FINURA

MARKET REPORT Q2 2018

QUARTERLY MARKETS REVIEW - Q2 2018

A look back on what was a volatile second quarter for financial markets..

- Global equities made gains in a volatile quarter, as resilient economic and earnings data vied with an unsettling geopolitical backdrop to establish the market's direction. Bond markets struggled despite risk aversion escalating late in the quarter.
- In the US, positive earnings momentum and supportive economic data outshone the China-US trade posturing to lift equities.
- Eurozone equities also delivered gains. The European Central Bank announced that interest rates will remain at current levels through summer 2019.
- The UK's FTSE All-Share index rose sharply as investors reduced their underweight in the country. The absence of a rate hike was a further positive, contributing to further decline in the value of sterling.
- Japanese equities advanced despite the rising trade tensions. The Japanese yen lost ground against a generally stronger dollar.
- Emerging markets equities recorded sharp falls in Q2 with US dollar strength a significant headwind. Escalating trade tensions contributed to weakness across a number of Asian emerging markets.
- In bond markets, US 10-year Treasury yields rose significantly in April (i.e. prices fell), and touched a seven-year high in mid-May, before risk aversion led to buying of perceived "safe-havens".

THE US

US equities advanced in Q2, with positive earnings momentum and supportive economic data ultimately outshining escalating US-China trade posturing. Consumer confidence remained strong and retail sales data suggested a rebound in consumption from a softer Q1. The unemployment rate also reached an 18-year low of 3.8%, accompanied by robust wage growth. Average earnings in May were 2.7% higher than a year earlier. As expected, the Federal Reserve (Fed) raised the target rate for Fed Funds by 0.25% and marginally increased its 2018 forecasts for growth and inflation. It now anticipates two further rate increases for this year and three for next.

The positive economic data was, however, balanced by moves from the Trump administration to impose tariffs on Chinese imports, and withdraw from the Iran nuclear accord. In combination, the steps amounted to a more combative trade posture from the US, driving oil prices higher, and weighing on longer-term growth expectations.

Over the quarter, energy, consumer discretionary and technology stocks performed well, while a rotation into more traditionally defensive[1] areas supported real estate and utilities. Industrial stocks were weaker given the discussions surrounding trade sanctions, and financials were weaker due to a flattening of the yield curve (outlined below).

EUROZONE

Eurozone equities posted positive returns in the second quarter. Top performing sectors included energy, information technology and healthcare. Financials were among the main laggards, posting a negative return; Italian banks in particular struggled amid political uncertainty in May. Elsewhere, auto stocks fell against a backdrop of intensifying trade concerns as US President Trump threatened tariffs on imported vehicles.

The quarter was marked by the return of political risk. There were concerns that Italy could need fresh elections following the inconclusive outcome of the March vote. Markets feared that this would turn into an effective referendum on Italy's membership of the euro. However, a governing coalition was eventually formed between populist parties, the League and the Five Star Movement. Spain also saw a change of government, although this was largely greeted with calm by markets. Late in the period, German Chancellor Angela Merkel clashed with sister party the CSU over immigration policy.

Economic data from the eurozone pointed to steady growth but at a slower pace than last year. GDP growth for the first quarter was 0.4%, down from 0.7% in Q4 2017. However, the flash eurozone composite purchasing managers' index for June came in at 54.8, an improvement on the 18-month low of 54.1 seen in May. The European Central Bank (ECB) announced that it expects to end its quantitative easing programme in December 2018. The ECB added that interest rates will remain at current levels through the summer of 2019.

UK

The FTSE All-Share index rose 9.2% over the period, enjoying strong relative performance versus global equities. UK equities bounced back as international investors reduced their underweight in the country, albeit sentiment towards the UK remains extremely negative. Prior to the period under review, the UK's unpopularity with international investors had hit levels not seen since the global financial crisis. This situation had weighed heavily on UK returns at a time when investor sentiment in general was fragile, amid fears that resurgent inflationary pressures in the US could derail the "Goldilocks scenario" of low inflation and stable growth.

