

Schroders Quarterly markets review - Q3 2020

A review of markets in the third quarter when global equities moved higher, led by Asia.

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Global equities gained in Q3 but regional performances diverged with Asia and the US outperforming Europe and the UK. Government bond yields were little changed, however, corporate bonds enjoyed a positive quarter.

US shares gained in Q3, supported by signs of economic recovery and loose monetary policy. The Federal Reserve will now use average inflation targeting in setting interest rates, allowing for temporary overshoots in inflation.

Eurozone shares were virtually flat, lagging behind global markets as Covid-19 infections rose sharply in several countries and local restrictions to curb the virus were reintroduced.

UK equities fell during the period – extending their year-to-date underperformance of other regions – with the market's significant exposure to poorly performing stocks in the oil and financial sectors proving unhelpful.

Japanese shares gained over the quarter, despite the yen strengthening. Shinzo Abe resigned as prime minister and was replaced by Yoshihide Suga.

Emerging market (EM) equities advanced in Q3 2020, despite a further acceleration in new cases of Covid-19 in certain countries, and an escalation in US-China tensions.

Government bond yields were generally little changed although European yields fell (meaning prices rose) after news of the €750 billion recovery fund. Corporate bonds had a positive quarter.

Commodities delivered a positive return. Livestock and agriculture were the best-performing components while industrial metals posted a strong gain.

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US

US equities gained in Q3 despite a decline in September as risk appetites slipped. Overall, the US economy's recuperation continued, and the Federal Reserve's (Fed) messaging remained highly accommodative. The Fed will now use average inflation targeting (AIT) in setting the policy interest rate, allowing for temporary overshoots in inflation. The new policy means the Fed is willing to wait until inflation has gone above 2% until it responds. Furthermore, the latest dot plot – the Fed's own projection of the future path of interest rates - suggests that policymakers see rates at the zero lower bound through to and including 2023. However, US markets wobbled late in the quarter amid a resurgence in European Covid-19 cases, as well as questions over refreshed fiscal stimulus measures. Adding to these worries was uncertainty over a smooth transition of power if President Trump loses his re-election bid.

The US unemployment rate dropped to 8.4% in August, down from 10.2% in July and below consensus expectations of 9.8%. The labour force participation rate also improved, but it is still below its February pre-pandemic level. Industrial production rose for the fourth consecutive month in August, albeit at a much lower rate than earlier in the summer, signalling a slowing recovery in manufacturing. Similarly, retail sales increased in August, but again at a slower rate and below consensus expectations. Spending at food and beverage stores continued to be strong.

Consumer discretionary stocks – particularly restaurants and appliances or apparel retailers - performed well. Distribution companies were stronger and helped to lift the industrials sector, at odds with the performance of several airlines still facing headwinds from languishing passenger numbers. Energy names – similarly - were broadly weaker on expectations that fuel demand will remain subdued.

Eurozone

Eurozone equities were virtually flat over the quarter. The rate of improvement in economic data slowed over the quarter and worries took hold over sharply rising Covid-19 infections in many European countries. The energy and financials sectors saw the sharpest falls while materials and consumer discretionary advanced, with automotive and luxury goods stocks generally faring well.

In July, the EU approved a €750 billion fund to help member states recover from the pandemic. The fund will be made up of €390 billion of grants and €360 billion of loans to be distributed among EU member states. The money will be borrowed by the European Commission and guaranteed by all EU member states. Covid-19 infections rose rapidly in several countries as the quarter progressed, notably Spain and France, and new restrictions to contain the virus were announced. However, these restrictions tended to be localised, rather than the blanket countrywide measures seen in the first phase of the virus. Various European countries, including Germany, extended their furlough schemes which are designed to support jobs through the crisis.

Business activity stalled in September with the flash purchasing manager's index (PMI) falling to 50.1, down from 51.9 in August. 50 is the level that separates expansion in business activity from contraction. The PMI surveys are based on responses from companies in the manufacturing and services sectors. Eurozone annual inflation turned negative, at -0.2% in August compared to 0.4% in July.

