FINURA

MARKET COMMENTARY
JULY 2019

INFOGRAPHIC: THE GLOBAL ECONOMY

What is left in the toolkit for central banks in developed markets?

Read article here

Interest rates remain low with little room to make cuts but there are other tools that can be used if needed

Forward guidance
Signalling policy intent helps lower interest rate expectations

Quantitative Easing (QE)
Buying government bonds drives yields down

Expanding scope of QE
Buying credit and equities creates a wealth effect

Tiered interest rates and "yield curve control"*
Makes negative rates and QE more sustainable

Helicopter money
Central banks print money and distribute it directly

But these all have limitations, increasing the reliance on fiscal policy (i.e. tax and spending) in the next economic downturn

*i.e. control of both short-term and long-term interest rates

Why central banks' arsenal gives emerging markets (EM) an advantage

Read article here

In emerging markets today...

Interest rates look to be too high in many cases

Even after adjusting for **inflation interest rates are positive**, a result of a tight stance on monetary policy

This means EM central banks can **cut without worrying about inflation**

Because...

When the US Federal Reserve (Fed) hiked interest rates in 2018, and then looked set to continue in 2019...

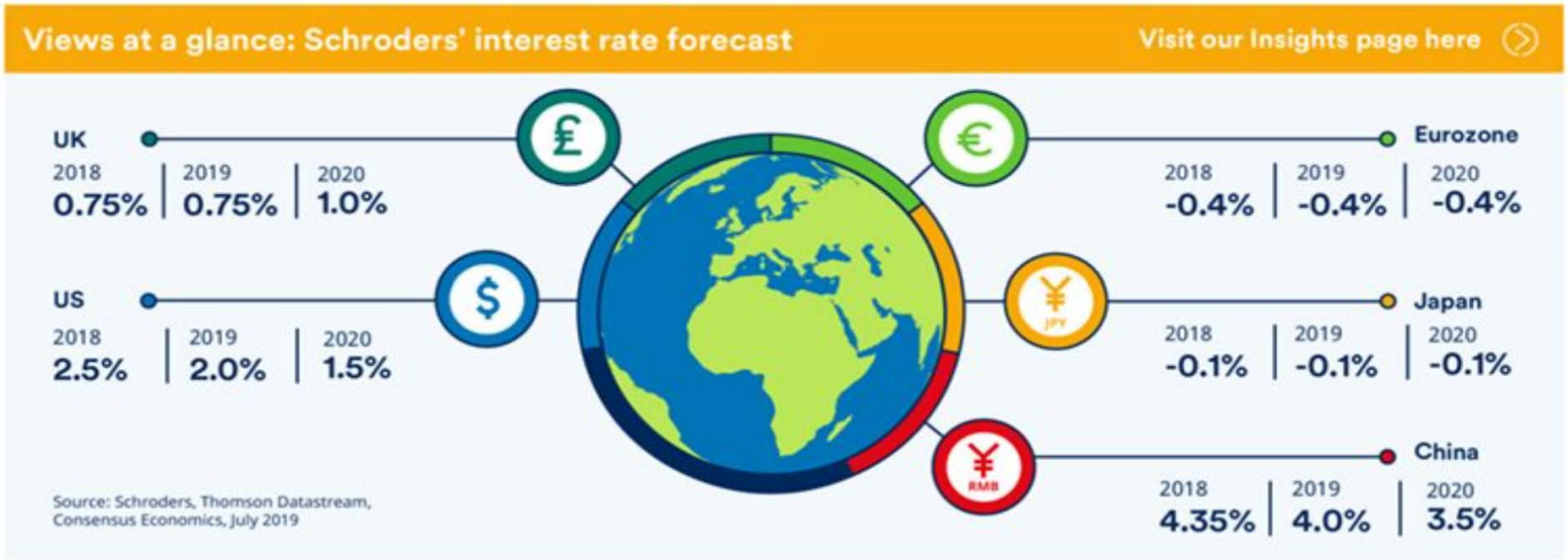
...policy was kept tight in EM, with precautionary hikes in some cases

So, **EM are left with maximum monetary munitions**

Now...

