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Schroders

Quarterly markets review

Overview of markets in Q2 2016

Highlights:

- Markets made a confident start to Q2 although the UK's vote to leave the EU overshadowed other developments by the end of the period. Global equities delivered positive returns in US dollar terms. Commodities gained, with energy outperforming.
- US equities gained over the quarter, supported by expectations that additional interest rate rises would be delayed.
- The UK's FTSE All-Share was among the strongest markets as a sharp depreciation in sterling was viewed as advantageous to a stockmarket comprising predominantly overseas earners.
- Eurozone equities had a turbulent quarter following the UK referendum, with financials particularly under pressure.
- Japanese equities posted considerable declines as a sharp appreciation in the yen (up 9.1% against the dollar) had a particularly negative impact on the stockmarket.
- Emerging markets slightly lagged developed markets. Brazilian equities were up sharply as the real rallied strongly against a backdrop of easing political risk
- Government bond yields were sharply lower over the quarter, with the 10-year German Bund yield dropping into negative territory.

US

US equities ended the quarter higher, with the S&P 500 advancing 2.5%. The index experienced a highly volatile end to the period in the wake of the UK's surprise decision to exit the European Union. However, the benchmark managed to hold onto the gains it achieved earlier in the quarter as central banks successfully took steps to shore up investor confidence. Comments by Federal Reserve (Fed) officials, led by chair Janet Yellen, in the run-up to and following the referendum saw expectations for additional rises in US interest rates significantly pushed back.

US equities achieved the majority of their gains for the quarter during the month of May when macroeconomic newsflow improved, including an upgrade to first quarter US GDP growth. The recovery in the data allayed fears about the durability of US growth, and added to an expectation at that time that the Fed might increase interest rates as soon as the summer. Financial stocks performed well in anticipation that higher interest rates would improve the profitability of the banking sector. However, these gains were reversed in June, as the probability of a near-term rise in interest rates began to rapidly diminish.

US rate expectations moved out following mixed economic data points at the beginning of June, with May's non-farm payrolls[1] release notably disappointing. Expectations were deferred further in the immediate run up to the referendum, when Yellen repeatedly flagged the wider risks of Brexit to global growth. At the very end of June, in the wake of the UK's Leave decision, Fed Board of Governors member Jerome Powell went on the record to caution that Brexit had created additional uncertainties for the world economy.

[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.

Eurozone

Eurozone equities declined in the second quarter with the MSCI EMU index returning -2.2%. The index had advanced in both April and May but these gains were reversed in the wake of the UK's referendum on EU membership in June. The timescale for leaving and economic implications remain unclear, and the consequent uncertainty weighed on stockmarkets across Europe.

Another focus was Spain's general election which delivered another hung parliament, although the centre-right People's Party increased its share of seats. In May, eurozone finance ministers agreed to a framework allowing potential debt relief for Greece.

Ireland was the weakest regional stockmarket over the quarter, followed by Italy. At sector level, financials bore the brunt of the selling pressure, especially banks. Italian banks remained a particular focus with the government considering additional measures to recapitalise the sector. The energy sector delivered strong returns as oil prices rose over the period. Meanwhile, sectors perceived as safe havens – namely healthcare and consumer staples – also posted positive returns.

On the economic front, eurozone Q1 GDP growth was revised back up again to +0.6% quarter-on-quarter. Eurozone annual inflation (consumer price index) returned to positive territory in June at +0.1% compared to -0.1% in May. The eurozone composite purchasing managers' index dipped to 52.8 in June from 53.1 in May, implying a slightly slower pace of economic growth.

UK

UK equities rose over the period, with the FTSE All-Share advancing by 4.7%. The majority of these gains were achieved in June, despite severe volatility in equity markets after the UK voted to leave the European Union. Sterling fell sharply against its major trading currencies in the wake of the surprise decision; however, the UK equity market recouped all of its post-Brexit losses as investors anticipated the beneficial impact of a weakened currency to its predominately overseas earnings base.

The market was also supported in the wake of the referendum by guidance from Bank of England governor Mark Carney that the central bank could provide additional monetary policy stimulus to counter the impact on the domestic economy. At the same time expectations for additional rises in US interest rates were further deferred.

