Schroders

Quarterly Markets Review
Overview of markets in Q2 2017

Highlights

- Global equity markets advanced in Q2 with MSCI World returning 4.2% (in US dollars). A strong corporate earnings season and generally positive economic data supported gains, while political risk eased in Europe.
- US equities gained despite some mixed economic data and amid political uncertainty over the ability of the US administration to push through its fiscally expansive policies.
- Eurozone equities gained. Reduced political risk, positive economic data and improved corporate earnings all supported shares. Gains were capped by worries the central bank could start to tighten policy.
- UK equities made positive returns amid robust corporate earnings although it was a volatile quarter amid uncertainty over the political backdrop and the future path of monetary policy.
- Japan registered positive returns amid an encouraging corporate earnings season and an upbeat assessment from the Bank of Japan on the health of the economy.
- Emerging market equities benefited from the supportive global backdrop, outperforming developed markets. A notable exception was Russia amid a sharp decline in Brent crude prices.
- In fixed income, government bond yields were well-supported for much of the period, though a sell-off in the last week of June resulted in losses for Bunds and gilts for the quarter overall.

US

The S&P 500 recorded a total return of 3.1% over the quarter. US equities advanced despite some mixed economic data while the Federal Reserve (Fed) looked through disappointing inflation readings and further tightened monetary policy. At the June meeting of the Federal Open Market Committee the US central bank raised base rates by 25 basis points and set out detailed plans to reduce its balance sheet.

A number of forward-looking activity indicators failed to build on the highs they achieved in Q1 2017, including those tracking the health of the manufacturing and consumer sectors. However, official consumer spending data remained resilient, adding to hopes the US economy would bounce back in the second quarter following GDP growth of 1.4% in Q1 (annualised).

Political uncertainty remained an important feature in the market as President Trump dismissed the FBI director James Comey. This raised doubts over the ability of the administration to push its fiscally expansive policies and also weighed on the dollar. The dollar was further negatively impacted amid rising expectations that central banks in other major developed economies are also preparing to tighten monetary policy.

Large cap equities outperformed small and mid caps over the period, with the Russell 2500 and Russell 2000 recording respective total returns of 2.1% and 2.5%. Healthcare, industrials and financials were among the top-performing sectors, while consumer staples, energy and telecommunication services underperformed.

Eurozone

Eurozone equities advanced in the second quarter with the MSCI EMU index returning 1.8%. Reduced political risk, a positive economic backdrop and improved corporate earnings all helped to support share prices.

However, the final week of the quarter saw a pullback after upbeat remarks by European Central Bank President Mario Draghi were interpreted to mean that economic stimulus measures could soon be withdrawn.

Political risk was the focus in the early part of the quarter as the French presidential elections approached. However, centrist and pro-EU candidate Emmanuel Macron won a convincing victory and his new party also won a significant proportion of seats in the legislative elections. Markets responded positively as this should enable him to push through his reform agenda and the risk of a eurozone break-up has greatly diminished.

Economic news continued to be encouraging, with forward-looking indicators suggesting a pick-up in growth. The German Ifo business climate survey reached another record high in June. Eurozone annual inflation dipped to 1.3% in June from 1.4% in May but ECB President Draghi commented that the threat of deflation is over.

The first quarter corporate earnings season was positive with many companies reporting both sales and profit growth. Despite the generally brighter backdrop, the top sector performers were largely in defensive[1] areas of the market. Real estate and utilities were the top gainers, with utilities were boosted by merger & acquisition speculation. The energy sector registered a negative return for the quarter.

UK

The UK equity market was volatile over the quarter amid uncertainty over the economic outlook, the political backdrop, and the future path of monetary policy. The FTSE All-Share generated a total return of 1.4% (generally supported by robust corporate results), although there was a marked variation in performance during the period.

The market failed to make progress over April as it was held back by the large-cap resources sectors against the backdrop of weaker crude oil and industrial metal prices. By contrast, domestic cyclical areas of the market performed well (as did sterling) after the UK prime minster called the snap general election for 8 June. At the time it was widely anticipated that the Conservatives would strengthen their majority, putting them on a stronger footing before the start of Brexit negotiations.

UK equities then performed very well over May, led by large caps which rallied amid sterling weakness and a rotation back towards defensive sectors and away from cyclicals. This occurred as concerns around the global economic outlook increased, with mixed economic data out of the Chinese and US economies. There was another step down in commodity prices, further dampening inflation expectations, and questions arose around the ability of the US administration to push through its fiscally expansive policies.

