

Quarterly Markets Review

Overview of markets in Q3 2017

Highlights

- Global equities posted a quarter of solid gains in Q3. Economic growth stayed in something of a “Goldilocks” zone overall, with stable expansion and benign inflation backed by positive earnings releases.
- The S&P 500 rose over the quarter amid some supportive macroeconomic data, a robust quarterly reporting season and further weakness in the US dollar.
- Eurozone equities advanced against a backdrop of positive economic data. The possibility that the European Central Bank (ECB) could soon reduce its stimulus measures continued to be a focus for the market.
- The UK’s FTSE All-Share index also rose, led by the resources sectors as both industrial metal and crude oil prices recovered.
- Japanese equities also posted gains amid improving economic data. Politics took the headlines as Prime Minister Abe called an election to be held in October.
- Emerging markets outperformed. Brazil was the strongest index market amid some reform progress, coupled with a reduced prospect of a return for the leftist Workers Party in the 2018 elections.
- Bond yields were little changed over the quarter, reflecting a largely unchanged global economic backdrop. Corporate bonds made positive returns, outperforming government bonds.

US

The S&P 500 recorded a total return of 4.5% over the period. US equities were supported by generally positive macroeconomic data, including news that the economy grew at a healthy 3.1% rate in the second quarter (annualised). A robust quarterly reporting season and further weakness in the dollar were additional tailwinds as US equities recorded new record highs.

Sentiment was undimmed by increased political uncertainty amid rising tensions with North Korea and the ongoing failure of the Trump administration to realise its policy goals. In the wake of hurricanes Harvey and Irma, both economic data and forward-looking activity indicators deteriorated towards the period end. However, the market judged that any potential negative impact on growth would be transitory, as did the Federal Reserve (Fed) in its statement following the latest Federal Open Market Committee (FOMC) meeting.

The FOMC statement confirmed that [measures to reduce its balance sheet](#) would begin in October, despite persistently weak inflation. The upbeat tone of the report, and accompanying press conference by Fed chairman Janet Yellen added to expectations for a further increase in US base rates this year. Cyclical¹ areas of the market performed well, including financials, industrials and energy, with the latter also supported by a recovery in crude oil prices.

¹ 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.

Eurozone

European equities notched up a modest advance in the third quarter. The MSCI EMU index returned 4.3%. Eurozone economic data remained robust over the three months. GDP growth was [confirmed at 0.6%](#) in the second quarter, up from 0.5% in the first quarter. The European Commission's economic sentiment indicator rose to 111.9, its highest level since July 2007. Unemployment in the eurozone remained at 9.1% in August - stable compared to July and the lowest rate since February 2009.

The possibility that the European Central Bank (ECB) could reduce its stimulus measures continued to be a focus for the market. In September, ECB President Mario Draghi said that the central bank governing council [had discussed various scenarios](#) to do with the quantitative easing programme. Details are expected to be released in October. The prospect of tighter monetary policy pushed up the euro for much of the period. In late September, a weaker-than-expected performance for Angela Merkel's CDU/CSU in the German elections saw the euro soften slightly.

Energy was the top performing sector as oil prices edged higher over the quarter. In general, more cyclical sectors were the best performers while defensives lagged. Materials and information technology were also among the top performing sectors while healthcare was the only one to register a negative return for the quarter.

UK

UK equities rose over the period amid a stable global growth outlook. Sterling strengthened against a weak dollar, and noticeably so in September after the Bank of England (BoE) indicated it would normalise base rates relatively soon. The appreciation in the currency negatively weighed on the market and the FTSE All-Share rose 2.1% on a total return basis, a relatively poor performance versus global equities.

The resources sectors performed well. Mining outperformed in line with higher industrial metal prices with news of resilient Chinese growth in the first half of 2017. Industrial metal prices were also supported by supply-side constraints and weakness in the US dollar. Meanwhile, the oil & gas sector performed very well against the backdrop of higher crude oil prices.

Industrials also outperformed over the period, and a number of domestic areas of the market did well too. Having been out of favour in recent quarters some domestic cyclical areas bounced back sharply, in line with the recovery in sterling.

On the negative side, many of the internationally diversified defensive areas of the market performed poorly against the backdrop of sterling strength and rising long-term government bond yields. Bond yields rose as central banks moved to tighten monetary policy. These factors contributed to a poor performance from the FTSE 100, which rose by 1.8%, versus a 3.9% total return from the FTSE 250 (ex investment companies).

Japan

After moving sideways in July and August, the Japanese market rose in September to record a gain of 4.7% for the quarter. The market rise was led by oil and mining stocks although a weaker tone for the currency later in the quarter also helped auto stocks to outperform. One persistent feature for much of the period was the underperformance of financial-related and real estate stocks, with all the subsectors declining in absolute terms despite the market's rise.

