Schroders

Monthly markets review

Overview of markets in July 2014

Highlights:

- Global equities delivered negative returns in July amid heightened geopolitical tensions and speculation over when the Federal Reserve will raise interest rates. Emerging markets outperformed their developed market peers.
- In the US, the S&P 500 posted a negative return. Macroeconomic data largely confirmed the ongoing improvement in the US economy, particularly in the labour market, although this in turn raised concerns that US interest rates could rise sooner than expected.
- Eurozone equities delivered negative returns, impacted by fears over the financial health of one of Portugal's largest banks as well as worries that the economic recovery might be slowing.
- Japan registered positive returns, outperforming other developed markets, as corporate earnings benefited from the weaker yen.
- Emerging markets posted positive returns. Emerging Asia was the strongest region, supported by an improved tone to macroeconomic data from China.

US

In the US, the S&P 500 index returned -1.4%. Much of the downward pressure came on the final day of the month when the index suffered its steepest one-day fall since April. Over the month, economic data releases continued to be largely upbeat but this served to intensify speculation that the Federal Reserve may need to raise interest rates sooner than expected. Data showed an ongoing improvement regarding the employment situation with the jobless rate falling to 6.1% in June. GDP showed a strong rebound for the second quarter with an annualised growth rate of 4.0%. Consumer confidence also improved with the Conference Board's index rising to 90.7 in July, the highest level since October 2007. The employment cost index, which measures the growth of employee wages and benefits, climbed 0.7% in the second quarter. However, the housing market remained a notable weak spot. New home sales fell 8.1% in June compared to the previous month.

Minutes from the Federal Reserve's (Fed) latest policy-setting meeting indicated that the tapering of the quantitative easing programme would end in October, provided the economic recovery remains on track. At the end of the month, the first sign of dissent emerged from within the Federal Open Market Committee as Charles Plosser objected to the guidance that current low rates would likely be maintained for a considerable time after the asset purchase programme ends. He argued that the guidance does not reflect the economic progress made so far.

Merger & acquisition activity continued during the month, with pharmaceutical group AbbVie finally clinching a deal to buy UK-listed Shire while Twentieth Century Fox made an offer for Time Warner. In testimony to Congress, Fed chair Janet Yellen commented that valuations of smaller companies as well as some social media and biotechnology stocks appeared stretched, prompting some mid-month volatility.

Eurozone

Eurozone equities delivered negative returns in July. The volatile situation in Ukraine and capital concerns facing a Portuguese bank weighed on returns, as did worries that the region's nascent economic recovery may be slowing. Industrial production data from the three largest economies – Germany, France, and Italy – were disappointing. Overall, the eurozone registered a 1.1% month on month decline in industrial production in May.

However, the flash reading of the eurozone composite purchasing managers' index (PMI) for July was more encouraging, coming in at 54.0 compared to 52.8 in June. As expected, the European Central Bank kept interest rates on hold following the policy moves announced at its June meeting. Inflation continued to be well below target, dipping to 0.4% in July from 0.5% in June. Outside the eurozone, Sweden's Riksbank cut interest rates to 0.25% from 0.75% in an effort to stimulate growth.

Concerns over the health of the region's banks re-emerged after audit problems at Banco Espirito Santo's parent company. The news caused a temporary spike in Portuguese government bond yields as investors feared the state may have to step in to support the bank. Ratings agency Moody's lifted Portugal's credit rating to Ba1, just below investment grade, arguing that Banco Espirito Santo's difficulties were unlikely to affect government finances. There was little sign of contagion effects on other peripheral markets. Portugal's stockmarket delivered a steep negative return for the month, underperforming other eurozone markets. At sector level, information technology was the only sector to register positive returns for the month, supported by some strong quarterly earnings reports. Energy delivered the weakest returns as softer oil prices saw the sector retrace some of the gains made earlier this year.

UK

In spite of mounting geopolitical concerns around the globe the FTSE All-Share index registered only a modest decline in July, falling 0.3%. At the sector level, basic materials (led by the miners) were the clear outperformers over the month. Oft thought of as a proxy for emerging market growth, a number of positive data releases from China buoyed the sector. China's official manufacturing purchasing managers' index (PMI) reached 51.7 in July – a 27-month high and an indication that the government's stimulus programme is beginning to take effect. Financials also fared well over the month as better-than-expected results from a number of banks lifted the sector. On the downside, the oil & gas and consumer services sectors underperformed the market – the latter dragged down by lacklustre returns from the domestic supermarkets.