The Fed has indicated interest rate cuts ahead and global inflation remains low

So, the region's central banks have **room to ease rates**



Source: Schroders as at July 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	🟡	We maintain a neutral view as weakening economic momentum is offset by support from dovish central banks.
	Government Bonds	🟢	We hold a positive view as although valuations look stretched, bonds remain a useful defensive asset in portfolios in times of market volatility.
	Commodities	🟡	We remain neutral overall on commodities, but we are positive on gold as it can be useful in times of increased liquidity and geopolitical risks.
	Corporate Bonds	🟢	We are positive as attractive short-term valuations offset longer-term concerns over fundamental credit quality.
Equities	US	🟢	We are positive as the momentum of the US stock market continues to be one of the strongest among the major markets, despite valuations becoming less appealing.
	UK	🔴 ▼	Political uncertainties and the risk of a sterling bounce in the longer term are the main headwinds for the UK equity market (a stronger pound tends to be negative for UK shares as when overseas earnings are translated back into sterling they are worth less).
	Europe	🟡	We remain neutral. A dovish US Federal Reserve (Fed) may weaken the US dollar against the euro and threaten the recently improved European earnings outlook.
	Japan	🟡	We maintain a neutral view as although there are signs of a recovery, export weakness remains a concern.
	Pacific ex-Japan	🟡	We continue to hold a neutral view as export weakness in Singapore remains a drag and momentum is lagging.
	Emerging Markets	🟢	A positive G20 outcome may alleviate near-term pressures, but trade concerns are likely to continue. Markets with a stronger domestic focus present the most interesting opportunities.
Government Bonds	US	🟢	We remain positive as the weak economic outlook and continuing US-China trade war rhetoric are likely to increase demand for Treasuries.
	UK	🟢	We remain positive as UK government bonds (gilts) could profit from further political uncertainty in the UK. In particular, the increasing threat of a "No-Deal" Brexit. Investors tend to head for the perceived safety of gilts at times of uncertainty.
	Germany	🟢 ▲	We have upgraded to double positive. Increased liquidity, investors seeking yields higher than cash rates and possible new stimulus measures by the European Central Bank (ECB) should benefit bonds with longer maturities.
	Japan	🟢	We are positive as export weakness because of the continuing trade war may drive investors towards the relative safety of bonds.
	US Inflation Linked	🟢	We continue to be positive on US inflation.
	Emerging Markets Local	🟢 ▲	We have upgraded to single positive. More dovish tones from major central banks should provide support as investors search for yield.

	Category	View	Comments
Investment Grade Corporate Bonds	US	🟡	We remain neutral as although technical data has improved, valuations have deteriorated.
	Europe	🟢	We maintain a positive view as dovish statements and new appointments at the ECB have increased the likelihood that accommodative monetary policy will continue.
	Emerging Markets USD	🟡	We remain neutral as valuations are still unattractive.
High Yield Bonds	US	🟡	We remain neutral on US high yield bonds as although valuations are attractive, concerns over fundamental credit quality remain.
	Europe	🟢	We remain positive as although valuations are less appealing, the fundamentals are still attractive.
Commodities	Energy	🟡	We maintain a neutral outlook.
	Gold	🟢	We are positive on gold as dovish Fed comments and escalating geopolitical tensions in the Middle East will likely increase demand for the precious metal.
	Industrial Metals	🟡	We maintain a neutral stance on industrial metals.
	Agriculture	🔴 ▼	We are negative on agriculture due to uncertainty on production and Chinese imports.
Currencies	US $	🟢	We remain positive on the US dollar as it may be used as a hedge against weaker global growth.
	UK £	🔴	We remain negative on the pound as the increased probability of a "no-deal" Brexit compounds the effects of weak economic data.
	EU €	🟡	We remain neutral as the ECB's recent indication of further stimulus is a headwind for the euro.
	JAP ¥	🟢	We are positive on the yen as its safe haven status could prove beneficial in a weak economic environment.
	Swiss F	🟡	We remain neutral on the Swiss franc as European industrial weakness is spreading to Switzerland.

