Schroders

Monthly Markets Review
Overview of markets in October 2017

Highlights

- Global equities made further progress in October. Several major indices set new record highs, while volatility reached an historic low.
- US equities were supported by economic data that remained positive despite the disruption caused by hurricanes Harvey and Irma. The technology sector was buoyed by strong results.
- Eurozone equities gained. The economic backdrop remained encouraging and the central bank announced that quantitative easing will be extended to September 2018 but the pace of purchases would be reduced.
- In the UK, resources sectors led the market higher as Chinese macroeconomic data remained supportive and crude oil prices continued to rebound.
- In Japan, the TOPIX advanced as investors reacted positively to Prime Minister Abe's general election victory late in the month.
- Emerging markets posted a strong return with ongoing strength in global growth proving supportive. South Korea and Taiwan performed well with technology stocks registering robust gains.
- US yields edged higher on growing expectations of progress toward fiscal reform, while Bunds dropped as the European Central Bank announced tapering of bond purchases.

US

The S&P 500 rose 2.3% over the period. US equities were supported by generally positive macroeconomic data, including better-than-expected third-quarter GDP growth of 3.0% (annualised), and robust corporate earnings (particularly from the technology sector). Sentiment towards US equities remained buoyant despite lacklustre inflation remaining a concern.

A strong contribution from personal consumption in part drove the resilient "advance" GDP estimate, as spending bounced back strongly in the wake of hurricanes Harvey and Irma. Consumer sentiment was buoyant with the Conference Board consumer confidence index surpassing the peak it achieved at the start of 2017, hitting 125.9, the highest level since December 2000.

The Trump administration made some progress in the Senate with its proposed tax reforms. However, reports that any corporate cuts might be phased in over five years did weigh on the smallest, most domestic names. The Russell 2000 and Russell 2500 indices lagged the wider market, respectively gaining 0.9% and 1.55%. Both indices had previously rallied sharply in September when markets first began to price back in the prospect of a bi-partisan tax agreement. Conversely, after faltering in September, larger-cap technology stocks rebounded over the month following some very strong results.

Eurozone

Eurozone equities rose in October with the MSCI EMU index returning 2.4%. Commodity sectors performed well with both energy and materials among the top gainers. Utilities and information technology also outperformed. Healthcare and telecommunication services posted negative returns.

Data showed that the eurozone's economic recovery is continuing. The region's GDP grew by 0.6% in the third quarter, a slight slowdown from 0.7% in Q2 but still strong. Meanwhile, inflation slowed to 1.1% year-on-year in October from 1.3% in September and the unemployment rate fell to 8.9% in September, the lowest rate since January 2009. European Central Bank (ECB) President Mario Draghi gave a positive assessment of the outlook for the eurozone economy at the central bank's October meeting. He announced that quantitative easing would be extended to September 2018 but that the pace of purchases would be reduced from €60 billion per month currently to €30 billion.

Political factors returned to the fore in October. The aftermath of Catalonia's unofficial independence referendum caused some short-lived volatility. Madrid has suspended the power of the autonomous region's government, taken over the responsibilities of the parliament, and called fresh regional elections for 21 December. Elsewhere, elections in Austria saw victory for the centre-right/Christian democratic ÖVP. Italian Prime Minister Gentiloni won a vote in parliament on reforming the electoral system in a move that is likely to limit the rise of the populist Five Star Movement.

UK

The FTSE All-Share index returned 1.9% over October. Resources sectors led the market higher as industrial commodity prices continued their recent strong run against the backdrop of stable global growth and supply-side drivers. The market made good progress despite losing some of its recent positive earnings momentum.

Generally positive sentiment towards China, whose economy grew at a steady 6.8% in the third quarter (year-on-year), supported metal prices, as did ongoing steps by the authorities to cut back on inefficient and polluting industrial capacity. Meanwhile, growing hopes for a synchronised global economic recovery underpinned crude oil prices, as did increased expectations that OPEC-led production cuts would be extended.

A troubled Conservative Party conference, mixed UK economic data and the prospect of higher base rates brought domestic political and economic uncertainties back into focus. Despite this backdrop, however, the more UK-centric mid caps outperformed marginally, with the FTSE 250 (ex investment companies) index returning 2.0% versus a 1.8% gain in the FTSE 100.