UK

UK equities lagged behind other regions during the period – extending their year-to-date underperformance – with the market's significant exposure to poorly performing stocks in the oil and financial sectors proving unhelpful. Renewed fears around a disorderly Brexit also weighed on sentiment, as did worries towards the end of the period around the implications of a second wave in Covid-19 infections. Rising infection rates necessitated the re-imposition of localised restrictions following similar measures taken in continental Europe.

Notwithstanding these new measures, the country's economic recovery continued as Covid-19 restrictions were generally eased. The second quarter reporting season underlined increased corporate confidence with many companies resuming guidance on their likely financial performance for the rest of 2020. Where they felt it appropriate, a number of others also resumed the payment of dividends that they had deferred in the spring – many of these payments had been deferred just prior to the AGM season and at a time of peak uncertainty related to the global pandemic.

A number of UK focused areas of the market, and mid cap equities in particular, performed poorly over September following the re-imposition of localised restrictions and fears about the impact of these on the UK economy. However, many domestically focused areas performed well over the quarter as a whole as their valuations began to reflect the more encouraging macroeconomic data seen over the summer. In contrast, sterling strength against a weak dollar weighed on large UK companies with exposure to international markets, as a stronger pound makes their products more expensive. There was renewed merger & acquisition interest from overseas firms in UK quoted companies at period end.

Japan

The Japanese equity market trended upwards during the quarter and the Topix Index recorded a total return of 5.2%. This was despite a gradual strengthening of the yen against the US dollar over the period. There were some brief periods of style reversal but, across the quarter as a whole, the market was led by strong momentum in higher-valuation stocks. Small cap stocks were notable outperformers in September and have now more than recouped the sharp underperformance seen during the market turmoil in the first quarter of the year.

Domestically, the quarter was dominated by the change in Japan's prime minister. Shinzo Abe announced his resignation as prime minister of Japan on 28 August, due to the resurgence of a long-standing health problem, just four days after he recorded the longest continuous term of any Japanese prime minister. Following his resignation, Yoshihide Suga, the Chief Cabinet Secretary, quickly emerged as the frontrunner and he duly won the LDP's leadership election on 14 September. His

position as the new prime minister was then confirmed in a special Diet session on 16 September.

The change in leader had little impact on the overall market. However, Mr Suga's widely reported comments on the scope for mobile charges to be reduced led to underperformance across the telecom sector in September. The exception to this was mobile operator NTT DoCoMo. In an unexpected move, the parent company, NTT, which already owns 66% of DoCoMo, offered a significant premium to minority shareholders to acquire the remaining 34%. There were several other high-profile corporate developments, including the announcement of a planned merger of two major leasing companies, Mitsubishi UFJ Lease and Hitachi Capital.

Although corporate profits are clearly under pressure, the quarterly earnings reporting season, which concluded in early August, brought more positive surprises than we might have expected. Economic data released in the last few weeks has also been slightly skewed to positive surprises, especially in industrial production, which saw a larger rebound than expected. Inflation, however, has trended slightly below expectations, partly as a result of targeted government policy to provide discounts on domestic travel and education.

Asia (ex Japan)

Asia ex Japan equities recorded a strong return in Q3, led by Taiwan, where IT sector stocks underpinned gains. India, Korea and China all posted double-digit returns and outperformed the MSCI Asia ex Japan index. In India, relatively good monsoon rains were supportive and towards the end of the period the government also passed agricultural and labour reforms. This was despite further increase in the number of daily new cases of Covid-19, and as tensions with China on the Himalayan border persisted. In China, economic data signalled ongoing recovery and Q2 corporate earnings results were positive. However, tensions with the US escalated, including new restrictions on Chinese telecoms company Huawei, and as President Trump signed an executive order to prevent US companies from doing business with TikTok and WeChat.

Conversely, Thailand and Indonesia and, to a lesser extent, the Philippines and Singapore all finished in negative territory and underperformed the index. In Thailand, the lack of improvement in the tourism sector was a drag on the economic recovery. In Indonesia, Covid-19 cases rose and had an increasing impact, especially in rural areas. As a result, tighter restrictions were brought in for Jakarta.

Emerging markets

Emerging market equities registered a robust return in Q3, aided by optimism towards progress on a Covid-19 vaccine and ongoing economic recovery. US dollar weakness proved supportive. The MSCI Emerging Markets Index increased in value and outperformed the MSCI World.

