Schroders

Monthly markets review

Overview of markets in February 2017

Highlights:

- Global equity markets made gains in February. Investors were again encouraged by widespread improvement in global economic data.
- US equities performed very well. President Trump promised a “phenomenal” tax plan, although further details are yet to emerge. Expectations rose that US interest rates would soon increase.
- In the eurozone, encouraging macroeconomic data supported equity gains. All sectors aside from financials registered positive returns.
- UK equities were supported by a variety of factors, including robust corporate results, M&A activity, and positive macroeconomic data. Sterling weakness was a further tailwind.
- Japanese equities posted positive returns, supported by a generally encouraging results season for corporates.
- Emerging market equities recorded a positive return in February and outperformed developed markets. A number of emerging markets benefited from currency strength.
- February proved positive for global sovereign and corporate bonds. The most notable exception was shorter-dated US Treasuries, which were relatively weak, though the 10-year index gained.

US

US equities performed very well over the month with the S&P 500 recording a gain of 4.0%. The market performed very well as US President Donald Trump promised a “phenomenal” tax plan, although further details are yet to emerge. Economic data continued to be supportive, with US employment numbers and manufacturing purchasing managers’ indices (PMIs) pointing to growth. It was revealed that US non-farm payrolls[1] increased by a greater-than-expected 227,000 in January, albeit average hourly wage growth slowed to 2.5%, from 2.8% in December.

Expectations increased greatly that the Federal Reserve (Fed) would increase base rates at its next meeting on 14-15 March. This was after the minutes of the Federal Open Market Committee for 31 January – 1 February revealed that many members thought it would be appropriate to raise rates “fairly soon” and following hawkish comments from chair Janet Yellen and other bank policymakers.

Having performed poorly in January, pharmaceutical companies bounced back after Donald Trump pledged to streamline the regulatory approval process for new drugs. Financials also performed well against a more supportive political backdrop after Trump ordered a review of major banking rules put in place following the 2008 financial crisis.

Eurozone

Eurozone equities gained in February. GDP growth for Q4 2016 was revised down slightly but forward-looking economic indicators were strong. The flash composite purchasing managers’ index rose to 56.0 in February

[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.

from 54.4 in January. The German Ifo business confidence survey also moved higher, with both the expectations and current assessment components beating market expectations. Minutes from the 19 January European Central Bank meeting struck a dovish tone, indicating that the ECB would remain flexible on meeting its bond-buying objectives.

The consumer staples sector was the top gainer for the month after merger & acquisition activity. US group Kraft Heinz made an approach worth $143 billion for Unilever. This was swiftly rejected by the Anglo-Dutch firm, which then made a commitment to boost profits and conduct an in-depth review of its business. The information technology sector also performed strongly.

By contrast, financials were the only sector to register a negative return for the month. In part this was due to doubt being cast on the likelihood of the London Stock Exchange-Deutsche Börse merger going ahead. The UK exchange said it would not be able to sell a bond trading platform in time to comply with an official deadline. Banks were also under pressure amid some volatility in bond markets, with the spread between French and German yields widening due to concerns over the upcoming French election. There were also some disappointing 2016 results from certain lenders.

UK

The FTSE All-Share index rose 3.1% as the market regained some of the momentum it lost during a lacklustre January. UK equities were supported by a variety of factors, including some robust corporate results, M&A activity, a decline in long-dated government bond yields, positive macroeconomic data and hopes of an increase in global defence budgets. Sterling weakness was a further tailwind as the dollar strengthened. Meanwhile, a more conciliatory approach by the US administration to the pharmaceuticals industry was a further plus point.

Unilever performed very well after US peer Kraft Heinz launched a bid (swiftly rejected) while investors welcomed Reckitt Benckiser's agreed takeover of US-headquartered baby milk manufacturer Mead Johnson. Also in consumer goods, the tobacco sector performed well, in line with other bond proxies[2] in the telecommunications, utilities and real estate sectors. This was against the backdrop of falling gilt yields which retreated in line with developed market sovereign bonds.

The Bank of England upgraded its 2017 growth projections (from 1.4% to 2.0%). The Office for National Statistics (ONS) confirmed that the UK economy had expanded at a faster-than-expected 0.7% in the final quarter of last year (versus its previous estimate of 0.6%). However the ONS did downgrade the 2016 annual growth figure to 1.8%, from 2.0%. Some of the domestically-focused areas of the market performed well, including financials and housebuilders. The more UK-orientated FTSE 250 (ex investment companies) index outperformed large caps, generating a total return of 3.5% over the month, versus 3.1% from the FTSE 100.

