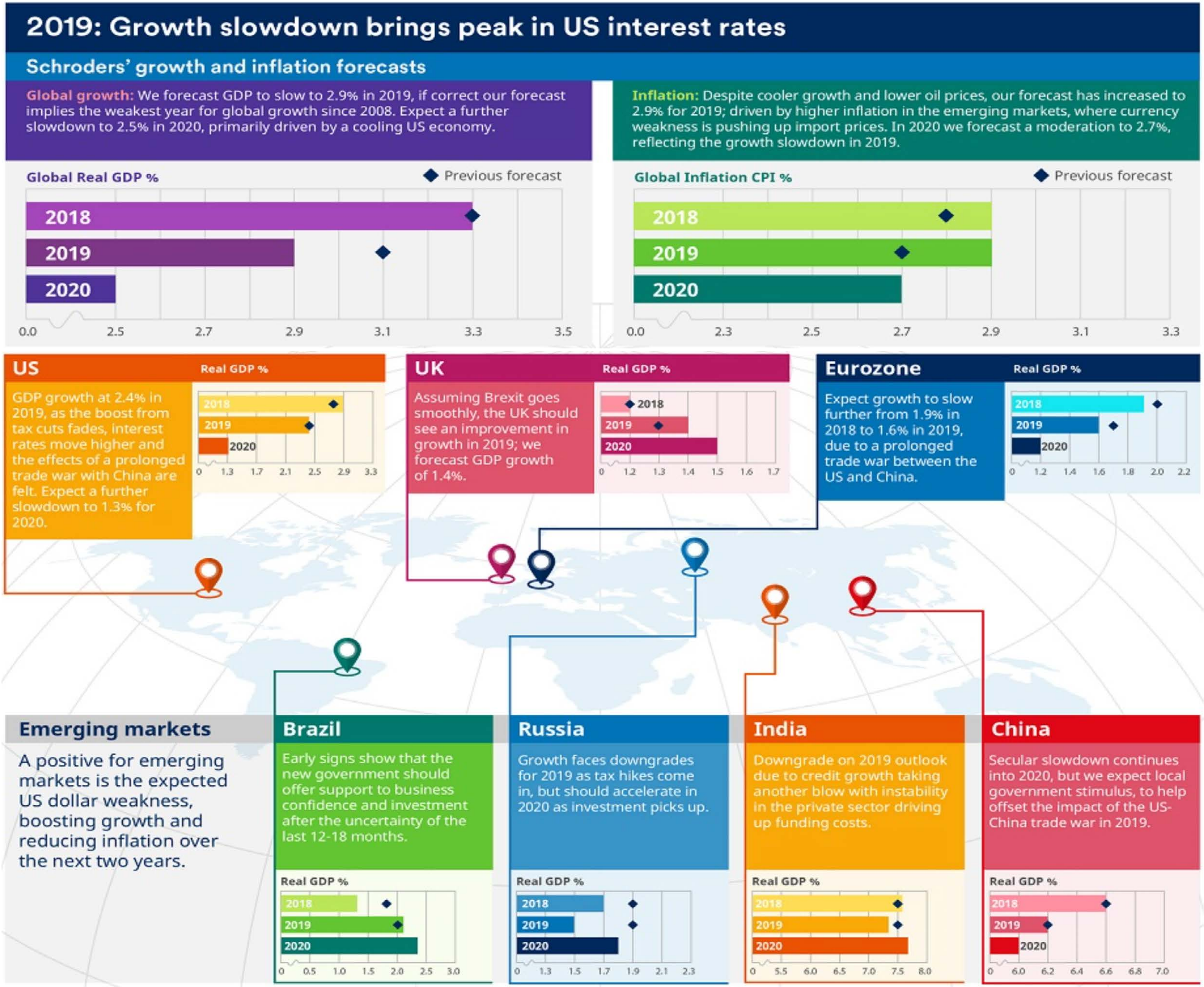
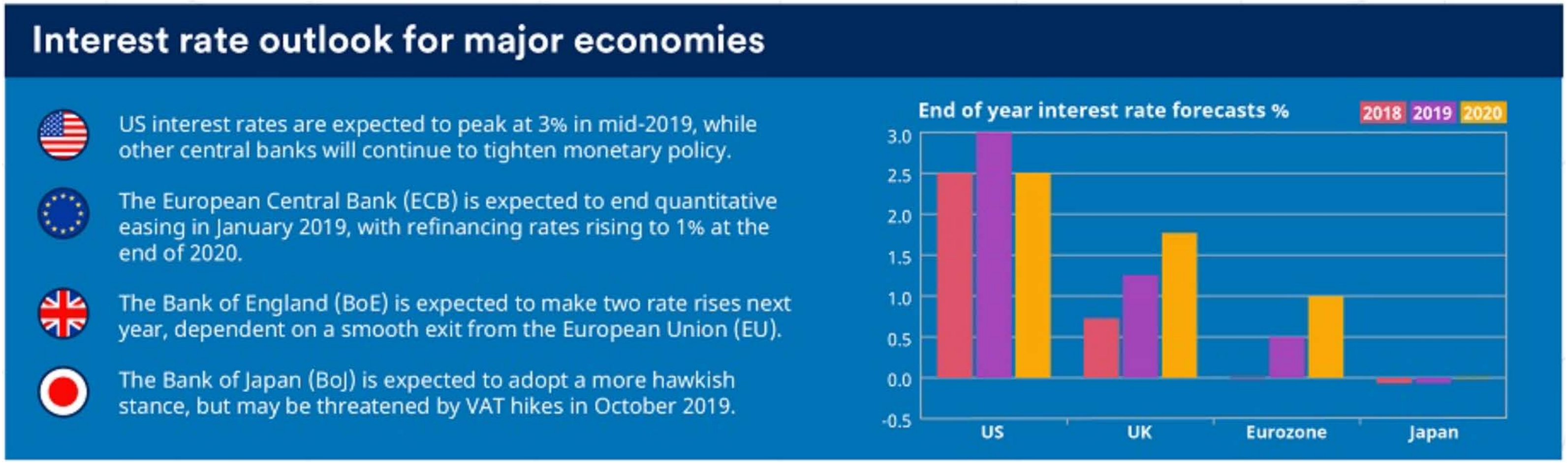
MARKET COMMENTARY DECEMBER 2018

