Schroders

Quarterly Markets Review
Overview of markets in Q4 2017

Highlights

- Global equities capped off a strong year with gains in the fourth quarter. In fixed income, the US Treasury and German Bund yield curves flattened.
- The S&P 500 made a strong advance in the quarter, buoyed by hopes of tax reform.
- Eurozone equities declined amid some profit-taking and simmering political risk, although economic data remained positive.
- The UK's FTSE All-Share index saw positive returns, supported by gains for resource stocks and progress on Brexit negotiations.
- Japanese equities posted gains as the incumbent LDP won the October general election while corporate earnings were strong.
- Emerging market equities recorded a strong gain in Q4 and outperformed developed markets with political developments supporting gains.
- US Treasury yields rose over the quarter, and the yield curve flattened, amid growing momentum behind a tax reform bill which is expected to stimulate growth and inflation.

US

In the US, the S&P 500 ended a strong year with a fourth-quarter gain of +6.6%. Two Republican defeats in Senate contests in Alabama and Virginia during the quarter spurred House and Senate Republicans into action. Fearing the defeats are a sign of things to come in next year's mid-term elections, they agreed the long-awaited tax reform bill. Markets rallied on the news, with big permanent cuts for corporations as the centrepiece of the package.

US equities were also supported by generally positive macroeconomic data, including better-than-expected third-quarter GDP growth of 3.0% (annualised). Employment data over the period was partly distorted by the effects of the hurricane season. However, non-farm payrolls rose by a stronger-than-expected 228,000 in November although wage growth remained subdued. As had been widely anticipated, the US Federal Reserve (Fed) lifted interest rates by 25 basis points (bps) in December. The Fed also raised its growth forecasts for 2018 to 2.5% from 2.1%.

The quarter also saw robust corporate earnings, particularly from the technology sector. Cyclical[1] areas of the market performed well, with gains led by the consumer discretionary sector, technology and financials. The utilities sector underperformed.

Eurozone

Eurozone markets ended 2017 on a negative note with the MSCI EMU index returning -0.5% in the fourth quarter. Profit-taking after this year's gains and a stronger euro were in part to blame for the downward move.

[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.

The healthcare, telecoms and financials sectors underperformed, while materials was the top gainer. Within healthcare, some corporate updates disappointed the market, including below-consensus Q3 revenues from pharmaceutical firm Sanofi.

Data showed the eurozone's economy recovery continuing. The region's GDP grew by 0.6% in the third quarter, albeit a slight slowdown from 0.7% in Q2. Meanwhile, inflation was 1.5% in November 2017, up from 0.6% in the same month in 2016. The unemployment rate fell to 8.8% in October, the lowest rate since January 2009. In October, the European Central Bank 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 events returned to the fore in the quarter. In Germany, coalition talks collapsed between Angela Merkel's CDU/CSU and the liberal FDP and the Greens. However, the centre-left SPD agreed to talks with the CDU in an effort to resolve the impasse. Catalonia held a regional election which failed to resolve the independence issue. Separatist parties retained a slim majority overall but Ciudadanos, who favour the union with Spain, emerged as the largest single party.

UK

The FTSE All-Share index rose 5.0% over the period amid further evidence of a sustained recovery in the global economy. This was underlined as the International Monetary Fund (IMF) upgraded its global growth forecast for 2017 to 3.6%, from 3.2% reflecting rising hopes for a sustained synchronised recovery.

Industrial metal prices rallied against the generally favourable backdrop for global and Chinese demand in particular. Chinese supply-side measures were also a factor as the authorities cut back on inefficient and polluting capacity. Mining companies performed very well as a result. The oil and gas sector also outperformed over the period as crude oil prices were supported after OPEC-led production cuts were extended until the end of 2018. In addition, the oil majors delivered strong third-quarter results, underpinned by ongoing cost and capital expenditure discipline. This added to market confidence that their dividends will be covered by cashflows, even at spot crude oil prices significantly lower than the current level.

On the domestic front, despite a sluggish economy, the Bank of England's (BoE) monetary policy committee raised interest rates for the first time since November 2007, from a record low of 0.25% back to 0.50%. Annual consumer price index inflation reached 3.1% in November, breaching the BoE's upper target. The UK Budget did little to dispel the fears around the UK economy as the Office for Budget Responsibility downgraded its GDP growth forecasts. However, hopes rose towards the period end around progress with Brexit negotiations, with an agreement struck to allow talks to proceed to the future of trade arrangements.

