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Quarterly markets review - Q3 2019

A review of markets in Q3, when economic data pointed to an ongoing slowdown and central banks in the US and Europe eased monetary policy.

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Investment Communications Team

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- It was a mixed quarter for shares, with developed markets making small gains while emerging markets fell. The US-China trade dispute rumbled on, as did global growth concerns, but central banks remained supportive.

- US equities achieved modest gains. Stocks in the financials, utilities and energy sectors gained most. The healthcare sector was weaker, given its perceived political sensitivity. The Federal Reserve cut rates twice.
- Eurozone shares advanced. The European Central Bank announced new measures designed to stimulate the economy, including restarting quantitative easing.
- Shares in the UK also rose, although concerns around the global economic outlook weighed heavily on the commodity and financial sectors. Brexit uncertainty remained high as Boris Johnson took over as prime minister.
- Japanese shares gained with the yen little changed over the period. The Upper House elections in July were won comfortably by Prime Minister Abe's party.
- Emerging markets felt the effect of a renewed escalation in the US-China trade dispute and global growth concerns. Those markets most sensitive to US dollar strength came under pressure, notably South Africa but also Indonesia.
- Government bond yields declined markedly over the quarter due to heightened risk aversion in August when US-China trade tensions escalated. The US 10-year Treasury yield briefly dipped lower than the two-year yield, a yield curve inversion indicating significant economic pessimism among bond investors.

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US

US equities made modest gains in Q3, despite ongoing growth concerns and uncertainty surrounding US-China trade. The growth concerns were most pronounced in August, when the Federal Reserve's (Fed) conservative messaging around its policy response underwhelmed investors. The Fed acted as expected by cutting rates by 25 basis points both in July and in September, but has not committed verbally to a more extended easing cycle. The US yield curve inverted in the month, a phenomenon which often precedes recession. Despite the ebb and flow of optimism over a trade war resolution, any concrete plans to remedy the ongoing US-China dispute remain elusive. Increasing speculation over possible impeachment proceedings for President Trump further added to uncertainty.

US economic data was largely stable, albeit it continued to moderate. Unemployment remains at 3.7% and wage growth in August was stronger (month-on-month) than anticipated. However, new non-farm job additions were lower than expected in August, at 130,000 versus predictions of 158,000. Consumer confidence also weakened; the August

Conference Board consumer confidence index fell to 125.1 from 134.2 (the index reflects prevailing business conditions and likely developments for the months ahead, detailing consumer attitudes and buying intentions).

Less economically sensitive areas of the market generally performed more strongly. Utilities, real estate and consumer staples were amongst the quarter's better performers. Energy and materials were weaker areas of the market, given expectations of a more challenging demand environment. Healthcare remains a matter of heated debate in the run-up to the 2020 US presidential election, and the political sensitivity caused the sector to lag the market.

Eurozone

Eurozone shares made gains in the quarter. Amid ongoing worries over trade wars and global growth, the best-performing sectors included utilities, real estate and consumer staples. Underperformers over the quarter were energy and consumer discretionary. However, the market saw a rotation in September with financials, which had previously been out of favour this year, leading the gains.

Economic data remained lacklustre with confirmation that the eurozone economy expanded just 0.2% in Q2. Annual inflation was 1.0% in August, compared to 2.1% in the same month in 2018. Speculation over the possibility of further stimulus from the central bank dominated the summer. In September, the European Central Bank (ECB) took steps to boost the flagging economy, including restarting quantitative easing and committing to buying assets until its inflation target is reached. Christine Lagarde, head of the International Monetary Fund, was nominated to replace Mario Draghi as president of the ECB when his term ends on 31 October.

Italian politics was back in focus as the governing coalition of the right-wing League and populist Five Star broke up. Instead, Five Star formed a new coalition with the Democratic Party, which is expected to be less confrontational over EU budget rules. Spain will hold a general election on 10 November, the fourth in four years, after the last election in April failed to produce a governing coalition.

UK

UK equities recorded modest gains in what was a mixed quarter for global stocks. Amid concerns about the world economic outlook, many investors favoured assets perceived to have defensive qualities. These included so-called "quality growth" companies which are characterised by their superior and defensible earnings growth.

A strong performance from quality growth stocks, and other defensive sectors, helped the UK stock market achieve positive returns over the period. Merger and acquisition activity was also supportive – trade and private equity buyers took advantage of the relative valuation opportunity of UK equities, sterling weakness and readily-available cheap debt financing.

