Schroders

Monthly Markets Review
Overview of markets in August 2017

Highlights

- The MSCI World index eked out a positive return in August. Escalating US-North Korea tensions and Hurricane Harvey's Texas landfall weighed on sentiment but economic data remained largely positive.
- US equities were supported by generally positive economic data, including an upward revision to second quarter GDP growth. However, the energy sector performed poorly in the wake of Hurricane Harvey.
- Eurozone equities declined and the stronger euro was a headwind. The euro's gains came as domestic economic indicators remained robust.
- UK shares gained with some less economically-sensitive sectors performing well while the mining sector was lifted by a stronger backdrop for industrial metals prices.
- Japanese equities posted only a small decline as a positive corporate earnings season helped offset worries about North Korea and a stronger yen.
- Emerging market equities outperformed developed markets. Higher commodity prices supported stockmarkets in Latin America.
- North Korea-related concerns contributed to government bond yields declining. Speeches from central bank chiefs Janet Yellen and Mario Draghi at the Jackson Hole symposium were notable for their lack of hawkish sentiment.

US

The S&P 500 returned 0.3% over the month. US equities were supported by generally positive macroeconomic data, including an upward revision to second quarter GDP growth to 3.0% (annualised). The market made further progress despite ongoing political uncertainty, on the both the domestic and overseas fronts, and the disruption to the US oil & gas industry in the wake of Hurricane Harvey.

The upward revision to second quarter GDP was in part led by personal consumption. Better-than-expected July retail sales data offered further encouragement here for the coming quarter while surveys tracking US consumer sentiment in August recovered. The preliminary estimate of the University of Michigan's consumer sentiment index rose to 97.6 (from a final reading of 93.4 in July) while the Conference Board Consumer Confidence Index ticked up to 122.9 in August, inching back towards the highs it struck earlier in the year.

Forward-looking indicators overall were mixed as it was revealed that the Institute for Supply Management's manufacturing index had moderated somewhat to 56.3 in July (from a three-year high of 57.8 in June). Meanwhile, inflation data remained sluggish with core personal consumption expenditure for July of 1.4% year-on-year. Information technology was the best-performing sector, followed by utilities which rallied inline with falling long-term Treasury yields. Gains here were offset by a poor performance from the energy sector as a result of the Harvey-related disruption.

Eurozone

Eurozone equities declined slightly during August with the MSCI EMU index returning -0.5%. A strengthening currency was a headwind for the equity market. The euro's gains came as domestic economic data remained robust. GDP growth was confirmed at 0.6% in the second quarter, up from 0.5% in the first quarter. The flash composite purchasing managers' index rose to 55.8 in August from 55.7 in July, suggesting ongoing growth momentum. The European Commission's economic sentiment indicator rose to 111.9, its highest level since July 2007. Meanwhile, annual inflation was estimated to pick up to 1.5% in August from 1.3% in July.

Given the stronger data, investors were also looking ahead to the European Central Bank's (ECB) policy-setting meeting in September. The ECB is widely expected to give some details on tapering its quantitative easing programme.

On the equity market front, the financials and telecommunications sectors registered the steepest declines. Telecom Italia was a faller as France's Vivendi said it does not exercise control of the group. Utilities were the top gainers following good first half results for German power firms RWE and E.On.

UK

The FTSE All-Share index returned 1.4% over the month driven by a combination of factors. An ongoing recovery in industrial metal prices supported the mining sector as did the rally in precious metals amid rising geopolitical risks. Defensive[1] areas of the market also performed well as risk aversion rose and were further supported by falling long-term government bond yields.

Generally positive sentiment towards China's economy – despite some mixed data- supported industrial metals as did supply-side constraints, including steps by the Chinese authorities to reduce steel capacity. These measures have driven up domestic steel prices with a positive knock-on effect for iron ore prices which recorded double-digit gains in August.

Yields on long-term gilts fell in line with other developed sovereign bond markets as expectations moderated for monetary tightening by the world's major central banks. The Bank of England added to the dovish sentiment after it kept base rates on hold at the latest Monetary Policy Committee meeting and downwardly revised UK growth forecasts in the August quarterly inflation report.