The oil & gas, basic materials, healthcare, and consumer goods sectors - all major overseas earners - saw powerful period-end rallies as sterling weakened, and these moves defined the whole quarter. The latter two sectors were further supported by a rotation towards large-cap defensive equities against the backdrop of heightened risk aversion. Meanwhile, an ongoing recovery in crude oil prices over the quarter underpinned the oil & gas sector as US production continued to decline and amid supply disruptions, such as those caused by wildfires in Canada and unrest in Nigeria's Niger Delta oil-producing region.

Japan

The Japanese equity market fell by 7.4% in the second quarter but a sharp appreciation of the yen reversed this for a sterling-based investor to produce a return of +6.1%. Japan's economic data has been somewhat better than expected recently, although inflation measures have remained sluggish. However, the moves in equity and currency markets in the second quarter were largely dictated by just two events.

During April, consensus expectations had formed solidly behind the view that the central bank would extend its negative interest rate policy which had been introduced in January, and also extend the asset purchase programme. In the event, the decision of the central bank to take no action, which was announced on the last trading day of April, constituted a major surprise.

In late June this was followed by the external shock delivered by the result of the UK referendum on the EU which created further uncertainty and accelerated the appreciation of the yen. In the last few days of the quarter there was a modest recovery in stock prices, in common with other major markets. In Japan, however, this recovery remained rather more muted as investors tried to assess the impact of the currency appreciation on expectations for earnings growth over the next couple of years.

Asia (ex Japan)

Asia ex Japan equities finished the second quarter of 2016 in marginally positive territory. Sentiment swung on Brexit worries and markets gained ground late on in the period on expectations that the US Fed would delay its planned rise in interest rates, following the “Leave” victory. Chinese equities finished broadly flat over the period as disappointing trade data in April was followed by mixed data for May – with imports contracting at their slowest pace since October 2014 but the decline in exports picked up from April’s pace, suggesting a slowdown in demand in the US and Europe.

Over the quarter, the People’s Bank of China weakened its yuan mid-point by the most in nearly a year, as Brexit-related angst saw predictions that further depreciation in the currency, along with capital outflows, was likely. The yuan ended the quarter down -2.9%, with the bulk of the losses coming in May and June.

In Hong Kong, stocks finished the quarter up on expectations that the Fed would delay raising interest rates. Over the strait in Taiwan, shares rose on gains in technology stocks which benefitted from higher-than-expected estimates of orders for the new Apple iPhone. Korean stocks declined on the planned inclusion of Chinese companies in the MSCI index, which saw foreign investors take profits.

In ASEAN, Indonesia and Philippine stocks were the big winners as both benefitted from increased public infrastructure spending plans, while Thai stocks also gained. Meanwhile, Indian equities advanced on a more optimistic outlook for rural demand as a severe drought in the country looked set to end.

Emerging markets

The MSCI Emerging Markets (EM) index modestly underperformed the MSCI World. Latin American equities enjoyed a strong quarter. Peru was bolstered by confirmation of the country’s status in the MSCI EM index and a successful presidential election. Brazil was also sharply up, as President Dilma Rousseff was formally suspended on impeachment charges. Vice-president Michel Temer took charge and announced a series of policy measures which were well received by the market. Temer also appointed a new cabinet and changed the head of the central bank. Returns were magnified by an 11.8% rally in the real. Mexico was the only regional market to finish in negative territory with a 5.5% depreciation in the Mexican peso weighing on returns.

In emerging Asia, the Philippines was the strongest market with gains primarily attributable to the presidential election victory of populist Rodrigo Duterte. Elsewhere, India posted a solid gain and outperformed as the central bank cut rates by 2bps to 6.5%. China modestly underperformed as stimulus measures announced in Q1 appeared to wane. Malaysia was the weakest regional market.

Emerging EMEA equities were more mixed. Russia outperformed, with a 25.5% rise in the price of Brent crude boosting local equities, and the rouble which advanced 4.8% relative to the US dollar. Moreover, the central bank cut interest rates by 50bps to 10.5%, as inflation eased. The central European markets of Hungary, Czech Republic and Poland all underperformed amid uncertainty over the impact of Brexit. Poland lagged by a wide margin, with domestic politics weighing heavily on sentiment, in particular the prospect for pension reform. Greece and Turkey, where the prime minister resigned and was replaced by a minister loyal to President Erdogan, also lagged.

