

Schroders

Quarterly markets review

Overview of markets in Q3 2015

Highlights:

- Global equities declined amid worries about the economic slowdown in China and the implications for global growth. Emerging market equities underperformed developed markets.
- The US Federal Reserve's decision to defer 'lift off' of interest rates was a key moment in the quarter and exacerbated the sense of uncertainty in markets.
- In the eurozone, the autos sector came under severe pressure after revelations that VW had misled regulators on emissions from diesel vehicles.
- Japanese equities suffered amid weaker-than-expected data for Japan's economy. Stocks were further pressured as the yen saw inflows due to its perceived 'safe haven' status.
- Weak Chinese economic data was a drag on emerging markets while Brazil was also a focus as S&P Ratings downgraded the country's debt to non-investment grade.
- The third quarter was broadly positive for global bonds, as commodity price weakness and fears over global economic growth led investors to seek out 'safe havens'.

US

US equities performed poorly, in line with global equities, as markets fretted about the extent of the economic slowdown in China and emerging markets, and what that might mean for global growth. The S&P 500 fell 6.4%.

While the Federal Reserve (Fed) delayed its much-anticipated 'lift off' in interest rates, this was not taken as a positive signal by investors. Markets instead focused on the comments made by Fed chair Janet Yellen at the subsequent news conference, where she cited worries about the world economic outlook in explaining the decision to delay a rate hike. In the currency markets, the US dollar was weaker over the quarter against most other major currencies, depreciating by 2.2% compared to the yen and 0.3% versus the euro. Against the pound sterling, however, the dollar was 3.7% stronger.

Amid the 'risk-off' environment the equity market's bond proxies performed well, notably utilities, which was the only sector to rise. The defensive consumer staples sector also performed relatively well. The resource sectors continued to weaken, while healthcare's strong run came to an abrupt halt, after Democratic Party presidential hopeful Hillary Clinton attacked pharmaceutical pricing.

On the data front, there were few signs that the consumer-led recovery was slowing down, as the Conference Board measure of consumer confidence improved to 103.0 in September, back to January's high. Second-quarter GDP growth was revised upwards, from 3.7% to 3.9% (annualised).

Eurozone

Eurozone equities registered negative returns as worries over global growth weighed on appetite for risk assets. These concerns were partly driven by weaker data from China and the authorities' moves to devalue the yuan. Uncertainty over US monetary policy also contributed to the risk-off sentiment, as did a scandal over emissions from VW diesel vehicles.

The downbeat global mood overshadowed further encouraging data from the eurozone. GDP rose by 0.4% quarter on quarter in Q2 (revised up from a preliminary reading of 0.3%). The flash composite purchasing managers' index (PMI) for September was 53.9, down from 54.3 in August. The French economy showed

improvement, including consumer sentiment rising to 97 points in September – its highest level in nearly eight years. However, eurozone inflation remained well below target at just 0.1% in August compared to 0.2% in July. Elsewhere, the eurozone approved Greece's €86 billion bailout package and the Greek electorate went to the polls again with left-wing party Syriza emerging as the victor once more.

On the corporate front, all sectors saw negative returns although healthcare and telecommunications held up better than the rest. Auto stocks were among the worst performers over the period, due in part to expectations that a slowing Chinese economy would see reduced demand. Further pressure was then heaped on the sector after revelations that VW had misled regulators in emissions tests on its diesel vehicles. VW set aside €6.5 billion in provisions and the scandal ensured that Germany's Dax was one of the weakest European indices for the quarter.

UK

The FTSE All-Share declined by 5.7% amid concerns of a deeper-than-feared slowdown in the Chinese economy and an across-the-board deceleration in emerging markets growth. Emblematic of the pressures facing the resource companies, the share price of FTSE 100 mining and trading group Glencore fell by almost two thirds as the market focused on its high level of financial gearing in a weak commodity price environment.

Reflective of the risk-off environment, government bonds performed well with FTSE Group's All Stocks Index, which tracks UK gilt prices, rallying 3.1%. There was a strong performance from bond proxies too, such as the utility firms and cigarette companies. Indeed, the stable and defensive companies performed well more generally, among them Reckitt Benckiser and Unilever. However, merger and acquisition (M&A) activity did play a part in the consumer staples' good performance, as drinks giant SABMiller confirmed an approach from Anheuser-Busch InBev, while Imperial Tobacco was at the centre of break-up speculation.

