MARKET COMMENTARY
MAY 2019

INFOGRAPHIC: THE GLOBAL ECONOMY

Why Turkey and Argentina do not pose a contagion risk to other emerging markets

Key concerns...

Currency volatility
Turkey's central bank is running low on US dollars to defend the currency

Soaring inflation
In March, both region's respective central banks struggled to stay on top of inflation. Meanwhile, the rest of emerging markets remained flat or falling

Political risk
Turkey's president has compromised the central bank's independence

Argentine elections in Oct could see the return of a populist president

Our perspective

We think any concerns of contagion are overblown. Both regions are not the symptom of a wider problem in emerging markets; they face unique problems in both the economic and political spheres

Why a pick-up in UK growth may prove deceptive

UK inventories hit record high in March

Once stockpiling ends, GDP growth likely to slow

Fall in demand and sales leading to unsold stocks building up

Lack of warehouse space could lead to production being wound up

Excess inventories could be discounted or destroyed

Meanwhile, the Bank of England (BoE) unlikely to raise interest rates
Delay on next spending review due to new October Brexit deadline

Our perspective

Higher GDP figures that are driven by stockpiling not by final demand indicates a growth slow down in the near term

*The purchasing managers' index is based on survey data from companies in the manufacturing and service sectors. A reading above 50 indicates expansion

Views at a glance: The global economy - by GDP

Schroders
Real GDP forecast y/y%

	2018	2019	2020
World	3.2%	2.8%	2.7%
US	2.8%	2.4%	1.6%
Eurozone	1.8%	1.3%	1.4%
UK	1.4%	1.1%	1.5%
Japan	0.7%	0.7%	0.4%
BRICs	5.7%	5.5%	5.5%
China	6.6%	6.3%	6.1%

Source: Schroders, Thomson Datastream, Consensus Economics, April 2019

Source: Schroders as at May 2019.

MULTI-ASSET INVESTMENT VIEWS

KEY

▲ Up from last month ▼ Down from last month

Positive · Positive/Neutral · Neutral · Neutral/Negative · Negative

	Category	View	Comments
Main Asset Classes	Equities	Neutral ▼	We expect equities to deliver a small positive return over cash, given our view that a slowing macro environment may offer only modest support for equity markets.
	Government Bonds	Positive/Neutral ▲	We upgraded from neutral to positive this month off the back of positive momentum within the asset class.
	Commodities	Neutral	We remain neutral, driven by a flat macroeconomic backdrop that shows few signs of growth, yet provides sufficient resilience at this stage to avoid a full recession.
	Credit	Positive/Neutral	The credit rally is set to continue following a strong start to the year.
Equities	US	Positive/Neutral	We continue to favour US equities because of their high quality earnings.
	Europe	Neutral ▲	Upgraded as both earnings and sales results have improved since the last quarter.
	UK	Neutral/Negative	A stronger pound will provide a headwind for the UK market in the near term, specifically for large cap stocks.
	Japan	Neutral	We retain a neutral view, with a lack of confidence continuing to undermine stronger fundamentals.
	Pacific ex-Japan	Neutral	A weak domestic environment in Australia significantly impacts the regional index and makes us neutral, despite our more positive view on Singapore and Hong Kong.
	Emerging Markets	Positive/Neutral	We continue to have a positive view on the region for its higher growth potential. China is currently benefitting from a series of domestically focused mini-stimuli gaining traction, but the spillover benefits to other countries remains questionable.
Government Bonds	US	Neutral ▲	The upgrade is driven by the weakening cyclical outlook based on our models, and the recent escalation in trade wars between the US and China.
	UK	Neutral ▲	Gilts could provide an alternative for investors if there is a sharp fall in equities following their YTD rally.
	Germany	Positive/Neutral ▲	We have upgraded our view to positive as German bonds are more attractive than US bonds.
	Japan	Neutral	We retain a neutral view as the Bank of Japan's policy stance will continue to limit the yield of Japanese government bonds in the medium term.
	US Inflation Linked	Positive/Neutral	We remain positive on US break-evens, which offer value against rising wages/inflation.
	Emerging Markets Local	Neutral	Despite a stable outlook, we expect future returns to be driven only by short-dated bonds.

