FINURA

MARKET COMMENTARY
FEBRUARY 2019

INFOGRAPHIC: THE GLOBAL ECONOMY

Eurozone: European shares are "clearly unloved"

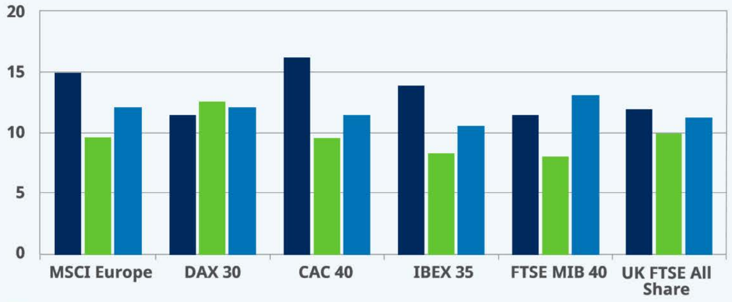
Eurozone activity data has been falling sharply, prompting concerns of a recession

The full effects of the US-China trade war are set to hit European manufacturers, especially:

But it's not all bad news...

- We do not expect a eurozone recession
- European stocks currently look cheap and have great potential to outperform

The P/E[1] of the German DAX is just 11.4 which is lower than the previous two recessions



Source: Thomson Datastream, Schroders Economics Group. 29 January 2019.

Emerging Market (EM) update: Our view

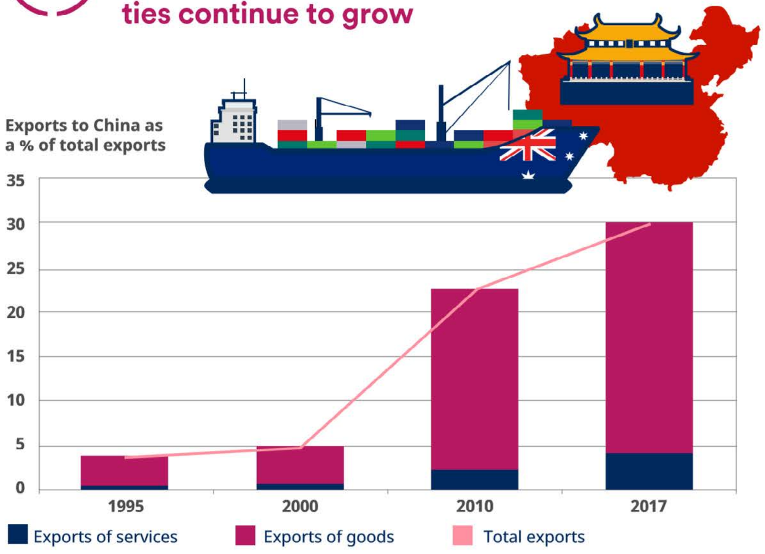
Dollar weakness in 2019 may reduce costs for indebted EM countries

2019 looks to be better than 2018 but not as good as 2017

Commodity price deflation could mean a contraction of global trade values

Australia and China: Looking beyond commodities

China has been a key driver of Australian exports of commodities and the economic ties continue to grow



Source: Thomson Reuters Datastream, Schroders Economics Group, 30 January 2019.

But it's not all about commodities, **China has boosted Australian exports of services**

Visitors from China are now the largest tourist group and they spend more money, on average, than any other

This is set to continue to grow

Chinese tourist's expenditure in Australia by 2020

Chinese visitors in 2020

However, China's slowdown presents some risk for the Australian economy

Due to the trade links, lower Chinese demand could cause a **reduction in Australian exports**

Aussie dollar is likely to weaken since investors use it as an alternative way to get exposure to China's economic activity due to the Chinese renmimbi being state controlled.

1 The price to earnings (P/E) ratio is a company's prices relative to its earnings per share. Here it is the average of all the P/E ratios for all stocks in the DAX index.

Source: Schroders as at February 2019.

