Market Commentary

Market Commentary for the Period 1st July 2017 – 30th September 2017

Global equity markets rose over the period in broad terms, led by strong returns across Asian and emerging markets. Early in the quarter, the IMF downgraded its UK growth forecast for the year following a weak first quarter. Their forecast for US growth was also reduced for the next two years given the lack of clarity around the timing and nature of US fiscal policy changes. Conflict between North Korea and multiple countries intensified, particularly with alternating comments between Donald Trump and Kim Jong-un. Multiple central banks across developed economies announced stimulus withdrawal measures or their intentions to reduce stimulus. Angela Merkel secured a fourth term as German chancellor, while in Spain there was a substantial vote in favour of Catalonian independence. Fixed income markets were little changed over the period.

US equity markets produced attractive returns over the quarter, despite escalating tensions with North Korea and stimulus withdrawal announced by the central bank. Conflict between the US and North Korea dominated the headlines with comments between leaders intensifying over the period. After reports that the country was developing nuclear weapons, North Korea fired two missiles over Japan which flew over Hokkaido Island before crashing into the North Pacific Ocean. Japan, US, China and Russia condemned the test and the UN made attempts to restrict oil imports and ban textile exports to North Korea in response. The US treasury was later authorised to implement sanctions against firms and financial institutions conducting business with North Korea with similar measures in China. Trump threatened to 'totally destroy' North Korea if forced to defend the US or its allies and later threatened that the regime's leaders wouldn't be around for much longer. Kim Jong-un responded saying that the whole world should remember it was the US who declared war on their country.

President Trump failed to pass the Healthcare Bill to replace Obama's Affordable Care Act (known as Obamacare) for the second time raising some doubt around his ability to pass other bills through congress. He later scrapped two business councils after business leaders left given the Presidents' handling of violent clashes in Virginia. He was later reported as saying at a rally in Arizona that he would close down the US government if necessary to build his wall across the Mexican border. He also said it would be likely he would terminate NAFTA at some point. Hurricanes Harvey and Irma caused multiple deaths and left tens of thousands homeless, significantly impacting both Texas and Florida. In Texas, over 20% of US oil refining capacity was temporarily taken offline causing a significant rise in gasoline prices.

The Federal Reserve left interest rates unchanged whilst hinting there would be one more rate rise by year-end in their most recent meeting. The central bank confirmed the details of their 'balance sheet normalisation program' which is essentially a slow reversal of the bank's stimulus implemented after the 07/08 global financial crisis. In their statement, the bank commented that higher inflation would be likely on a temporary basis driven by the hurricane aftermath. US second quarter GDP rose to 3.1% q/q (annualised) which far surpassed the previous quarter. Inflation rose to 1.9% y/y in August due to rising shelter and gasoline costs following the closure of refineries in the Gulf coast due to

Hurricane Harvey. Unemployment unexpectedly rose to 4.4% in August, but remains at significantly low levels relative to history.

UK equity markets were divided with mild gains in large cap stocks and stronger returns in medium to small sized companies. In the House of Commons, the EU withdrawal bill passed its first hurdle where the UK would no longer be bound by the European Court of Justice. There are believed to be around 7,900 instruments passed in parliament which implement EU legislation currently. Theresa May later delivered a speech in Florence on Brexit proposing a transition period where current market relationships would continue on existing terms. May said the UK would honour commitments made during the periods of membership paying an ongoing contribution to cover the UK's side of the costs. She confirmed that if results of negotiations were unacceptable, a 'no-deal' scenario would be possible. Credit ratings agency Moody's cut their rating for the UK by one notch on concerns over weakening public finances and the impact of Brexit on economic growth. They expressed that policy and legislative adjustments would limit the governments' capacity to address other challenges such as weak productivity growth.