Japan

The Japanese stockmarket again moved broadly sideways in February, but ended the month at the top of its recent range to record a gain of 0.9% for the month as a whole. The yen also showed less volatility compared to recent months, but strengthened slightly against most major currencies.

Sector performance showed no clear pattern. Some cyclical areas such as marine transportation and pulp & paper continued to lead the market, but some recent underperformers among defensive sectors - such as pharmaceuticals and foods - were also comfortably ahead of the index in February. The strongest sector was rubber products due to a sharp rise in Bridgestone's share price after the announcement of an unexpectedly large share buyback. The weakest area in the month was the telecom sector while autos continued to suffer from uncertainty over the direction of US trade policy.

From Japan's perspective, the main political event was the meeting between Prime Minister Abe and President Trump in Washington and Florida. The meeting appeared to be surprisingly cordial despite the

[2] Bond proxies are equities that are presumed to resemble bonds in terms of their ability to provide low-risk income but with higher yields.

previous rhetoric around Japan's foreign exchange policy and the Trans-Pacific Partnership (TPP) trade agreement.

The corporate results period for the quarter to December concluded in mid-February. Overall, the results were very solid with over 60% of companies reporting positive surprises compared to the consensus. Throughout the last two months, earnings revisions have been strongly positive and, although the trend remains favourable, forecasts now include much of the positive impact of the yen weakness seen in the second half of 2016.

Asia (ex Japan)

Asia ex Japan equities continued on their upward trajectory in February as the region delivered strong gains, spurred on by the broader "Trump bump" rally seen in global stockmarkets. In China, stocks gained on continued positive news for the world's second-largest economy. The ongoing restrictions on the property market and further restrictions being placed on capital outflows also saw liquidity diverted into equities. The People's Bank of China (PBoC) raised short-term interest rates right after the Chinese New Year holiday, hiking yields on open market operations by 10 basis points – the first such hike since 2013 and a signal that the central bank is looking to gradually tighten monetary policy.

Meanwhile, in Hong Kong stocks advanced over the month on more investor optimism over China and as mainland Chinese investors were strong buyers in the market via the Stock Connect scheme. Over the strait in Taiwan, stocks hit a near two-year high as foreign investors returned to the market while Korean stocks also finished up with its technology sector performing well.

In ASEAN, Indonesia and Thailand both gained but Philippine stocks were the regional outlier and declined. Indian stocks were the star performer in Asia as they outperformed the region on the back of strong foreign capital inflows.

Emerging markets

Emerging market equities recorded a positive return in February and the MSCI Emerging Markets index outperformed the MSCI World index. A number of emerging markets benefited from currency strength compared to the US dollar over the period. This included Egypt, which was the best performing index country. Turkey outperformed with the lira amplifying gains. The currency rallied as the central bank tightened monetary policy through liquidity controls. The lira also benefited from improved investor sentiment towards risk assets.

Among the major markets, India delivered a robust return and outperformed. The potential headwind of demonetisation on growth has yet to be reflected in economic data. GDP for the final quarter of 2016 surprised to the upside, growing 7% year-on-year. China outperformed by a more modest margin as macroeconomic indictors remained stable. Official manufacturing PMI for January was firm at 51.3, while trade data was stronger than expected.

The main exception to the positive trend was Russia which underperformed following a period of strong performance in 2016. Energy prices were flat over the period, the expected rate cuts to stimulate growth have not yet materialised and optimism over a significant improvement in relations with the West has diminished.

Global bonds

February proved positive for global sovereign and corporate bonds, albeit with some exceptions. The most notable exception was shorter-dated US Treasuries, which were relatively weak, though the 10-year index gained. In the US, investors weighed Fed meeting minutes and a statement from Chair Janet Yellen as well as the prospect of more detail on President Trump's fiscal plans. The Fed minutes were interpreted as being somewhat ambiguous, tempering expectations for rate hikes in 2017 and in turn supporting bonds. But US Treasuries pared gains as the prospect of President Trump's address to Congress, and expectations of more detail on fiscal stimulus plans, came into focus.

European sovereign bonds made gains, especially the core markets of the UK and Germany. French and Italian bonds made gains too, but spreads widened further to Bunds from already high levels. Gains in the UK

and Germany likely reflected safe haven demand, amid still heightened political uncertainty, as economic data remained strong. In France, bonds declined steeply on signs of growing support for Front National presidential candidate Marine Le Pen. They reversed course later in the month, however, after the prospects for the more moderate Emmanuel Macron appeared to improve.