Deteriorating sentiment towards the UK economy was reflected in sterling weakness and a mixed performance from domestic cyclicals. Mid caps lagged, with the FTSE 250 ex investment trusts index rising 0.3% versus a 1.6% increase in the FTSE 100.

Japan

The Japanese market ended down 0.1% for the month. Volumes were low and market moves appear relatively modest against a difficult external environment and a generally stronger tone for the currency. The equity market was held back primarily by financial-related stocks, with the four largest sector declines coming from insurance, securities, real estate, and banks. A mixed group of sectors showed positive returns, including oil, air transport, and metals.

The main economic news was the release of GDP data for the quarter to June, which showed much stronger growth than consensus expectations. This marks the sixth consecutive quarterly growth in Japan's GDP for the first time in more than 10 years. The composition of growth clearly shows a lower dependence on external demand, with the domestic economy increasingly taking up the running, led by corporate capital expenditure.

There is growing evidence that the performance of corporate Japan is improving. This was initially suggested by the results for the fiscal-year to March 2017 but has been reinforced by the results for the quarter to June. The majority of companies produced positive earnings surprises compared to the consensus and a much higher proportion than usual were prepared to revise up their full fiscal-year numbers.

Away from the real economy, Prime Minister Abe reshuffled his cabinet in early August in an attempt to rebuild his personal authority and stem the precipitous decline in popularity seen in the previous month. With domestic politics temporarily taking a back-seat, North Korea has again emerged as the dominant risk facing Japan.

[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.

Asia (ex Japan)

The bull market remains intact as Asia ex Japan equities recorded another month of positive gains since the start of the year. In August, Asian equities managed to deliver low positive returns despite geopolitical tensions resurfacing in August, while in the rest of the markets, global equity markets stayed flat. Persistently and pervasively low inflation data had cast doubts over the potential tightening by the US Fed and the ECB with the markets anticipating continued accommodation from the central banks.

In terms of market performance, Thailand and China were the key outperforming markets in the region, boosted by strong returns in its Healthcare and Consumer Staples sectors respectively. On the opposite end of returns, Korea fell the most on the back of unrest in the Korean peninsula. Additionally, the raised tax ceilings, potential chaebol[2] reforms and the conviction of Samsung's JY Lee were further catalysts that led to general negative market sentiment of the Korean market.

Emerging markets

Emerging market (EM) equities generated a solid gain in August with a positive global backdrop proving supportive. A pick up in commodity prices was also beneficial for several EM markets, notably in Latin America. Peru was the strongest index market while Brazil and Chile also outperformed.

Russian equities also rallied, in part following weaker performance in recent months. Furthermore, July inflation was below forecast, raising the prospect for additional interest rate cuts. Elsewhere in emerging Europe, Hungary generated a robust return, with positive earnings results from large index names OTP Bank and MOL Hungarian Oil underpinning gains. Poland outperformed as economic indicators remained robust. Q2 GDP was 3.9% year-on-year while retail sales increased to 6.8% year-on-year in July.

In contrast, South Korea underperformed given elevated political risk in North Korea and slowing momentum in the improvement in some companies' profitability. Qatar lagged as the diplomatic crisis showed little sign of being resolved. Pakistan underperformed by a wide margin, despite the appointment of a new prime minister.

Global bonds

Government bond yields declined over the month due to safe haven buying on escalating tensions between the US and North Korea. Corporate bonds continued to perform well in absolute terms. Speeches from central bank chiefs Janet Yellen and Mario Draghi at the Jackson Hole annual economic symposium were notable for their lack of any hawkish sentiment.

Geopolitical tensions impacted markets as North Korean nuclear missile tests prompted fierce rhetoric from President Trump and increased US sanctions. On the domestic US front, there was more drama in Washington as President Trump dismissed Steve Bannon as his chief strategist. More constructively, reports suggested the US government is making progress with fiscal reform plans. Brexit stayed firmly in the headlines with the two sides remaining very much at odds and disagreement over the UK's 'exit bill' in particular hindering progress.