	Category	View	Comments
Investment Grade Corporate Bonds	US	●	A less favourable earnings backdrop alongside elevated valuations lead us to maintain our negative outlook for US investment grade.
	Europe	●	The European credit backdrop is healthy for now, with continued low interest rates and debt affordability for corporates looking set to improve even further.
	Emerging Markets USD	●	Accommodative policy in the US has removed the headwind to emerging market debt in the near term; however, unappealing valuations keep us neutral.
High Yield Bonds	US	●	Valuations drive our neutral score.
	Europe	●	European high yield is trading at attractive levels compared to both historic valuations and fundamentals.
Commodities	Energy	●	Remain neutral as energy markets appear balanced after the Saudi commitment to fill the gap created by Iranian sanctions.
	Gold	● ▲	Upgraded to positive based on potential growth disappointment.
	Industrial Metals	●	Continue to trade broadly flat since being swept along in the January rally and there are no meaningful signs that this will change.
	Agriculture	● ▼	Downgraded to negative on the back of strong harvests in South America (coupled with existing high stock levels) and weakening prospects for the US-China deal.
Currencies	US $	● ▼	The US dollar is expected to remain firm in the near term but to weaken later in the year as rates peak in the US.
	UK £	●	Sterling has been boosted by the assumption that the economy enters a transition period rather than crashing out of the EU.
	EU €	●	Remain neutral with the European Central Bank's ultra-dovish stance, the uncertainty around Italian politics and the wait for a stabilisation in European growth all still weighing on the euro.
	JAP ¥	●	Dovish comments from the Bank of Japan keep our view neutral. We may look to upgrade the JPY view if we believe the risk of global recession has risen.
	Swiss F	●	We maintain neutral, reflecting the balance between weak fundamentals and the currency's safe haven status.

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, May 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 at markets in May when stocks fell as trade tensions ratcheted up.

HIGHLIGHTS

- Global stock markets fell in May across all major regions. Investor nervousness over the outlook for global growth grew as US-China trade tensions ratcheted up. Government bond yields fell markedly (i.e. prices rose) amid a move towards perceived safe havens.
- US equities were significantly weaker. Concerns that the trade disputes will damage global demand weighed on the energy sector, with the tech sector also weaker.
- Eurozone equities declined. Industries sensitive to the trade environment such as autos and semiconductors fell sharply. Economic data generally remained lacklustre.
- UK equities also performed poorly over the month, with sectors such as financials, industrials and mining lagging. Sterling was weaker amid heightened Brexit uncertainty following the resignation of Prime Minister May.
- Japanese stocks fell on the global trade worries. The yen strengthened against other major currencies, reflecting its perceived safe haven status, which tended to add to downward pressure on share prices.
- The worsening US-China trade dispute triggered a slump in Asia ex Japan equities. Chinese stocks fared worst amid the deepening trade conflict and weaker-than-expected economic data.
- Emerging market equities also fell amid worries over trade and supply chain disruption. Russia, Brazil and India outperformed. The Indian general elections saw victory for Prime Minister Modi and his party.
- Global government bonds benefited as investors turned towards safe havens, with yields falling (i.e. prices rising). The US 10-year Treasury yield finished the month close to 2.1%, levels not seen since late-2017.

THE US

US equities were significantly weaker in May after US-China trade talks broke down. The US government increased the tariff rate on $200 billion of Chinese goods to 25% from 10% and China responded by hiking the tariffs on $60 billion of imports from the US. The Federal Reserve (Fed) maintained the dovish stance it has held since the start of the year.

Economic data released during the month was mixed with total nonfarm payroll employment increasing by 263,000 in April, sending the overall unemployment rate to 3.6%, from 3.8% a month earlier. Wage growth remained steady at 3.2% compared with a year earlier. The US manufacturing purchasing managers' index[1] (PMI) fell two points to 50.6, while the new orders component declined to below 50, indicating that the sector is contracting. However, US consumer confidence remains robust, with a reading of 134.1 in May, compared with 129.2 a month earlier.