FINURA

INFOGRAPHIC: THE GLOBAL ECONOMY





Source: [Schroders as at December 2018.]

MULTI-ASSET INVESTMENT VIEWS

KEY

▲ Up from last month ▼ Down from last month

Positive | Postive/ Neutral | Neutral | Neutral/ Negative | Negative

	Category	View	Comments
Main Asset Classes	Equities	Postive/Neutral	Our models suggest valuations for equities are turning more reasonable after recent corrections. However, some caution is warranted. Improving (lower) valuations often come with worsening momentum and increasing volatility.
	Goverment Bonds	Neutral/Negative	The economic picture has deteriorated amid disappointing data, but we think that government bonds have rallied too far, leaving valuations expensive.
	Commodoties	Postive/Neutral	Expected return from commodity futures has fallen back to its historic average. We like gold as a hedge against further economic weakness.
	Credit	Neutral/Negative	November saw spreads – the amount of yield above government bonds - widening across sectors in all regions, continuing a pattern of weakness in credit for the year to date.
Equities	US	Postive/Neutral	Although earnings revisions have deteriorated, our expectations for earnings and revenue growth for next year are still supportive of the region.
	Europe	Neutral	With the US dollar downgrade, a resulting stronger euro may become a headwind for European equities. The region's political and economic climate remains fragile.
	UK	Neutral	Momentum and economic indicators are both close to neutral levels, so we remain slightly cautious on the UK equities.
	Japan	Postive/Neutral	Productivity is improving, deflation may be over and private company investment (capex) is rising, so we believe Japanese equities offer an attractive proposition for equity risk.
	Pacific ex-Japan	Neutral	Ongoing trade war developments, together with local country-specific risk factors, pose a threat to profits, but as valuations become more attractive, we keep a neutral stance.
	Emerging Markets	Postive/Neutral	Valuations are, in our view, attractive especially following the significant sell-off so far this year. A more stable dollar could be a catalyst for a stronger EM earnings story in coming months.
Government Bonds	US	Neutral/Negative	Data has disappointed, but we think the market has overshot to become too dovish. Treasuries can still be a useful diversifier against an economic slowdown.
	UK	Neutral ▲	Brexit uncertainty means the range of possible outcomes is still very wide – the Bank of England could be hiking or cutting next year.
	Germany	Neutral ▲	Whilst valuations look high, the steep yield curve and disappointing data mean that investors will likely continue to own Bunds, thus tempering any negative view.
	Japan	Neutral	Mixed growth data amid the absence of significant inflation pressures will likely leave the Bank of Japan on hold for some time. Japanese government bonds are in the middle of the Bank of Japan's range.
	US Inflation Linked	Neutral ▼	We are now neutral on US inflation, as a lower oil price weighs against the late cycle effects of tightening capacity.
	Emerging Markets Local	Neutral	Cyclical headwinds continue to prevent us from taking advantage of the improvement in local market valuations.