Developed market government yields declined by about 20-25 basis points (bps). US Treasury 10-year yields narrowed from 2.29% to 2.12%, 10-year gilt yields from 1.23% to 1.03% and Bund 10-year yields from 0.54% to 0.36%. Corporate bonds made gains, but underperformed government bonds and investment grade[3] outperformed high yield. The BofA Merrill Lynch Global Corporate Bond Index rose 0.80% over the month, with the high yield equivalent rising 0.27%. The US dollar continued to drift lower mainly against the euro.

Turning to convertibles, stockmarkets showed a heterogeneous picture in August and the MSCI World index was up only slightly. After a relatively weak start the US market clawed back into positive territory while most European bourses ended the month with a loss. Convertible bonds, as measured by the Thomson Reuters Global Focus Convertible index, shed -0.3% in US dollar terms. Implied volatility, as a typical measure of the price for the conversion right, remains just over 30% while historic volatility figures are extremely low. Our value models detect a cheapening within our investable convertible universe. While about one-third of

[2] A chaebol is a large family-controlled conglomerate in Korea.
[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.

convertibles are quite rich in value, the overall valuation level came down in August to a much more attractive pricing level.

Commodities

The Bloomberg Commodities index generated a small gain. The industrial metals component rallied sharply, as macroeconomic data in China reflected healthy demand. Iron ore rose 13.1%, zinc was up 12.8% and copper climbed 6.5%. The energy segment posted a more modest gain. Natural gas returned 8.8% as supply data surprised to the downside. By contrast, Brent crude was down 0.5%, in part given higher production from Saudi Arabia, Nigeria and Libya in July. The agricultural component registered a negative return with wheat, corn and soybean prices all firmly lower. Grain prices fell back as concern over the impact of drought diminished. Precious metals moved higher over the month, amid increased geopolitical uncertainty; gold and silver were both up 4.1%.

Overview

Total returns (%) – to end August 2017

	1 month			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	-0.64	0.19	2.51	9.45	16.84	18.76
MSCI World Value	-1.58	-0.75	1.54	8.48	15.80	17.70
MSCI World Growth	0.28	1.12	3.46	10.39	17.85	19.78
MSCI World Smaller Companies	-0.86	-0.03	2.28	10.04	17.46	19.39
MSCI Emerging Markets	1.42	2.27	4.63	17.09	24.99	27.04
MSCI AC Asia ex Japan	0.53	1.37	3.71	17.27	25.19	27.24
S&P500	-0.53	0.31	2.63	8.88	16.23	18.14
MSCI EMU	-0.44	0.39	2.71	17.85	25.81	27.87
FTSE Europe ex UK	-0.33	0.51	2.83	16.13	23.97	26.00
FTSE All-Share	-1.72	-0.90	1.39	5.37	12.48	14.33
TOPIX*	-0.49	0.35	2.67	9.44	16.83	18.74

	1 month			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	0.31	1.15	3.49	-7.33	-1.07	0.55
JPM GBI UK All Mats	-1.13	-0.30	2.01	-11.02	-5.01	-3.45
JPM GBI Japan All Mats**	0.16	0.99	3.33	-13.34	-7.49	-5.97
JPM GBI Germany All Mats	1.33	2.18	4.54	-2.86	3.70	5.40
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	0.04	0.88	3.22	-3.26	3.27	4.97
BofA ML US Corporate Master	0.01	0.85	3.18	-4.26	2.21	3.88
BofA ML EMU Corporate ex T1 (5-10Y)	0.78	1.62	3.97	0.90	7.71	9.48
BofA ML £ Non-Gilts	-1.79	-0.96	1.33	-7.65	-1.42	0.20
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	-0.50	0.34	2.66	2.71	9.65	11.45
BofA ML Euro High Yield	0.20	1.04	3.38	6.67	13.87	15.74

Source: DataStream.

Local currency returns in August 2017: *-0.05%, **0.60%.

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