



FINURA

MARKET COMMENTARY
SEPTEMBER 2018

MULTI-ASSET INVESTMENT VIEWS - SEPTEMBER 2018

KEY

▲ Up from last month ▼ Down from last month

● Positive ● Postive/Neutral ● Neutral ● Neutral/Negative ● Negative

	Category	View	Comments
Main Asset Classes	Equities	●	Despite the expected market impact from US trade policy, we believe a future move away from politically-focused markets will create positive opportunities in equities.
	Government Bonds	●	Despite cyclical headwinds, growth appears robust and we believe a further rise in yields is required to catch up with the improved backdrop.
	Commodities	●	Top down the cyclical environment is positive for commodities; on a bottom-up view most sectors are supported by tight supply and demand characteristics.
	Credit	●	Following a brief period of relief in July, August saw spreads resume widening although this was mitigated by government bond moves across investment grade in all regions.
Equities	US	●	We continue to have regional preference for the US given the resilience of corporate earnings.
	Europe	●	Our view on eurozone equities remains unchanged, as we take into account global trade tensions and tightening financial conditions.
	UK	●	We are neutral as we believe the market is still dominated by the political noise with little sign that this can be resolved soon.
	Japan	●	While weakness in macroeconomic data and cyclical indicators suggest a slowdown, attractive valuations keep us neutral.
	Pacific ex-Japan	●	Momentum indicators have declined in the past couple of months but we see areas of opportunity at the regional level.
	Emerging Markets	●	Despite a fall in the momentum indicator for emerging markets, especially China, we remain positive as valuations are starting to look attractive.
Government Bonds	US	●	Treasuries continue to look expensive. Given the Federal Reserve's tendency to telegraph rate hikes we do not see the pace of tightening as an issue.
	UK	●	Valuations remain expensive. Uncertainties around Brexit continue and further rate hikes may not materialise until a credible Brexit plan comes together.
	Germany	●	Bunds remain expensive. As the European Central Bank steps away from quantitative easing, the market will have to focus on whether low yields are sustainable.
	Japan	●	We believe that inflation is the critical factor in whether the Bank of Japan might consider normalisation. We expect the current monetary policy stance to stay in place until inflation is close to target.
	US Inflation Linked	●	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	●	We remain neutral as cyclical headwinds prevent us from taking advantage of the improvement in local market valuations.



	Category	View	Comments
Investment Grade Corporate Bonds	US	●	Fundamentals may be starting to weaken as shareholder friendly behaviour becomes more prevalent, to the detriment of bond holders.
	Europe	●	European corporates are in a stronger position, though the recent pickup in merger and acquisitions and shareholder activism is indicative of a maturing cycle in the region.
	Emerging Markets USD	●	We believe that the regional mix and positive earnings growth marginally favours EM corporates and sovereigns over their developed market high yield counterparts.
High Yield Bonds	US	●	High yield is expensive and vulnerable to outflows, with technicals in particular unlikely to be as favourable as they were in the first half of the year.
	Europe	●	Continuing political instability in the region is likely to limit spread tightening, hence we retain our negative view.
Commodities	Energy	●	Global oil inventories are low; over the next six months there are risks to supplies from a number of OPEC countries that could lead to a spike in oil prices.
	Gold	● ▼	Downgrade to single negative driven by our momentum signal and the increase in US 5-year real yields. Gold has not materially reacted to protectionist politics.
	Industrial Metals	●	Industrial metals look oversold on risks to global trade, fundamentals are supportive and China looks set to boost demand with increased infrastructure spending.
	Agriculture	●	The recent sell-off has been based on concerns over trade war escalation as opposed to fundamentals; in addition, the risks relating to El Niño look to be underpriced.
Currencies	US \$	● ▲	Despite the dollar being expensive, we see room for further deterioration in growth and political sentiment against a continued backdrop of tight liquidity.
	UK £	● ▲	We no longer see a strong case for excessive sterling depreciation given that hard Brexit, having emerged as a serious possibility, now appears mostly priced in.
	EU €	● ▼	The euro has been downgraded on further economic slowdown and increased political tension between core and periphery.
	JAP ¥	● ▲	The Bank of Japan is now seen as being forced to lift-off from its extremely dovish stance; weak external growth should also support the yen as a risk-off currency.
	Swiss F	●	We remain neutral - with its status as a safe haven currency, the Swiss franc should see relative outperformance vs. the euro.




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, September 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.