M&A activity continued to be a theme across the market, with Pearson selling the Financial Times to Japan's Nikkei, generic drug specialist Hikma Pharmaceutical acquiring US peer Roxane Laboratories and Shire making a hostile bid for drugmaker Baxalta. In addition, US activist hedge fund ValueAct Capital took a stake in industrial conglomerate Smiths Group, there was a merger agreement between Betfair and bookmarker Paddy Power, and HSBC announced it is to dispose of its Brazilian unit Bradesco.

Elsewhere, there were notable profit warnings from engineer Rolls-Royce, due to issues at its core civil aerospace unit, and from industrial valves and actuators manufacturer Rotork. The latter suffered a particularly weak August, following project cancellations and deferrals, which analysts say were mainly related to its oil and gas clients. Weir Group, a maker of industrial pumps and actuators, warned on revenues due to a slowdown in demand from the oil & gas industry. Wolseley, a supplier of plumbing, heating and other building materials, also warned on revenues following a decline in activity in its North American industrial market, particularly in the major oil-producing states.

Japan

The Japanese stockmarket came under heavy selling pressure in the third quarter as the benchmark TOPIX Index fell 12.8%, in yen terms, amidst slowing global growth and weaker-than-expected data for the Japanese economy. Stocks slid to an eight-month low while the Japanese yen strengthened as the currency saw inflows based on its perceived 'safe haven' status. August saw the start of a global selloff that engulfed markets while the delay in an interest rate hike by the US Fed also hit sentiment. Foreign investors were significant sellers in the Japanese market over the period. Heightened levels of uncertainty also led to a sharp strengthening of the yen against major currencies, reversing most of the weakness seen year-to-date.

Locally, the corporate results season was solid and beat consensus expectations but on the data front, the numbers remained mixed. Core inflation fell for the first time in over two years, entering deflationary territory in August, and increased the pressure on the Bank of Japan to further ease monetary policy. However, labour market conditions remained on the right track. Weakening economic sentiment also led to a questioning of the merits of Abenomics and the market now seems preoccupied with the potential setback to corporate earnings prospects going into next year.

Asia (ex Japan)

Asia ex Japan equities delivered negative returns as volatility in Chinese markets, particularly A-shares, and slowing growth in the world's second-largest economy led to a global selloff. Chinese equities led the losses as the country's A-shares saw heavy selling pressure on the deleveraging and unwinding of margin financing

– a strong driver of the Chinese market rally earlier in the year – as well as on uncertainty over the Chinese government's willingness to support the stockmarket. A devaluation of the yuan by the People's Bank of China (PBoC) in early August, via the currency's daily fixing rate, also hit sentiment. The closely-watched Caixin China manufacturing PMI reading for August plumbed a six-year low of 47.3 while the PBoC also cut interest and reserve requirement ratio rates in an attempt to support growth.

Meanwhile, Hong Kong stocks fell sharply on weaker China data as well as a slowdown in its local economy, given lower Chinese consumer spending. Taiwanese equities declined, led by its large technology sector, on worries over slowing global growth while Korea, a fellow export-oriented economy, saw its market fall on the back of a weaker Korean won and soft trade data.

In ASEAN, all markets declined, with Thailand and the Philippines falling on growth concerns. Indonesian stocks suffered the most as its currency hit a multi-year low amidst disappointing growth data. Although Indian stocks also declined, they were the region's best performer as the economy continues to show signs of a pick-up in growth while a larger-than-expected interest rate cut late in the period helped to support the market.

Emerging markets

Emerging markets registered a sharp decline as US rate hike uncertainty, concerns over the health of the Chinese economy, political risk and commodity price weakness all contributed to risk aversion. The MSCI Emerging Markets (EM) index underperformed MSCI World. In emerging EMEA, South Africa was down sharply and underperformed with rising expectations for a tightening in global liquidity acting as a headwind for the market. Turkey also lagged. Coalition negotiations, following indecisive elections, failed and fresh elections will take place in November. Meanwhile, the government joined US-led attacks on IS in Syria and Iraq, but also cracked down on the Kurdistan Workers Party (PKK), leading the group to end its ceasefire with the government. Greece was the weakest index country. Although a third bailout deal was agreed, the imposition of capital controls means banks are now expected to require a sizeable recapitalisation.

In emerging Asia, India held up best. Q2 GDP growth eased to 7% year on year but economic data generally remained constructive. In September, the central bank then cut rates more than anticipated to 6.75%, after inflation eased to 3.7%. Amid some high volatility, particularly in July, China lagged. Macro data continued to weaken and the authorities cut the main interest rate and lowered bank reserve ratio requirements. The central bank also altered the way it fixes the renminbi, to be more market driven, raising wider concerns on the health of the economy and sparking uncertainty over future policy responses. Indonesia underperformed with currency weakness magnifying negative returns. The country has a high current account deficit and the market was negatively impacted by expectations of an interest rate hike from the Fed.