In terms of UK economic data, there were a number of reasons to be cheerful. PMI manufacturing was a positive surprise as it reached the highest level in seven months. PMI construction was also supportive – the headline index accelerated to the second highest level in more than a decade. On the employment front, the KPMG/REC employment report pointed to further gains in labour demand. It noted that wage pressures are picking up with the index for pay growth among new hires of permanent staff at a record high (official wage data remains subdued, however). UK core CPI unexpectedly rebounded to 2%. The largest contributions to the rise in the headline rate came from the clothing, food & non-alcoholic drinks and air transport sectors. Consensus estimates for a rate interest hike by the Bank of England remain in late 2014/early 2015.

Japan

The Japanese equity market rose a further 2.1% in July, the third consecutive monthly increase. The yen was virtually unchanged against sterling during the month, but weakened against the US dollar. In general the equity market and currency have shown much lower correlation in recent months, suggesting that investors may be focusing more on company-specific fundamentals, rather than simply viewing Japan as a broad macro-trade on the currency. The equity market in July was led by non-ferrous metal stocks, rubber companies (primarily auto tyre manufacturers) and electrical appliance makers. All financial-related sectors, including banks, underperformed with the weakest areas being insurance, securities brokers and "other financials" (primarily leasing companies and consumer finance).

Economic data began to deteriorate sharply in July, with industrial production data and retail sales numbers significantly below expectations. While the second quarter of 2014 was always expected to be weak following the increase in consumption tax in April, data released in July suggest that the economy has not yet recovered momentum. Data on the labour market was also mixed with positive indications of tighter conditions offset by very little evidence yet of meaningful increases in wages. Contrary to the macro data, many companies continue to display increasing levels of confidence in the outlook. The earnings results season for the April to June quarter was just beginning at the end of July and early indications suggest that profit growth for many companies could exceed initial expectations.

Asia (ex Japan)

Asia ex Japan equities continued on their strong run in July as markets again delivered positive returns following a brighter outlook for the US economy and a pickup in key growth data for the Chinese economy. Chinese equities bounced back strongly over the month as the Shanghai Composite posted its best monthly performance since December 2012, and also hit a nine-month high, following stronger-than-expected data from the world's second-largest economy. Second quarter GDP growth of 7.5% year-on-year was in line with expectations and the widely-watched HSBC manufacturing PMI showed its first expansion in six months as the 50.7 June reading took the gauge beyond the 50-point level that separates growth from contraction. Trade data were rather mixed as exports came in below market expectations yet June inflation of just 2.3% means there is significant room for Chinese authorities to increased targeted 'mini-stimulus' measures in the second half of the year. Hong Kong equities followed suit by posting strong gains as the benchmark Hang Seng Index reached a three-year high over the month.

Meanwhile, Taiwan's market finished flat despite the island's economy posting strong second quarter GDP growth of 3.8% year-on-year as the run up in its technology sector paused for breath. Fellow exporter Korea saw its market reach a three-year high in July as strong foreign fund inflows continued to support market sentiment while better-than-expected industrial production numbers and a US$40 billion stimulus package from the government also contributed to further gains. In ASEAN, the Philippine market was marginally up while Thailand continued its run by posting another solid month of gains following renewed optimism over the direction of its economy after a coup restored a degree of stability in the country. Indonesia was the region's big winner as it surged on the announced presidential victory of former Jakarta governor, and market favourite, Joko Widodo. India also posted gains as Narendra Modi's new government unveiled a budget aimed at boosting growth and encouraging foreign investment.

Emerging markets

In the emerging markets, some encouraging macroeconomic data releases out of China, positive reform momentum in certain markets, and an accommodative liquidity environment helped the MSCI Emerging Markets (EM) index to outperform its developed world counterpart over the period.

