FINURA

MARKET COMMENTARY
OCTOBER 2018

MULTI-ASSET INVESTMENT VIEWS - OCTOBER 2018

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 ▲	We have upgraded equities as valuations have improved and investor attention is moving away from trade wars and towards fundamentals.
	Goverment Bonds	Neutral/Negative	We remain negative on duration, although the recent rise in yields has taken valuations closer to fair levels. Growth is robust and inflation pressures are slowly rising.
	Commodoties	Postive/Neutral	The cyclical environment remains positive from a top-down perspective, while most underlying sectors are supported by tight supply and demand characteristics.
	Credit	Neutral/Negative	There has been a renewed tightening of spreads, although developed market investment grade has lagged.
Equities	US	Postive/Neutral	We keep a moderately positive view on US equities as they continue to demonstrate the strongest momentum in both price and earnings revisions.
	Europe	Neutral	While we expect European equities to grind out a small positive return into year-end, the market will struggle to outperform the global index.
	UK	Neutral	If Brexit uncertainty abates, sterling could recover but this is unlikely to be supportive for UK large cap stocks given their global revenue exposure.
	Japan	Postive/Neutral ▲	We have upgraded our view in recognition of the early signs of earnings recovery and relatively attractive valuations, and will look for opportunities to build up exposure.
	Pacific ex-Japan	Neutral	Trade war escalation could potentially impact growth, together with a strengthening dollar, which could also prove a headwind for profits.
	Emerging Markets	Postive/Neutral	Valuations are attractive, especially following the significant sell-off so far this year. Investors may find the strong EM earnings story attractive in coming months.
Government Bonds	US	Neutral/Negative	The recent rise in yields has taken valuations closer to fair levels, but trade war-related risks and supply/demand dynamics may lead to a steepening in the long end.
	UK	Neutral/Negative	Uncertainties around Brexit continue, and further rate hikes may not materialise until a credible Brexit plan comes to light.
	Germany	Negative	Bunds remain expensive, with no rate hikes priced until late 2019 / early 2020. Nonetheless, the recent sell-off helps, so we may reduce our underweight soon.
	Japan	Neutral	We remain neutral as we expect monetary policy to stay firm given the persistently slack inflation.
	US Inflation Linked	Postive/Neutral	We remain positive on US inflation. While seasonal effects will turn negative, our latest research suggests that stagflationary fears will trump this technical factor.
	Emerging Markets Local	Neutral	We maintain a neutral view. Despite the improvement in local market valuations, cyclical headwinds are still present.

	Category	View	Comments
Investment Grade Corporate Bonds	US		Fundamentals for bond holders are starting to weaken as shareholder friendly behaviour becomes more prevalent.
	Europe		The difficult-to-price regional political risk and spreads only modestly above long-term norms suggests maintaining the existing underweight.
	Emerging Markets USD		We maintain our view that the regional mix and path of earnings marginally favours high quality EM corporates and sovereigns over their high yield counterparts.
High Yield Bonds	US		We expect the technical 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		Oil continues to lead the commodity rally, validating our positive view given the potential for supply shocks and tight global spare capacity.
	Gold		With positions held outside the US at an all-time high (50%), we see higher sensitivity to the US dollar, which we expect to appreciate and weigh on gold prices.
	Industrial Metals		Fundamentals remain supportive given that we assume China will increase infrastructure spending and initiate policies to stabilise credit growth.
	Agriculture		Agriculture should rebound from over-sold levels.
Currencies	US $		Despite its expensive valuation, we see room for further deterioration in growth and political sentiment against a continued backdrop of liquidity tightness.
	UK £		We do not see a strong case for excessive depreciation given that hard Brexit, having emerged as a serious possibility, now appears mostly priced in.
	EU €		Our negative view is unchanged as risk for further economic slowdown persists and political tension between core and periphery is ongoing.
	JAP ¥	▲	Japanese growth remains robust and there are some signs of higher inflation, which will have an impact on Bank of Japan policy. JPY also acts as a hedge for a global slowdown.
	Swiss F		With its status as a safe haven currency, CHF should see relative outperformance vs. EUR.