The Bank of England maintained interest rates and the current level of stimulus at their most recent meeting. They commented that some withdrawal of monetary stimulus is likely to be appropriate over the coming months taking into consideration inflation which they expect to surpass 3% shortly. The UK government recorded their first budget surplus since 2002 in July as more money came in from self-employed tax receipts. A Treasury spokesperson commented that although they were making good progress in strengthening public finances, the national debt remains too high. UK second quarter GDP remained at 0.3% q/q with fixed investment proving the greatest driver of growth. Inflation rose to 2.9% y/y in August driven predominately by rising costs for clothing and motor fuels. Unemployment fell to 4.3% in July marking the lowest rate since May 1975.

European equity markets performed well as uncertainty subsided following multiple elections across Europe. The German election resulted in a win for Angela Merkel and the CDU/CSU party alliance with 33% of the votes, but this marked their worst result since 1949. Martin Schulz of the SPD party won 20.5% of the votes but ruled out a potential coalition with Angela Merkel to form a majority. The most likely scenario is now a three party coalition. All parties rejected working with the nationalist AfD party which won 12.6% of the votes and will therefore enter parliament for the first time. In Spain, around 2.3 million people voted on the independence of Catalonia with preliminary results showing 90% in favour. The Catalan President reported that the region may move towards a unilateral declaration of independence within the week following the results. The Spanish government deemed the vote to be illegal, causing protests and riots.

The European Central Bank held interest rates and confirmed that current levels of stimulus would run until the end of the year. President Mario Draghi expressed that discussions around reducing stimulus would likely commence this autumn. Eurozone second quarter GDP rose to 0.6% q/q boosted predominately by household consumption, fixed investment and exports. Inflation rose to 1.5% y/y in August driven by rising energy prices. Unemployment remained unchanged at 9.1% in July which remains the lowest rate since February 2009.

Japanese equity markets recovered from a dip later in the quarter to deliver mildly positive returns. Japanese Prime Minister Abe called a snap election to take place at the end of October, a year earlier than scheduled, to overcome a national crisis following growing threats from North Korea. The Bank of Japan maintained interest rates and levels of stimulus in their most recent meeting. The central bank re-iterated points made in previous meetings. This included the expectation that the economy would turn to moderate expansion and that the bank would continue with their stimulus measures until inflation was sustainably above their 2% target. Japanese second quarter GDP rose to 0.6% q/q maintaining a sixth straight quarter of growth, marking its longest run of expansion since 2006.

Inflation rose to 0.7% y/y in August, which was the highest rate since March 2015, driven largely by a faster rise in food costs. Unemployment remained at 2.8% in August, the lowest rate in 23 years.

Emerging markets posted strong returns amid a period of multiple interest rate cuts, geopolitical tensions and credit rating downgrades. Several central banks continued to cut interest rates across emerging economies including Brazil, Russia and India by 1%, 0.5% and 0.25% respectively. All decisions were based on falling inflation. Turkish Prime Minister Erdogan threatened to shut off the pipeline bringing oil, typically 500 to 600 thousand barrels a day, from Northern Iraq to the market. This was following an independence referendum to see whether Northern Iraq should become an autonomous Kurdish region, which the Turkish President strongly opposed to.

Chinese second quarter GDP remained at 6.9% y/y, the strongest level in almost two years, driven in part by a pickup in industrial output and retail sales. Credit ratings agency Standard & Poor's cut their rating for China and Hong Kong by one notch each. With China, they expressed concerns over a prolonged period of strong credit growth increasing economic and financial risks. Ratings were also cut for three foreign banks with primary operations in China on fears they would not be able to avoid default if the country defaulted on its sovereign debt. With Hong Kong, the agency were troubled by the potential spill-over risks should deleveraging in China be more disruptive than expected.

In fixed income markets, bond yields were largely unchanged with a marginal rise in the UK having an adverse impact on prices. This was driven predominately by the Bank of England's remarks that they would likely take measures to address above target inflation expected shortly. Comments on the withdrawal of stimulus from both the Federal Reserve in the US and the European Central Bank did not have the same impact over the period. Yields on UK, US and German 10 year bonds ended the quarter at 1.36%, 2.33% and 0.46% respectively.