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Marketing material

Monthly Markets Review
Overview of markets in February 2018

Please note any past performance mentioned in this document is not a guide to future performance and may not be repeated.

Highlights

- Financial markets were broadly weaker in February. Higher-than-expected US wage data first put bond markets under pressure - as investors priced in the potential for a more proactive Federal Reserve - before worries spread to equity markets.
- US equities were weaker over the month. Confirmation that macroeconomic data remains broadly resilient did, however, allow markets to recover some poise by month-end.
- Eurozone equities also saw negative returns, again with the declines coming early in the month. By sector, healthcare posted the steepest decline.
- The FTSE All-Share index fell in February. Comments from the Bank of England Governor Mark Carney indicated that UK interest rates are likely to go up sooner and faster than previously expected.
- Japanese equities also declined; the yen strengthened during the month, especially against sterling. The pharmaceuticals and telecommunications sectors outperformed.
- Emerging markets equities were not immune from the wider market volatility and recorded a negative return with US dollar strength a headwind.
- US Treasury yields oscillated significantly over the first few days of February, and then rose steadily thereafter. Corporate bonds made negative total returns and underperformed government bonds.

US

US equities declined sharply in early February. The correction was precipitated by an uptick in US wage inflation data that prompted investors to reappraise the Federal Reserve's (Fed) likely pace of policy tightening. The market weakness was exacerbated by a rise in the VIX (volatility) index, which forced leveraged short volatility strategies to close their positions. Confirmation that macroeconomic data remained broadly resilient did, however, allow markets to recover some poise by month-end.

US retail spending did fall in January but in the context of a very strong Q4 for consumer activity. Furthermore, consumer confidence remains near historic highs. The University of Michigan Consumer Sentiment index posted its second highest reading since 2004 in February, despite the market volatility. US unemployment remains low and business activity indicators are robust. Consumer price inflation was also higher than expected in January.

Accordingly, more cyclical[1] sectors – financials and consumer discretionary names - were more resilient over the month. Technology stocks were also amongst the best performing names. Energy names were materially weaker on supply pressures. Consumer staples, telecoms and real estate were among the weaker market sectors.

[1] Cyclical stocks are those whose business performance and share prices are directly related to the economic or business cycle. Defensives are those whose business performance is not highly correlated with the larger economic cycle - these companies are often seen as good investments when the economy sours.

Eurozone

Eurozone equities ended February in the red, returning -3.8% over the month. The sell-off that began in late January continued into February, although the low point of the month was reached on 9 February with markets recovering thereafter. That sell-off was largely prompted by expectations of rising inflation and interest rates, primarily in the US.

Sectors that are perceived as "bond proxies" (those with predictable returns) saw the biggest declines over the month, particularly healthcare. The best performing sectors were energy and information technology but all sectors declined. Nonetheless, the earnings season continued positively with many companies beating consensus expectations and issuing confident outlooks for the coming year.

Eurozone inflation moderated to 1.2% in February from 1.3% in January. The eurozone composite purchasing managers' index (PMI) dipped to 57.5 in February, retreating from the near 12-year high reached in January. GDP growth was confirmed at 0.6% quarter-on-quarter in Q4 2017. The European Commission revised up its economic growth forecasts, now expecting GDP growth of 2.3% in 2018 and 2.0% in 2019.

UK

UK equities took their lead from the US, failing to fully recover from a sharp sell-off at the beginning of the month following the abrupt return of equity market volatility.

Bond proxies performed poorly amid rising expectations that central banks – including the Bank of England (BoE) – will continue to tighten monetary policy. Resources sectors also performed poorly against the backdrop of weaker crude oil and industrial metal prices.

Expectations for a further tightening in monetary policy rose as evidence continued to build for a sustained recovery in the global economy. In its latest quarterly inflation report the BoE nudged up its forecast for UK GDP growth in 2018 from 1.7% to 1.8%, against the backdrop of stronger growth in the rest of the world. Comments from the BoE and its governor Mark Carney indicated that UK interest rates are likely to go up sooner and faster than previously expected.