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, October 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.

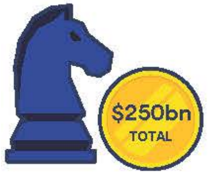
INFOGRAPHIC: THE GLOBAL ECONOMY OCTOBER 2018

Global: Will trade wars end the economic cycle?

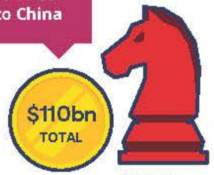
Heading for a prolonged dispute

Neither US nor China is willing to back down

Approx. 90% of US imports into China



US
Imposed additional $200bn on Chinese imports



China
Responded with additional $60bn on US imports

On its own, the trade war should not derail the economic cycle, and would need to escalate beyond US and China to have significant effect on global growth

However, combined with impact of tighter monetary policy and fading fiscal stimulus, trade wars may weigh on growth in 2019 and **end US expansion in 2020**

If the US dollar weakens, this may **offset the negative impact on emerging market equities**

Winner?

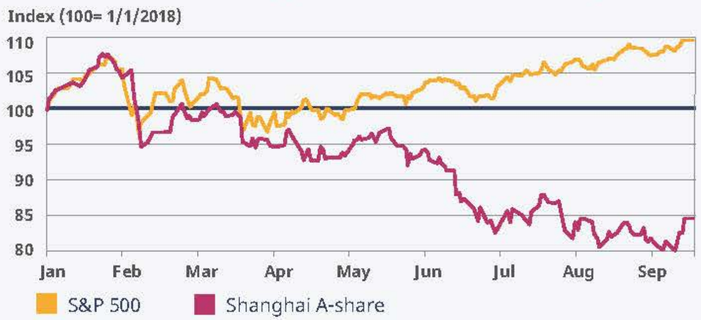
If all trade between the two nations becomes subject to tariffs, **US is likely to win**

(%) GDP affected if tariff imposed on all goods:

1% of US GDP

3.5% of Chinese GDP

Stock markets also suggest that the US is winning the trade war



Source: Thomson Reuters Datastream, Schroders Economics Group, 24 September 2018

Source: Schroders as at October 2018.

Italy: Highly indebted government remains a concern for investors

2019 budget deficit target unveiled on 27 September

Recommended budget
1.6% of GDP

Announced target
2.4% of GDP

European Commission (EC) to assess budget

from 15 October

EC likely to instruct Italy to lower target, but has little power to force them to comply

Short-term impact

Expect investors to come back to Italy **due to higher yield on bonds** which could make them attractive investments

Long-term impact

Poor demographics, lack of investment and weak productivity growth rate will make it difficult for Italy to keep public finances sustainable

Japan: Hidden slack in unemployment may keep lid on wages

2% inflation target

Bank of Japan (BoJ) policy slightly tightened

BoJ

BoJ more **concerned about side-effects of ultra loose monetary policy** and may gradually withdraw monetary stimulus despite failure in progress towards 2% inflation target

Strong wage data and low unemployment rate suggests **tight labour market**

However, hidden **slack in female participation rate** along with entrenched cultural factors should keep the lid on wage growth in long run

Unemployment at a 25-year low, at 2.5%

MONTHLY MARKETS REVIEW OCTOBER 2018

A review of markets in October when shares fell sharply amid ongoing concerns over global growth and trade.

HIGHLIGHTS

- October saw the sharpest one-month decline for global equities since May 2012. Bond markets reflected the risk-off market sentiment, with government bond yields outside the US broadly lower.
- US equities declined amid investor concerns over the durability of the economic cycle. The Federal Reserve (Fed) raised rates and indicated significant scope for further hikes.
- Eurozone equities declined. In addition to worries over global growth and trade, there was nervousness surrounding the Italian 2019 budget proposal, which was rejected by the European Commission.
- The UK's FTSE All-Share fell over the month but it outperformed global equities during a very challenging month. A number of defensive large caps bucked the market declines.
- Japanese equities fell steeply with economically-sensitive areas of the market – such as shipping – leading the declines. The yen strengthened slightly against the dollar as global uncertainty continued to increase.
- Emerging markets equities lost value. Mexico was the weakest index country with equities and the peso selling off sharply on rising concerns over the incoming government's policies. Brazilian equities rallied in anticipation of a market-friendly election outcome, confirmed at the end of the month.
- US government bond yields continued higher (i.e. prices fell) in October on positive economic data and Fed's policy trajectory. Outside the US, government yields mostly declined.