	Category	View	Comments
Investment Grade Corporate Bonds	US	🟠	Fundamentals are continuing to weaken and the relatively low quality composition of the market makes it vulnerable to further spread widening.
	Europe	🟠	Fundamentals have been relatively strong but the region remains buffeted by political and trade headwinds, weighing on projected earnings at a time when supply exceeds demand.
	Emerging Markets USD	🟡	We believe that the regional mix and underlying path of earnings marginally favours investment grade emerging market corporate bonds over their high yield counterparts.
High Yield Bonds	US	🟠	We expect the supply/demand situation in US high yield to deteriorate and maintain our view that it is overpriced and vulnerable.
	Europe	🟠	The European market is due a period of readjustment from what remain extraordinarily low levels of yield as conditions start to normalise.
Commodoties	Energy	🟡	Without oil production cuts or unpredictable supply shocks (e.g. Iran, Libya and Venezuela), supply and demand looks well balanced.
	Gold	🟢 ▲	Gold continues to show safe-haven characteristics as equity volatility rises and bond yields fall, but any further strength in the US dollar remains a headwind.
	Industrial Metals	🟡 ▼	Investor sentiment remains cautious awaiting concrete evidence for trade details, and of Chinese infrastructure stimulus and growth stabilization.
	Agriculture	🟢	We remain positive given attractive fundamentals and scope for further recovery should trade war resolutions materialise.
Currencies	US $	🟡 ▼	We expect softer US activity to translate into lower rates, providing an important liquidity boost for the rest of the world and a flatter dollar.
	UK £	🟡	The Prime Minister winning her no-confidence vote is a sign the chance of a no-deal Brexit has fallen, but would need parliament approval / Second referendum to add to sterling.
	EU €	🟡 ▲	Upgraded on the basis of expecting a flattish USD, as well as some tentative signs of recovery.
	JAP ¥	🟢 ▼	We were too optimistic on JPY, given that valuation is not extreme. Continue to expect monetary policy convergence to drive JPY next year.
	Swiss F	🟡	We expect the Swiss National Bank Governing Board to leave monetary policy unchanged, only raising interest rates when euro-area policy makers begin to hike.

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.
Source: Schroders, December 2018. The views for equities, government bonds and commodities are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). The views for currencies are relative to US dollar, apart from US dollar which is relative to a trade-weighted basket.

MARKETS REVIEW

A look back on markets in Q4 when global equities suffered steep declines amid persistent worries over trade and economic growth.

HIGHLIGHTS

- Global equities posted sharp declines in Q4 on persistent concerns over global trade and slowing economic growth. Government bond yields generally fell (i.e. prices rose), reflecting the broad uncertainty.
- US equities declined, with especially steep falls in December. The Federal Reserve raised rates, as expected. Warnings from several high profile IT firms fanned fears that earnings growth may slow.
- European equities also declined, with trade tariffs, slower Chinese growth and Brexit combining to form a difficult environment. Data continued to point to slowing momentum in the eurozone economy.
- The FTSE All-Share fell over the period, with global developments setting the tone for the market. Sterling fell in response to political noise around Brexit, with worries of a "no deal" departure from the EU coming to the fore again.
- Japanese equities lost value, with weakness coinciding with periods of yen strength as the currency continued to be viewed as a safe-haven at times of increased uncertainty.
- Emerging markets equities lost value with the familiar array of global trade and growth concerns weighing on returns. Brazilian equities and the real rallied ahead of the market-friendly election outcome; confirmed in late October.
- Bond yields were lower (i.e. prices rose) over the quarter, broadly reflecting increased risk aversion and volatility amid continued macro uncertainty relating to trade tensions, Brexit and politics in Italy.