Latin America was the worst performing region with commodity price declines having a negative impact on several markets. Currency weakness across the region amplified losses. Colombian equities were impacted by lower oil prices and the peso was down 16.6%. Brazil recorded the steepest decline as the macro outlook deteriorated and the government went back on a commitment to a primary surplus in 2016, prompting a credit rating downgrade to junk status.

Global bonds

The third quarter of 2015 was broadly positive for global bonds, as commodity price weakness and fears over global economic growth led investors to seek out perceived 'safe havens'. Amid the uncertainty, accommodation in monetary policy remained high or increased. In August, additional easing measures were introduced by the Chinese central bank. In September, the Fed announced its headline policy rate would not rise. Global government bond yields were almost universally lower in Q3. Investment grade¹ corporate bonds inched into positive territory, although high yield bonds struggled.

The 10-year Treasury yield fell from 2.35% to 2.04% in Q3. The 10-year gilt yield fell from 2.02% to 1.76%, as the equivalent Bund yield declined from 0.76% to 0.59%. In peripheral Europe, government bond yields fell more steeply. The Italian 10-year yield fell from 2.33% to 1.73% and the Spanish 10-year yield fell from 2.31% to 1.89%.

¹ 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.

In corporate bond markets, the investment grade BofA Global Corporate Index generated a total return of 0.25%, outperforming the high yield index which declined -4.51% (both in local currency). Sterling denominated bonds were the strongest performers among major investment grade indices in the quarter, followed by the dollar investment grade corporate bond index. Euro denominated equivalents produced negative total returns. In high yield indices, dollar denominated bonds were substantially weaker than either of the euro or sterling equivalents, though all were negative on a total returns basis.

Overview: total returns (%) – to end of Q3 2015

Equities	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
MSCI World	-8.50	-8.33	-4.83	8.00	-4.57	2.13
MSCI World Value	-9.29	-9.12	-5.65	3.37	-8.66	-2.25
MSCI World Growth	-7.73	-7.56	-4.02	12.68	-0.43	6.56
MSCI World Smaller Companies	-9.82	-9.65	-6.19	11.65	-1.34	5.59
MSCI Emerging Markets	-17.93	-17.78	-14.64	8.32	-18.98	-13.29
MSCI AC Asia ex Japan	-17.09	-16.94	-13.76	-0.58	-12.15	-5.98
S&P500	-6.61	-6.44	-2.86	12.47	-0.61	6.37
MSCI EMU	-8.53	-8.36	-4.85	3.66	-8.40	-1.96
FTSE Europe ex UK	-8.29	-8.12	-4.60	4.46	-7.69	-1.21
FTSE All-Share	-9.34	-9.18	-5.70	3.31	-8.71	-2.30
TOPIX*	-11.05	-10.89	-7.48	12.38	-0.69	6.28

Government bonds	3 months			12 months		
	EUR	USD	GBP	EUR	USD	GBP
JPM GBI US All Mats	1.76	1.95	5.85	17.88	4.17	11.48
JPM GBI UK All Mats	-0.65	-0.47	3.34	15.01	1.63	8.77
JPM GBI Japan All Mats**	2.87	3.06	7.00	6.32	-6.05	0.54
JPM GBI Germany All Mats	1.83	2.02	5.92	3.61	-8.45	-2.02
Corporate bonds	EUR	USD	GBP	EUR	USD	GBP
BofA ML Global Broad Market Corporate	-0.41	-0.23	3.59	9.67	-3.09	3.71
BofA ML US Corporate Master	0.20	0.39	4.23	14.70	1.36	8.48
BofA ML EMU Corporate ex T1 (5-10Y)	-0.29	-0.10	3.72	-0.25	-11.86	-5.66
BofA ML £ Non-Gilts	-2.92	-2.74	0.98	10.57	-2.29	4.57
Non-investment grade bonds	EUR	USD	GBP	EUR	USD	GBP
BofA ML Global High Yield	-4.82	-4.64	-1.00	7.21	-5.27	1.39
BofA ML Euro High Yield	-2.28	-2.10	1.65	0.18	-11.48	-5.26

Source: DataStream. Local currency returns in Q3 2015: *-12.78%, **0.87%.

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