THE US

In the US, investor concerns over the durability of earnings strength and the economic cycle added to numerous ongoing geopolitical issues that have hampered markets this year, and equity markets were sharply lower. The Federal Reserve (Fed), not only raised rates in October – as expected – but indicated significant scope for further hikes. This led investors to question how much longer the historic equity bull market will continue.

In aggregate, leading economic indicators remain broadly stable but do indeed point towards more hawkish Fed policy. The US labour market remains exceptionally tight. Unemployment dropped to 3.7% from 3.9% in September; its lowest point in almost half a century. Wage growth remains robust at 2.8%. Indeed, Federal Open Market Committee notes indicate that businesses across the nation are reporting "difficulty finding qualified workers", suggesting wage growth should persist.

Softer earnings releases from tech giants Amazon and Alphabet seemed, initially, to confirm the fears over earnings strength. However, so far the Q3 earnings season continues to suggest strong corporate momentum. Through the month, traditionally cyclically-sensitive[1] sectors – such as energy and industrials - declined most noticeably. More defensive areas held up comparatively well.

EUROZONE

In common with other regional equity markets, eurozone shares had a tough October and the MSCI EMU index returned -6.5%. A combination of factors contributed to the weak returns, including tightening global financial conditions, trade concerns, the ongoing dispute over Italy's budget, and some weaker corporate earnings. Individual stock moves were very volatile over the month, particularly in reaction to earnings announcements. The weakest sectors overall in the eurozone were materials and information technology. Certain IT stocks, such as STMicroelectronics, were among those to deliver disappointing earnings. Telecommunication services was the only sector to post a positive return.

On the economic front, GDP data confirmed a slowdown in the eurozone economy, with a 0.2% quarter-on-quarter growth rate in Q3 compared to 0.4% in Q2. Forward-looking surveys also softened: the flash composite purchasing managers' index[2] for October came in at a 25-month low of 52.7, down from 54.1 in September. As expected, the European Central Bank made no change to monetary policy. It still expects to end net asset purchases by year-end and to keep policy rates unchanged at least until after summer 2019.

Italy's draft 2019 budget was rejected by the European Commission, giving a three-week deadline for Italy to respond with a new draft or potentially face fines. However, ratings agency Moody's kept the country's debt rating at investment grade, rather than downgrading to junk as some had feared.

UK

The defensive merits of the UK stock market saw it outperform global equities during a very challenging month. A number of defensive large caps bucked the market declines and as a result the FTSE 100 held up relatively well, retreating 4.9%.

Lower down the market capitalisation scale, uncertainty around Brexit and a number of stock-specific disappointments weighed heavily on returns. The FTSE 250 (ex investment companies) index fell by 7.0% and the FTSE Small Cap (ex investment companies) retreated by 7.1%. The FTSE All-Share returned -5.2%.

The UK Budget was brought forward to October in order to avoid a clash with Brexit negotiations, and the Office for Budget Responsibility (OBR) published its revised growth forecasts for the UK economy. The economic advisory body revised real GDP growth for 2018 down from 1.5% to 1.3% (primarily due to the poor weather in Q1), but upgraded forecasts further out.

The OBR said that its forecasts were predicated on an orderly departure from the EU next March. A disorderly exit would have "severe short-term implications" for the economy, the level of sterling, asset prices and public finances, although the scale of the impact would be hard to predict given the lack of a precedent, said the OBR.

JAPAN

Japanese equities fell steeply during October, ending the month the month 9.4% lower. The yen strengthened slightly against the dollar, especially in the first half of the month, as global uncertainty continued to increase. All sectors fell in October, with the declines led by shipping companies together with other economically-sensitive areas, such as steel, chemicals and machinery. The most notable feature of the market environment was the underperformance of many of the growth stocks which have led the market in recent quarters. Value stocks tended to be hit less hard in the market decline which resulted in

outperformance from many financial-related sectors, including banks.

