Issued in August 2016

Schroders

Monthly markets review

Overview of markets in July 2016

Highlights:

- Equity markets recovered following June's Brexit-related sell-off as investors were reassured by the accommodative rhetoric from central banks and prospects for fiscal stimulus.
- US equities advanced against a backdrop of mixed macroeconomic data and some strong quarterly earnings, particularly from the technology sector.
- Eurozone equities posted positive returns, supported by some good corporate results and reassuring macroeconomic data. Banks continued to dominate the headlines ahead of the month-end stress tests.
- UK equities gained as the political picture stabilised following the Brexit vote with Theresa May becoming the new prime minister.
- Japanese equities gained despite a stronger yen over the month. Expectations grew surrounding the prospect of increased fiscal stimulus.
- Emerging markets outperformed amid expectations that the supportive liquidity environment was set to continue. Brazil generated a solid gain although China lagged.
- In fixed income, US and UK sovereign bond yields continued to fall.

US

US equities ended July higher with the S&P 500 ahead by 3.7%, achieving new all-time highs. Economic data was mixed in a month which began with much better-than-expected non-farm payrolls and ended with disappointing second-quarter GDP data. Amidst these conflicting signals regarding the resilience of the US economic recovery, market expectations waxed and waned as to when - or indeed if - the Federal Reserve (Fed) might further tighten monetary policy.

The beginning of the month was characterised by uncertainty in the wake of the UK's decision to leave the European Union, and the ensuing volatility it caused across global markets. Comments by Fed officials following the unexpected result saw expectations for additional rises in US interest rates significantly pushed out. In the event, the Federal Open Market Committee (FOMC) decided at its 26-27 July meeting that the near-term risks to the economic outlook had diminished, suggesting it was more relaxed about any potential wider referendum implications.

At the same time the FOMC kept open the possibility of a further increase in rates in 2016 as it highlighted the recovery in the US labour market, which had been underlined by the better-than-expected June non-farm payrolls. But the more hawkish mood was subdued by news that the US economy had only grown 1.2% in the second quarter after investment fell and as companies ran down their inventories. There were also downward revisions to first and fourth-quarter GDP, raising new questions as to the resilience of the US recovery.

The technology sector led the market higher in July, with Alphabet and Amazon performing particularly well after announcing strong second-quarter results. This offset a poor performance from the energy sector as crude oil prices declined and amid weak second-quarter results from the large integrated oil and gas groups.

Eurozone

European equities registered positive returns in July, supported by a positive start to the second quarter earnings season. There was also some encouraging forward-looking macroeconomic data, suggesting resilience despite the UK's Brexit vote.

The top performing sectors for the month were consumer discretionary and information technology (IT). In particular, the auto sector fared well after strong results from companies including Volkswagen and Peugeot. IT stocks were boosted by good results from companies including SAP and ASML. There were some signs of rotation in the market as investors sought out growth sectors, such as technology, in preference to quality sectors, which have become somewhat expensive, and value plays such as banks which are pressured by low interest rates. Banks, particularly Italian lenders, remained in focus amid capital concerns ahead of the latest stress test results which were published after the market close on the final day of the month. The energy sector underperformed with crude prices retreating during the month while the telecoms sector also lagged.

The flash eurozone composite purchasing managers' index (PMI) was 52.9 for July, down from 53.1 in June but comfortably in expansion territory. The German IFO business climate survey beat expectations at 108.3 although the ZEW investor confidence survey fell sharply in July. Eurozone GDP rose by 0.3% in the second quarter, a slower pace than in the first quarter. Annual inflation was estimated at 0.2% in July. The European Central Bank kept monetary policy unchanged.

UK

UK equities extended their gains following the country's decision to leave the EU as investors further anticipated the beneficial impact of a weakened currency to their predominately overseas earnings base. The market also performed well against a more stable political backdrop after rival Conservative Party leadership contenders made way for Theresa May to become the new prime minister.

While the Bank of England (BoE) did not cut interest rates, the new government signalled that austerity measures were likely to be eased, confirming that a target to restore government finances to surplus by 2020 would slip. In addition, new Chancellor of the Exchequer Philip Hammond said fiscal policy could be "reset" as economic data gave a clearer picture as to the economic consequences of the referendum. The FTSE All-Share index delivered a total return of 4.0% over the period.

The healthcare, industrials and basic materials sectors - which are all major overseas earners - performed strongly against the weak currency backdrop, and were further buoyed by some robust results, amid a generally positive second-quarter earnings season. Merger & acquisition activity acted as an additional support to the market, with Japan's SoftBank making an approach for FTSE 100 semiconductor design specialist ARM Holdings.