Mid cap equities outperformed large caps with the FTSE 250 ex Investment Trusts index falling 2.8% over the month versus a 3.4% retreat in the FTSE 100. UK small caps lagged, with the FTSE Small Cap ex Investment Trusts index 3.9% lower.

Japan

In common with other major markets, Japanese equities suffered a sharp setback in early February before rebounding slightly to end the month with a total return of -3.7%. The Japanese yen strengthened during the month, especially against sterling.

The rapid spike up in market volatility led to outperformance of some typically defensive areas such as pharmaceuticals and telecommunications although food stocks underperformed. Cyclical sectors were generally weaker than the market, with marine transport and rubber products showing the sharpest declines. Despite some dramatic market moves there was very little new information for equity investors. The quarterly results season for Japanese companies closed with strong aggregate numbers and the positive revision cycle continued.

Investors should also have welcomed the decision by the ruling Liberal Democratic Party to recommend the reappointment of Mr Kuroda for a second term as governor of the Bank of Japan. This has eliminated one area of potential uncertainty and should ensure a stable policy environment.

Economic data released in late February were generally weaker than those seen in recent months, but seem to be influenced by a number of one-off factors. The sharp downturn in industrial production on a year-on-year basis probably stemmed from differences in the timing of Chinese New Year, while domestic consumption numbers suffered as a result of poor weather. The initial release of quarterly GDP was also below expectations, but several components may be revised in the light of subsequent data releases.

Asia (ex Japan)

Asia ex Japan equities lost value amid increased volatility in February. The MSCI Asia ex Japan index fell 5.0% and underperformed the MSCI World.

India was the weakest index country with banking stocks leading the market lower. An alleged fraud at state-controlled Punjab National Bank raised concern over the wider sector. Chinese equities were also down, with real estate and financials stocks among the weakest index names. Despite this, macroeconomic data released during the month was broadly stable. Korean equities also underperformed, in part due to weak Q4 earnings results.

The Taiwanese and Hong Kong markets held up better than the wider index but finished in negative territory. Thailand was the only index country to record a positive return with utilities and energy stocks proving supportive.

Emerging markets

Emerging market equities were not immune from the wider market volatility and recorded a negative return with US dollar strength a headwind. The MSCI Emerging Markets index decreased in value and modestly underperformed the MSCI World.

The emerging European markets of Poland and Hungary were among the weakest index countries with currency weakness amplifying negative returns. Indian equities were also firmly lower amid concern that an alleged fraud at a state-owned bank could have negative implications for the wider banking sector.

Chinese equities also experienced a pullback over the month. However, economic indicators were broadly stable with the Caixin manufacturing PMI unchanged at 51.5 in January while industrial production growth ticked up to 6.2% year-on-year (YoY) in December.

In contrast, Russia posted a small gain and outperformed. Industrial production growth increased to 2.9% YoY in January, recovering from weakness in late 2017. Meanwhile, inflation fell to 2.2% YoY and the central bank lowered its key interest rate by 25bps to 7.5%, in line with expectations.

Global bonds

US Treasury yields continued to rise at a robust pace as strong jobs data gave further fuel to growth and inflation expectations. Treasuries were impacted by the volatility spike early in the month, with yields oscillating significantly over the first few days. They rose steadily thereafter, reaching an intra-month high of 2.95%. For the month overall, 10-year yields increased from 2.70% to 2.86%, with similar rises in five and two-year yields.

European yields moved sideways, following January's upward move, with Bund 10-years down slightly from 0.70% to 0.66% and French 10-years from 0.97% to 0.92%. Italian 10-year yields were lower from 2.02% to 1.97%, while Spain's ticked up from 1.43% to 1.46% having fallen in January. UK 10-year gilt yields were marginally lower at 1.50%. Spain issued a 30-year bond for the first time in two years, the latest in a string of new issues from peripheral European countries. The issue raised €6 billion though demand significantly exceeded this.

