

Market Commentary

Q1 2012

UK (all returns are in £ unless otherwise stated)

The FTSE All-Share Index ended the first quarter 6.1% higher. The European Central Bank's Long Term Refinancing Option provided much-needed liquidity to the European banking system and healthier economic data from the US boosted investor sentiment further. The Bank extended further its Quantitative Easing programme, by £50bn to £325bn. The reason for extending the QE programme further was supported by mostly disappointing economic news. It was confirmed that the UK economy contracted in the fourth quarter, activity in the service sector grew at its slowest pace in three months according to a PMI survey, and unemployment reached a new 17-year high. In the corporate sector, a key event was the huge losses reported by the state-owned banks – RBS and Lloyds Banking Group, after they wrote down their Greek debt and compensated customers for mis-sold PPI policies. However, both stocks gained as the market acknowledged that the two are strengthening their capital bases. Elsewhere, companies generally reported strong earnings: Rolls Royce delivered profits that surpassed the £1 billion mark for the first time and Diageo also posted excellent profits. In contrast, Tesco reported weak Christmas trading and its first profit warning in 20 years, while Game Group was the latest retailer to enter administration. Over the period, higher beta stocks performed well, along with mid to small-cap stocks. The industrials sector finished the best-performer, while more defensively-oriented sectors such as health care and telecoms remained out of favour among investors.

Data Source: Confluence

Europe (all returns are in € unless otherwise stated)

European markets delivered a positive return during the first quarter of 2012, with the Russell Developed Europe ex UK Large Cap Net Index gaining 8.8%, as the latest agreement in the Greek crisis provided succour to European investors. Just as pertinent was the ECB's second round of Long-Term Refinancing Operations (LTRO), a process by which European banks can take out 1% three-year loans from the ECB in exchange for a wide range of collateral. This was well-received by equity investors, who believe LTRO has averted another credit crunch or bank failure. In the UK, meanwhile, the Bank of England extended its Quantitative Easing programme by £50bn to £325bn. The best-performing market over the quarter was Germany, where the news continued to show that its economy was significantly outperforming its eurozone neighbours. Although German GDP contracted in quarter four, confidence remains reasonably high: unemployment is at a 15-year low. By contrast, the Spanish market performed poorly as investors were sceptical over the new government's ability to appease both its electorate and creditors. Spanish unemployment is now more than 23%. Over the period, higher beta stocks performed well, along with mid to small-cap stocks. The consumer discretionary sector finished the best-performer, while more defensively-oriented sectors such as telecoms remained out of favour among investors.

Data Source: Confluence

US (all returns are in US\$ unless otherwise stated)

The Russell 1000 Index returned 12.7% during the first quarter of 2012 after three consecutive positive months. Economic releases were generally upbeat, with Year-over-year GDP growth above 3.5% in the three months to February 2012 and unemployment decreasing from 8.5% in December to 8.3% in February. The price of a barrel of Brent crude oil rose 14.4% over the period and was of concern for investors and politicians, with President B. Obama reportedly considering actions to release strategic petroleum reserves in hopes of lowering the price of crude oil and related products. Technology was the best performing sector, led by computer technology companies, most notably Apple which returned

48%. After being out of favor during 2011, the financial services sector rebounded strongly, driven by diversified banks, including Bank of America and SunTrust Banks. In contrast, utilities stocks struggled as many investors came to believe that the relative valuation of the sector had become excessive due to outperformance in 2011. Within the energy sector, coal stocks fared worst, due to a combination of a warm winter in much of the US, natural gas substitution, and the prospect of new regulations from the Environmental Protection Agency (EPA).

Data Source: Confluence

Japan (all returns are in ¥ unless otherwise stated)

The Japanese equity market surged over the first quarter of 2012, with the Topix gaining 17.5% and closing at its highest level since July last year. The gain was driven mostly by hopes that the worst of Europe's debt crisis is over and expectations the US recovery will be sustained. Greece returned to centre stage over the period as European finance ministers debated and then approved a second, EUR130 billion bailout package that enabled the debt-laden nation to meet its immediate financing needs. Meanwhile, improving jobs and manufacturing data in the US suggest the recovery in the world's largest economy is strengthening. Sentiment was also boosted by comments from U.S. Federal Reserve chairman, Ben Bernanke, who reaffirmed the central bank's commitment to keeping borrowing costs lower for longer. The Japanese market was also well supported by speculation that Chinese officials will continue to loosen monetary policy in the wake of recent softer growth figures and the Bank of Japan's decision to expand its asset purchase program. Importantly, the latter had the effect of weakening the yen against its US counterpart and thus provided a welcomed boost to the country's struggling exporters. At the sector level, financials and consumer discretionary were the best performers over the quarter. Financials rallied on positive news flow out of Europe while consumer discretionary benefited from increasing demand which is being driven in part by reconstruction stimulus.