Many of the gains in May were undone in June. UK domestic cyclicals performed poorly as the polls narrowed ahead of the UK general election and sterling weakened further as a hung parliament materialised. An increasingly uncertain outlook for consumer spending also weighed on UK-focused sectors. Meanwhile, defensives reversed some of their gains of the previous month as long-dated government bond yields recovered on the back of comments from ECB Governor Mario Draghi and Bank of England Governor Mark Carney. These were taken to signal a shift towards tighter monetary policy, while the US Fed raised base rates by a further 25 basis points.

Japan

After weakening in the early part of April, the Japanese market trended upwards for most of the quarter to end 6.8% higher. The Japanese currency was volatile throughout the period, reflecting global uncertainty, but ended on a softer note against most major currencies.

The Bank of Japan's policy meeting passed without any change but the Bank did revise up its assessment of the economy, using much more positive language than has been seen for several years. The corporate results season for the fiscal year to March 2017 was completed in May, with a majority of companies reporting profit figures above expectations. Companies' own forecasts for the new fiscal year are slightly lower than expected but look excessively conservative in light of recent economic data.

[1] 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. Cyclical stocks are those whose business performance and share prices are directly related to the economic or business cycle.

At first sight, some of Japan's data releases at the end of the quarter looked a little weak, including the industrial production number for May. Nevertheless, the evidence from the quarterly Tankan survey clearly indicates growing confidence among Japanese corporates. The aggregate survey responses now indicate a shortage of capacity across all sizes of firms. This is a meaningful change from the excess capacity situation the economy has faced for almost all of the last 20 years. Despite this relatively positive backdrop, an improvement in equity market sentiment was constrained by geopolitical events and, in particular, a significant escalation in tension around North Korea.

There was no clear pattern to sector performance. Real estate stocks and leasing companies performed well as they rebounded from the relative lows seen at the end of March, while insurance stocks underperformed. Cyclical sectors also showed a mixed performance with paper stocks and chemicals rising by more than the market, while steels, autos and shipping stocks lagged. The strongest sector by far was "other products", driven by the continued rise in Nintendo's share price.

Asia (ex Japan)

Asia ex Japan equities continued on their strong run in 2017 to record another period of solid gains in the second quarter. These came on the back of improving data for the Chinese economy and a broader risk-on approach from global investors. Chinese stocks saw robust gains over the period as better economic data and a landmark decision in mid-June, by index provider MSCI, to include Chinese A-shares[2] in a range of its benchmark indices supported sentiment. The Chinese yuan also finished up strongly as the currency rebounded over the period to finish up 1.6% against the US dollar.

In nearby Hong Kong, stocks tracked China markets higher on investor optimism following a solid earnings results season for its blue-chip heavyweights. Over the strait in Taiwan stocks advanced led by the island's technology sector. Korean stocks were among the region's best performers after an election victory for new President Moon Jae-In – who is looking to reinvigorate the economy and implement meaningful corporate governance reforms.

In ASEAN, all markets finished up with Indonesia and the Philippines the strongest performers while Thailand underperformed the region. Meanwhile in India, stocks gained but also underperformed broader regional returns on the possible short-term impact of the implementation of its much-awaited national goods and services tax (GST) at the start of July.

Emerging markets

Emerging market equities were beneficiaries of a supportive global backdrop in the second quarter, in particular US dollar weakness. The MSCI Emerging Markets index registered a strong gain and outperformed the MSCI World index.

Further signs of improvement in global growth were positive for markets including Poland, Korea and Taiwan. Elsewhere, Turkish equities rebounded strongly with US dollar weakness, domestic stimulus and a firmer outlook for exports to Europe all boosting sentiment. China also recorded a strong gain as macroeconomic data remained firm, despite measures to gradually withdraw liquidity. Greece was the strongest index market as the country reached agreement with Eurogroup creditors for the release of an €8.5 billion loan tranche. This covers upcoming debt repayments in July.

In contrast, Russian equities and the rouble lost value, with a sharp decline in Brent crude the key headwind. Brazilian equities were also lost value as political risk increased following corruption allegations against President Temer. Qatar was the weakest market, negatively impacted by the imposition of an economic and diplomatic blockade by neighbouring countries, notably Saudi Arabia.

Global bonds

Continued accommodative monetary policy, positive economic data and still subdued inflation provided a healthy backdrop for bonds over the quarter. Demand for risk assets was strong to the benefit of corporate

[2] China A-shares are the shares of companies incorporated in mainland China and traded in Shanghai or Shenzhen, quoted in Chinese renminbi.

and emerging market (EM) bonds. European economic indicators remained strong, with purchasing managers indices (PMIs) at multi-year highs. The US showed signs of rebounding after a slow start to the year as consumption recovered. Inflation has still not taken hold convincingly though, either in the US or Europe.

Politics remained a prominent theme with further controversies relating to President Trump. In particular, the sudden and controversial dismissal of the Head of the FBI in May raised questions of the possibility of impeachment. In Europe, French and Italian spreads narrowed as political uncertainty faded. The moderate Emmanuel Macron won the French presidential and later parliamentary elections convincingly, while the possibility of an early election in Italy was ruled out.