The US administration blacklisted Chinese tech giant Huawei on security fears and said it will impose a new tariff of 5% on all Mexican imports in a bid to force Mexico's government to stem the flow of migrants entering the US across its southern border. The technology, energy and industrial sectors were among the weakest performers in May as investors became nervous about the prospects for global growth. Utilities, healthcare and consumer staples, whilst also lower, proved to be more resilient. The real estate sector outperformed.

EUROZONE

Eurozone equities experienced declines in May with the MSCI EMU index returning -6.4%. The outlook for global trade remained a primary concern as tensions between the US and China escalated and US President Trump threatened to apply 5% tariffs on goods from Mexico. This led to a "risk off" environment that saw investors favour lower risk assets such as government bonds rather than equities.

In the eurozone the materials and financials sectors saw the steepest declines while perceived safe havens such as utilities and consumer staples fared better. Those industries most sensitive to global trade, such as autos and semiconductors, fell sharply. Data from Germany showed that the country avoided recession, with a GDP growth rate of 0.4% in Q1. However, forward-looking data remained somewhat lacklustre. The Ifo business climate index fell to 97.9 points, indicating a worsening mood among German businesses.

Italy's fiscal position was in focus after the European Commission (EC) cut its forecast for 2019 Italian GDP growth to 0.1% from 0.2%. This would mean the budget deficit would exceed the level previously agreed between Italy and the EC. The elections to the European Parliament were another focus with centrist parties losing ground in many countries while Green parties made gains and anti-EU populists made only a limited advance.

UK

UK equities performed poorly over the month as economically-sensitive sectors, including financials, industrials and mining, lagged. Sterling retreated sharply amid renewed Brexit uncertainty, and fears of a disorderly exit from the EU were not soothed after Prime Minister Theresa May announced her resignation following a revolt within her own party.

Despite the political uncertainties, the preliminary Q1 GDP release from the Office for National Statistics revealed the economy expanded 0.5%, in line with expectations. In its latest quarterly inflation report the Bank of England upwardly revised its 2019 growth forecast, from 1.2% to 1.5%. This reversed part of the forecast downgrade made at the time of the previous inflation report in February, when the bank cut 2019 growth from 1.7% to 1.2%.

Evidence emerged that the surge in manufacturing activity seen before the initial 31 March Brexit deadline has begun to unwind. Markit's UK manufacturing purchasing managers' index (PMI) slipped two points to 53.1 in April, supporting fears that the pick-up had been driven by stockpiling, to guard against a disorderly EU departure. On a more positive note, services activity stabilised, with Markit revealing that its services PMI picked up to 50.4 in April, bouncing back from the sub-50 level in March.

JAPAN

The Japanese equity market fell sharply at the beginning of the month and ended May with a total return of -6.5%. Global macroeconomic and political factors were again dominant. The yen strengthened against other major currencies, reflecting its perceived safe haven status, which tended to add to downward pressure on equity prices.

The principal development was the escalation of trade issues. Any remaining hopes for an early resolution to the US-China

dispute were dashed by the sudden announcement of sharp increases in US tariffs on imports from China. These higher levels will inevitably have a much greater volume impact, with repercussions throughout global supply chains. In addition, the US campaign against Huawei in particular is already having a marked impact on Japanese electronic component suppliers. These negative factors have exacerbated the reaction to a cyclical slowdown in earnings growth, which was evident in the recently announced corporate results for the final quarter of the fiscal year.

The announcement of new US tariffs on Mexico will also impact many Japanese auto companies who have invested in production facilities which they previously believed would have long-term viability under the original NAFTA agreement. The direct bilateral trade talks between the US and Japan have taken a backseat and any substantive announcements will now be delayed until August, safely after G20 meeting and Japan's July elections.