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	Neutral	The improvement in investor sentiment following the recent change in the Federal Reserve's (Fed) policy stance is supportive, but we still expect equities to trade within a range, albeit with heightened volatility.
	Goverment Bonds	Neutral ▲	Weaker economic growth supports bonds overall, despite some expensive valuations. Our score remains neutral.
	Commodoties	Neutral ▼	Gold should benefit from lower interest rates, while energy remains volatile.
	Credit	Neutral/ Negative	January saw an unusually strong and uniform rally across credit sectors. Continued policy tightening has seen most credit categories recover significantly from their lows at the start of the year.
Equities	US	Neutral	With the recent change in the Fed's policy stance, worries over "recession in 2020" have softened and are likely to support investor sentiment in coming weeks, but risks to the earnings outlook remain unanswered.
	Europe	Neutral/ Negative	European equities appear cheap but this is warranted, in our view, given the political and cyclical challenges facing the region.
	UK	Neutral/ Negative ▼	Downgraded, as UK equities are likely to see the support from a weaker sterling decline.
	Japan	Neutral	Japanese equities have underperformed global equities in local currencies in recent months, despite improved valuations and stable economic growth. Lack of confidence - particularly among international investors - remains a challenge and is likely to take time to resolve.
	Pacific ex-Japan	Neutral	Asia would benefit if trade war tensions fade. However, many countries are seeing weakness in their housing markets with a knock-on economic impact.
	Emerging Markets	Postive/ Neutral	EM forward valuations are now back to 2015 levels after the large sell-off in 2018. The Fed pause and Chinese stimulus are likely to provide support for EM equities while investors continue to wait for resolutions of US-China trade conflicts.
Government Bonds	US	Neutral	US bond yields look fairly priced after the recent dovish move by the Fed.
	UK	Neutral/ Negative ▼	The bond market is not pricing in enough hikes for the UK. There will possibly be a hike, as indicated by the Bank of England, if there is a Brexit resolution.
	Germany	Neutral	European data continues to disappoint, and our view is that German growth is being suppressed by fears of a European recession.
	Japan	Neutral	Japanese activity data continues to show weakness in external demand and the manufacturing sector. The headwinds are also being reflected in Japanese earnings.
	US Inflation Linked	Postive/ Neutral	We maintain a positive view that US breakevens offer value.
	Emerging Markets Local	Neutral	We remain neutral. Whilst cyclical (dollar) and technical (outflows) factors have improved, valuations have already moved back to long-term averages.

	Category	View	Comments
Investment Grade Corporate Bonds	US		Spreads do not yet appear excessive when compared to recent historical highs (2011 and 2016). We remain concerned about the deterioration of credit quality in the universe.
	Europe	▲	We are of the view that European investment grade spreads offer better short-term value, particularly should our core "muddle-through" scenario for the eurozone prove right.
	Emerging Markets USD		Following a challenging December, there were positive excess returns which may well continue in the near term given the accommodative backdrop.
High Yield Bonds	US		Remains stable for now although expensive on a historical basis. Strong levels of interest coverage support US high yield (HY) for the moment.
	Europe		Despite recent inflows, it is too early to say whether this represents a secular shift, as this would require stabilisation in economic data and an improved political backdrop.
Commodoties	Energy		The oil market in 2019 looks largely in balance but we expect heightened volatility.
	Gold		Despite the equity market rally, gold has not given back the gains it made through the equity market tumble in December thanks to a dovish Fed and weaker US dollar (USD).
	Industrial Metals		Industrial metals have limited upside unless China introduces large-scale fiscal initiatives.
	Agriculture		Agriculture remains our preferred way to gain exposure to the political premium of US-China negotiations, supported by favourable valuations and weather risks.
Currencies	US $		We remain neutral on USD as both global and US growth are slowing down, causing the Fed to pause their hiking cycle and loosen liquidity conditions marginally.
	UK £		The outlook is uncertain whilst awaiting the Brexit negotiations to be concluded; economic growth is slowing and that should increasingly weigh on the currency.
	EU €		We see the Euro staying range-bound, hemmed in by both the dovish Fed and the European Central Bank, which is turning less hawkish as economic growth weakens in the eurozone.
	JAP ¥		The Japanese Yen remains an excellent hedge against slowing global growth. We expect the currency to strengthen as US yields decline in response to coincidental slowing US growth.
	Swiss F		The Swiss franc (CHF) has weakened as risk conditions have improved and is at the bottom of its trading range. We expect ultimately weak growth fundamentals to trump liquidity, meaning that chasing CHF weakness is not justified.