The primary influences on equity investor sentiment appear to have been the ongoing escalation of trade issues and the anticipation of further increases in US interest rates as the Federal Reserve attempts to regulate the US economy. The abrupt short-term reversal in market leadership also suggests that a degree of unwinding was overdue in stocks with stretched valuations.

From Japan's perspective, very little actually changed during the month. The Bank of Japan's regular policy committee meeting resulted in no change to monetary policy, as expected. Economic data released during the month was somewhat mixed, with industrial production much weaker than expected, but all recent data needs to be viewed in the context of the natural disasters affecting Japan in recent months.

One surprise was the earlier than expected confirmation that the next increase in consumption tax will go ahead as planned in October 20198. In addition to a range of exemptions from the higher rate, the government is also planning a series of stimulus measures designed to mitigate the type of economic dislocation seen around previous tax increases.

ASIA (EX JAPAN)

Asia ex Japan stocks suffered sharp losses in October amid the global sell-off in equities. Markets were buffeted by fears about China's slowing economic growth and trade tensions with the US, while the pace of US interest rate hikes was another concern.

China's economy expanded by 6.5% year-on-year in the third quarter, its weakest quarterly growth since the global financial crisis. Industrial production fell in September, though retail sales growth accelerated. The central bank lowered the amount of cash that banks must hold as reserves in a bid to spur growth. Meanwhile, regulators stepped up efforts to bolster market sentiment, including supporting share buybacks and encouraging private equity funds to buy shares in listed firms. Even so, the renminbi slid against the US dollar and Chinese stocks ended the month with double-digit losses. Hong Kong equities also retreated.

In South Korea, concerns over the weakening global economic outlook weighed on its export-oriented economy. The government unveiled fresh measures to revive economic growth and create jobs. Shares in Taiwan were dragged lower by declines in the energy and information technology sectors. Indian equities lost ground as the rupee hit a record low against the US dollar following the Reserve Bank of India's surprise decision to keep interest rates unchanged. The currency was also hurt by reports of a widening rift between the government and the central bank. In comparison, ASEAN markets such as the Philippines and Indonesia fared better, though they also posted negative returns.

EMERGING MARKETS

Emerging markets (EM) equities lost value in October, with global growth and trade uncertainty driving risk aversion. Weak corporate earnings were also a headwind in several markets, notably in Asian EM. The MSCI Emerging Markets index decreased in value and underperformed the MSCI World.

Korea was among the weakest index markets with weak macroeconomic data and ongoing global trade concerns compounded by disappointing corporate earnings results. Taiwan, where technology stocks were among the weakest names, and China also corrected and lagged the index. In China, Q3 GDP growth slowed by more than expected to 6.5% year-on-year. Meanwhile high frequency survey data remained subdued and the authorities announced a series of measures aimed at supporting the economy, including a 1% cut to reserve ratio requirements for banks.

Mexico was the weakest index market as equities and the peso sold off sharply on rising concerns over the incoming government's policies, and the implications for investment. A public referendum rejected the building of a new airport in Mexico City (which is already one-third complete).

By contrast, Brazilian equities and the real rallied in anticipation of a market-friendly election outcome, which was confirmed at the end of the month.

GLOBAL BONDS

US government bond yields continued higher in October. Economic data remained positive, and stronger than in other regions, while Fed Chair Jerome Powell indicated there remains significant scope for further rate hikes. Ten-year yields increased from 3.06% to 3.15% and the two-year yield from 2.82% to 2.87%. This ran counter to a broader risk-off trend, which propelled the US dollar index to gains of 2%.

Outside the US, government yields mostly declined. UK 10-year yields fell from 1.57% to 1.44% amid expectations the Autumn Budget would confirm an ongoing reduction in government borrowing, while September inflation data undershot expectations.

