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Schroders

Quarterly markets review

Overview of markets in Q4 2016

Highlights:

– The fourth quarter saw government bond yields rise amid expectations for higher inflation after the US election victory for Donald Trump. Equity markets generally gained, with financial stocks performing well.

– US equities advanced and macroeconomic data largely improved. The quarter was dominated by the presidential election and the Federal Reserve (Fed) raised interest rates.

– Eurozone equities made gains. Financials performed well amid higher bond yields and the European Central Bank extended its quantitative easing programme.

– UK equities also moved higher, supported by financials while resources stocks performed well after OPEC agreed to cut oil production.

– Japanese stocks were strong, drawing support from the currency as the yen weakened in November and December.

– Emerging market equities underperformed, posting a negative return owing to uncertainty over US trade and foreign policy, as well as the prospect of tighter US dollar liquidity.

– Government bond yields moved higher and yield curves steepened. Global corporate bonds generated negative total returns but outperformed government bonds.

US

US equities performed well as the S&P 500 advanced 3.8%. The build-up to the presidential election and subsequent victory of Republican candidate Donald Trump dominated markets over the period. Trump's plans to cut taxes, boost infrastructure spending and reduce regulations were seen as positive for domestic growth and small and mid-cap equities performed particularly well, with the Russell 2000 and Russell 2500 recording respective gains of 8.8% and 6.1%.

More widely, the fiscally expansive policies of the incoming administration further moved the global policy discussion away from a sole reliance on monetary stimulus. They acted as a spur to inflation expectations already buoyed by the modestly improved global growth outlook since the summer. The market looked past the possible negative implications of the new government, including the risk of a rise in protectionist trade policies. The country's major equity benchmarks recorded fresh all-time highs in the period.

The Federal Open Market Committee raised interest rates against the backdrop of continued strength in the US economy. This strength was underlined by a further run of robust non-farm payrolls[1] data and decline in the unemployment rate, which dipped to 4.6% by November. Meanwhile, it was confirmed that GDP grew 3.5% year-on-year in the third quarter, a pronounced pick-up in activity from the first half of 2016.

Eurozone

Eurozone equities were stronger over the quarter, with the MSCI EMU index returning 8.1%. The period was marked by a rotation away from the more defensive, 'bond proxy' sectors, and towards value areas of the market that are seen as beneficiaries of rising bond yields. This rotation picked up momentum after the US presidential election victory for Donald Trump in November.

[1] Non-farm payrolls are a means of measuring employment in the US and represent the total number of people employed, excluding farm workers, private household employees and those employed by non-profit organisations.

Financials was the top performing sector as rising bond yields eased concerns over banks' profitability. In addition, Italian banks performed well as expectations grew that the government would intervene to support them if required. Commodities-related stocks were also strong, especially in the energy sector. By contrast, the real estate, consumer staples and utilities sectors delivered negative returns for the quarter. These are sectors that had performed strongly in the low bond yield environment, and therefore underperformed as yields started to pick up.

The European Central Bank extended its quantitative easing programme to December 2017 but cut monthly bond purchases to €60 billion. The programme had previously entailed €80 billion of purchases until March 2017. The eurozone economy continued its slow recovery, with GDP growth of 0.3% in the third quarter. Annual inflation edged up to 0.6% in November, from 0.5% in October. The unemployment rate fell to 9.8% in October, the lowest since July 2009.

On the domestic political front, Italy saw a change of prime minister with Matteo Renzi resigning after losing a referendum on constitutional change. Paolo Gentiloni, also from the centre-left, is the new prime minister. In Spain, Mariano Rajoy was elected for a second term as prime minister after ten months of deadlock following inconclusive elections.

UK

The FTSE All-Share index rose 3.9% over the period. This was against the backdrop of increased global inflation expectations as the policy discussion moved away from a sole reliance on monetary stimulus. Inflation expectations were also buoyed by the modestly improved global growth outlook since the summer. Reflecting the pivot towards fiscal spending, the new UK Chancellor of the Exchequer Philip Hammond officially abandoned his predecessor's pledge to run a balanced budget. He set out modest spending plans in his first Autumn Statement and left the option open to borrow and spend more. Meanwhile, Prime Minister Theresa May criticised the Bank of England's (BoE) stimulus policies.

Gilt yields rose as the broad-based sell-off in developed market bonds gathered momentum, accentuating the rotation from defensives and towards cyclical[2] areas of the market in what was dubbed the "reflation trade"[3]. Financials performed particularly well as yield curves steepened. The resources sectors performed well against the backdrop of more supportive Chinese macroeconomic data and higher crude oil prices after OPEC agreed production cuts.

Fears about potential negative economic impacts of the UK's "Leave" decision receded. The Office for National Statistics reported that the UK economy had grown at a better-than-expected 0.6% over the third quarter. Consumer spending remained resilient, despite the prospect of real wages falling in 2017, as well as higher energy prices and risks of imported inflation due to sterling weakness.