THE US

US equities declined materially in Q4 - with especially steep falls in December - due to fears over economic momentum and slower earnings growth. The US-China trade dispute also continued to hamper investor optimism. The large cap S&P 500 index outperformed the small & mid cap Russell 2500 index (-16.7%), but still declined by -13.5%.

The Federal Reserve (Fed) raised interest rates in December on continued stability in economic data. The labour market remained extremely strong. However, the central bank grew otherwise more dovish in tone, signalling a more cautious view for coming months. It has revised down its "dot plot" (median rate projection), meaning it now expects two rate increases in 2019 instead of three previously, reflecting more cautious economic forecasts. GDP growth forecasts were revised down in 2018 and 2019, with inflation projections also adjusted downwards.

Warnings from several high profile firms – particularly in information technology (IT) and most notably from Apple - also fanned fears that earnings growth may slow. IT was amongst the quarter's weaker sectors, while energy names struggled with expectations of softer China demand that weighed on oil prices. Less economically-sensitive sectors, such as utilities, generally performed better although most areas of the market lost ground.

EUROZONE

It was a poor quarter for equities and Europe was no exception with the MSCI EMU index returning -12.7%. Worries over rising US interest rates, trade tariffs, slower Chinese growth and Brexit continue to combine to form a difficult environment for higher risk assets like shares. The defensive sectors of communication services and utilities – often perceived as safe havens – were the only sectors to register a positive return. Materials and information technology were among the worst performing sectors. The period included the third quarter earnings season with company results greeted with sharp share price swings, even in cases where earnings met market expectations. Several carmakers warned that slower demand and delays to new emissions tests would weigh on their full-year results.

Data continued to point to slowing momentum in the eurozone economy. The flash composite purchasing managers' index[1] for December showed business activity slowed to the weakest level in over four years. The index came in at 51.3, down from 52.7 in November. The "gilets jaunes" protests in France and ongoing weak demand for new cars were among the factors weighing on activity. As expected, the European Central Bank confirmed the end of its bond-buying programme in December and reiterated that interest rates would remain on hold "at least through the summer of 2019".

December saw the end of the long-running dispute over Italy's 2019 budget. The Rome government agreed to delay some spending measures, meaning 2019's budget deficit will be 2.04% compared to the 2.4% initially envisaged. However, the agreement failed to quell concerns about the health of the country's banks and financials were weak in the quarter.

UK

The FTSE All-Share retreated 10.2% over the period, falling sharply, inline with global equities. It was one of the worst quarters for global equities in many years as fears over the outlook for the world economy came to a head against the backdrop of tightening global monetary conditions, US-China trade tensions and European political uncertainty. Many UK domestic-focused sectors also performed poorly as worries of a "no deal" exit from the EU intensified after the UK published its draft EU Withdrawal Agreement (endorsed by EU leaders) which triggered another period of intense political uncertainty.

Several senior and junior ministers resigned in protest at the Withdrawal Agreement, raising questions over the stability of the UK government, and the final parliamentary passage of the deal. The prime minister struggled to gain sufficient support from parliament for the agreement in its initial form, with one of the main issues being the backstop arrangement to avoid a hard border between Northern Ireland and the Irish Republic. A "meaningful vote" on the agreement was deferred until January, in turn sparking a no confidence vote in the PM's leadership of the Conservative Party, which she won by 200 to 117.

Despite the uncertainty, and the risk of a UK recession in the event of a "no deal", the economy continued to recover from the very poor start to 2018. UK Q3 GDP growth came in at 0.6% quarter-on-quarter as expected, up from 0.4% in Q2 and the fastest pace since Q4 2016. More recent data, however, has been volatile: UK retail sales disappointed in October, falling -0.5% month-on-month, but bounced back very sharply in November, increasing by 1.4% month-on-month, which was significantly above consensus expectations. UK households enjoyed an acceleration in wage growth and lower inflation over the period.

JAPAN

The Japanese equity market reflected the deterioration in global sentiment, and ended the quarter down -17.6%. Weakness was particularly concentrated in October and late December, which coincided with periods of yen strength as the currency continued to be viewed as a safe-haven at times of increased uncertainty.