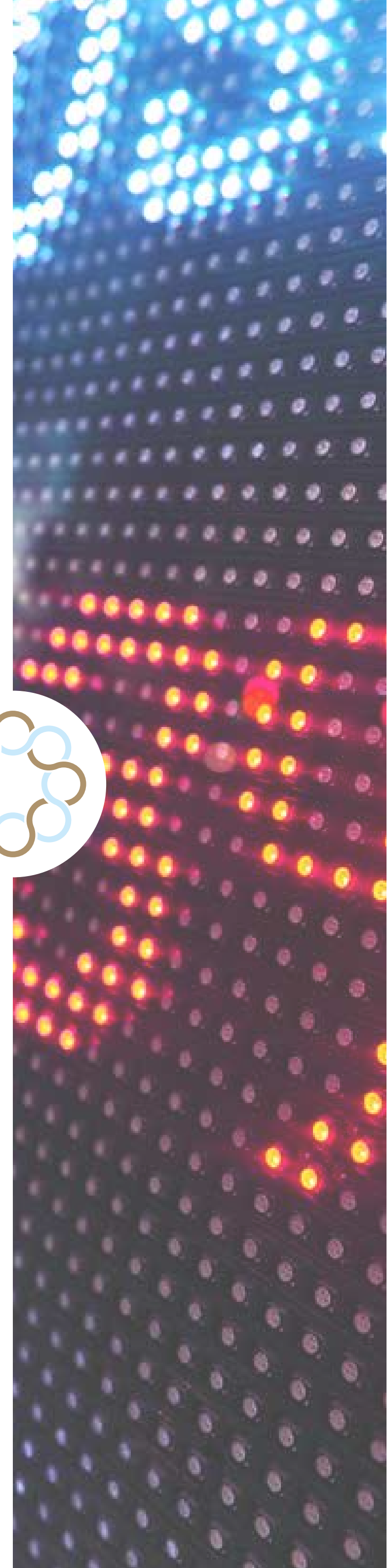
The absence of a rate hike was a further positive for UK equities, as it contributed to a renewed decline in the value of sterling against a strong US dollar. As a result, the more internationally exposed large caps outperformed mid caps. Ongoing merger and acquisition activity also supported returns over the period.

The oil and gas sector performed very well, in line with higher crude oil prices. These climbed in response to robust global demand, continued supply discipline and geopolitical uncertainty after the US withdrew from the Iran nuclear agreement. Trade war rhetoric resumed towards the end of the quarter, negatively impacting financials and other areas of the market exposed to emerging markets, which appear vulnerable to escalating trade tensions and the strong dollar.

Sterling performed poorly after the Bank of England backed away from a much-anticipated rate rise (in sharp contrast to an increasingly hawkish Fed). This followed a raft of disappointing macroeconomic data, which culminated in the Bank reducing its 2018 growth forecasts – it is now expecting the UK economy to expand by 1.4% this year, versus 1.8% previously.

JAPAN

Despite generally weak sentiment during the past three months, the Japanese equity market showed a positive total return of 1.1% for the quarter. Although further uncertainty was created



by rising trade tensions, the Japanese yen lost ground against a generally stronger dollar.

The results season for the fiscal year which ended in March was completed in early May, with profit numbers broadly in-line with expectations after a period of successive upward revisions in the second half of 2017. Companies' own expectations for the year to March 2019 appear to be rather conservative, partly as a result of the stronger yen rates prevailing at the time the forecasts were made, which potentially leaves room for upward revisions later in the year.

Much of the quarter was very quiet in terms of Japan-specific news, with investors focused instead on escalations in trade tension between the US & China and increased strains within the European Union. The most important aspect for Japan has been the increased potential for the US to apply tariffs to auto imports. Although Japanese makers already have consistently moved production facilities offshore, auto exports still represent a significant part of Japan's trade balance. The complexity of auto supply chains creates further uncertainty for Japanese automakers who are already re-evaluating their global strategy in the light of the new-found propensity of the US to tear up pre-existing trade agreements.