Many of the UK-focused sectors rebounded strongly following their sharp falls in the wake of the unexpected referendum result, including the financials, housebuilders and travel and leisure companies. This was reflected in a recovery in the mid caps, as the FTSE 250 (ex investment trusts) rose 6.2% over the month, recouping almost all the losses that it incurred following the Leave vote. On the negative side, the oil & gas sector performed poorly as crude oil prices retreated and amid mixed second-quarter results from the integrated majors.

Japan

The Japanese stockmarket recovered from its June sell-off, rising 6.2% in July. Although the sharpest daily gains during the month coincided with yen weakness, it was encouraging that the market advance was maintained despite the yen actually strengthening for the month as a whole. The sector and style trends seen in recent months reversed sharply from early July. Financial stocks including insurance, securities and banks outperformed the market significantly, having been out of favour for much of the last twelve months. Meanwhile, previously leading sectors such as foods, retail and telecommunications underperformed. The weakest sectors in absolute terms were oil & coal and air transport. The "other products" sector was among the top performers, driven by Nintendo which has a minority stake in the recently released "Pokémon Go" game for smartphones.

The Upper House elections resulted in a convincing win for Prime Minister Abe. His stronger mandate was seen to clear the path not only for increased fiscal stimulus to be announced in the short term but also for more focus on longer term structural reforms. The renewed emphasis on fiscal stimulus came at an opportune time as there was a growing belief among investors that the Bank of Japan's (BoJ) monetary expansion has largely run its course and cannot, in isolation, deliver on the central bank's 2% inflation target. Although there were widespread expectations for further easing ahead of the BoJ's policy meeting at the end of July, in the event there was only limited expansion of the asset purchase programme and no further moves in interest rates.

Economic data showed a continuation of recent trends in the labour market, with a further decline in the unemployment rate to just 3.1% and additional expansion of job openings. Industrial production also surprised on the upside, but most measures of inflation were slightly below consensus expectations. The last few days of July also saw the start of the corporate results season for the first quarter of the financial year. So far there seem to be more positive than negative surprises. Although this partly reflects the conservative nature of initial forecasts, it may be encouraging that the impact of earlier yen strength was no worse than expected.

Asia (ex Japan)

Asia ex Japan equities delivered positive returns in July as the Brexit vote shock saw central banks globally commit to maintaining loose monetary policy, while a likely delay in the raising of US interest rates by the Fed also boosted share prices in the region. Chinese equities finished the month up as the world's second-largest economy saw GDP expand by 6.7% year-on-year in the second quarter – a slightly better-than-expected number. The widely-watched Caixin manufacturing PMI posted a June reading of 48.6, down from May's 49.2, and below the 50 mark that separates growth from contraction. However, this was offset by more positive data in the services sector which continued to show expansion, with Caixin's services PMI jumping to 52.7 in June from a 51.2 reading in May. In other areas, data were still sluggish. Both exports and imports dropped in June as soft demand both at home and abroad weighed on numbers.

In Hong Kong, stocks advanced on increased mainland Chinese buying interest in H-shares[1]. Over the strait in Taiwan, shares also saw strong gains on foreign investor inflows on the back of upbeat earnings and higher dividends. Korean stocks saw gains for similar reasons as foreign investors turned net buyers.

In ASEAN, the Philippines, Indonesia and Thailand all gained as global monetary easing and the likely delay in the next interest rate hike by the Fed boosted sentiment for shares. Meanwhile, Indian equities also advanced on expectations of more policy easing by the Reserve Bank of India and as hopes were high that a much-needed goods and services tax bill will be passed.

Emerging markets

Expectations for a supportive liquidity environment for longer proved beneficial for emerging markets in July. The MSCI Emerging Markets (EM) index recorded a strong return to outperform the MSCI World.

Egypt was the best performing index market. The country has entered negotiations with the International Monetary Fund (IMF) regarding a reputed $21 billion loan over three years. South Africa outperformed, boosted by a rally in the rand. The expected deferral of global interest rate hikes was positive given the country's high current account deficit. Turkey was the weakest emerging EMEA market, and the lira lost value against the US dollar after elements of the military launched a coup. The attempt failed and President Erdogan remains in power. However, a state of emergency was declared and the government detained around sixty thousand people.

In emerging Asia, Thailand was the strongest market with banking stocks among the better performing names. The country holds a referendum on a new constitution in early August. China recorded a positive return but underperformed. Both official and Caixin PMI manufacturing releases showed deterioration, whilst exports were also modestly weaker. The Philippines was the weakest market, but finished in positive territory.