Taiwan, where strong performance from IT stocks supported gains, and South Korea were among the best-performing index markets. India outperformed the MSCI Emerging Markets Index as monsoon rains remained reasonable and the government made progress with agriculture and labour reforms. This was in spite of continued increases in the number of new Covid-19 cases as well as tensions with its border with China. China also finished ahead of the index as the economy continued to recover. Q2 GDP growth rebounded to 3.2% year-on-year, after a fall of -6.8% in Q1, and was stronger than expected. Q2 earnings results were also ahead of expectations, notably in the e-commerce sector. However, US-China tensions continued to escalate. These included additional measures against Chinese technology companies, and President Trump's executive order to end Hong Kong SAR's special status with the US.

Conversely, Turkey recorded a negative return and was the weakest market in the index, primarily due to lira weakness. This was despite a 200bps interest rate rise from the central bank in September. Thailand and Indonesia underperformed, as did the CE3 markets of Poland, Czechia and Hungary, as new cases of Covid-19 increased. Russia and Brazil also finished behind the index. In Russia, uncertainty over US foreign policy due to the US presidential election and, later in the period, crude oil price weakness, weighed on sentiment. In Brazil, concern over the fiscal outlook was the main headwind.

Global bonds

The tone was predominantly positive or “risk on” in markets over the quarter, underpinned by policy measures, the gradual reopening of economies and, to some degree, hopes of a Covid-19 vaccine. The Federal Reserve (Fed) announced a change to its inflation targeting regime in August, saying it would target an average 2% inflation rate, allowing periods of overshoot. This was well received by markets.

September saw a more muted tone in markets amid rising Covid infection rates and renewed localised lockdowns in some countries. US election uncertainty began to build, particularly concerns that the outcome will be contested, and the Fed disappointed by leaving policy unchanged.

Government bond yields were mixed. The US 10-year yield finished at 0.68%, three basis points (bps) higher, with the UK 10-year yield six points higher at 0.23%. The UK yield fell in September as Brexit uncertainty resumed and there was further discussion of negative interest rates from the Bank of England.

European government bonds performed well as sentiment toward the region improved markedly after the EU announced a €750 billion pandemic recovery fund. The German 10-year yield fell by 7bps, finishing at -0.52%, while Italy’s yield fell by 39bps and Spain’s by 22bps. The euro gained over 4% against the US dollar, while the dollar index lost just over 3.5% overall.

Corporate bonds enjoyed a decidedly positive quarter, as riskier assets were broadly buoyant and monetary policy helped anchor yields at low levels. Investment grade returned 1.8%, while high yield debt returned 4%. Sectors worst affected by Covid, such as retail and leisure, partially recovered (source: ICE BofAML). Investment grade bonds are the highest quality bonds as determined by a credit rating agency; high yield bonds are more speculative, with a credit rating below investment grade.

In emerging markets, hard currency government bonds returned 2.3% and corporate bonds returned 2.6%. Hard currency refers to money that is issued by a nation that is seen as politically and economically stable, such as US dollars. Local

currency bonds made a modest positive return, while EM currencies were mixed, but slightly negative overall (source: JP Morgan).

Convertible bonds, as measured by the Thomson Reuters Global Focus index, gained 5.5% in US dollar terms, compared to 7.9% for the MSCI World equity index. The asset class delivered well in the quarter's differing market environments, with a strong upside participation in the first two months - when shares gained - and good resilience in the last month when shares came under pressure. With equity markets strongly up over the quarter as a whole, convertible bonds were in demand and the US region in particular became more expensively valued from what had been cheap levels.

Commodities

Commodities, as measured by the S&P GSCI Index, delivered a positive return in the third quarter, aided in part by US dollar weakness. Livestock and agriculture were the best-performing components. Industrial metals posted a strong gain, led by steel, iron ore and zinc. The positive return from precious metals was driven mainly by a rally in the silver price. Energy was the only component to finish in negative territory, posting a slight fall. Crude oil prices fell back in September amid concern over the sustainability of the recovery in global growth. An extension of supply cuts from OPEC (the Organisation of Petroleum Exporting Countries) and partner nations also remained unclear.