Sterling weakened further over the period, falling sharply in early October following the prime minister's rhetoric concerning a "hard Brexit" at the Conservative Party conference. The currency subsequently recouped some of its losses after the BoE upgraded UK growth projections, the High Court ruled parliamentary approval was required to start the EU exit process and the government struck a more conciliatory tone over Brexit.

Japan

The Japanese equity market rose each month in the quarter to produce a strong total return of +15.0%. After strengthening for most of 2016, the Japanese yen weakened sharply in November and December. The pattern for the quarter was dictated primarily by the US election and investors' subsequent assumption of an increased growth stimulus in the early stages of the Trump presidency. The election result also had an immediate negative impact on bond markets, with yields rising globally amid expectations for an acceleration of policy tightening by the US Fed in 2017. In Japan, however, the pick up in yields was relatively muted given the Bank of Japan's ongoing commitment to manage the yield curve through its bond purchase programme. The result was a widening of the expected interest rate differential between the US and Japan and, consequently, a sharply weaker yen.

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[2] Cyclical stocks are those whose business performance and share prices are directly related to the economic or business cycle. Defensives are those whose business performance is not highly correlated with the larger economic cycle - these companies are often seen as good investments when the economy sours.
[3] Reflation is a fiscal or monetary policy designed to expand a country's output and curb the effects of deflation.

Although the rise in interest rates could ultimately outweigh the Bank of Japan's desire to maintain 10-year yields around zero, the current conditions remain manageable. Therefore, as widely expected, there were no changes made at the December meeting of the policy committee.

While the US election was the key event driving investor sentiment, market leadership in Japan remained broadly unchanged from previous quarter. As a result, the market was driven upwards by financial-related sectors, especially securities companies, banks and insurance stocks, which are seen as the major beneficiaries of higher interest rates. Conversely, defensive areas such as foods and pharmaceuticals, which had lagged the market since July saw further sharp underperformance, especially in November and early December.

Asia (ex Japan)

Asia ex Japan equities fell in the last quarter of 2016 as Donald Trump's surprise victory in the US presidential election saw heightened expectations of a faster pace in interest rate rises by the US Fed. Broader emerging market assets saw a selloff as US Treasury yields rose sharply over the period.

In China, stocks fell on the back of weaker investor sentiment following a ramp up in property curbs as well as tightening liquidity. Capital outflows also intensified over the period on the back of a greater depreciation of the Chinese yuan as China's foreign exchange reserves at the People's Bank of China (PBoC) fell nearly US$ 70 billion in November, a decline of 2.2% from the previous month and the largest drop since January. The yuan declined -3.9% against the greenback over the quarter.

Meanwhile, in Hong Kong, stocks fell as newly-introduced property tightening policies weighed on sentiment for developers. Over the strait in Taiwan, the market was down, driven by the technology sector on the back of uncertainty surrounding trade policies following the outcome of the US presidential election. Similarly, Korean equities were down on protectionist concerns as well as on an ongoing corruption scandal involving President Park Geun-hye.

In ASEAN, all markets were weaker on worries over the pace of US interest rate hikes by the Fed, with the Philippine market the biggest loser given governance concerns that President Rodrigo Duterte's brutal crackdown on drugs could harm business sentiment. Meanwhile, India's market declined as the economic fallout from an abrupt government ban on existing 500 and 1,000 rupee notes weighed on investor sentiment.

Emerging markets

The MSCI Emerging Markets index recorded a negative return, owing to uncertainty over US trade and foreign policy, as well as the prospect of tighter US dollar liquidity. Those markets and currencies perceived as most sensitive to a tighter global interest rate environment posted the steepest declines. This included Turkey, Malaysia and Indonesia.

Uncertainty around a potential change to US trade policy was a headwind to certain markets in particular. Mexican equities and the peso were directly impacted by these concerns and the central bank hiked rates 50bps to 5.25% to support the currency. The Chinese market also lost value in part given concerns of protectionist policy implementation by the US. The potential for US monetary policy tightening to accelerate has supported the US dollar and led the renminbi to devalue, increasing pressure on capital outflows from China.

By contrast, a recovery in energy and commodity prices was beneficial for a number of markets. Russia registered the strongest index return, boosted by a rally in Brent crude. This followed the agreement of production cuts by OPEC, with further agreements with ten non-OPEC members including Russia subsequently reached. Expectations for higher fiscal spending in the US triggered a strong rise in industrial metals prices, particularly iron-ore but also copper. This benefited Latin American equities with Peru, Chile and Brazil all registering positive returns and outperforming.

Global bonds

In the final quarter of 2016, global bond market movements were overwhelmingly driven by political factors. At the forefront of the political dynamics stood the victory of Donald Trump in the US presidential election, but upcoming elections in Europe also rose in prominence as potentially destabilising influences. The uncertainty surrounding the UK's negotiations to withdraw from the European Union also impacted bond portfolios significantly. Despite the volatility, expectations for global economic growth tentatively grew more optimistic.