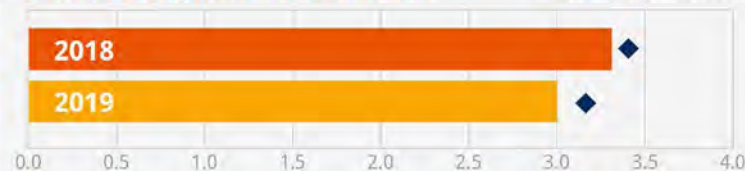
INFOGRAPHIC: THE GLOBAL ECONOMY SEPTEMBER 2018

Global forecast update

Downgrade expectations to global growth

 **2018:** Led by weaker forecasts for Europe and Japan after disappointing H1

Global GDP growth forecast (%):  Previous forecast



 **2019: Deeper and more prolonged trade war between US and China -** Tariffs and uncertainty likely to impact global trade and capital investment spending




Slowdown in export orders signals weaker trade



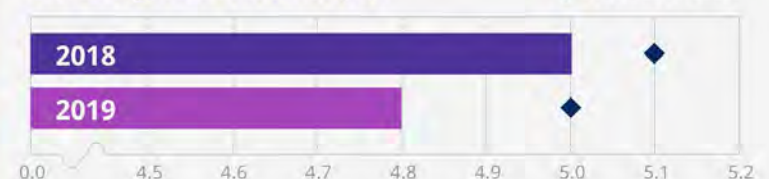
Emerging markets (EM)

Downgrade due to:

-  Downgrades to developed markets
-  Pessimistic outlook for global trade



EM GDP growth forecast (%):  Previous forecast



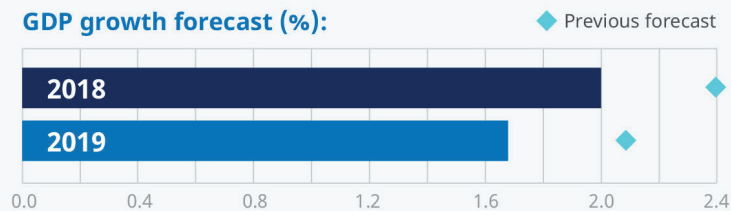
Eurozone growth forecast



2018: GDP growth forecast downgraded
due to trade wars impact and weak net exports



GDP growth forecast (%):



2019: Trade tensions holding back external demand
but domestic demand likely to remain firm above trend

European Central Bank (ECB)

Monetary policy still on hold despite signs of wage inflation emerging

ECB cautious of:



External factors (escalation of trade wars):

if global trade weakens, Europe is likely to suffer as it is more geared towards external trade



Italian budget tensions:

new populist government to propose budget. If they announce a big fiscal splurge, Italian government bond yields may rise sharply, which may also impact other peripheral markets

UK: growth forecast revised down



Summer weather boosted retail spending, improving consumption and investment in second quarter, but net trade was weak



Brexit uncertainty also remains high as negotiations reach crescendo



WHAT NEXT FOR INTEREST RATES AND INFLATION?

Inflation in July drifts further away from the 2% target, but we believe the next rate rise will take place in 2019 - depending on Brexit progress

Inflation rose by more than expected in August, with headline inflation up from 2.5% to 2.7%. By contrast, the market was anticipating a slight decline to 2.4%.

Transport, clothing and recreation were big contributors to overall price rises. Transport fares reflected higher fuel prices while the jump in recreation costs was due to package holiday prices – which could be temporary. Energy prices appear to have peaked, while we expect food prices to rise further as prices of imports accelerate again.

WHAT WILL THIS MEAN FOR THE BANK RATE?

One month's data is unlikely to change the Monetary Policy Committee's (MPC) stance for now, and we continue to expect no change in the Bank rate before March 2019. The timing of the next increase still depends much upon Brexit and the progress – or lack of progress – in the negotiation process.

However, the data does suggest domestic price pressures are building. If some form of Brexit agreement is reached and we move smoothly to the Brexit transition period, the MPC may be inclined to bring increases forward. Following this latest inflation data, markets have brought forward their expectation of the next rate rise slightly, boosting gilt yields and sterling.

Markets still point to May 2019 as being the point at which the Bank Rate will next increase.

WHAT WE SAID ON 5TH SEPTEMBER...

Strong US manufacturing suggests the Fed will raise rates this month, despite trade tensions.

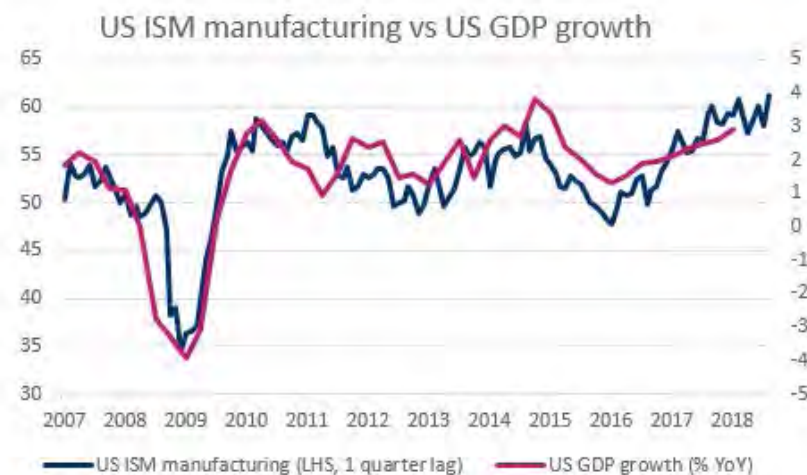
Despite anxiety around the prospect of further escalation in the US-China trade spat we expect US interest rates to continue to rise in line with our previous forecasts.