In contrast, many economically-sensitive areas of the market performed poorly, including the UK's heavyweight financial and commodity sectors. This contributed to a notable underperformance in the FTSE 100, which rose 1.0%, compared to a 3.6% total return from mid caps (FTSE 250 ex investment companies).

Many of these trends reversed towards the end of the period as expectations rose that policymakers might switch from monetary to fiscal measures to stimulate economic activity and inflation. Forward-looking indicators continued to point to a loss of momentum in the UK economy, amid a global slowdown in activity, and Q2 GDP growth was confirmed at -0.2%.

Brexit and domestic political uncertainty remained elevated as Boris Johnson took over as the UK's new prime minister on a "do or die" pledge to achieve Brexit. He followed this up by saying he'd rather be "dead in a ditch" than ask the EU for an extension to the country's EU departure date. However, legal developments increased expectations that a "no deal" exit on 31 October would be averted.

Japan

Market weakness in early August was more than reversed in September to produce a total return of 3.4% for the three months. The Japanese currency initially strengthened after the cut in US interest rates, but subsequently weakened to end the quarter little changed.

The main domestic political event was the Upper House elections in July, 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 uncertainty over the rise in consumption tax in October.

Bi-lateral trade negotiations between the US and Japan seemed to make some progress. So far, this process appears relatively straightforward for Japan, as many of the "concessions" which the US is seeking were already on offer within the framework of the multi-lateral TPP negotiations, from which the US withdrew.

The recent cut in US interest rates again raised expectations for additional easing moves by the Bank of Japan. In the very short term, the counterintuitive weakening of the yen has created some breathing space by easing deflationary pressure. The only real policy development came during September, with a fine-tuning of bond purchases in an attempt to encourage a steeping of the yield curve.

The Bank of Japan stepped back from its purchases of exchange-traded funds, after maintaining a very consistent run-rate in the first eight months of the year. Meanwhile, survey data suggests that corporate managements are increasingly viewing their own share prices as attractive, which is one factor behind the near-doubling, year-on-year, in the value of share buybacks announced from April to September. Other interesting developments at the corporate level included several restructurings of long-term strategic shareholdings.

Asia (ex Japan)

Asia ex Japan equities lost value in Q3 amid renewed intensification of US-China trade tensions and rising concerns over global growth. The MSCI Asia ex Japan Index fell -4.5% and underperformed the MSCI World.

Hong Kong SAR was the weakest index market, as demonstrations continued, despite the authorities efforts to resolve social unrest. Malaysia, Singapore and Thailand all posted negative returns and underperformed.

China and South Korea lagged the index by a more modest margin. In China, the authorities announced fresh policy support in response to domestic weakness. Meanwhile the US announced new tariffs on $300 billion of goods imported from China which did not already face a levy, some of which took effect in September. In South Korea, a trade dispute with Japan weighed on sentiment somewhat. By contrast, Taiwan posted a positive return, underpinned by strong performance from technology stocks.

Emerging markets

Emerging market equities were down as US-China trade tensions escalated and concerns over global growth continued to mount. The MSCI Emerging Markets Index decreased in value and underperformed the MSCI World.

Argentina was the weakest index market as surprise primary election results triggered a major sell-off in equities and the currency. Those markets more sensitive to a stronger US dollar came under pressure, notably South Africa but also Indonesia. Saudi Arabia and Colombia underperformed with crude oil price weakness a headwind.

China underperformed by a more modest margin. The US announced 10% trade tariffs on $300 billion of goods imported from China, some of which took effect in September. Following the announcement, the renminbi weakened beyond the symbolic seven-per-dollar threshold, and in response the US Treasury labelled the country a currency manipulator. The US also announced plans to increase existing tariffs of $250 billion of Chinese goods from 25% to 30% in October. China responded by announcing tariffs on $75 billion of US goods.

By contrast, Turkey registered a robust return, as the central bank cut interest rates by a total of 7.5% over the quarter, more than expected. Taiwan also outperformed, driven by strong performance from technology stocks.

Global bonds

Government bond yields declined markedly over the quarter due to risk aversion in August when US-China trade tensions escalated. The US announced a marked increase in tariffs and China retaliated with its own measures including allowing a devaluation of the renminbi. There was some retracement in September as the US and China announced talks would resume in early-October, giving rise to optimism. Geopolitics remained very much to the fore, with impeachment proceedings launched against US President Trump towards the end of the quarter.