The quarter saw doubts emerging around the Trump "reflation trade"[3] with the administration still yet to make a meaningful fiscal policy announcement. This helped to keep longer-dated US Treasury yields anchored though the two-year yield rose steadily from mid-April onwards pricing in another rate hike ahead of the decision in June.

Government bond yields were well supported for most of the quarter, but a sell-off in the final week reversed earlier gains for Bunds and gilts and pared gains for US Treasuries. This sell-off was drawn by comments from central bank leaders in the US, Europe and the UK, taken as signalling increased hawkishness. The move was more pronounced in Europe and the UK than in the US with the euro and sterling rising against the US dollar.

The US 10-year yield fell from 2.39% to 2.30% over the quarter and the five-year from 1.92% to 1.89%. Two-year yields rose from 1.25% to 1.38%. The 10-year Bund yield rose from 0.33% to 0.46%, the five-year increased from -0.38% to -0.22% and two-year from -0.74% to -0.57%. The 10-year gilt rose from 1.14% to 1.26%. Five-year yields rose from 0.56% to 0.70% and two-year yields increased from 0.12% to 0.36%. Corporate bonds performed strongly, well ahead of government bonds, with investment grade[4] credit rising 1.75% and high yield 1.98% (in local currency).

Buoyant equity markets provided good tailwinds for convertible bonds in the second quarter. The Thomson Reuters Global Focus convertible bond index finished the quarter with a strong gain of 1.59% in US dollar terms. With rising markets, a lot of convertibles moved in the money[5] and the average equity exposure has increased – especially among the Nasdaq-related US information technology names. In Europe, our models indicate high convertible valuations. Japan and Asia are the regions which still offer many attractive convertible bonds. The primary market remained very active with almost $15 billion of new convertible bonds coming to the market.

Commodities

The Bloomberg Commodities index declined in Q2. Energy was the weakest component as Brent crude fell 9.3%. OPEC members and other producer nations extended production cuts but these were not as deep as the market had anticipated. The weakness was exacerbated by rising US production. Industrial metals were down, with iron ore falling heavily on concern of weaker demand from China and elevated stockpiles in the country. The agriculture component was down slightly with declines in sugar and coffee the key headwinds. In precious metals, silver was particularly weak, falling 9.3%, but gold was more resilient.

[3] Reflation is a fiscal or monetary policy designed to expand a country's output, seeking to bring the economy back up to the long-term trend after periods of stagnation or contraction.
[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] "In the money" convertible bond securities are those where the stock price is above the exercise price.

Overview

Total returns (%) – to end Q2 2017

	3 months			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	-2.28	4.22	0.32	15.78	18.86	22.32
MSCI World Value	-3.37	3.05	-0.80	16.45	19.56	23.04
MSCI World Growth	-1.17	5.40	1.46	15.08	18.15	21.59
MSCI World Smaller Companies	-2.10	4.40	0.51	18.30	21.45	24.99
MSCI Emerging Markets	-0.24	6.38	2.41	20.95	24.17	27.79
MSCI AC Asia ex Japan	1.65	8.40	4.35	23.76	27.06	30.76
S&P500	-3.33	3.09	-0.76	14.84	17.90	21.33
MSCI EMU	1.76	8.52	4.47	25.73	29.08	32.84
FTSE Europe ex UK	2.43	9.24	5.16	22.14	25.40	29.05
FTSE All-Share	-1.21	5.35	1.42	11.80	14.78	18.12
TOPIX*	-0.72	5.88	1.92	17.59	20.73	24.24

	3 months			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	-5.05	1.26	-2.52	-5.02	-2.49	0.35
JPM GBI UK All Mats	-3.90	2.48	-1.35	-6.39	-3.90	-1.10
JPM GBI Japan All Mats**	-6.95	-0.77	-4.47	-14.87	-12.60	-10.05
JPM GBI Germany All Mats	-1.14	5.42	1.49	-4.53	-1.99	0.87
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	-2.92	3.52	-0.34	-0.05	2.61	5.60
BofA ML US Corporate Master	-3.95	2.42	-1.40	-0.32	2.33	5.32
BofA ML EMU Corporate ex T1 (5-10Y)	0.61	7.29	3.29	1.84	4.55	7.60
BofA ML £ Non-Gilts	-2.13	4.36	0.47	-0.19	2.47	5.45
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	-3.28	3.15	-0.71	9.49	12.41	15.68
BofA ML Euro High Yield	2.35	9.15	5.07	9.66	12.58	15.86

Source: DataStream.

Local currency returns in Q2 2017: *6.76%, **0.06%.

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