Economic data was mixed, with the largest positive surprise coming in real GDP growth for the first quarter of 2019. This showed real GDP grew at an annualised rate of 2.1% during the quarter when consensus expectations were for a decline. Although the detailed breakdown is not particularly encouraging for the domestic economy, it does mean that Japan is likely to avoid a technical recession in the short-term. Nevertheless, political commentators continue to ascribe a significant probability to a postponement of the consumption tax increase planned for October.

ASIA (EX JAPAN)

Asia ex Japan equities slumped in May as the worsening US-China trade dispute triggered losses across global markets. The US raised tariffs on US$200 billion worth of Chinese imports to 25%, from 10%, while China announced retaliatory tariffs on US goods. Tensions between the two countries escalated after the US put Chinese telecommunications group Huawei on a trade blacklist, citing security concerns. Sentiment was further rattled by reports that more Chinese technology companies could be penalised.

Chinese stocks fared worst amid the deepening trade conflict and weaker-than-expected economic data for April. Industrial production growth fell to 5.4%, from 8.5% in March. Retail sales rose 7.2% year-on-year, the slowest pace in 16 years. Exports dropped 2.7%, down from a 14.2% jump in March. Hong Kong equities also retreated. Markets in South Korea and Taiwan slid, dragged lower by steep declines in technology heavyweights. In comparison, Indian stocks outperformed as prime minister Narendra Modi and his party won a landslide victory in national elections. The industrials and financials sectors recorded the biggest gains.

ASEAN (Association of Southeast Asian Nations) markets largely outpaced the broader region though most closed in negative territory. The Philippines was the only market to post modest gains, helped by advances in communication services and consumer staples stocks. In political developments, Philippine president Rodrigo Duterte's allies won a resounding victory in mid-term elections. Elsewhere, president Joko Widodo was re-elected as Indonesia's president.

EMERGING MARKETS

Emerging market equities fell in May as US-China trade talks unexpectedly broke down, and global growth concerns increased. Separately, the US announced plans for a 5% levy on Mexican imports. The MSCI Emerging Markets Index declined and underperformed the MSCI World.

China was the weakest index market, negatively impacted by the escalation in trade tensions. The US increased tariffs on $200 billion of Chinese goods imports from 10% to 25%. It also blacklisted Chinese telecoms company Huawei and threatened to levy tariffs on the remaining $300 billion of goods imported from China. China retaliated by raising tariffs on $60 billion of US goods imports from an existing 5-10% range to a maximum of 25%. In addition, China indicated that it is compiling an unreliable entities list of foreign companies considered to have damaged the interests of Chinese companies for non-commercial reasons. Meanwhile domestic economic data for April, notably industrial production, saw some pullback after signs of improvement in March.

South Korea and Taiwan underperformed, amid expectations for supply chain disruption and a negative impact from weaker global trade. Other laggards were Colombia, where a correction in the price of crude oil weighed on sentiment, and Chile, where copper price weakness was a headwind.

By contrast, Russia posted a solid gain, benefitting from a strong rally in state controlled oil company Gazprom. Brazil and India also outperformed. India registered a small gain as Prime Minister Modi's Bharatiya Janata Party was re-elected with a stronger mandate.

GLOBAL BONDS

An escalation in US-China trade tensions precipitated a sharp risk-off move in markets in May following several months of strong gains. While expectations had been growing that the two sides would reach an agreement, none materialised. The US raised tariffs on $200 billion of Chinese imports to 25% from 10% with China later retaliating. The US additionally blacklisted Chinese technology company Huawei, barring US companies from selling to them, and threatened a 5% import tariff on Mexico.

Economic data was broadly underwhelming. The US composite leading indicator dropped to a three-year low with both the manufacturing and services components dipping close to contractionary levels. Data across the eurozone was mixed. German activity data continued to disappoint, particularly in manufacturing, while unemployment unexpectedly rose. However, data out of France showed some signs of improvement, with stronger-than-expected business confidence.

Global government bond yields fell markedly. The US 10-year Treasury yield was 38 basis points (bps) lower, finishing the month at close to 2.1%, levels not seen since late-2017. The difference between 10-year and three-month US Treasury yields fell below zero once more. This inversion in the yield curve (longer maturity yields are usually higher than shorter-dated) indicated bond investors' negative view of the economic outlook.