The 10-year US Treasury yield tightened by nine basis points (bps) to 2.36% over the month, while the five-year yield was little changed at 1.93%. The two-year yield rose from 1.20% to 1.26%. In Europe, the 10-year Bund yield fell from 0.44% to 0.21%, the five-year yield from -0.40% to -0.57% and the two-year yield from -0.70% to -0.90%. The UK 10-year yield came down from 1.42% to 1.15%, the five-year yield from 0.62% to 0.55% and the two-year yield down from 0.13% to 0.10%. The spread of 10-year French bonds over Bunds widened from 60 to 68 bps and from 22 to 38 bps at the two-year level.

Global credit markets continued to advance and outperformed government bonds. The investment grade[3] BofA Merrill Lynch Global Corporate index rose 1.2%, outperforming government bonds by 0.3%, while global high yield credit rose 1.5%, an outperformance of 1.1% over sovereigns. Regionally, UK investment grade proved strongest rising 2.7%, though this was broadly in-line with gilts, while UK high yield rose 1.6%, an outperformance of 0.5% above government bonds. In the US, investment grade was up 1.1% and high yield 1.6%. European high grade credit rose 1.2%, marginally lagging Bunds. European high yield rose 1.0%, modestly ahead of government bonds.

It was a constructive month for emerging market debt, especially local currency-denominated (JP Morgan GBI-EM Global Diversified Composite), which rose 2.7%. The Mexican peso has performed strongly of late following the post-US election selloff. The US dollar sovereign index (JP Morgan EMBI Global Diversified) rose 2.0%, while emerging market corporate issues (CEMBI Diversified Broad Composite) rose 1.4%.

Turning to convertible bonds, investors enjoyed yet another calm month on the global stock exchanges. The overall MSCI World index was up 2.8%. Convertible bonds, as measured by the Thomson Reuters Global Focus convertible index, gained 1.2% in US dollar terms in February. The price move has resulted in some convertibles - especially in US information technology related names - building up quite high equity risk. At the same time, valuations for the universe became slightly richer. Good convexity[4] value can still be found in Asian and Japanese names.

Commodities

The Bloomberg Commodities index was marginally positive. The industrial metals component generated positive returns while agriculture declined modestly and energy fell more noticeably. Copper and zinc fell by -1.0% and -1.2% respectively after strong gains last month, while nickel gained 10.2% and aluminium rose 5.6%. Among soft commodities, coffee declined -6.2% and sugar fell -5.9%. Natural gas again fell dramatically as inventories looked to have swelled. The -11.0% fall weighed on the energy sector, while coal was little changed. Gold rose 3.1% and silver rose 4.3%.

[3] 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.
[4] 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 February 2017

	1 month			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	4.58	2.82	3.96	24.72	21.97	36.59
MSCI World Value	4.14	2.40	3.52	28.22	25.38	40.42
MSCI World Growth	5.03	3.27	4.41	21.28	18.61	32.83
MSCI World Smaller Companies	3.89	2.15	3.28	30.27	27.39	42.67
MSCI Emerging Markets	4.83	3.07	4.20	32.87	26.90	45.52
MSCI AC Asia ex Japan	5.15	3.39	4.53	29.76	26.90	42.11
S&P500	5.74	3.97	5.12	27.80	24.98	39.96
MSCI EMU	2.66	0.94	2.05	17.74	15.14	28.95
FTSE Europe ex UK	2.68	0.95	2.07	16.20	13.64	27.26
FTSE All-Share	3.72	1.98	3.11	12.14	9.66	22.81
TOPIX*	3.30	1.57	2.68	24.76	22.01	36.63

	1 month			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	2.24	0.53	1.63	0.90	-1.33	10.50
JPM GBI UK All Mats	3.77	2.03	3.16	-2.92	-5.06	6.32
JPM GBI Japan All Mats**	2.68	0.96	2.07	2.94	0.66	12.73
JPM GBI Germany All Mats	1.60	-0.11	0.99	0.14	-2.07	9.67
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	2.43	0.72	1.82	7.41	5.04	17.64
BofA ML US Corporate Master	2.85	1.13	2.24	8.75	6.35	19.10
BofA ML EMU Corporate ex T1 (5-10Y)	1.53	-0.17	0.93	5.53	3.20	15.57
BofA ML £ Non-Gilts	3.14	1.41	2.53	1.65	-0.59	11.33
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	2.92	1.19	2.31	22.53	19.83	34.20
BofA ML Euro High Yield	0.95	-0.74	0.35	13.19	10.69	23.96

Source: DataStream. Local currency returns in February 2017: *0.94% **0.34%. Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of any overseas investments to rise or fall.

Source: Schroders

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