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, July 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 July when shares made a modest advance and all eyes were on the Federal Reserve meeting at the end of the month.

HIGHLIGHTS

- Shares in developed markets gained in July but emerging market shares fell amid US dollar strength. Government bond yields fell (i.e. prices rose), while corporate bonds outperformed.
- US equities made gains. Although GDP growth slowed, economic data and earnings generally remained resilient compared to the rest of the world. The Federal Reserve cut interest rates at the end of the month.
- Eurozone equities were virtually flat in July. Top performing sectors included IT and consumer staples. The eurozone economy expanded by 0.2% in Q2, slowing from 0.4% in Q1.
- In the UK, Boris Johnson was confirmed as the new prime minister, raising the possibility of a more extreme Brexit outcome. The drop in sterling was a boost to companies with overseas earnings.
- Japanese shares gained modestly. Prime Minister Abe's party won the Upper House elections which effectively removed any uncertainty over the rise in the consumption tax, scheduled for October.
- Emerging market shares fell, faced by the headwind of a stronger US dollar. South Korea was weak due to a trade dispute with Japan and India underperformed following a disappointing Union Budget announcement.
- US Treasury yields were unchanged but yields fell in Europe (meaning that prices rose). Corporate bonds outperformed government bonds.

THE US

US shares rose modestly in July and outperformed other major stock markets. Investors broadly moved into perceived safe havens such as US Treasuries as trade tensions continue to cloud the outlook for investors and companies alike. However, a positive start to the second quarter earnings season buoyed relative US performance. The Federal Reserve (Fed) acted late in the month to cut interest rates by 25 basis points, but Fed chair Jerome Powell said the cut is "not the beginning of a long series of rate cuts". Investors expecting greater commitment to policy slack were disappointed. Risk appetites dwindled and the US dollar rallied.

The US economy remains on a path of waning growth. Real GDP (which is adjusted for inflation) rose at an annual rate of 2.1% in Q2, a significant slowdown from the 3.1% growth rate recorded in Q1. The July flash composite purchasing managers' index (PMI) [1] inched up by 0.1 to 51.6, with service sector activity offsetting the weakest manufacturing reading since 2009. 164,000 jobs were added to the economy according to the July nonfarm payrolls, which was in line with estimates. Unemployment remains extremely low.

By sector, communication services and information technology performed well over the month, primarily on better-than-expected earnings for Texas Instruments and Alphabet. The energy sector was weaker over the month, with healthcare also among the laggards..

EUROZONE

Eurozone shares were virtually flat in July and the MSCI EMU index returned 0.1%. Top gaining sectors included information technology and consumer staples, boosted by strong Q2

results from companies including Nokia and Danone. Energy and financials were among those that declined. Deutsche Bank reported its largest quarterly loss since 2015 and announced 18,000 job cuts as part of a restructuring plan.

Data showed the eurozone economy expanded by just 0.2% in Q2, slowing from a growth rate of 0.4% in Q1. Annual inflation dropped to 1.1% in July from 1.3% in June. The European Central Bank (ECB) indicated that it was drawing up plans to stimulate the economy given the weak growth and below-target inflation. A package of stimulus measures, including possible rate cuts, is expected to be announced in September. Christine Lagarde, currently head of the International Monetary Fund, was nominated to replace Mario Draghi as president of the ECB when his term ends on 31 October.

The European Commission decided not to take disciplinary action against Italy over its budget deficit after concluding that the Rome government is no longer in breach of the EU's fiscal rules. Spain may face a further general election this year as the Socialist (PSOE) party failed to agree on forming a coalition with Podemos.

UK

The UK was one of the best performing major stock markets over July, in local currency terms. Sterling fell sharply as a result of increased Brexit uncertainty which provided a boost for overseas earners at the top end of the market. Merger and acquisition activity was also supportive. A number of large cap companies which are perceived to have dependable growth prospects extended their strong year-to-date gains amid concerns around the outlook for the global economy. The share prices of these so-called "quality growth" stocks have risen far more quickly than their earnings.