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, February 2019. 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 February when easing trade tensions helped support equity market gains.

HIGHLIGHTS

- Global equities made further progress in February as investors grew optimistic that a resolution to the US-China trade standoff is drawing nearer. Government bond yields broadly rose (i.e. prices fell).
- US equities rose. The news that the US has suspended the imposition of increased tariffs on $200 billion of Chinese goods was supportive.
- Eurozone equities also gained. A source of support was the suggestion that the European Central Bank could restart its targeted long-term refinancing operations, which offer cheap loans for banks.
- UK equities rose but lagged global equities as a result of sterling strength, which was due to rising hopes that the UK would avoid a disorderly exit from the European Union.
- Japanese equities gained as fears receded over the extent of the global slowdown. After moving sharply stronger at the end of 2018, the yen has gradually weakened again.
- Emerging markets (EM) equities recorded a marginal gain in February, boosted by the easing US-China trade tensions.
- Government bond yields rose in February with sentiment and conditions continuing to favour riskier assets. Corporate bonds outperformed government bonds.

THE US

US equities gained in February. There was little change in the backdrop from an earnings and economics perspective. Q4 GDP growth, released later in February than usual, indicated quarter-on-quarter growth of 2.6%. This was stronger than expectations of 2.2%, but slower than the 3.4% growth in Q3 and is expected to slow again in Q1. Employment data remained robust. Similarly, US earnings remain stable – 70% of company earnings were better than expected – but earnings expectations for future quarters continue to fall.

However, Congress and the White House reached an agreement early in February to end the government shutdown. Investors were then further cheered by hopes that trade posturing between the US and China could soon draw to a close. The US has suspended the imposition of increased tariffs on $200 billion of Chinese goods that was planned to take effect on 1 March. US equities rallied on hopes that a deal will be made.

All areas of the S&P 500 advanced, although differences between sectors was significant. Companies in the IT and industrial sectors were amongst the strongest over the month, while consumer discretionary and communication services only just edged into positive territory.

EUROZONE

Eurozone equities gained in February with the MSCI EMU index returning 3.9%. Progress in US-China trade talks helped to lift sentiment towards riskier assets such as equities. Another source of support was the suggestion that the European Central Bank could restart its targeted long-term refinancing operations, which offer cheap loans for banks. Banks were among the top performers while economically-sensitive sectors such as industrials and materials also fared well. Weaker sectors included real estate and utilities.

Data confirmed that the eurozone economy grew by just 0.2% in the final three months of 2018. Germany saw zero growth while there was confirmation that Italy had slipped into recession. However, Spain saw a growth rate of 0.7% and France 0.3%. The flash composite purchasing managers' index[1] (PMI) for February came in at 51.4, up from 51.0 in January, but the manufacturing component was in contraction with a reading of 49.2. Consumer surveys were more encouraging, with an uptick in the European Commission's flash consumer confidence survey for February. On the political front, Spain's prime minster called a snap election scheduled for 28 April after parliament failed to pass the 2019 budget.

UK

The UK stock market performed well over the period, although lagged global equities as sterling recovered amid growing hopes that the country would avoid a disorderly Brexit. Many domestically focused areas also extended their recent recoveries, further helped by some better-than-expected data.

The UK labour market bucked a wider slowdown in the economy during the fourth quarter of 2018 while nominal wage growth remained robust. The Office for National Statistics also revealed that UK inflation had fallen to a two-year low in January and that retail sales had bounced back strongly from a poor December.