Away from politics, forward-looking economic indicators had been pointing towards a recovery from the short-term GDP decline seen in the first quarter. Data on the real economy released at the end of June subsequently provided some positive surprises with industrial production and inflation data for Tokyo both ahead of expectations. Although investors have apparently become rather accustomed to the strength of the labour market, a decline in the unemployment rate to 2.2% is still significant and should be viewed as positive for inflationary expectations.

With investors tending to be wary of taking additional risks during this period of uncertainty, most cyclical areas of the market, such as shipping companies and machinery producers were weaker, while there was clear outperformance from defensive sectors including foods and railways. The continued rising trend in oil prices also had a marked impact on sector performance, pushing up refiners & distributors but holding back consumers of oil such as airlines.

ASIA (EX JAPAN)

Asia ex Japan equities were firmly down in Q2, with global trade concerns serving to increase risk aversion. The MSCI Asia ex Japan Index generated a negative return and underperformed the MSCI World.

ASEAN markets were among the weakest index countries while Korea also fell sharply. This was despite positive developments with regards to peace on the Korean peninsula; an Inter-Korea Summit in April saw leaders from the South and North pledge to agree a formal end to the war between the two sides. US President Trump subsequently met with North Korean leader Kim Jong-un in Singapore in June. In Malaysia, the market declined after the unexpected election victory of Mahathir Mohamad's Harapan alliance ended the ruling coalition's 60 years in power. Taiwan also underperformed with IT sector names leading the market lower.

India, which had underperformed by a wide margin in Q1, and China finished in negative territory but held up better than the wider index. In China, the central bank cut the reserve ratio requirement for banks by a total of 1.25% over the quarter to encourage lending and support growth. However, a combination of slowing domestic growth momentum and global trade uncertainty contributed to weakness later in the quarter and the currency depreciated relative to the US dollar.

EMERGING MARKETS

Emerging markets (EM) equities recorded a sharp fall in Q2 with US dollar strength a significant headwind. Escalation in global trade tensions also contributed to risk aversion as US-China trade talks failed to deliver a sustainable agreement. Meanwhile the US moved to extend steel and aluminium tariffs to the EU, Canada and Mexico, resulting in the announcement of retaliatory measures. The MSCI Emerging Markets Index recorded a negative return and underperformed the MSCI World.

Brazil was the weakest index market as a truck driver strike paralysed the economy and amplified political uncertainty. Ahead of October's presidential election, no centrist candidate saw a significant improvement in opinion poll ratings. Those markets exposed to ongoing global liquidity tightening also came under pressure, notably Turkey where currency weakness forced the central bank to implement an emergency rate hike in May. Early presidential elections, subsequently won by incumbent President Erdogan and a coalition led by his Law and Justice Party, added to uncertainty. Weak eurozone growth and uncertainty stemming from Italian politics were negative for a number of emerging European emerging markets, notably Hungary and Poland.

The emerging Asian markets of Thailand and South Korea were also firmly down and underperformed, negatively impacted by global trade uncertainty. China posted a negative return but outperformed. This was despite concerns over growth later in the period that contributed to yuan weakness. Signs of slowing momentum in the domestic economy were exacerbated by deterioration in the outlook for global trade.