The final days of the month saw new Federal Reserve Chair Jay Powell address congress for the first time. Powell's testimony was taken as marginally more bullish on the economy and as such more hawkish on the outlook for interest rates. The market moved to price a moderately faster pace of rate hikes in 2018.

Corporate bonds made negative total returns and underperformed government bonds with a slightly larger decline in investment grade[2] (IG) than high yield (HY). Euro credit IG proved most resilient, while US dollar and sterling IG saw significant falls. Sterling HY performed relatively well. Energy underperformed, across IG and HY, as the oil price was impacted by the decline in risk assets. Emerging market bonds too declined, with hard currency sovereign debt down 2%, local currency and corporates down 1%.

[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.

Turning to convertibles, global equity markets shed about 9% from peak to trough, giving up some of the fast-earned gains from the recent rally. Convertible bonds offered protection with the maximum drawdown for the global index at only -3.9%. For the month as a whole, convertible bonds as measured by the Thomson Reuters Global Focus Convertible index, returned -0.9% in US dollar terms. Implied volatility, a good measure of convertible valuations, remained around 29%. Some of the European convertible names richened slightly in the market rebound towards the end of the month, but on balance valuations remained stable.

Commodities

The Bloomberg Commodities index posted a negative return in February. The energy component recorded the steepest decline as natural gas (-11%) and Brent crude (-6.4%) both lost value. US dollar strength and rising oil production weighed on spot prices. The firmer US dollar was similarly negative for industrial metals with copper (-2.6%), zinc (-3.3%) and lead (-4.8%) all losing value. Precious metals were weaker too, with gold down -1.5% and silver -4.5%. In contrast, the agriculture component registered a positive return, with wheat in particular performing well.

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

Overview

Total returns (%) – to end February 2018

	1 month			12 months		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	-4.1	-2.1	-1.1	17.4	2.2	6.0
MSCI World Value	-5.1	-3.1	-2.0	11.8	-2.6	0.9
MSCI World Growth	-3.2	-1.2	-0.1	23.1	7.3	11.2
MSCI World Smaller Companies	-4.0	-2.0	-0.9	16.7	1.7	5.4
MSCI Emerging Markets	-4.6	-2.6	-1.6	30.5	13.7	17.9
MSCI AC Asia ex Japan	-5.0	-2.9	-1.9	31.9	14.9	19.2
S&P500	-3.7	-1.6	-0.6	17.1	2.0	5.8
MSCI EMU	-5.8	-3.8	-2.8	26.2	9.9	13.9
FTSE Europe ex UK	-5.7	-3.7	-2.7	24.8	8.7	12.7
FTSE All-Share	-6.3	-4.3	-3.3	15.6	0.7	4.4
TOPIX*	-1.5	0.6	1.7	23.3	7.4	11.4

	1 month			12 months		
Government bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	-0.8	1.3	2.4	-0.5	-13.3	-10.2
JPM GBI UK All Mats	-2.9	-0.8	0.3	9.4	-4.7	-1.2
JPM GBI Japan All Mats**	2.8	5.0	6.1	5.7	-7.9	-4.6
JPM GBI Germany All Traded	-1.9	0.2	1.2	11.8	-2.6	1.0
Corporate bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	-1.8	0.3	1.4	6.2	-7.5	-4.1
BofA ML US Corporate Master	-1.5	0.6	1.7	2.3	-10.9	-7.6
BofA ML EMU Corporate ex T1 (5-10Y)	-2.2	-0.1	0.9	17.3	2.2	5.9
BofA ML £ Non-Gilts	4.0	-1.9	-0.9	11.8	-2.6	1.0
Non-investment grade bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	-1.3	0.8	1.9	7.0	-6.8	-3.4
BofA ML Euro High Yield	-2.8	-0.7	0.3	20.1	4.6	8.4

Source: DataStream.

Local currency returns in February 2018: *-3.7%, **0.4%.

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