Japan

Japanese equities gained ground to record a rise of 8.7% for the quarter while the yen ended little changed. After considerable initial uncertainty over the potential outcome of October's snap general election, the likelihood of an LDP victory increased steadily. This enabled 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, helping to maintain upward momentum in the market after Mr Abe's victory was confirmed.

The latest quarterly corporate results season continued the strong trends seen in the previous three months. The majority of companies again exceeded expectations and the positive cycle in earnings revisions was maintained. Individual share prices reacted positively to any evidence of improved pricing power as Japan exits a long period of deflation.

After some slightly disappointing economic numbers seen in November, virtually all the data released in December exceeded expectations. The unemployment rate declined to 2.7%, a new low for this cycle, while the number of people employed extended the rising trend seen throughout 2017. Inflation data also unexpectedly improved and industrial production and retail sales were comfortably ahead of forecast. Meanwhile, the Bank of Japan's quarterly Tankan survey recorded the strongest sentiment among large manufacturing companies for more than 11 years.

The improved economic prospects and strong corporate results tended to favour more cyclical areas of the market, including paper stocks, machinery and trading companies. Conversely, traditionally defensive areas such as pharmaceuticals, telecoms and utilities all lagged the rising market.

Asia (ex Japan)

The MSCI Asia ex Japan index was up 8.2% in Q4. India and Korea generated the strongest gains. India outperformed as the government announced plans for a significant recapitalisation for state-controlled banks. Korea benefited from China's effort to reset relations, which had deteriorated after South Korea proceeded with THAAD missile deployment.

Hong Kong and China recorded strong gains but finished slightly behind the index. In China, Q3 GDP growth was stable at 6.8% albeit higher frequency data reflected a moderate deterioration in activity. The 19th Communist Party Congress was held during October and emphasised a focus on the quality of growth and addressing structural risk. Following the Fed's December hike, the People's Bank of China (PBoC) did hike some rates by 5 bps. The PBoC also preannounced a targeted cut to the required reserve ratio, to take effect in January 2018.

Elsewhere, Thai stocks outperformed, supported by upbeat GDP numbers. Indonesian stocks performed in-line with the broader market. Taiwan stocks underperformed amid volatility in technology stocks during the quarter.

Emerging markets

Emerging markets recorded a strong gain in Q4, with political developments supporting gains. The MSCI Emerging Markets index increased in value and outperformed the MSCI World.

South Africa was the strongest index market as pro-reform candidate, Cyril Ramaphosa, was elected as leader of the African National Congress. This development increased the prospect for a return to more orthodox policy after elections in 2019. Greek equities rallied as the country reached agreement with international creditors over reforms, paving the way for the dispersal of further bailout funds. India also outperformed as the government announced plans for a major recapitalisation for state-controlled banks. Meanwhile, South Korea benefited from China's effort to reset relations, which had deteriorated after South Korea proceeded with full THAAD missile deployment.

In contrast, Mexico posted a negative return and was the weakest index country. This was largely attributable to peso weakness, amid concern that negotiations to modernise Nafta may collapse. Brazil also posted a negative return as a result of currency weakness. Congress voted not to send corruption allegations against President Temer to the Supreme Court in October. However, the president received slightly less support than in a previous vote, raising concern that his political capital may be waning. This has led to concern over the government's ability to pass reforms required to control public debt.

Global bonds

US Treasury yields rose over the quarter, and the yield curve flattened, amid growing momentum behind a tax reform bill which is expected to stimulate growth and inflation. December saw yield volatility around this as doubts led to yields initially dropping to 2.34% before reversing to 2.50% in the run-up to the bill being approved by the Senate. For the quarter overall, 10-year yields increased from 2.33% to 2.41%, five-year yields rose from 1.93% to 2.21% and two-year yields from 1.48% to 1.89%.

In Europe, positive economic momentum continued unabated, with manufacturing activity at multi-year highs. The ECB announced the reduction of asset purchases, but extended the programme, which proved a significant boost to bond yields. Government yields in Spain, Italy and France performed well on the announcement, but the moves were either reduced or undone later on due to political factors. In Catalonia, a snap parliamentary election, called following the referendum vote for independence, saw pro-independence parties win 70 out of 135 seats. Spanish yields fell from 1.61% to 1.54% over the quarter, but had reached 1.45% at end-November. Italian 10-year yields were down from 2.12% to 1.99% over the quarter, but they sold off by 25 basis points (bps) in December as a general election was confirmed for March. French 10-year yields finished three bps higher on the quarter after rising from 0.68% to 0.78% in December. The Bund curve flattened with 10-year yields dropping from 0.47% to 0.43%, five-year yields rising from -0.26% to -0.19% and two-year yields from -0.69% to -0.62%.