Sterling was weak on renewed fears of a disorderly EU departure after Boris Johnson came to power as the UK's new prime minister on a "do or die" pledge to achieve Brexit on 31 October. Meanwhile, figures from the Office for National Statistics revealed GDP rebounded 0.3% in May, following a 0.4% contraction in April.

Markit's UK manufacturing purchasing managers' index (PMI) slipped to 48.0 in June, from 49.4 in May. Meanwhile the services PMI fell to 50.2, close to the 50 level which separates contraction from expansion, stoking fears of a further loss of momentum in the economy's dominant consumer-exposed sector. On a positive note, retail sales rebounded in June, defying expectations for another month-on-month decline.

JAPAN

The Japanese stock market ended the month with a total return of 0.9%. The yen was marginally weaker against the US dollar in July, although this move was sharply reversed on the first day of August following the cut in US interest rates.

The main domestic event was the Upper House elections which were won comfortably by Mr Abe's Liberal Democratic Party. However, the party fell just short of the two-thirds majority, which would have facilitated Mr Abe's pursuit of constitutional reform. More importantly for equity investors, the result confirmed continuity of policy for the foreseeable future, and effectively removed any remaining uncertainty over the rise in consumption tax in October.

The Bank of Japan made no changes to policy or guidance but the accompanying statements suggest a more proactive stance is possible if the yen were to appreciate to a level that threatened to impact the real economy. Data released in July generally confirmed the existing outlook for Japan, although industrial production data was weaker than expected.

Trade disruption and the global economic slowdown continue to impact Japanese corporate results and future guidance. The reporting season for the quarter ended June 2019 was well underway by the end of July, with a slightly negative bias and the likelihood of a quarter-on-quarter decline in aggregate earnings. Although most of these factors are already priced in to the equity market, companies are likely to maintain a conservative approach to their full-year guidance.

ASIA (EX JAPAN)

Asian shares, as measured by the MSCI Asia ex Japan index, registered a negative return in July. Q2 earnings results and economic data for the region were mixed.

South Korea, where a trade dispute with Japan weighed on the outlook, and India were the weakest index markets. In India, the Union Budget announcement was disappointing while economic data and initial earnings season results were lacklustre. Thailand also lagged, as the market fell back following strong performance in June.

Conversely, Taiwan posted a solid gain, led higher by IT stocks which continued to be impacted by US-China trade developments. The easing of US restrictions on Chinese telecoms company Huawei boosted sentiment somewhat. Indonesia and the Philippines finished in positive territory and outperformed. China posted a small negative return but outperformed the MSCI Asia ex Japan index. Trade talks with the US resumed albeit little progress was achieved. However, economic data for June saw some recovery.

EMERGING MARKETS

Emerging market equities fell back in July, with US dollar strength a headwind. The MSCI Emerging Markets index decreased in value and underperformed the MSCI World.

South Korea was the weakest index market amid a trade dispute with Japan. President Trump's criticism of the country's special status at the World Trade Organisation (WTO) also exacerbated ongoing concerns over trade and global growth. South Korea is deemed a developing country under the WTO regime. India underperformed following a disappointing Union Budget announcement. Mexico, where the finance minister resigned citing differences with the president, and the Andean markets of Chile and Peru also lagged.

By contrast, Turkey registered a robust return as the central bank cut interest rates by 425bps to 19.75%; more than an expected 250bps cut. Brazil posted a positive return amid progress in pension reform progress. Taiwan also outperformed, led higher by technology stocks, which continued to be affected by sentiment towards the US-China trade dispute.

GLOBAL BONDS

Expectations of an interest rate cut in the US continued to build as the 31 July Fed policy meeting came into view. As the meeting drew closer investors seemed all but certain of a 25 basis point

(bps) cut, with some expecting 50 bps. The Fed implemented a 25 bps cut at its meeting, taking rates to 2.00-2.25%, but tempered expectations of further rate cuts.

