Issued in November 2016

Schroders

Monthly markets review

Overview of markets in October 2016

Highlights:

- The MSCI World index declined (in US dollar terms) and was outpaced by emerging market equities.
- US equities fell amid uncertainty ahead of the presidential elections, as well as expectations that a rate rise would be forthcoming in December.
- Eurozone equities advanced, supported by encouraging macroeconomic data as well as solid quarterly earnings reports.
- UK equities delivered positive returns as further sterling weakness supported globally diversified large cap stocks such as the resources sectors and the international banks.
- Japanese equities were supported by a weaker yen, with financial sectors leading the gains.
- Emerging markets delivered positive returns overall. Brazilian equities outperformed after a budget spending cap was approved earlier than expected.
- October was a weaker month for global bond markets as inflation expectations rose in a number of markets. Government bond yields were sharply higher overall.

US

US equities fell over the month with the S&P 500 recording a loss of 1.8% amid political uncertainty in the run up to November's presidential election. This was also against the backdrop of expectations that the Federal Reserve (Fed) would raise base rates again before the end of 2016, despite some mixed macroeconomic data.

The minutes of September's meeting of the Federal Open Market Committee (FOMC) revealed that, of the members of the rate-setting body who had argued in favour of holding rates, several had stated it a "close call". Subsequent to the period end, the statement following the 1-2 November FOMC meeting said the case for a further hike had "continued to strengthen".

First GDP estimates confirmed US growth has picked up sharply, with the economy expanding at an annualised rate of 2.9% in the third quarter. However, inflation data remains mixed, with the US Department of Labor's core consumer price index moderating slightly to 2.2% in the 12 months ending September.

Meanwhile, it was revealed that growth in non-farm payrolls[1] had eased marginally again in September. Many high-yielding sectors, including real estate, telecoms and healthcare, performed poorly against the backdrop of significantly higher long bond yields. Financials performed well, led by the banks. This was following robust third-quarter results from the sector, driven in part by increased volatility in bond and currency markets following the UK's decision to exit the European Union.

Eurozone

Eurozone equities made gains in October. The MSCI EMU index returned 1.3%, supported by some encouraging macroeconomic data as well as gains for the financials sector. Quarterly results from a number of banks, including France's BNP Paribas, exceeded analysts' estimates. The energy sector also outperformed,

[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.

as did consumer discretionary – most notably the luxury goods sub-sector. Real estate was the weakest sector amid expectations that rates could rise in the US, as well as some uncertainty over monetary policy in Europe. The consumer staples sector was also under pressure, with brewer Anheuser-Busch InBev posting Q3 results that fell short of consensus estimates.

The European Central Bank (ECB) kept monetary policy unchanged. ECB President Mario Draghi suggested that the Bank would decide in December whether or not to extend its €80 billion quantitative easing programme beyond the current deadline of March 2017. The eurozone economy continued to grow slowly, expanding by 0.3% over the third quarter. Inflation showed signs of picking up with a rise of 0.5% month-on-month in October compared to 0.4% in September. In terms of forward-looking data, the composite eurozone purchasing managers' index (PMI) for October hit a ten-month high of 53.7.

On the political front, Spain's Mariano Rajoy was elected for a second term as prime minister after ten months of deadlock following inconclusive elections. He will lead a minority government. Portuguese bonds were in focus over the month with ratings agency DBRS opting to keep the country's sovereign debt rating at investment grade, meaning Portuguese debt is still eligible for the ECB's bond-buying programme.

UK

The FTSE All-Share index rose 0.6% over the month. This was against the backdrop of a weak sterling, which fell sharply against its major trading currencies amid ongoing uncertainty around the economic and political consequences of the UK's decision to leave the European Union (EU). UK Prime Minister Theresa May indicated the government was prepared to pursue a "hard Brexit" and announced that formal proceedings to take the UK out of the EU would begin before the end of March 2017. She also used the annual Conservative Party conference to criticise the Bank of England's (BoE) stimulus policies.

Some of the globally diversified large caps, such as the resources sectors and the internationally-focused banks outperformed as investors discounted the incremental benefit of further sterling weakness to their overseas earnings bases. Barclays led the banking sector higher after it reported better-than-expected third quarter results.

The market made progress despite a poor-performance from the heavyweight consumer goods sector and regulated utilities, which underperformed against the backdrop of sharply higher long-term bond yields. Bond yields rose in line with higher inflation expectations as markets worried about the implications of a weaker pound. These fears were given focus by data which revealed that inflation had risen sharply in September, to its highest level in almost two years.

Many of the UK's domestically-orientated sectors lagged, as reflected in the underperformance of the mid caps, with the FTSE 250 (ex investment companies) index declining by 2.2% over the period. By contrast, the FTSE 100 generated a total return of 1.0%.

Japan

The Japanese stockmarket rose consistently during October to register a total return of 5.3% for the month. The yen weakened against most of Japan's major trading partners, including the US dollar, which improved equity investor sentiment in the short term.