From Japan's perspective, very little actually changed during the quarter. The Bank of Japan's regular policy committee meetings resulted in no change to monetary policy, as expected. Economic news was somewhat mixed, but all the data needs to be viewed in the context of a succession of natural disasters in Japan which caused some slowdown in activity followed by a relatively strong rebound in subsequent months. After a long run of incremental positive data, there are now some signs that the rate of improvement in the labour market may be peaking out. One surprise during the quarter was the earlier than expected confirmation that the next increase in consumption tax will go ahead as planned in October 2019.

There was little fresh corporate news for investors after the quarterly results announcements. However, Softbank, the communications conglomerate, did complete a significant initial public offering of its Japanese mobile phone arm, despite the poor market environment. Nissan also grabbed the headlines following the arrest of Carlos Ghosn and his subsequent removal from his position as chairman of the company. Away from the spotlight, however, Japanese companies have announced record levels of share buybacks in the wake of their interim results, as the trend towards better shareholder returns continues.

ASIA (EX JAPAN)

Asia ex Japan equities extended their losses in a volatile quarter for world markets. The MSCI Asia ex Japan index recorded a negative return, though it outperformed the MSCI World index. Persistent concerns over the US-China trade conflict and the pace of US interest rate hikes dominated sentiment. The darkening global economic outlook further troubled investors. Notably, China's economy recorded its weakest quarterly growth since the global financial crisis. Industrial production and retail sales also slowed more than expected, heightening growth concerns. Policymakers responded with measures to support the economy, including cutting banks' reserve requirement ratios and boosting credit for small and private companies.

Across the region, export-oriented markets Taiwan, South Korea and China posted sharp declines. Taiwanese and South Korean stocks were dragged lower by steep falls in technology heavyweights. In China, healthcare and energy were the worst performing sectors. Hong Kong equities retreated but outpaced the region as strong gains in consumer staples stocks helped mitigate losses.

Meanwhile, the plunge in crude oil prices lifted some net oil importers; Indonesia, the Philippines and India bucked the downtrend to close higher. The Indonesian rupiah was also buoyed by Bank Indonesia's surprise interest rate increase. In India, a widening rift between the government and the Reserve Bank of India culminated in the unexpected resignation of the central bank governor. A former civil servant was appointed as the new head of the central bank.

EMERGING MARKETS

Emerging markets lost value in Q4 as the US-China trade dispute persisted and concerns over global growth increased. The MSCI Emerging markets index decreased in value but outperformed the MSCI World.

Mexico was among the weakest index markets as rising concern over the incoming government's policies, and the implications for investment, led to a sell-off in equities and the peso. A series of public consultations were held during the quarter, the most notable of which rejected the building of a new airport in Mexico City (which is already one-third complete).

The Asian EM of Taiwan, South Korea and China all underperformed with a combination of trade uncertainty, disappointing corporate earnings and technology cycle concerns a headwind. In China, Q3 GDP growth by more than expected to 6.5% YoY while higher frequency data continued to deteriorate and the authorities announced further measures to support the economy. Elsewhere, a sharp fall in crude oil prices was a headwind for several oil producing EM, notably Colombia but also Russia.

By contrast, Brazil posted a strong gain as equities and the real rallied in anticipation of a market-friendly election outcome, which was confirmed with Jair Bolsonaro's run-off victory in late October. Several markets sensitive to external pressures also posted gains, including Indonesia and India, which benefited from the decline in crude oil prices.

GLOBAL BONDS

Bond yields were lower over the quarter, broadly reflecting increased risk aversion and volatility amid continued macro uncertainty relating to trade tensions, Brexit and politics in Italy. Comments from Fed Chair Jerome Powell indicated a slightly dovish shift though the Fed implemented the fourth rate rise of the year in December. US 10-year Treasury yields fell from 3.06% to 2.68%.

In Europe, 10-year Bund yields declined from 0.47% to 0.24% as data remained lacklustre. At its final meeting of the year, the ECB confirmed it would end its bond purchase programme, but downgraded its growth and inflation forecasts for the year. Italian 10-year yields were volatile, but overall fell from 3.15% to 2.74% as the government reached an agreement with the EU on the budget, having reduced its fiscal deficit target to 2.04% (previously 2.40%).