Political events moved rapidly. The quarter started with a sweeping defeat for the LDP in the Tokyo Assembly elections at the hands of Governor Koike, but ended with Mr Abe calling a snap general election to be held in late October. This appears to be a calculated gamble by Prime Minister Abe to take advantage of a rebound in his personal popularity which had previously dipped sharply following some relatively minor scandals. With other opposition parties in disarray, Ms Koike is in the process of forming a new party to contest the election but it may prove difficult to quickly replicate her local success at the national level.

Economic data continued to improve. Data released in September for industrial production was better than forecast and there was also a jump in headline inflation, with core CPI rising to 0.7%. The Bank of Japan released its quarterly Tankan survey showing further improvements in business conditions. Japanese

companies in aggregate now see themselves as short of labour and capacity. This has led to an upward revision in their previously overly-conservative expectations for capital expenditure.

Meanwhile, there were no changes in policy from the Bank of Japan. Ten-year bond yields remained close to the central bank's target of zero percent. The gradual but consistent improvements in the economic environment were reflected in corporate results for the first quarter of the fiscal year. The majority of companies reported better-than-expected results and there has been a strong cycle of upward revisions in consensus profit forecasts during the past three months

For the second consecutive quarter, the principal risks have come from outside Japan as the uncertain prospects for the implementation of a US growth-oriented policy and moves towards increased isolationism have held back sentiment. The escalation of tension over North Korea also continued to create uncertainty.

Asia (ex Japan)

Asia ex Japan equities continued on their solid run so far in 2017, delivering positive returns in the third quarter on the back of dovish signs from the US Fed and more upbeat sentiment on the Chinese economy. Chinese stocks led regional gains as they advanced strongly on signs that growth was picking up momentum. Share prices were supported by better-than-expected data for the world's second-largest economy, with GDP expanding in the second quarter by 6.9% year-on-year – maintaining the same pace of growth from the first quarter. A stronger yuan also helped ease any fears over capital outflows as the currency advanced +1.9% against the US dollar over the quarter.

In nearby Hong Kong, stocks gained on positive sentiment surrounding China and on a solid earnings season for a number of its blue chip companies. In Taiwan, stocks finished the period marginally ahead with the island's technology sector driving gains. Korean equities shrugged off rising tensions with North Korea to deliver solid gains during the quarter on the back of robust global demand.

Meanwhile in ASEAN, Indonesian equities declined while Philippine stocks advanced. Thai stocks were the biggest winner in Southeast Asia and rose on hopes that increased spending would spur growth. Indian equities finished the quarter ahead, helped by an interest rate cut early in the period, but later gave up some gains on profit-taking.

Emerging markets

Emerging markets (EM) equities recorded a robust return in Q3 with a backdrop of steady global growth and modest inflation proving supportive. US dollar weakness, continued momentum in the Chinese economy and a pickup in commodity prices were all positive for EM equities.

Brazil was the strongest index market. Some reform progress, coupled with diminished prospects of a return to power for the leftist Workers Party in the 2018 presidential elections, were a tailwind. Furthermore the central bank was able to ease policy as inflation continued to fall. Russian equities rallied as crude prices picked up and lower inflation opened the door for further interest rate cuts. China performed strongly as Q2 GDP growth increased 6.9% year-on-year, showing little impact from the authorities' moves to selectively tighten liquidity.

Elsewhere, Chile and Peru benefited from improved commodity prices. In Chile, sentiment was also boosted by opinion polls which showed centre-right candidate, Sebastian Piñera, had extended his lead ahead of a presidential election in November. The CE3 markets of Poland, Hungary and Czech Republic also registered strong gains.

In contrast, Pakistan posted a negative return and was the weakest index market as the Supreme Court disqualified the prime minister from office. Greece declined amid a sell-off in banking stocks. Turkey also underperformed, largely due to weakness in September as the Fed announced plans to reduce its balance sheet. Tighter global liquidity is negative for Turkey due to its high current account deficit.

Global bonds

Bond yields oscillated over the quarter and, with the exception of the UK, which sold-off sharply in September, were ultimately little changed against a largely unchanged global economic backdrop. While the late-June selloff initially continued in July, it came to a halt as growing expectations of a hawkish shift among central banks were reined in. Yields moved lower in August, precipitated by safe haven buying, before reversing course once more in September as risk appetite returned.

The global economic upswing continued with data confirming the US second quarter growth rebound. The “Goldilocks” scenario of moderate expansion combined with only moderate inflation, particularly in core measures, allowing for gradual withdrawal of monetary stimulus remained in place. The Federal Reserve (Fed) announced it will commence the reduction of its balance sheet at a rate of \$10 billion a month from October. The European Central Bank (ECB) gave indications it is preparing to taper its quantitative easing (QE).