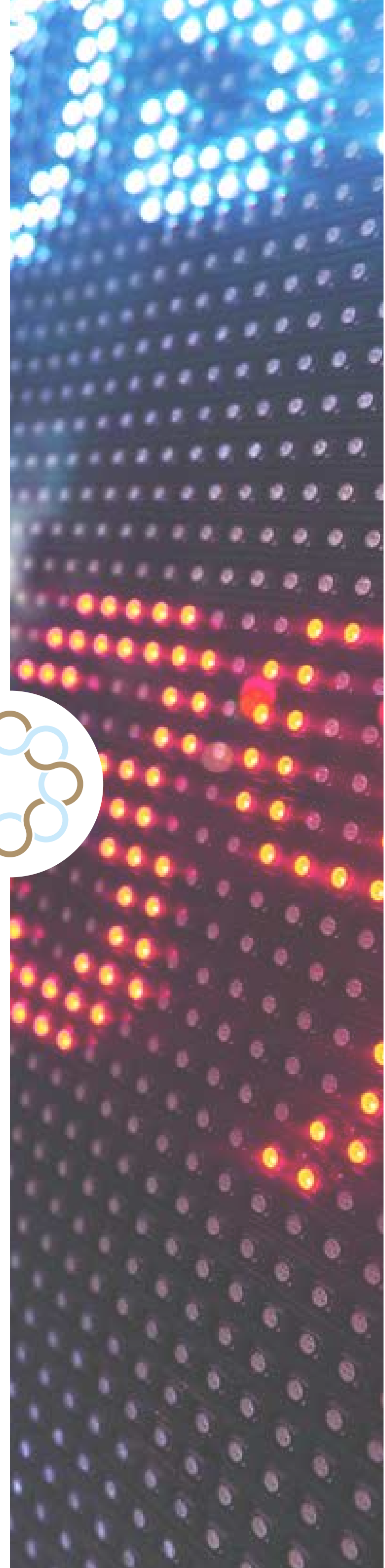
GLOBAL BONDS

Global bond markets suffered from bouts of volatility in Q2 due to a confluence of factors. These included a greater dispersion between accelerating US growth and a softening of economic activity elsewhere, escalating trade tensions between the US and China and the formation of a populist coalition government in Italy.

US 10-year Treasury yields rose from 2.74% to 2.86%. They rose significantly in April, touching a seven-year high in mid-May, as growth and inflation expectations continued to build, before risk aversion and "safe haven" buying led to a significant retracement. Bund 10-year yields fell from 0.50% to 0.30% on safe haven demand and as European data saw further softening.

The US yield curve flattened with two-year yields increasing from 2.27% to 2.53%. The spread between two and 10-year yields reached its lowest point since 2007. The Fed raised rates and kept to its hawkish tone at its June meeting.

Italian 10-year yields increased from 1.79% to 2.68% and two-year yields from -0.33% to 0.72%, as the formation of a populist coalition government in May raised concerns over Italy's future relationship with Europe. Spain suffered some contagion effect with 10-year yields rising from 1.16% to 1.32%.



Global corporate bonds made negative total returns with US dollar investment grade (IG)[2] and euro high yield (HY) leading the declines. US dollar HY made positive excess returns, outperforming euro and sterling counterparts, as technicals (lower supply) and fundamentals remained supportive.

Emerging market (EM) bonds had a difficult quarter, particularly local currency bonds, impacted by the strengthening US dollar, while certain EM countries saw marked currency weakening due to idiosyncratic risks.

Convertible bonds showed their protective qualities in Q2 against volatile equity markets. The overall MSCI World equity index gained 0.7% in the quarter. Convertible bonds, as measured by the Thomson Reuters Global Focus Convertible Index, returned 0.6% in US dollar terms. The primary market was very active and the new supply of interesting convertible bonds has resulted in a slight cheapening in valuations. Japanese and Asian convertibles remain undervalued.

COMMODITIES

The Bloomberg Commodities index posted a slightly positive return in Q2. Crude oil prices continued to rally, with President Trump's decision to withdraw the US from the Iran nuclear accord contributing to higher prices, despite OPEC announcing plans to boost supply. The industrial metals index registered a small gain. Nickel (+11.9%) and aluminium (+8.4%) were firmly up while zinc (-11.5%) and iron ore (-1.7%) lost value. The agricultural component registered a sizeable decline with grains prices losing value on global trade concerns. Gold and silver fell -5.4% and -1.6% respectively.

[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.
[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.