This follows surprisingly strong US manufacturing data released on 4 September.

The Institute for Supply Management's (ISM) manufacturing index surged to a 14-year high (and near-35 year high) in August, coming out significantly higher than expected.

The report showed new orders at a seven month high, while inventories, production and order backlogs also picked up during August, reminding us of the underlying strength in the US economy. However, almost two-thirds of survey respondents reported higher input costs due to trade tariffs, so the impact is inflationary if these higher costs are passed on to consumers.

We are monitoring the ISM as a key way of tracking corporate reactions if the US administration goes ahead with the next stage of tariffs on \$200 billion of Chinese imports. But this latest ISM report suggests trade tensions have had a limited negative impact so far on domestic economic activity – giving the Fed scant reason to pause its policy of gradual increases. A rate increase this month is almost fully priced in.



Source: Datastream

WHAT WE SAID ON AUGUST 15TH...

Inflation rose for the first time in eight months – driven largely by an increase in the price of popular computer games. Headline inflation as measured by the Consumer Price Index ticked up by one tenth of a percentage point to 2.5%, in the latest data published on 15th August.

Energy prices and cultural spending showed the biggest rises. The latter category includes computer games, where prices are volatile. Overall, these increases were offset by the year-on-year fall in prices for other major consumer categories including clothing, footwear, furniture and household goods.

The effect of weaker sterling on future inflation
Falling prices of clothing and other items suggest that the inflationary effects caused by the post-referendum drop in sterling – which triggered a rise in the prices of imported goods

– is now fading.

But renewed sterling weakness more recently suggests we will see a modest increase in the price of imported goods.

UK inflation data released on 15th August suggests the Bank of England will keep rates on hold for the rest of this year. The timing of the next rate rise, which we expect to be in 2019, will depend significantly upon progress made in the Brexit negotiations.

WHAT WE SAID ON AUGUST 2ND...

The Bank of England has raised the benchmark Bank Rate by 0.25 percentage points to 0.75% at its August meeting on Wednesday.

This was widely expected, but the slight surprise is that all nine members of the rate-setting Monetary Policy Committee (MPC) voted for a rate increase. They also agreed that further rate increases will be needed to bring inflation back toward its long-term target of 2% (see below).

The MPC sees UK economic growth running at above its potential rate of 1.5% per year in the next two years, despite the risks posed by Brexit and rising global trade tensions. In turn it expects inflation to run above target for longer than previously thought - giving rise to the likelihood of further interest rate increases.

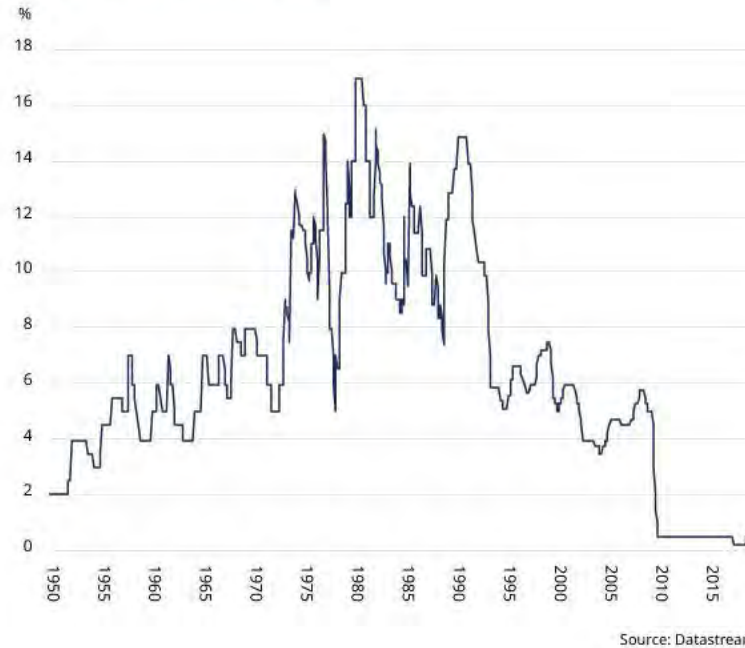
INTEREST RATES REMAIN NEAR THEIR HISTORIC LOWS

At 0.75%, the Bank Rate is still far lower than at any point in the latter half of the last century.