Global bonds

Markets made a confident start to Q2, with much of the momentum from March’s recovery carrying into April and May. Positive economic data releases in developed markets combined with ongoing policy support from most global central banks to form an upbeat start to the quarter. However, the UK’s EU referendum in late June ultimately overshadowed other market drivers by the end of Q2. The “Leave” vote from the UK took many investors by surprise; the number of positions built in anticipation of a “Remain” vote exacerbating market volatility in the days immediately after the result. Sterling fell by over 11% on 24 June, while government bond yields were sharply lower.

The 10-year gilt yield fell from 1.42% at the end of March to 0.87% by the end of Q2, with much of the decline attributable to the final days of June. The 10-year US Treasury yield fell less sharply, but dropped from 1.77% to 1.47%. The 10-year Bund yield declined from 0.15% to -0.13%. Yield movements in the eurozone periphery balanced the more uncertain economic backdrop with expectations of more policy accommodation from the

European Central Bank. The Italian 10-year yield rose 2bps in Q2 to 1.26% as the Spanish equivalent fell from 1.44% to 1.16%.

The BofA Merrill Lynch Global Corporate index generated a positive total return in Q2 of 3.0% and excess returns over government bonds of 0.7%. Across investment grade[2] US dollar, euro and sterling credit markets, only sterling credits generated negative excess returns in Q2 (-0.2%). The BofA Merrill Lynch Global High Yield index generated positive total returns of 5.1% (in local currency).

Convertible bonds showed a significant level of protection against equity market volatility throughout the second quarter. The Thomson Reuters Global Focus index, as the main measure for balanced convertible bond strategies, lost -0.59% in US dollar terms. After the strong correction in convertible bond valuations in the first quarter, convertible bond pricing remains cheap. On a regional level, Japan stays the most undervalued market with just a minor uptick towards the end of the quarter. At the same time, European convertibles cheapened after the UK referendum to leave the EU.

[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 Q2 2016

	3 months			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	3.82	1.21	8.82	-1.91	-2.20	15.07
MSCI World Value	4.30	1.68	9.33	-2.63	-2.91	14.22
MSCI World Growth	3.34	0.75	8.32	-1.22	-1.51	15.88
MSCI World Smaller Companies	4.38	1.76	9.41	-3.03	-3.31	13.76
MSCI Emerging Markets	3.39	0.80	8.38	-11.46	-11.72	3.87
MSCI AC Asia ex Japan	3.10	0.51	8.07	-11.46	-11.72	3.86
S&P500	5.09	2.46	10.16	4.30	3.99	22.34
MSCI EMU	-2.23	-4.68	2.48	-11.01	-11.27	4.39
FTSE Europe ex UK	-0.59	-3.08	4.20	-9.60	-9.86	6.05
FTSE All-Share	-0.11	-2.62	4.70	-12.87	-13.12	2.21
TOPIX*	4.07	1.46	9.08	-6.66	-6.93	9.50

	3 months			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	4.91	2.27	9.96	7.10	6.79	25.63
JPM GBI UK All Mats	1.70	-0.85	6.60	-2.48	-2.76	14.39
JPM GBI Japan All Mats**	15.77	12.86	21.35	31.53	31.15	54.29
JPM GBI Germany All Mats	2.90	0.31	7.85	8.49	8.17	27.26
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	4.80	2.17	9.85	6.15	5.84	24.52
BofA ML US Corporate Master	6.17	3.50	11.28	7.69	7.38	26.32
BofA ML EMU Corporate ex T1 (5-10Y)	2.00	-0.56	6.92	6.64	6.34	25.10
BofA ML £ Non-Gilts	-0.64	-3.13	4.15	-7.18	-7.45	8.88
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	7.14	4.45	12.30	2.51	2.21	20.25
BofA ML Euro High Yield	1.73	-0.83	6.63	2.45	2.15	20.18

Source: DataStream. Local currency returns in Q2 2016: *-7.39%, **3.02%.