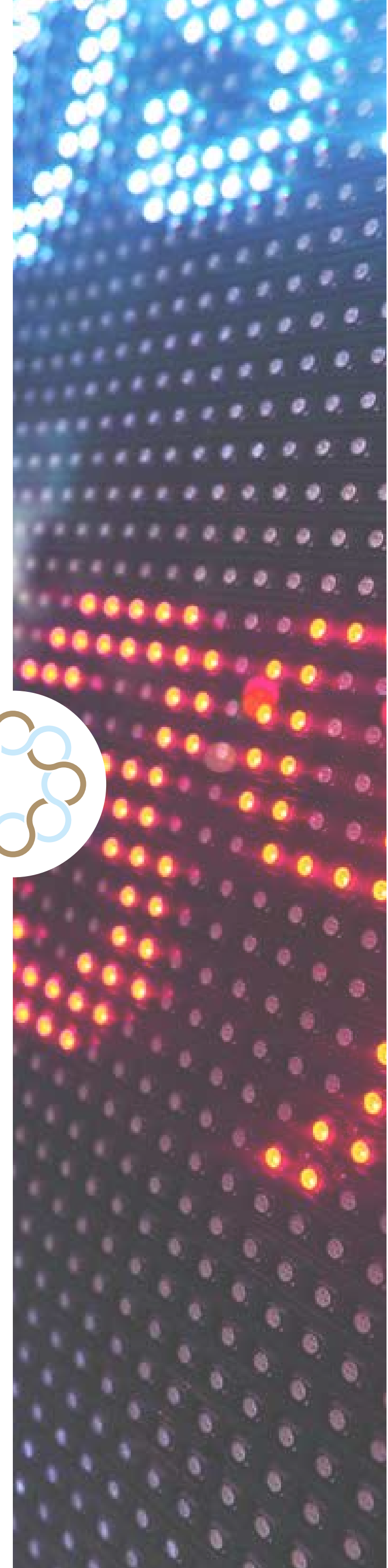
Source: Schroders Quarterly markets review - Q2 2018. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

TOTAL RETURNS (%) – TO END JUNE 2018

	3 MONTHS			12 MONTHS		
Equities	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
MSCI World	1.7	7.2	8.1	11.1	8.5	9.3
MSCI World Value	-0.2	5.1	6.0	5.6	3.1	3.9
MSCI World Growth	3.6	9.1	10.0	16.6	13.9	14.7
MSCI World Smaller Companies	3.3	8.8	9.7	14.8	12.2	13.0
MSCI Emerging Markets	-0.8	-3.1	-2.2	8.2	5.7	6.5
MSCI AC Asia ex Japan	-5.4	-0.3	0.5	9.9	7.4	8.1
S&P500	3.4	9.0	9.9	14.4	11.7	12.5
MSCI EMU	-2.7	2.5	3.4	5.8	3.3	4.0
FTSE Europe ex UK	-2.7	2.5	3.4	4.2	1.8	2.5
FTSE All-Share	2.8	8.3	9.2	10.8	8.2	9.0
TOPIX*	-3.0	2.2	3.1	11.3	8.7	9.5

	3 MONTHS			12 MONTHS		
Government Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
JPM GBI US All Mats	0.1	5.4	6.4	-0.6	-2.9	-2.2
JPM GBI UK All Mats	-5.8	-0.7	0.1	3.7	1.3	2.1
JPM GBI Japan All Mats**	-3.8	1.4	2.3	2.8	0.4	1.1
JPM GBI Germany All Traded	-3.8	1.3	2.2	4.5	2.0	2.8
Corporate Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global Broad Market Corporate	-2.4	2.9	3.7	0.5	-1.8	-1.1
BofA ML US Corporate Master	-0.9	4.3	5.3	-0.7	-3.0	-2.3
BofA ML EMU Corporate ex T1 (5-10Y)	-5.5	-0.4	0.5	3.8	1.4	2.1
BofA ML £ Non-Gilts	-0.6	-1.0	-0.1	2.4	-0.0	0.7
Non-investment Grade Bonds	**USD**	**EUR**	**GBP**	**USD**	**EUR**	**GBP**
BofA ML Global High Yield	-1.3	4.0	4.9	2.1	-0.3	0.4
BofA ML Euro High Yield	-6.2	-1.2	-0.3	3.2	0.8	1.6

Source: DataStream.
Local currency returns in Q2 2018: *1.1%, **0.3%.
Past performance is not a guide to future performance and may not be repeated.



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