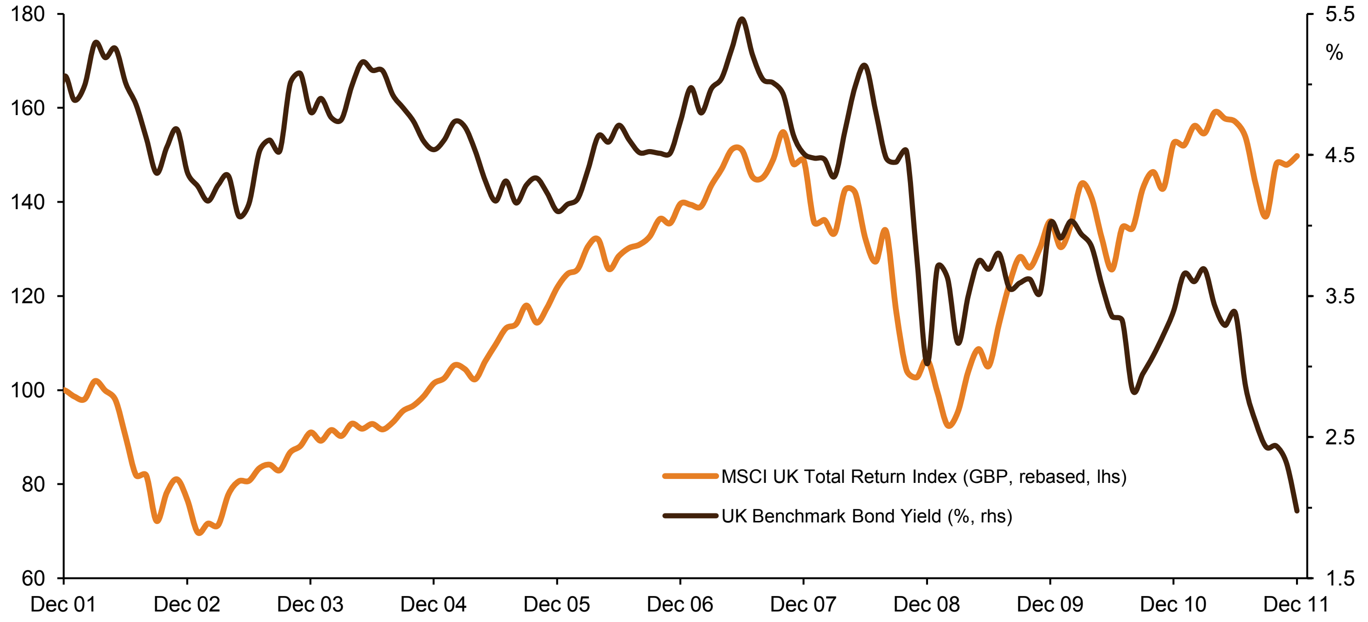


European equities and bonds

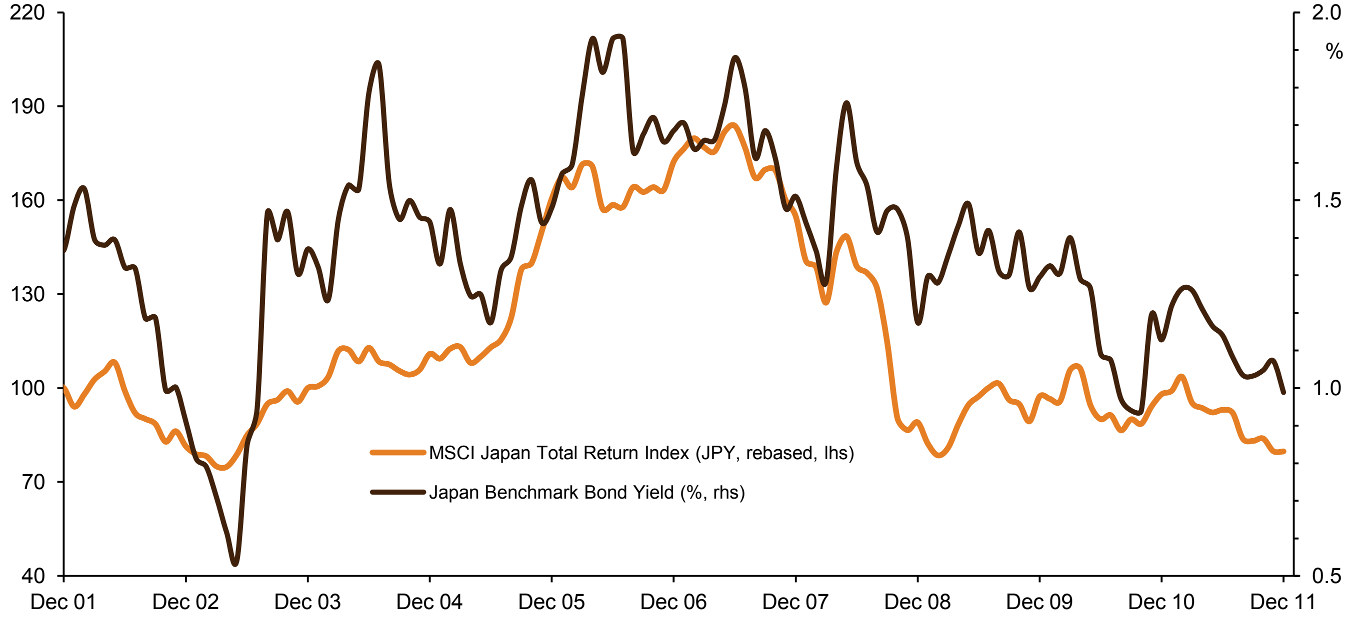


Source: MSCI, Bloomberg, 31 December 2011.

UK equities and bonds

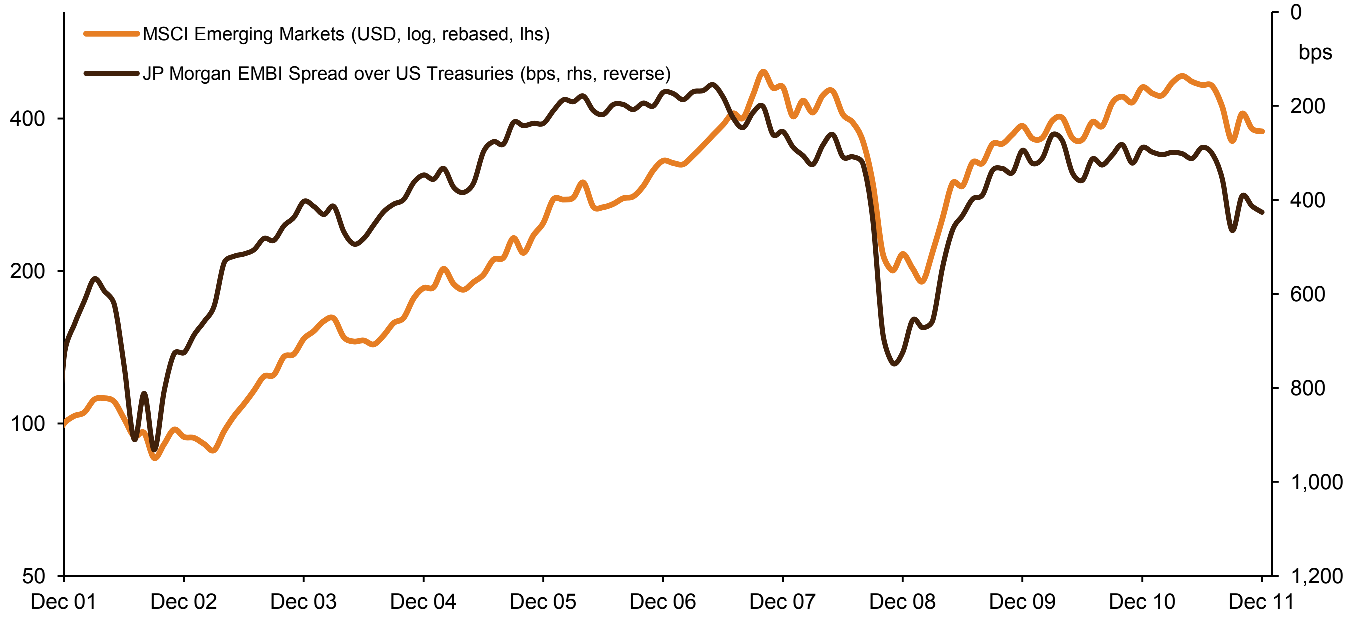


Japanese equities and bonds



Source: MSCI, Bloomberg, 31 December 2011.

Emerging markets equities and bonds



Source: MSCI, Bloomberg, 31 December 2011.

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