US 10-year Treasury yields finished the month unchanged, following the significant drop year-to-date. US retail sales, labour market and core consumer inflation data were firm, while manufacturing indicators were comparatively weak.

In Europe, the German 10-year yield fell seven bps to -0.40% and the French 10-year yield fell 17bps to -0.18%. The Italian 10-year yield was over 50bps lower. While the ECB kept its monetary policy settings unchanged, it hinted that further accommodation could be announced in September. European industrial production data produced a positive surprise, but overall data remained muted.

Boris Johnson was confirmed as the UK's new prime minister, which appears to raise the possibility of a more extreme Brexit outcome. The UK 10-year gilt yield, having lagged in previous months, fell 20bps. The Bank of England (BoE) continues to view Brexit as a binary risk to its economic outlook.

Corporate bonds had another positive month, across both investment grade[2] (IG) and high yield (HY), outperforming government bonds. The difference, or spread, between corporate over government yields narrowed. In IG, the euro and sterling markets performed particularly well, helped by the downward moves in rates.
Emerging market (EM) bonds had another positive month. The US dollar strengthened, rebounding after June's drop, but certain EM currencies performed well given the prospect of lower US rates.

COMMODITIES

In commodities, the S&P GSCI Spot index was down in July, with US dollar strength a headwind. Soft commodities were weak, most notably wheat and corn prices. Industrial metals recorded a small gain, supported by a rally in nickel and steel prices. The energy component of the index posted a marginally positive return, underpinned by a rally in natural gas prices. Brent crude was slightly lower. Precious metals posted a solid gain, amid a 6.2% rally in gold spot prices.

[1] The purchasing managers' index is based on survey data from companies in the manufacturing and service sectors. A reading above 50 indicates expansion while a reading under 50 indicates contraction.

[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 JULY 2019

	1 MONTH			12 MONTHS		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	0.5	2.8	4.5	3.6	8.9	11.0
MSCI World Value	-0.2	2.1	3.8	0.4	5.5	7.5
MSCI World Growth	1.1	3.4	5.1	6.9	12.3	14.5
MSCI World Smaller Companies	0.6	2.9	4.5	-3.3	1.6	3.5
MSCI Emerging Markets	-1.2	1.0	2.7	-2.2	2.8	4.8
MSCI AC Asia ex Japan	-1.8	0.5	2.1	-3.0	1.9	3.9
S&P500	1.4	3.8	5.4	8.0	13.5	15.7
MSCI EMU	-2.1	0.1	1.8	-6.0	-1.2	0.7
FTSE Europe ex UK	-1.9	0.3	2.0	-2.2	2.7	4.7
FTSE All-Share	-1.9	0.4	2.0	-5.5	-0.7	1.3
TOPIX*	0.1	2.4	4.1	-5.8	-1.0	1.0

	1 MONTH			12 MONTHS		
Government Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	-0.1	2.2	3.9	7.9	13.4	15.6
JPM GBI UK All Mats	-1.6	0.6	2.2	0.8	5.9	8.0
JPM GBI Japan All Mats**	-0.6	1.7	3.3	6.9	12.4	14.6
JPM GBI Germany All Traded	-1.3	1.0	2.6	1.5	6.7	8.8
Corporate Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	0.1	2.4	4.1	7.3	12.8	15.0
BofA ML US Corporate Master	0.7	3.0	4.6	0.5	16.1	18.3
BofA ML EMU Corporate ex T1 (5-10Y)	-0.3	2.0	3.6	3.3	8.6	10.7
BofA ML £ Non-Gilts	-1.8	0.4	2.1	0.8	6.0	8.0
Non-investment Grade Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	0.3	2.6	4.2	6.3	11.7	13.9
BofA ML Euro High Yield	-1.5	0.8	2.4	-0.2	4.8	6.9

Source: Thomson Reuters DataStream.
Local currency returns in July 2019: *0.9%, **0.2%.
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Source: Schroders, July 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. Past performance mentioned is not a guide to future performance and may not be repeated. The sectors, securities, regions and countries shown are for illustrative purposes only and are not to be considered a recommendation to buy or sell.

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