September saw the ECB announce a much anticipated new round of stimulus measures which helped sentiment. The Fed cut rates again, but disappointed markets by downplaying the prospect of further easing.

Economic data continued to show a slowdown in activity. In the US, the services sector and labour market remained resilient despite a continued downturn in manufacturing. Eurozone leading indicators deteriorated further, particularly in manufacturing.

The US 10-year Treasury yield was over 30 basis points (bps) lower, finishing the quarter at 1.67%. The 10-year yield reached below 1.5% in late-August, and briefly dipped lower than the two-year yield, a yield curve inversion (/en/insights/economics/economy-on-red-alert-with-yield-curve-close-to-inversion/) indicating indicating significant economic pessimism among bond investors.

In Europe, the 10-year Bund yield fell 24bps to finish even deeper in negative territory at -0.57%. The Italian 10-year yield saw a substantial move, falling 126bps to 0.82% due to anticipation, and ultimately announcement of new stimulus measures and a calmer political backdrop. The UK saw further escalation in Brexit uncertainty. The 10-year UK yield fell 34bps over the quarter, with most of this occurring in July.

Corporate bonds outperformed government bonds. They benefited from the decline in global yields and more recently an improvement in risk sentiment. Investment grade[1] corporate bonds outperformed the riskier high yield part of the market. The telecoms and utility sectors performed well. Across emerging market bonds, corporate debt and local currency government debt made positive returns, while emerging market currencies broadly weakened against the US dollar.

Global stock markets were volatile with a c.5% setback in July, then recovery in August. Convertible bonds, as measured by the Thomson Reuters Global Focus index, were flat over the quarter but managed this result with about half of the equity draw downs and half of the volatility. Turning to valuations, European convertibles became slightly more expensive.

Commodities

In commodities, the S&P GSCI Spot Index posted a negative return in Q3, negatively impacted by US dollar strength. Energy was the weakest component, amid a sell off in crude oil prices as demand concerns outweighed ongoing supply risks. This was despite a sharp price spike in mid-September following an attack on oil infrastructure in Saudi Arabia. Soft commodities were also weaker, led by corn. The industrial metals component recorded a slightly negative return amid demand concerns for some metals in China. By contrast, precious metals delivered sold gains, with gold and silver up 4.5% and 11% respectively as investors moved into perceived safe haven assets.

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 (net) % – to end Q3 2019

	3 months			12 months		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	0.5	5.0	3.8	1.8	8.5	7.8
MSCI World Value	0.5	5.0	3.8	0.7	7.3	6.6
MSCI World Growth	0.6	5.0	3.9	3.0	9.7	9.0
MSCI World Smaller Companies	-0.9	3.6	2.4	-5.4	0.8	0.1
MSCI Emerging Markets	-4.2	0.0	-1.1	-2.0	4.4	3.7
MSCI AC Asia ex Japan	-4.5	-0.2	-1.4	-3.4	2.9	2.2

S&P500	1.7	6.2	5.0	4.3	11.1	10.3
MSCI EMU	-1.8	2.6	1.4	-2.2	4.2	3.5
FTSE Europe ex UK	-1.6	2.8	1.6	0.5	7.1	6.4
FTSE All-Share	-1.9	2.4	1.3	-3.0	3.4	2.7
TOPIX*	3.1	7.7	6.5	-5.8	0.4	-0.3

	3 months			12 months		
Government bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	2.6	7.2	6.0	11.0	18.3	17.5
JPM GBI UK All Mats	3.3	7.9	6.7	8.2	15.2	14.4
JPM GBI Japan All Mats**	0.1	4.6	3.4	10.4	17.6	16.8
JPM GBI Germany All Traded	-2.2	2.2	1.0	1.5	8.2	7.4
Corporate bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	1.3	5.8	4.6	8.7	15.8	15.0
BofA ML US Corporate Master	3.1	7.7	6.5	12.9	20.3	19.5
BofA ML EMU Corporate ex T1 (5-10Y)	-2.4	1.9	0.8	2.3	9.0	8.3
BofA ML £ Non-Gilts	0.4	4.9	3.7	4.2	11.0	10.3
Non-investment grade bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	0.4	4.9	3.7	5.8	12.7	12.0
BofA ML Euro High Yield	-3.0	1.3	0.1	-1.3	5.2	4.5

Source: Thomson Reuters DataStream.

Local currency returns in Q3 2019: *3.4%, **0.4%.

Past performance is not a guide to future performance and may not be repeated.

[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.

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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.

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