Overall, government bond yields moved higher and yield curves steepened. The 10-year US Treasury yield rose from 1.59% to 2.44% in Q4. The five-year yield rose from 1.15% to 1.93% and the two-year yield rose from 0.76% to 1.19%. The European Central Bank confirmed in December that it will trim its bond buying programme from March 2017, but carefully avoided suggestions that the move constituted "tapering". The 10-year Bund yield at last climbed out of negative territory, moving from -0.12% to 0.21%.The five-year Bund yield rose a more modest 5bps to -0.53%. The two-year Bund yield fell from -0.68% to -0.77%. In the UK, the 10-year yield rose from 0.75% to 1.24% in Q4. The five-year rate rose from 0.22% to 0.49% and the two-year yield fell from 0.10% to 0.08%.

Global investment grade[4] credit – more sensitive to interest rate movements - generated negative total returns although managed to outperform government bonds in aggregate over Q4. Conversely, the quarter was a period in which high yield corporate bonds shone. The investment grade BofA Merrill Lynch Global Corporate index fell -2.4% (local currency) in Q4, outperforming government bonds by 1.0%. The outperformance was largely attributable to US investment grade credit, which declined in absolute terms but generated robust outperformance of 1.6%, due to the steeper rise in Treasury yields. Euro and sterling investment grade bonds fell less in absolute terms but modestly underperformed government bonds. The BofA Merrill Lynch Global High Yield index rose 1.6% (local currency) and outperformed government bonds by 3.7%. In high yield credit, all of the three major markets - US dollar, euro and sterling – generated positive total returns and excess returns.

Equity markets were buoyant in Q4 and convertible bonds benefited significantly from this tailwind. The Thomson Reuters Global Focus convertible bond index finished the quarter with a positive return of 1.2% in US dollar terms. The remarkable upside participation of more than 90% was a result of a natural bias of convertible bonds towards Japan, as well to a strong rally in US information technology names. Still, the implied volatility, as a typical measure of the price for the conversion right, remains under 30%. Our models indicate that a significant proportion of convex[5] convertibles are still valued at fair to even cheap levels.

Commodities

The Bloomberg commodities index delivered a positive return of 2.7% over the quarter. Energy was the strongest segment, up 10.6% amid rising oil prices. Brent crude rose 13.1% over the quarter following an agreement by OPEC and non-OPEC states to cut production. The industrial metals complex was also firmly higher, supported by some more encouraging macroeconomic data from China.

By contrast, agriculture was weaker over the period. Gold was also weaker as the expectations of higher inflation and consequent rising bond yields over the quarter rendered the yellow metal less attractive to investors.

[4] Investment grade bonds are the highest quality bonds as determined by a credit ratings agency. High yield bonds are more speculative, with a credit rating below investment grade.

[5] Convex (or balanced) convertibles are the area of the convertible bond market that traditional convertible bond strategies focus on. This section is particularly interesting to investors because it provides high participation when the share price is rising and low participation when the share price is falling.

Overview: total returns (%) – to end of Q4 2016

	3 months			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	8.65	1.97	7.20	11.39	8.15	29.01
MSCI World Value	12.55	5.63	11.05	16.62	13.23	35.06
MSCI World Growth	4.77	-1.66	3.38	6.30	3.21	23.11
MSCI World Smaller Companies	9.57	2.84	8.12	16.64	13.25	35.09
MSCI Emerging Markets	2.19	-4.08	0.83	14.95	11.60	33.12
MSCI AC Asia ex Japan	-0.12	-6.25	-1.44	8.93	5.76	26.15
S&P500	10.62	3.82	9.15	15.31	11.96	33.55
MSCI EMU	8.09	1.45	6.65	5.25	2.19	21.90
FTSE Europe ex UK	6.22	-0.30	4.81	3.35	0.35	19.69
FTSE All-Share	5.29	-1.18	3.89	0.81	-2.12	16.75
TOPIX*	6.33	-0.20	4.92	6.56	3.46	23.41

	3 months			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	2.17	-4.11	0.81	4.14	1.11	20.61
JPM GBI UK All Mats	-2.23	-8.23	-3.53	-4.43	-7.21	10.68
JPM GBI Japan All Mats**	-9.12	-14.70	-10.33	10.03	6.83	27.43
JPM GBI Germany All Mats	-2.48	-8.47	-3.78	4.08	1.06	20.54
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	1.89	-4.37	0.53	7.39	4.27	24.37
BofA ML US Corporate Master	3.48	-2.88	2.10	9.13	5.96	26.39
BofA ML EMU Corporate ex T1 (5-10Y)	-1.68	-7.72	-2.99	6.15	3.06	22.94
BofA ML £ Non-Gilts	-1.46	-7.52	-2.78	-4.51	-7.29	10.59
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	7.03	0.45	5.60	18.20	14.76	36.89
BofA ML Euro High Yield	1.82	-4.43	0.47	9.09	5.92	26.34

Source: DataStream. Local currency returns in Q4 2016: *14.95%, **-1.76%.

Past performance is not a guide to future performance and may not be repeated.