The market was led upwards by financial sectors, including securities companies and insurance stocks. Banks also outperformed, but to a much lesser extent. Several cyclical areas of the market performed strongly, especially shipping companies, which were driven by the announcement of plans by the three largest Japanese shippers to merge their container businesses. The exception among cyclical sectors was steel which underperformed in October alongside more defensive areas such as telecoms, foods and pharmaceuticals.

The period since the Bank of Japan's July policy meeting has been characterised by lower volatility and a relatively stable domestic macroeconomic environment. A greater probability of a US interest rate increase led to a slightly weaker yen against the US dollar. These benign trends were joined by a perception of greater certainty around the US presidential election outcome although, by the end of the month, this confidence rapidly dissipated. The Bank of Japan held a further policy meeting at the very end of October but, as was widely expected, this resulted in no changes to interest rates or to the asset purchase programme. Although the target rate for inflation of 2% remains in place, the central bank did partially accept reality by reducing its own expectations for inflation in 2018.

With no surprises in economic data, investors were able to focus on the latest quarterly earnings results season which began in the last week of October. Although earnings momentum still appears slightly weak, this has already been largely discounted in stock prices and sequential improvements are likely in the coming quarters. The earnings revision index has already shown steady improvement in recent months as the impact of yen strength seen earlier this year begins to fade.

Asia (ex Japan)

Asia ex Japan equities fell back in October on worries over an impending interest rate rise by the US Federal Reserve and continuing concerns surrounding Chinese growth. Chinese equities delivered negative returns over the month as yuan depreciation, a step up in property curbs and tightening liquidity all weighed on sentiment. Over the month, it was announced that third quarter GDP growth for the Chinese economy was 6.7% year-on-year – in line with expectations – but weaker September trade data highlighted the difficulties facing world's second-largest economy.

Meanwhile, in Hong Kong stocks fell as Southbound flows via the Stock Connect scheme with the mainland Chinese market, which had driven the market higher over the previous months, dried up amid waning buying interest. Over in Taiwan, the market gained as strong demand for the new iPhone 7 buoyed the island's technology stocks. In Korea, stocks fell on the back of a deepening governance crisis that has hit President Park Geun-hye.

In ASEAN, Thailand and the Philippines both saw their markets fall with the former declining on news of the death of King Bhumibol Adulyadej – the world's longest-serving monarch. Indonesia's market finished flat. Meanwhile, Indian stocks fell slightly as a sluggish start to the quarterly earnings season weighed on sentiment.

Emerging markets

It was a relatively subdued month in emerging markets, ahead of the US presidential election and amid increasing consensus for a Fed rate hike in December. The MSCI Emerging Markets index recorded a marginally positive return and outperformed the MSCI World.

Several emerging markets benefited from positive political developments over the month. Brazil was the best performing market as congress approved a budget spending cap well ahead of market expectations. In Egypt, the market delivered a strong gain amid increasing expectations for IMF board approval on a $12 billion loan. Mexico also outperformed. External political developments provided a tailwind to the peso as concerns over the forthcoming US election eased.

By contrast, a political scandal in Korea had a negative impact on the market given concern the crisis could delay economic reforms and the 2017 budget. Chinese equities also generated a negative return and underperformed. Third quarter GDP growth of 6.7% year-on-year (y/y) was in line with expectations while other macroeconomic indicators were generally stable or incrementally positive. However, a surge in property sales growth to 34% y/y prompted the government to implement restrictions on property linked lending. This weighed heavily on real estate sector stocks. The UAE declined and was the weakest index market as a series of earnings releases disappointed, notably among banks.

Global bonds

October was a weaker month for global bond markets with inflation expectations integral to a number of market developments. In the UK, BoE Governor Mark Carney intimated that policy concessions could be made for higher prices if such a move might contribute to stable growth. In Europe, a rise in headline eurozone inflation - to a two-year high - added credence to speculation that the ECB may be considering tapering of its quantitative easing scheme. In the US, meanwhile, the furore surrounding the upcoming election did nothing to dim expectations of a Fed hike in December; inflation has recently risen in the US too.

While it was a challenging month for most asset classes, those with higher interest rate sensitivity were especially vulnerable. Government bond yields were sharply higher overall. Investment grade[2] corporate bonds generated negative total returns, although outperformed government bonds. High yield credit was generally more resilient.

The 10-year Treasury yield rose from 1.59% to 1.83% and yields were higher across the curve. The same dynamic was reflected in the UK. The 10-year gilt yield rose from 0.75% to 1.25%, the five-year yield rose from 0.22% to 0.59% and the two-year yield rose from 0.10% to 0.26%. In the eurozone, the 10-year Bund yield rose from -0.12% to 0.13%, but shorter dated Bunds were less affected.

The investment grade BofA Merrill Lynch Global Corporate Index declined -0.9% and generated excess returns of 0.4%. The high yield equivalent index climbed 0.4% and outperformed by 1.0%. Sterling was the weakest major investment grade market in October and underperformed gilts. Bond returns for both the investment grade US and euro corporate indices were similar, both declining -0.8%. Excess returns for both indices were positive –at 0.5% and 0.4% respectively.