In Europe, German Bund 10-year yields were 21bps lower, moving back below zero, while French and Spanish yields also fell. Concerns around Italian politics and debt levels resurfaced resulting in 10-year yields increasing by nearly 10bps and two-

year yields by 23bps. UK economic data remained resilient, but UK 10-year gilt yields fell 30bps as Brexit uncertainty remained heightened with Prime Minister Theresa May announcing her resignation.

With investors turning to safe havens, global government bonds benefited while riskier assets underperformed. Given the deterioration in investor sentiment, high yield[2] underperformed investment grade credit. Meanwhile, emerging market (EM) bond yields fell, both across sovereigns and corporates, in investment grade notably, but EM currencies broadly weakened.

Convertible bonds as measured by the Thomson Reuters Global Focus index shed only 3% in US dollar terms compared to -5.8% for the MSCI World. As a result of the equity market sell-off, US convertibles became more cheaply valued. Europe remains the most expensive region, while Japanese and Asian convertibles are trading below fair value.

COMMODITIES

Commodities were hit by global growth concerns and the S&P GSCI Spot Index recorded a negative return. Energy dragged on the index as both Brent crude and natural gas prices fell. Industrial metals also recorded a negative return, with copper and zinc particularly weak. By contrast, agricultural commodities gained strongly. Corn and wheat prices gained as adverse weather conditions in the US increased the risk of yield shortfalls. Precious metals also posted a positive return, underpinned by a rising gold price.

[1] The purchasing managers' index is based on survey data from companies in the manufacturing sector. 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.

TOTAL RETURNS (NET) % – TO END MAY 2019

	1 MONTH			12 MONTHS		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	-5.8	-5.2	-2.5	-0.3	4.4	5.3
MSCI World Value	-6.3	-5.8	-3.1	-2.0	2.6	3.4
MSCI World Growth	-5.3	-4.7	-2.0	1.5	6.3	7.1
MSCI World Smaller Companies	-6.5	-6.0	-3.3	-8.4	-4.0	-3.3
MSCI Emerging Markets	-7.3	-6.7	-4.1	-8.7	-4.4	-3.6
MSCI AC Asia ex Japan	-8.5	-8.0	-5.4	-11.1	-6.9	-6.1
S&P500	-6.4	-5.8	-3.1	3.8	8.7	9.6
MSCI EMU	-6.4	-5.9	-3.2	-8.1	-3.8	-3.0
FTSE Europe ex UK	-4.9	-4.4	-1.7	-3.6	1.0	1.8
FTSE All-Share	-6.2	-5.7	-3.0	-8.3	-3.9	-3.2
TOPIX*	-4.1	-3.6	-0.8	-11.3	-7.1	-6.4

	1 MONTH			12 MONTHS		
Government Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	2.5	3.1	6.0	6.5	11.6	12.4
JPM GBI UK All Mats	-0.5	0.1	2.9	-1.1	3.6	4.4
JPM GBI Japan All Mats**	3.4	4.0	6.9	2.7	7.6	8.4
JPM GBI Germany All Traded	0.9	1.5	4.4	-0.7	4.1	4.9
Corporate Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	0.7	1.3	4.2	4.5	9.5	10.3
BofA ML US Corporate Master	1.4	2.0	4.9	7.5	12.6	13.5
BofA ML EMU Corporate ex T1 (5-10Y)	-0.7	-0.1	2.7	-0.1	4.6	5.4
BofA ML £ Non-Gilts	-2.3	-1.8	1.0	-1.2	3.5	4.3
Non-investment Grade Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	-1.2	-0.6	2.2	4.5	9.4	10.3
BofA ML Euro High Yield	-1.7	-1.2	1.6	-1.4	3.2	4.0

Source: Thomson Reuters DataStream.
Local currency returns in May 2019: *-6.5%, **0.8%.
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Source: Schroders, May 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.

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