The quarter saw a marked escalation in tensions between the US and North Korea. The tensions were a key factor behind the temporary rotation into lower-risk assets in August. During the quarter however there was little policy progress, although a framework tax reform plan, largely confirming plans for significant tax cuts, was unveiled in late September.

For the UK, the economy showed clear signs of slowing down, while inflation picked up, reaching 2.9% in August. During the quarter the Bank of England struck a more hawkish note with Governor Carney and a number of members of the Monetary Policy Committee openly discussing rate rises. This occurred against a backdrop of above target inflation and low unemployment, leading to a significant increase in UK government bond yields and a rally in sterling against both the euro and the dollar.

US 10-year yields began the period at 2.31% and finished at 2.33% with Bund 10-year yields virtually unchanged from 0.47% to 0.46%. 10-year UK gilt yields rose 10 basis points (bps) to 1.36%. The move reflected higher inflation and more hawkish central bank rhetoric. Corporate bonds made positive returns, outperforming government bonds. Global investment grade (IG)² credit rose 1.14% and high yield (HY) by 2.16%. The US led the way with IG gaining 1.37% and HY 2.04%.

Global equity markets finished the third quarter 2017 in positive territory with September the decisive positive month of the period. Convertibles thrived in this benign environment of rising markets. The Thomson Reuters Global Focus convertible bond index returned 1.4% in US dollar terms. Implied volatility, as a typical measure of the price of the conversion right, stayed low. However, convertibles richened and, especially in Europe, valuations look a bit stretched. On a positive side, the new issuance market for convertibles remained very active with just under \$20 billion of new paper being issued.

Commodities

The Bloomberg Commodities index rose in Q3. The energy component generated the strongest return, with Brent crude rallying 20.1% over the quarter. It was supported by a faster-than-expected fall in US crude inventories and increased expectation for an extension of production cuts amid rising global demand. Industrial metals also recorded a robust return as economic momentum in China remained firm. Iron ore was up 14.9% while zinc (+15.5%) and copper (+9.5%) both posted sizeable gains. In contrast, the agricultural component lost value. Wheat and corn prices fell sharply amid record global supplies. In precious metals, gold was up 3.2%, in part given an uptick in geopolitical concerns.

²Investment 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.

Overview

Total returns (%) – to end Q3 2017

Equities	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
MSCI World	1.27	4.96	1.62	12.95	18.83	15.05
MSCI World Value	0.97	4.65	1.32	13.09	18.97	15.19
MSCI World Growth	1.56	5.27	1.92	12.79	18.66	14.88
MSCI World Smaller Companies	2.59	6.34	2.95	14.35	20.29	16.47
MSCI Emerging Markets	4.23	8.04	4.60	16.83	22.91	19.00
MSCI AC Asia ex Japan	2.99	6.75	3.35	16.94	23.02	19.11
S&P500	0.80	4.48	1.16	12.75	18.61	14.84
MSCI EMU	4.35	8.16	4.72	23.06	29.46	25.35
FTSE Europe ex UK	3.24	7.01	3.61	20.47	26.73	22.70
FTSE All-Share	1.78	5.50	2.14	9.90	15.62	11.94
TOPIX*	0.86	4.55	1.22	10.54	16.29	12.59

Government bonds	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
JPM GBI US All Mats	-3.14	0.39	-2.80	-6.68	-1.83	-4.95
JPM GBI UK All Mats	-0.71	2.91	-0.36	-5.40	-0.48	-3.60
JPM GBI Japan All Mats**	-3.50	0.02	-3.16	-16.18	-11.82	-14.62
JPM GBI Germany All Mats	0.48	4.15	0.84	-3.88	1.12	-2.10
Corporate bonds	EUR	USD	GBP	EUR	USD	GBP
BofA ML Global Broad Market Corporate	-1.31	2.29	-0.97	-2.10	2.99	-0.28
BofA ML US Corporate Master	-2.21	1.36	-1.87	-2.80	2.26	-1.00
BofA ML EMU Corporate ex T1 (5-10Y)	1.46	5.16	1.81	0.77	6.01	2.64
BofA ML £ Non-Gilts	-0.21	3.44	0.15	-2.21	2.87	-0.40
Non-investment grade bonds	EUR	USD	GBP	EUR	USD	GBP
BofA ML Global High Yield	-0.77	2.85	-0.42	4.42	9.84	6.35
BofA ML Euro High Yield	1.78	5.49	2.14	7.86	13.46	9.86

Source: DataStream.

Local currency returns in Q3 2017: *4.74%, **0.20%.

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

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