Latin American equity markets were more mixed. Brazil generated a solid gain and outperformed as President Rousseff's impeachment trial drew near. Peru slightly outperformed. Minas Buenaventura was the strongest market stock, boosted by ongoing improvement in precious metals prices. Colombia was the weakest regional market. Lower crude oil prices were the key factor behind market declines and this was reflected in the peso, which lost 4.9% relative to the US dollar. Concerns over rising inflation led the central bank to hikes its benchmark rate 25bps to 7.5%.

[1] H-shares are shares of a company incorporated in mainland China that are traded on the Hong Kong stock exchange.

Global bonds

In July, as June's Brexit-led volatility began to ebb, bond investors returned to the more familiar ground of assessing central bank activity and potential policy alterations. In practice, little changed in the policy backdrop, but speculation surrounding policy accommodation or additional stimulus measures was rife. In Japan, the central bank left its existing stimulus package largely unchanged – the decision coming as something of disappointment to some investors – but expectations of significant fiscal stimulus later this year increased. The Bank of England (BoE) also kept rates on hold, commenting that it was too soon to see the referendum result's impact upon the economy. Nonetheless, markets saw the possibility of a BoE rate cut in 2016 as higher. The Fed did not change its target base rate in July, citing benign inflation prints.

The 10-year Treasury yield fell 2 basis points (bps) to 1.45% in July. The 10-year Bund yield rose 1 bps to -0.12%. In the UK, the 10-year rate moved more significantly, dropping from 0.87% to 0.69%. In Japan, the 10-year government yield rose from -0.22% to -0.19% and the rise continued into the first trading days of August.

Corporate bond markets were largely positive in both total and excess return terms in July. The investment grade[2] (IG) BoA Merrill Lynch Global Corporate index generated total returns of 1.6% and outperformed government bonds by 1.2%. The BofA Merrill Lynch Global High Yield index gained 2.5% in total returns and generated excess returns of 2.4%. Sterling credit indices recovered from a difficult June and were also bolstered by the prospect of the BoE's interest rate cut. Investment grade bonds generated total returns of 5.2% to outperform sterling high yield bonds which returned 3.6%.

In emerging market bonds, all three of the principal market components generated positive returns, as the Fed's inclination towards policy tightening seemed to recede in the short term. The US dollar sovereign index (JP Morgan EMBI Global Diversified) rose 1.8% for the month. Local currency bonds (JP Morgan GBI-EM Global Diversified Composite) rose a modest 0.6% in July while emerging market corporate issues (CEMBI Diversified Broad Composite) rose 1.6%.

[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. Investors cannot invest directly in any index.

Overview: total returns (%) – to end of July 2016

	1 month			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	3.57	4.25	4.97	-1.07	0.13	17.69
MSCI World Value	3.10	3.78	4.49	-1.32	-0.12	17.39
MSCI World Growth	4.04	4.72	5.44	-0.84	0.37	17.97
MSCI World Smaller Companies	4.84	5.53	6.25	1.24	2.47	20.44
MSCI Emerging Markets	4.40	5.09	5.81	-1.57	-0.38	17.09
MSCI AC Asia ex Japan	4.21	4.89	5.61	-2.37	-1.18	16.15
S&P500	3.01	3.69	4.40	4.35	5.61	24.13
MSCI EMU	5.13	5.83	6.55	-10.65	-9.56	6.30
FTSE Europe ex UK	4.02	4.70	5.42	-10.00	-8.91	7.06
FTSE All-Share	2.63	3.30	4.01	-12.73	-11.67	3.82
TOPIX*	5.60	6.29	7.02	-2.78	-1.60	15.66

	1 month			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	-0.22	0.43	1.12	4.94	6.22	24.84
JPM GBI UK All Mats	0.65	1.31	2.01	-3.54	-2.37	14.75
JPM GBI Japan All Mats**	-1.52	-0.87	-0.19	29.63	31.21	54.21
JPM GBI Germany All Mats	0.13	0.78	1.48	7.00	8.30	27.29
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	1.04	1.70	2.40	6.03	7.32	26.13
BofA ML US Corporate Master	0.78	1.44	2.14	7.04	8.34	27.33
BofA ML EMU Corporate ex T1 (5-10Y)	2.20	2.87	3.58	7.25	8.56	27.59
BofA ML £ Non-Gilts	2.86	3.53	4.24	-6.00	-4.85	11.83
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	1.87	2.54	3.24	4.00	5.27	23.73
BofA ML Euro High Yield	2.22	2.89	3.60	3.53	4.79	23.16

Source: DataStream. Local currency returns in July 2016: *6.18% **-0.97%. 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.