However, the UK economy slowed sharply in the final quarter of 2018 as Brexit uncertainty weighed on business investment. Real GDP growth fell from 0.6% in Q3 to 0.2% in Q4, lower than consensus forecasts of 0.3%. For 2018 as a whole GDP grew by 1.4% - its weakest growth rate since 2013.

This added to concerns around the outlook for the first half of 2019 and the Bank of England cut its growth forecasts in its latest Inflation Report. The bank lowered its annual average GDP growth projections from 1.7% to 1.2% for 2019, and from 1.7% to 1.5% in 2020.

JAPAN

The Japanese equity market recovered further ground in February, as fears continued to ease over the extent of the global slowdown. The Japanese market rose steadily in the second half of February to end the month 2.6% higher. After moving sharply stronger at the end of 2018, the yen has gradually weakened again.

The corporate results season ended in mid-February and was generally interpreted negatively, although the balance of earnings surprises was only slightly skewed to the downside. Despite a clear deterioration in fundamentals for some companies, the negative share price reactions were very muted, suggesting that almost all of the setback had already been discounted in stock prices. Overall, however, we see little fundamental deterioration in the domestic outlook, with most of the negative surprises driven by the sharper-than-expected slowdown in the external environment, especially in China. This particularly affected results in the automotive sector while many tech stocks were also impacted by the slowdown in smartphone sales.

Initial estimates of GDP growth for Q4 2018 were seen in February, with a slightly slower-than-expected rebound from the Q3 weakness which had, in turn, resulted from a series of natural disasters in Japan. Other short-term economic data released during the month was generally poor, with statistics on industrial

production and housing undershooting expectations. Inflation data, however, remained solid and the outlook for this year remains relatively firm.

ASIA (EX JAPAN)

Asia ex Japan equities extended their gains in February though returns across the region were mixed. Investors cheered signs of progress in US-China trade negotiations; US President Trump delayed the implementation of further tariffs on Chinese goods originally scheduled to take effect on 1 March. Markets in Hong Kong, Taiwan and China generated strong returns. Chinese stocks were further buoyed by news that index provider MSCI would increase the weighting of China-listed shares in its benchmark indices. Meanwhile, China's economic data continued to point to slowing momentum. The official PMI fell to a three-year low in February, its third straight month of contraction.

Elsewhere, Indian stocks trailed amid escalating geopolitical tensions with Pakistan following a deadly attack on Indian soldiers in the disputed Kashmir territory. Separately, the Reserve Bank of India cut its benchmark interest rate by 25 basis points to 6.25%, citing slowing economic growth and lower inflation. South Korean equities fell as the US-North Korea summit ended abruptly without an agreement on denuclearisation.

Recent outperformers in ASEAN (Association of Southeast Asian Nations) markets closed broadly lower. Indonesia fared worst, weighed down by steep declines in the consumer discretionary and materials sectors. The Philippines and Thailand also retreated. On a more positive note, Indonesia's economy expanded by 5.18% year-on-year in the fourth quarter thanks to strong consumption, investment and government spending.

EMERGING MARKETS

After a strong rally last month, emerging markets equities posted a marginal gain in February. The MSCI Emerging Markets Index increased in value but underperformed the MSCI World.

China was among the best performing index markets. In addition to positive developments on the trade front, a sharp increase in credit growth in January suggested that domestic policy support may be impacting activity. Taiwan also outperformed, amid gains for technology stocks.

By contrast, those markets most sensitive to external funding lost value amid a pick-up in the US dollar; this included South Africa, Turkey and Indonesia. Elsewhere, Brazil and Mexico also fell back. In Brazil, this was despite the announcement of an ambitious social security reform proposal. However, Q4 GDP growth of 1.1% year-on-year was weaker than expected.

GLOBAL BONDS

Government bond yields rose in February, meaning prices fell, with sentiment and conditions continuing to favour riskier assets. Sentiment remained positive on the back of the more dovish rhetoric from Federal Reserve Chair Jerome Powell and there was optimism around trade talks between the US and China.