Bank of England official bank rate



The latest increase is only the second in 11 years (scroll down for “The Brexit Effect”) and means that until now the Bank Rate has been at 0.5% or below for 113 months.

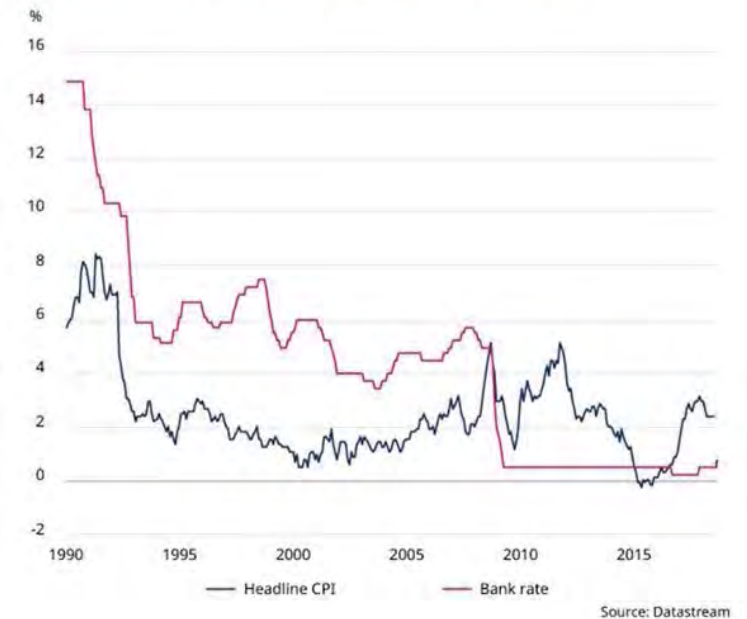
WHAT ABOUT THE LONG-TERM OUTLOOK FOR THE BANK RATE?

The main aim of the Monetary Policy Committee (MPC) is to meet the target of 2% inflation, in a way that supports economic growth and employment.

This means that at certain periods the MPC is tolerant of inflation which exceeds the 2% level. To some extent that is what has happened in the recent period, when a collapse in the value

of sterling caused the prices of imported goods to rise. The decision to raise rates to 0.75% rested in part on the Monetary Policy Committee’s fear that with unemployment at a 40-year low there will be an uptick in wage inflation – a different type of inflation. The MPC said in its notes: “Unemployment is low and projected to fall a little further...a small margin of excess demand emerges by late 2019 and builds thereafter, feeding through into higher growth in domestic costs than has been seen over recent years.”

UK Consumer Price Index vs Bank of England official bank rate



Our view is that rates will continue to rise gradually. We do not expect real interest rates (the difference between interest rates and prevailing inflation) to reach the levels in the period before the financial crisis of 2008-2009.

In its commentary alongside the decision to increase the rate to 0.75%, the MPC stated: “Any future increases...are likely to be at a gradual pace and to a limited extent.”

THE BREXIT EFFECT

Interest rates might have risen sooner, had it not been for the outcome of the EU referendum in June 2016.

Anxious about potential shocks to the economy arising from the decision to leave the EU, the Monetary Policy Committee responded by halving the Bank Rate from 0.5% to 0.25% in August 2016.

But subsequent economic growth was stronger than expected, and in November 2017 the Bank Rate was raised again to 0.5%.

We see Brexit as a key determinant for the pace of future policy measures including increases to the Bank Rate. If the UK avoids a “no-deal” or hard Brexit, the MPC may hasten the pace of rate increases (potentially making two further increases during the course of 2019), with the first rise coming in May 2019 after Brexit itself takes effect in March.

On the other hand, if we have a “no-deal” or hard Brexit, the Bank may delay further increases or even cut interest rates again.

WHAT DOES THE BANK RATE RISE MEAN FOR MORTGAGE RATES?

Household borrowing costs – or mortgage rates - are related to the Bank Rate, but are influenced by other factors too.

There is a further difference between “new mortgage rates” – the rates offered to borrowers who take out a new deal – and the rates applying to existing loans. The latter rates tend to be more

directly linked to movements in the Bank Rate.

With “tracker” mortgages, for instance, there is an explicit link between the rate the borrower pays and the Bank Rate. So for those “tracker” mortgage borrowers the latest 0.25 percentage point increase in the Bank Rate will translate into higher monthly repayments.

In the early phases of the financial crisis, a relative shortage of money for new mortgage lending meant that rates on new mortgages rose above the rates charged to existing borrowers. In recent years that trend has reversed and new borrower rates have fallen below those charged on existing mortgage stock.

Mortgage rates remain at very low levels. While rising rates are not helpful for consumers, the increases we envisage will not have a significant effect on households’ financial sustainability.

First published 28th September 2018 by Janet Mui, Global Economist, Cazenove Capital. Source: [What next for interest rates and inflation?](#)





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