In Europe, Bund 10-year yields fell from 0.47% to 0.39%, France's from 0.80% to 0.75%, as eurozone data remained broadly lacklustre and uncertainty around Italy continued. Italian 10-year yields increased from 3.15% to 3.43%. The ratings agency Moody's cut Italy's sovereign rating to one notch above sub-investment grade, citing concern over the country's recently announced budget.

Global investment grade[3] (IG) corporate bonds saw a total return of -0.9% (in local currencies). US dollar IG was weakest in total return terms (-1.4%), with sterling IG returning 0.4%, but underperformance relative to government bonds was consistent across markets.

Global high yield (HY) credit saw total returns of -1.3%. The US dollar market saw total returns of -1.6%, underperforming Treasuries. Euro HY saw a similar level of underperformance relative to government bonds.

Emerging market (EM) bonds saw negative total returns. Performance across EM currencies was mixed. Idiosyncratic events saw weakness in the Mexican peso and the South African rand, while an improvement of sentiment for the Argentinian peso and the Turkish lira saw these currencies achieve double-digit returns.

Global stock markets were hit hard with investors switching into a risk-off mode. The MSCI World index returned -7.6% in October.

Convertible bonds as measured by the Thomson Reuters Global Focus Convertible Index provided effective protection and ended the month with a return of -2.9% in US dollar terms. With this significant market move the risk/return characteristics of convertible bonds have significantly improved and so have valuations. Japan and Asia remain the cheapest regional convertible markets.

COMMODITIES

The S&P GSCI Spot Index fell 6.2% in October. Energy was the weakest component as spot prices fell on concerns over increased supply, with Brent crude down 11%. During the month, Saudi Araba announced that it will increase output to a record high, easing uncertainty over the impact of US sanctions re-implementation on Iran. The industrial metals component also declined, weighed down by US-China trade concerns and weaker macroeconomic data in China. Precious metals were mixed with gold gaining 1.9% and silver down 3.1%.

[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.

[2] 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.

[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.

Source: Schroders, October 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 OCTOBER 2018

	1 MONTH			12 MONTHS		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	-7.3	-5.0	-5.4	1.2	4.0	5.1
MSCI World Value	-5.3	-2.9	-3.4	-1.4	1.3	2.4
MSCI World Growth	-9.3	-7.0	-7.4	3.6	6.6	7.7
MSCI World Smaller Companies	-9.9	-7.7	-8.1	-2.2	0.6	1.7
MSCI Emerging Markets	-8.7	-6.4	-6.8	-12.5	-10.1	-9.1
MSCI AC Asia ex Japan	-10.9	-8.6	-9.0	-13.6	-11.2	-10.2
S&P500	-6.8	-4.5	-4.9	7.4	10.4	11.6
MSCI EMU	-8.7	-6.5	-6.9	-11.6	-9.2	-8.2
FTSE Europe ex UK	-7.1	-4.8	-5.2	-5.2	-2.5	-1.5
FTSE All-Share	-8.8	-6.5	-7.0	-4.1	-1.4	-0.4
TOPIX*						

	1 MONTH			12 MONTHS		
Government Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	-0.5	2.0	1.5	-2.1	0.7	1.8
JPM GBI UK All Mats	-1.1	1.4	1.0	-2.6	0.1	1.2
JPM GBI Japan All Mats**	0.8	3.4	2.9	0.8	3.6	4.7
JPM GBI Germany All Mats	-1.8	-1.3	-1.7	-4.3	-1.6	-0.6
Corporate Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	-1.6	0.9	0.4	-3.0	-0.3	-0.8
BofA ML US Corporate Master	-1.3	1.2	0.7	-2.8	-0.1	1.0
BofA ML EMU Corporate ex T1 (5-10Y)	-2.7	-0.2	-0.7	-4.5	-1.8	-0.7
BofA ML £ Non-Gilts	-1.5	1.0	0.5	-3.5	-0.8	0.3
Non-investment Grade Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	-1.7	0.8	0.3	-0.8	2.0	3.1
BofA ML Euro High Yield	-3.7	-1.3	-1.7	-4.3	-1.6	-0.6

Source: DataStream.
Local currency returns in October 2018: *-9.4%, **0.2%.
Past performance is not a guide to future performance and may not be repeated.

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