Brexit uncertainty was heightened as the announcement of a Withdrawal Agreement between the UK and EU drew widespread criticism. Prime Minister Theresa May took a last minute decision to postpone the parliamentary vote on the deal and soon after survived a confidence vote. Ten-year gilt yields fell from 1.57% to 1.28%.

Corporate bonds had a challenging quarter and underperformed government bonds. A deterioration of risk sentiment led to the broad-based underperformance across investment grade[2] credit sectors relative to government bonds. High yield (HY) was weak, led down by the energy sector, particularly in the US.

Emerging markets (EM) bonds saw performance improve as the quarter progressed with US dollar strength waning and currencies of oil exporters benefiting from weaker energy prices.

The MSCI World index lost 13% over the quarter. Balanced convertible bonds, as measured by the Thomson Reuters Global Focus hedged US dollar index, ended the quarter with a loss of -4.7% and hence protected investors from 65% of the equity downside. With equity market losses, the characteristics of the convertibles market changed once more and many of these securities are trading much closer to par value with significant upside. At the same time, valuations of convertibles bonds cheapened slightly. European convertibles remain slightly overvalued while discounts can be found in Asia and Japan.

COMMODITIES

The S&P GSCI Index fell sharply, primarily due to the large decline in the energy component. Crude oil prices declined heavily on concerns of oversupply in the face of a weakening outlook for global demand. The industrial metals component was also weaker, as deteriorating Chinese macroeconomic data weighed on demand expectations. Wheat and cotton prices fell but cocoa and sugar recorded positive returns. Precious metals prices posted solid gains as global growth concerns spurred demand for traditionally safe-haven assets.

[1] The eurozone purchasing managers' index is produced by IHS Markit and based on survey data from around 5,000 companies based in the euro area manufacturing and service sectors. A reading above 50 indicates expansion.

[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.

Source: Schroders, December 2018: 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.

TOTAL RETURNS (%) – TO END DECEMBER 2018

	3 MONTHS			12 MONTHS		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	-13.4	-12.0	-11.4	-8.7	-4.1	-3.0
MSCI World Value	-11.3	-9.8	-9.1	-10.8	-6.3	-5.2
MSCI World Growth	-15.4	-14.1	-13.4	-6.7	-2.0	-0.9
MSCI World Smaller Companies	-17.7	-16.4	-15.8	-13.9	-9.5	-8.5
MSCI Emerging Markets	-7.5	-6.0	-5.3	-14.6	-10.3	-9.3
MSCI AC Asia ex Japan	-8.7	-7.2	-6.5	-14.4	-10.1	-9.3
S&P500	-13.5	-12.1	-11.5	-4.4	0.4	1.6
MSCI EMU	-14.1	-12.7	-12.1	-16.9	-12.7	-11.7
FTSE Europe ex UK	-13.0	-11.6	-10.9	-14.8	-10.5	-9.5
FTSE All-Share	-12.3	-10.9	-10.3	-14.8	-10.5	-9.5
TOPIX*	-14.7	-13.3	-12.7	-13.7	-9.4	-8.4

	3 MONTHS			12 MONTHS		
Government Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	2.7	4.3	5.1	0.8	5.9	7.1
JPM GBI UK All Mats	-0.3	1.3	2.1	-5.3	-0.5	0.6
JPM GBI Japan All Mats**	5.2	6.9	7.7	3.8	9.1	10.3
JPM GBI Germany All Traded	-0.0	1.6	2.4	-2.6	2.3	3.5
Corporate Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	-0.8	0.8	1.6	3.5	1.4	2.5
BofA ML US Corporate Master	-0.0	1.6	2.4	-2.2	2.7	3.8
BofA ML EMU Corporate ex T1 (5-10Y)	-2.3	-0.7	0.0	-6.5	-1.8	-0.7
BofA ML £ Non-Gilts	-2.3	-0.7	0.0	-7.3	-2.6	-1.6
Non-investment Grade Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	-3.8	-2.3	-1.5	-3.3	1.5	2.7
BofA ML Euro High Yield	-5.1	-3.6	-2.9	-8.3	-3.6	-2.5

Source: DataStream.
Local currency returns in Q4 2018: *-17.6%, **1.6%.
Past performance is not a guide to future performance and may not be repeated.

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