Minutes from the European Central Bank (ECB) policy meeting suggested it is preparing a new cheap loan programme for banks, similar to the long term refinancing operations launched in 2016.

UK gilt yields saw sharp rises later on in the month on growing expectation that a "no-deal" Brexit would be avoided and the deadline extended. On mainland Europe, Bund yields were marginally higher. Spanish 10-year yields were two basis points (bps) lower, despite increased political risk as the country announced a snap general election. Italian 10-year yields were 16 bps higher.

Corporate bonds produced positive total returns and outperformed government bonds. High yield[2] corporate bonds performed particularly well, while within investment grade, Europe stood out. The more economically-sensitive sectors, automotive and capital goods notably, delivered good returns.

US-dollar denominated emerging market (EM) government bonds rose, but local currency bonds fell as a number of EM currencies came under pressure on idiosyncratic factors. EM corporate bonds performed well.

Global equity markets continued on their upward trajectory in February and the MSCI World index showed gain of 3.0% (in US dollars). Convertible bonds had a strong month and moved up almost as fast as equities. The Thomson Reuters Global Focus index was up 2.4% this month. The US region has become more expensive as a result of the equity rally. Japan and Asia ex Japan continue to offer discounts to fair value.

COMMODITIES

The S&P GSCI Spot Index rose in February. The oil price rebounded from early weakness, with supply concerns returning to the fore on production cuts by OPEC and other producers, a surprise fall in US crude inventories and stronger-than-expected US economic data. The energy component as a whole was up due to oil, although the natural gas price moved slightly lower. The industrial metals component was also firmer with copper leading the gains as the US-China trade tensions moderated. Soft commodities were weak across the board and precious metals were also down.

[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, February 2019: 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 (NET) % – TO END FEBRUARY 2019

	1 MONTH			12 MONTHS		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	3.0	3.8	1.9	0.4	7.6	4.0
MSCI World Value	2.6	3.4	1.4	-0.9	6.2	2.7
MSCI World Growth	3.4	4.2	2.3	1.7	8.9	5.3
MSCI World Smaller Companies	3.8	4.6	2.6	-0.8	6.2	2.7
MSCI Emerging Markets	0.2	1.0	-0.9	-9.9	-3.5	-6.7
MSCI AC Asia ex Japan	2.1	2.9	1.0	-8.2	-1.7	-4.9
S&P500	3.2	4.0	2.1	4.7	12.1	8.4
MSCI EMU	3.1	3.9	2.0	-9.3	-2.9	-6.1
FTSE Europe ex UK	3.2	4.0	2.1	-6.6	0.0	-3.3
FTSE All-Share	3.4	4.2	2.3	-1.8	5.2	1.7
TOPIX*	0.3	1.1	-0.8	-10.9	-4.6	-7.7

	1 MONTH			12 MONTHS		
Government Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	-0.3	0.5	-1.4	3.3	10.6	7.0
JPM GBI UK All Mats	0.1	0.9	-1.0	-1.0	6.0	2.6
JPM GBI Japan All Mats**	-2.0	-1.2	-3.0	-2.5	4.4	1.0
JPM GBI Germany All Traded	-1.1	-0.3	-2.0	-3.1	3.8	0.4
Corporate Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	0.3	1.0	-0.8	0.1	7.2	3.7
BofA ML US Corporate Master	0.4	1.1	-0.7	2.6	9.9	6.3
BofA ML EMU Corporate ex T1 (5-10Y)	0.2	1.0	-0.9	-5.4	1.3	-2.0
BofA ML £ Non-Gilts	1.1	1.9	-0.0	-1.7	5.3	1.9
Non-investment Grade Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	1.6	2.3	0.4	2.1	9.4	5.8
BofA ML Euro High Yield	1.0	1.8	-0.1	-6.0	0.7	-2.7

Source: Thomson Reuters DataStream.
Local currency returns in February 2019: *2.6%, **-0.3%.
Past performance is not a guide to future performance and may not be repeated.

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