In the UK, ten-year gilt yields were down from 1.36% to 1.19% with less pronounced decreases for five and two-year maturities. A November rate hike by the BoE was well anticipated and was accompanied by dovish guidance. Economic activity remains subdued and political uncertainty continues.

Corporate bonds capped a good year with positive total returns, outperforming government bonds. Investment grade[2] credit saw stronger returns than high yield, aside from in Europe, as the latter experienced challenging conditions in November having reached elevated valuations. The BofA Merrill Lynch Global investment grade (IG) index total return amounted to +1.0%, and for high yield +0.5% (returns in local currency). Sterling IG credit was the strongest. Euro and sterling high yield made good returns.

Convertible bonds globally benefited from the strong equity market rally in the fourth quarter. However, the significant write-down of Steinhoff, an international furniture retail holding company, had a strong negative influence on several of the convertible bond indices. The traditional benchmark for balanced convertible strategies, the Thomson Reuters Global Focus (hedged in USD), was only up 0.1% for the quarter. Convertible bond strategies with an underweight or zero weight in the three outstanding convertibles of this company were generally able to exceed the benchmark. Volatility picked up a little over the quarter, and valuations of convertible bonds cheapened.

Commodities

The Bloomberg Commodities index posted a robust return in Q4 of +4.7%, underpinned by a rally in industrial metals and energy. In industrial metals, nickel (+22%) and copper (+12%) and iron ore (+12%) posted the strongest gains as Chinese demand remained firm. Together with measures aimed at lowering environmental emissions, which have led to an increase in supply discipline, this put upward pressure on prices. In the energy segment, Brent crude surged +18.2%, primarily driven by an agreement among Opec, and a number of non-member countries such as Russia, to extend production cuts to the end of 2018. In contrast, agricultural commodities lost value, notably wheat and palm oil. In precious metals, gold gained +1.8% while silver was up +1.7%.

[2]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 Q4 2017

	3 months			12 months		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	5.6	4.0	4.8	23.1	8.1	12.4
MSCI World Value	4.7	3.1	3.9	18.0	3.6	7.7
MSCI World Growth	6.5	4.8	5.6	28.5	12.9	17.4
MSCI World Smaller Companies	5.3	3.7	4.5	23.2	8.2	12.5
MSCI Emerging Markets	7.5	5.8	6.6	37.8	21.0	25.8
MSCI AC Asia ex Japan	8.3	6.6	7.4	42.1	24.8	29.8
S&P500	6.6	5.0	5.8	21.8	7.0	11.3
MSCI EMU	1.1	-0.5	0.3	29.0	13.3	17.8
FTSE Europe ex UK	1.2	-0.4	0.4	28.7	13.0	17.5
FTSE All-Share	5.8	4.2	5.0	23.8	8.8	13.1
TOPIX*	8.6	6.9	7.7	26.6	11.2	15.6

	3 months			12 months		
Government bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	0.1	-1.4	-0.7	2.5	-10.0	-6.4
JPM GBI UK All Mats	2.9	1.3	2.0	11.6	-2.0	1.9
JPM GBI Japan All Mats**	0.3	-1.2	-0.5	3.7	-8.9	-5.3
JPM GBI Germany All Mats	1.6	0.0	0.8	12.3	-1.4	2.5
Corporate bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	1.4	-0.1	0.6	9.3	-4.0	-0.2
BofA ML US Corporate Master	1.1	-0.5	0.3	6.5	-6.5	-2.8
BofA ML EMU Corporate ex T1 (5-10Y)	2.6	1.0	1.7	17.8	3.5	7.6
BofA ML £ Non-Gilts	2.7	1.1	1.8	14.2	0.3	4.3
Non-investment grade bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	0.8	-0.8	-0.1	10.2	-3.2	0.7
BofA ML Euro High Yield	2.3	0.8	1.5	21.5	6.7	11.0

Source: DataStream.

Local currency returns in Q4 2017: *8.7%, **0.4%.

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