In emerging market debt, all three of the principal market components were weaker. The US dollar sovereign index (JP Morgan EMBI Global Diversified) fell -1.2%, the first decline since May. Local currency bonds (JP Morgan GBI-EM Global Diversified Composite) fell -0.9% while emerging market corporate issues (CEMBI Diversified Broad Composite) fell -0.01%.

October was another month in which convertible bonds outperformed global equity markets. Against falling stockmarkets, the Thomson Reuters Global Focus Convertible Bond index finished the month with slight loss of -0.12% (in US dollar terms). The implied volatility, as a typical measure of the price for the conversion right remains low at 29%. Our models indicate that a good quarter of convex convertibles are still undervalued.

Commodities

The Bloomberg Commodities index posted a small negative return, largely due to weak performance from the energy component. Brent crude (-1.6%) came under pressure amid doubts that OPEC's outline agreement on production cuts would be delivered. By contrast the agricultural component was positive, with sugar and soybean prices performing strongly. The industrial metals segment also delivered a positive return. In precious metals, both gold (-3.1%) and silver (-7.4%) were weaker.

[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 of October 2016

	1 month			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	0.56	-1.91	4.37	2.58	1.79	28.76
MSCI World Value	1.76	-0.74	5.61	4.34	3.54	30.97
MSCI World Growth	-0.64	-3.08	3.13	0.84	0.06	26.57
MSCI World Smaller Companies	-1.24	-3.67	2.50	5.47	4.66	32.39
MSCI Emerging Markets	2.77	0.25	6.66	10.52	9.67	38.72
MSCI AC Asia ex Japan	0.97	-1.51	4.79	7.73	6.90	35.22
S&P500	0.65	-1.82	4.46	5.32	4.51	32.20
MSCI EMU	1.34	-1.15	5.17	-4.19	-4.93	20.27
FTSE Europe ex UK	0.01	-2.44	3.80	-4.61	-5.34	19.74
FTSE All-Share	-3.10	-5.48	0.56	-10.60	-11.29	12.22
TOPIX*	4.04	1.49	7.98	5.79	4.97	32.79

	1 month			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	1.24	-1.24	5.08	4.35	3.54	30.98
JPM GBI UK All Mats	-7.56	-9.83	-4.06	-12.28	-12.95	10.11
JPM GBI Japan All Mats**	-1.52	-3.94	2.20	22.52	21.57	53.78
JPM GBI Germany All Mats	-2.11	-4.51	1.60	3.62	2.82	30.06
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	0.57	-1.90	4.38	6.23	5.41	33.34
BofA ML US Corporate Master	1.67	-0.83	5.52	7.86	7.03	35.39
BofA ML EMU Corporate ex T1 (5-10Y)	-1.02	-3.45	2.73	6.64	5.82	33.86
BofA ML £ Non-Gilts	-7.02	-9.30	-3.50	-11.93	-12.61	10.54
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	2.33	-0.18	6.20	10.20	9.35	38.32
BofA ML Euro High Yield	0.91	-1.57	4.73	6.18	5.36	33.28

Source: DataStream. Local currency returns in October 2016: *5.31% **-0.32%. 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.

Important Information: This document is provided by the Investment Communications team and may not necessarily represent views expressed in other Schroders communications, strategies or funds. This material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. Reliance should not be placed on the views and information in this document when taking individual investment and/or strategic decisions. 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. All investments involve risks including the risk of possible loss of principal. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy. Reliance should not be placed on the views and information in this document when taking individual investment and/or strategic decisions. Some information quoted was obtained from external sources we consider to be reliable. No responsibility can be accepted for errors of fact obtained from third parties, and this data may change with market conditions. This does not exclude any duty or liability that Schroders has to its customers under any regulatory system. MSCI: Third party data is owned or licensed by the data provider and may not be reproduced or extracted and used for any other purposes without the data provider's consent. Third party data is provided without any warranties of any kind. The data provider and issuer of the document shall have no liability in connection with the third party data. The Prospectus and/or schroders.com contains additional disclaimers which apply to third party data. FTSE: FTSE International Limited ("FTSE") © FTSE 2016. "FTSE®" is a trade mark of London Stock Exchange Plc and The Financial Times Limited and is used by FTSE International Limited under licence. All rights in the FTSE indices and / or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and / or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent. Regions/sectors shown for illustrative purposes only and should not be viewed as a recommendation to buy/sell. To the extent that you are in North America, this content is issued by Schroder Investment Management North America Inc., an indirect wholly owned subsidiary of Schroders plc and SEC registered adviser providing asset management products and services to clients in the US and Canada. For all other users, this content is issued by Schroder Investment Management Limited, 31 Gresham Street, London, EC2V 7QA. Registered No. 1893220 England. Authorised and regulated by the Financial Conduct Authority.