Mid caps performed well against the backdrop of some resilient trading updates, a pledge of further government support for the UK housebuilding sector, and merger & acquisition activity which was driven by overseas buyers.

Japan

The Japanese market rose steadily throughout October to record a total return of 5.5% for the month. The Japanese yen moved in a narrower range than seen in recent months and ended slightly weaker against the US dollar. Sector performance was very mixed in October with several economically-sensitive areas among the best and worst performers ahead of the start of the quarterly earnings reporting season. Several financial-related sectors, including insurance and real estate, continued to show slight improvement after protracted underperformance.

In the first half of the month, after considerable uncertainty over the potential election outcomes, the likelihood of an LDP victory increased steadily, enabling equity investors to form a view on the likely continuation of both monetary and fiscal policies. This more stable sentiment was matched by a significant pick up in net purchases of Japanese equities by foreign investors which helped to maintain upward momentum in the market immediately after the election.

In the final week of October Japanese corporations began reporting their results for the September quarter which are expected to continue the positive trend seen in the previous three months. Results announcements will continue into early November, with investors looking particularly for evidence of improved pricing power as Japan exits a long period of deflation.

Economic data for the month was positive but contained few surprises. Core CPI remained at 0.7% but other data points towards further pick up in coming months. Labour market data continues to suggest that Japan is operating close to full employment which bodes well not only for future wage growth but also capital spending by corporates.

Asia (ex Japan)

Asia ex Japan equities bounced back from a relatively muted September to register solid gains in October, with a dovish Fed and encouraging Chinese data driving stockmarkets higher. Chinese stocks delivered positive returns and reached a 26-month high as investors took comfort from stronger economic data and a cut in the reserve ratio requirement (RRR) for banks. China's 19th Party Congress also took place over the month but had a relatively muted impact on markets given the lack of any surprises. Stability in the Chinese yuan, which ended the month slightly stronger (+0.3%) against the greenback, also buoyed investor confidence.

In nearby Hong Kong, stocks finished broadly flat as the market took a breather following a strong run year-to-date. Taiwanese stocks were among the region's best performers as they climbed higher led by the island's technology sector given reported robust demand (in the form of lengthy shipment delays) for Apple's iPhone X. Korean stocks gained strongly to hit a record high as geopolitical tensions between the Korean and Chinese governments look set to ease.

Meanwhile in ASEAN, Philippine and Indonesian stocks were little changed while Thai stocks advanced. In India, stocks delivered robust returns as investors continued to buy into the market and were further encouraged by a US$32 billion government bailout of indebted state-owned banks.

Emerging markets

Ongoing strength in global growth was supportive of emerging markets and the MSCI Emerging Markets index posted a robust return to outperform the MSCI World.

South Korea and Taiwan were among the best-performing markets with technology stocks registering strong gains. South Korea also benefited from China's effort to improve relations, which had deteriorated after South Korea proceeded with THAAD missile deployment. Elsewhere, India posted a robust return as the government announced plans for a major recapitalisation for state-controlled banks.

In contrast, Mexican equities and the peso lost value amid concern that the negotiations to modernise Nafta may collapse. Furthermore, the economy contracted 0.2% quarter-on-quarter in Q3, in part given the impact of two major earthquakes and a number of hurricanes. Pakistan and Colombia posted more significant declines, in part due to stock-specific weakness.

Global bonds

Government bond yields diverged over the month. US yields edged upwards, the UK's ticked slightly lower and Bund yields dropped. US yields were lower mid-month as inflation data missed expectations. The core measure of consumer prices increased 0.1% on the month, missing expectations of a 0.2% increase. It was the sixth time in seven months the measure had missed expectations. Treasury yields later reversed course on several factors. US Congress approved a budget plan seen as paving the way to a bill on tax reform. There was growing speculation around the next governor of the Federal Reserve (Fed), namely that Janet Yellen will be replaced by a less dovish candidate.

In Europe, Bund yields reflected the European Central Bank's (ECB) announcement on tapering of bond purchases, which were halved to €30 billion a month, but extended to September 2018. An announcement had been widely anticipated and in the event it was taken as a relatively dovish move. In particular, the ECB, true to past form, left open the possibility that the programme could be increased again if needed. Italian bonds enjoyed a strong month benefiting from the ECB announcement, while an amendment to the constitution effectively reduced the possibility of the populist Five Star Movement getting into government. Amid these developments, Italian 10-year yields fell more than 30 basis points (bps).