Data Source: Confluence

Asia-Pacific (all returns are in US\$ unless otherwise stated)

The Russell Asia Pacific ex Japan Index (the index) jumped 13.0% in the first quarter of 2012, driven mainly by hopes that the worst of Europe's debt crisis is over and expectations the US recovery will be sustained. In Europe, finance ministers confirmed a second, EUR130 billion Greek bailout package that enabled the troubled nation to stave off default while stronger US jobs and manufacturing figures suggest the recovery in the world's biggest economy remains on track. The market was also well supported by speculation that Chinese officials will continue to ease monetary policy in the wake of recent softer growth and inflation figures. Importantly, whilst some question marks still hang over China's growth prospects, Russell maintains the view the country will successfully avoid a 'hard landing'. All countries within the index generated positive returns over the period, with Thailand, India and the Philippines leading the gains. Thailand rose as flood levels continued to recede, India benefited in part from recent cuts to the central bank's cash reserve ratio and the Philippines gained amid increasing foreign investment. Other countries to post strong, double-digit gains over the quarter were Singapore, Taiwan and South Korea. At the sector level, information technology, industrials and consumer discretionary made the biggest gains over the quarter as confidence in the global recovery improved. The traditionally defensive telecommunication services and utilities sectors were also stronger but lagged their more cyclical counterparts.

Data Source: Confluence

Emerging Markets (all returns are in US\$ unless otherwise stated)

The Russell Emerging Markets Index rose by 14.7% in US dollar terms, comfortably outperforming developed markets. Eastern Europe was the standout performer by region with Turkey, Hungary and Poland performing particularly well. The best performing market of all was Egypt (+35.7%), which benefited from easing political tensions and a rally from its oversold level after the chaotic events of 2011. The gearing of Eastern European economies and markets to the eurozone meant the tentative agreement between Greece and its creditors prompted a rally in equity markets there. While concern

remained over Hungary's (+21.3%) financial position, the market jumped after the government said it would negotiate a standby loan with the International Monetary Fund. Russia (+18.4%) was also a significant contributor to the outperformance of the region during the quarter as a beneficiary of rising oil prices. The largest country in Latin America, Brazil (+14.5%), delivered double-digit returns but underperformed the index. It was reported that unemployment plunged to a record low of 4.7% in December before ticking higher again in January and February. In response to this and a slowdown in industrial production, Brazil's central bank cut its benchmark interest rate to 9.75% from 10.5%, and while interest rates cuts in general help equity markets, the market was more focused on the increased inflationary risk as a result of the expanding monetary policy. China (+11.3%) performed well in January and February on hopes for a soft landing for the economy and as the People's Bank of China lowered the reserve requirements for banks. The market declined in March, however, as the government cut economic growth target to 7.5% from 8% and the country posted the biggest trade deficit in over 20 years. Elsewhere in Asia, India (+21.0%) was very strong in January when inflation dipped to its lowest level since 2009. This gave the Reserve Bank of India room to cut banks' reserve ratio to inject liquidity into the financial system. In March however, the market declined as another corruption scandal undermined confidence in the government and the economic data took a turn for the worse with inflation rising again.

Data Source: Confluence

Global (all returns are in US\$ unless otherwise stated)

The Russell Global Large Cap Index rose 11.7% over the first quarter of 2012, its best start to the year since 1998. Global equity markets continued the turnaround that began in the previous quarter and registered strong gains in January and February. Investors reacted increasingly positively to the improved credit conditions in Europe following the European Central Bank's successful Long-Term Refinancing Operations (LTRO). Continued flow of positive news on the US economy, most notably better-than-expected housing and unemployment data, helped lift sentiment. In this risk-tolerant environment, Emerging Markets (EM) unsurprisingly outperformed developed markets by 2.3%, with Eastern Europe leading. Among developed markets, the US was the strongest major market, followed closely by Europe. There was growing divergence between core eurozone countries such as Germany and Austria, which were among the strongest markets globally, and peripheral countries such as Spain and Portugal, which barely rose. Within Asia, Japan was actually the strongest market in local currency terms, but the surprise announcement by the Bank of Japan that it would target inflation prompted a significant depreciation in the Japanese yen, resulting in much lower US dollar returns. On a sector basis, technology and consumer discretionary led, while the financial sector continued to rally on improved credit conditions and favourable stress test results in the US. In contrast, traditional defensive sectors such as consumer staples, telecoms and utilities lagged for the quarter. Energy was another notable laggard.

Data Source: Confluence

Bonds (all returns are in US\$ unless otherwise stated)

The Barclays Capital Global Aggregate Bond Index returned 0.9% over the quarter. After a rocky second half of 2011, the first quarter of 2012 saw systemic risk dissipating, market volatility decreasing and credit spreads tightening. The primary catalysts were developments surrounding the European debt crisis, which provided clarity on policy and significantly reduced liquidity risk. First and foremost was the European Central Bank's LTRO (Long Term Refinancing Operation) programme, which injected €1 trillion worth of liquidity into eurozone banks, eliminating the probability of a Lehman-like event. Near term Greek pressure was alleviated as private borrowers agreed on terms of a principal write-down and the German parliament approved a second bailout of €130 billion. The events played out over a backdrop of an ongoing trend in global central bank easing (including the US Federal Reserve's forecast to remain on hold into 2014), positive US economic data and somewhat decreasing concerns of a China hard landing. At the end of the quarter there was some disappointment in EU finance ministers limiting fresh "firewall" funds to €500 billion, as a higher amount would demonstrate deeper EU commitment and potentially compel other countries to donate more to the IMF. The above events drove positive sentiment in risk assets, with Pan-European high-yield banks returning an astounding 24% and lowest quality global credits (rated Ca to D) returning 13%. Peripheral European

sovereign debt which had been struggling rebounded with strong returns. The positive environment helped capital to continue to pour into emerging market debt funds, bolstering their returns. Subprime mortgages did well, due in part to the Federal Reserve selling the remainder of its Maiden Lane II portfolio privately and some indications that the housing market may be nearing the bottom.

Data Source: Confluence

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