Emerging Asia was the best performing region over the month, led by gains in Indonesia where sentiment was boosted by the electoral victory of the business-friendly reformist, Joko Widodo. China was also a strong performer given broadly encouraging macroeconomic data releases that suggest the authorities' policy fine-tuning measures are taking effect. All of the Latin American markets lagged the EM index with the exception of Brazil, which performed broadly in line as optimism about some signs of a potential change in government following October's elections continued to drive gains. The improved Chinese data was also supportive. Chile was the biggest regional laggard amid continued local currency weakness and deteriorating confidence indicators. The central bank lowered interest rates by 25bps to 3.75% in a bid to support the slowing economy. In emerging EMEA, Qatar and the UAE were the strongest outperformers as both markets rebounded following a sharp selloff in June. Russia was negatively affected by a deterioration in the Ukraine situation and the weak growth outlook. Increasingly broad and severe Western sanctions on some Russian companies and sectors also weighed on sentiment. Hungary was the worst performer as index heavyweight Gedeon Richter suffered given its exposure to Russia.

Global bonds

Fixed income market returns were flatter in July having performing strongly for the first half of the year. The resurgence in geopolitical concerns meant that while sovereign bonds were relatively unchanged, riskier assets underperformed.

Gilt yields fell back in line with their US counterparts in July; the 10-year gilt yield fell from 2.67% to 2.60%. Investors' expectations of a rate rise from the Bank of England diminished in the short term, despite a rise in the core inflation number to 2%. In the US, the potential for a more hawkish shift in policy by the Federal Reserve remained at the forefront of investors' minds, with all eyes on the July Federal Open Market Committee meeting. Treasury yields rose modestly, with the 10-year rate rising from 2.53% to 2.56%. Bund yields meanwhile continued to grind lower, the 10-year rate reaching a new record low of 1.11% on 29 July before recovering slightly to 1.16% by month end. The escalation of the Ukraine/Russia crisis as well as expectations of a prolonged period of policy accommodation from the European Central Bank drove sovereign yields across the region to new lows.

In credit markets, the 12-month run of consecutively positive returns for high yield bonds came to an end. The Bank of America Merrill Lynch Global High Yield index fell -0.94% in July, while investment grade bonds eked out a positive total return of 0.10%. Sterling and euro credit indices were ahead of dollar names in July.

Overview: total returns (%) – to end of July 2014

	1 month			12 months		
Equities	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
MSCI World	0.71	-1.57	-0.32	8.62	16.58	4.69
MSCI World Value	0.71	-1.57	-0.32	8.64	16.7	4.80
MSCI World Growth	0.71	-1.57	-0.32	8.61	16.46	4.58
MSCI World Smaller Companies	-1.79	-4.02	-2.79	11.88	15.31	3.55
MSCI Emerging Markets	4.38	2.02	3.32	2.42	15.72	3.92
MSCI AC Asia ex Japan	6.24	3.83	5.15	2.81	18.89	6.76
S&P500	0.91	-1.38	-0.12	8.56	16.94	5.01
MSCI EMU	-3.37	-5.56	-4.35	16.22	16.91	4.98
FTSE Europe ex UK	-2.68	-4.88	-3.67	14.42	15.97	4.14
FTSE All-Share	0.73	-1.56	-0.30	9.77	17.61	5.61
TOPIX*	2.94	0.61	1.90	-0.43	11.14	-0.20

	1 month			12 months		
Government bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
JPM GBI US All Mats	2.16	-0.15	1.12	-2.74	2.40	-8.04
JPM GBI UK All Mats	2.05	-0.26	1.01	6.56	14.42	2.74
JPM GBI Japan All Mats**	0.96	-1.32	-0.06	-6.07	-1.42	-11.48
JPM GBI Germany All Mats	0.59	-1.68	-0.43	1.68	5.41	-5.34
Corporate bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global Broad Market Corporate	1.58	-0.72	0.55	1.22	7.26	-3.69
BofA ML US Corporate Master	2.20	-0.12	1.16	0.37	7.06	-3.86
BofA ML EMU Corporate ex T1 (5-10Y)	0.63	-1.65	-0.39	5.26	10.60	-0.69
BofA ML £ Non-Gilts	1.55	-0.75	0.52	8.76	17.38	5.40
Non-investment grade bonds	**EUR**	**USD**	**GBP**	**EUR**	**USD**	**GBP**
BofA ML Global High Yield	0.87	-1.42	-0.16	4.09	9.60	-1.58
BofA ML Euro High Yield	-0.33	-2.59	-1.35	8.73	11.68	0.29

Source: DataStream. Local currency returns in July 2014. *2.13% **0.17%.