US 10-year yields rose from 2.33% to 2.38%, five year yields from 1.94% to 2.02% and two year yields from 1.60% to 1.48%. UK 10-year gilt yields edged lower from 1.36% to 1.33%, five year yields from 0.80% to 0.78% and two year yields from 0.47% to 0.46%. Ten-year Bund yields dropped from 0.46% to 0.36%, five year yields from -0.27% to -0.35% and two year yields from -0.69% to -0.75%.

Corporate bonds registered positive total returns, exceeding government bonds. The BofA Merrill Lynch Global Corporate high grade and high yield[1] indices each returned 0.6% over the month (in local currency). European credit was the strongest region with returns of 1.1% supported by the decline in government yields. Emerging market (EM) debt hard currency returned 0.4%, while local currency denominated sovereign EMD returned -2.8%.

Convertibles thrived in this benign environment of rising equity markets. The Thomson Reuters Global Focus Convertible Bond index returned 1.3% in US dollar terms. Implied volatilities as a typical measure of the price of the conversion right stayed low. However, convertibles richened again and valuations now look stretched in the US as well as Europe. Our models detect relative value in Asian and Japanese convertible bonds. The global new issuance market for convertibles remained very active with $4.2 billion of new paper being issued last month. Finally, the Asian primary market jumped back into action with over $2 billion of new convertible bonds in October.

Commodities

The Bloomberg commodities index rose, led higher by the industrial metals component. Copper rallied 4.9% and zinc gained 3.9%, in part given concern over the outlook for supply of the metals in the face of firm demand. The energy component posted a positive return with the price of Brent crude (+6.7%) increasing amid ongoing signs of market tightening. The agricultural component also finished in positive territory with sugar (+4.5%) among the strongest soft commodities. Data in Brazil, the world's largest producer, showed a rise in the amount of sugar cane used in ethanol production, reducing sugar output. Precious metals were more subdued, with gold (-0.9%) marginally lower on the month, partly attributable to US dollar strength.

[1] 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.

Overview

Total returns (%) – to end October 2017

	1 month			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	3.4	1.9	3.0	16.2	23.5	13.5
MSCI World Value	2.5	1.0	2.1	14.0	21.1	11.4
MSCI World Growth	4.3	2.8	3.8	18.4	25.8	15.7
MSCI World Smaller Companies	3.0	1.5	2.5	19.2	26.7	16.5
MSCI Emerging Markets	5.1	3.5	4.6	19.4	26.9	16.7
MSCI AC Asia ex Japan	6.3	4.7	5.8	23.1	30.8	20.3
S&P500	3.8	2.3	3.4	15.6	22.9	13.0
MSCI EMU	2.4	0.9	2.0	24.4	32.2	21.6
FTSE Europe ex UK	1.9	0.4	1.5	22.8	30.5	19.9
FTSE All-Share	2.3	0.8	1.9	16.1	23.3	13.4
TOPIX*	6.0	4.5	5.5	12.6	19.7	10.1

	1 month			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	1.4	-0.1	0.9	-6.6	-0.7	-8.7
JPM GBI UK All Mats	0.7	-0.8	0.3	3.1	9.5	0.7
JPM GBI Japan All Mats**	0.5	-0.9	0.1	-14.4	-9.1	-16.4
JPM GBI Germany All Traded	0.7	-0.6	-1.0	-1.4	2.7	-1.8
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	1.6	0.1	1.1	5.1	-1.1	-3.4
BofA ML US Corporate Master	1.9	0.4	1.5	-2.6	3.5	-4.8
BofA ML EMU Corporate ex T1 (5-10Y)	1.5	0.0	1.0	3.3	9.8	1.0
BofA ML £ Non-Gilts	0.9	-0.6	0.5	6.1	12.8	3.7
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	1.8	0.3	1.4	3.9	10.4	1.5
BofA ML Euro High Yield	1.1	-0.4	0.6	8.0	14.8	5.5

Source: DataStream.

Local currency returns in October 2017: *5.5%, **-0.0%.

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

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