Market overview

The first quarter of 2017 was generally positive for most asset classes. Volatility was low as improving economic data showed the global recovery broadening. Positive political developments in Europe also helped, despite ongoing political uncertainty on both sides of the Atlantic. We believe it is encouraging that the market's progress was built on more than the prospect of fiscal expansion.

Against this backdrop, emerging market assets made the greatest gains. The region was supported by the improvement in global economic activity, ongoing stability in China's economy and industrial commodity markets, a weakening of the US dollar, and expectations that the tightening of global financial conditions will be gradual.

European equities also outperformed the broader market, benefitting from improved economic data and positive political developments. The latter included Mark Rutte's market-reassuring victory over Geert Wilders in the Dutch election in March, rising expectations that Emmanuel Macron will defeat Marine Le Pen to become France's next president and an encouraging victory for Angela Merkel in state elections in Germany.

US and UK equities made solid gains, but these were tempered by adverse political developments and each region lagged the broader market. In the US, concerns emerged that President Trump will have difficulty implementing some of the market-friendly policies he has promised, particularly after he failed to garner enough support to pass a new healthcare bill. In the UK, the government triggered Article 50 of the Lisbon Treaty, thereby beginning the official process of seceding from the European Union (EU).

On top of the improving macroeconomic backdrop, equity markets benefitted from a broad improvement in underlying corporate performance. The technology sector led the market amid strong results from a number of large bellwether companies within it. The materials sector also made gains with industrial commodity prices supported by both China's economic stability and the continuing adjustment of global commodity supply chains. Encouragingly, healthcare also bounced back after lagging the market in 2016 as a result of concerns over the potential emergence of policy headwinds. Conversely, the energy sector lagged as optimism that the Organisation of Petroleum Exporting Countries (OPEC) cartel will be able to support prices faded amid an acceleration in US production; nevertheless, the drag the sector has had on broader market earnings growth has diminished.

Fixed income markets generally lagged equities, but most sectors saw minor gains as yields consolidated after rising in the second half of 2016. Emerging market bonds made the greatest gains, supported by the same trends underpinning the region's equity markets. European fixed income lagged amid a minor shift in rhetoric from the European Central Bank (ECB); this was catalysed by Europe's broadening economic recovery and perceptions that the threat of deflation is dissipating. We note that the ECB is still expected to keep monetary policy extremely accommodative for some time, despite reducing the value of its monthly asset purchases in April, while political developments remain a key driver of this area of the market. Meanwhile, high yield generally outperformed sovereign and investment grade bonds.

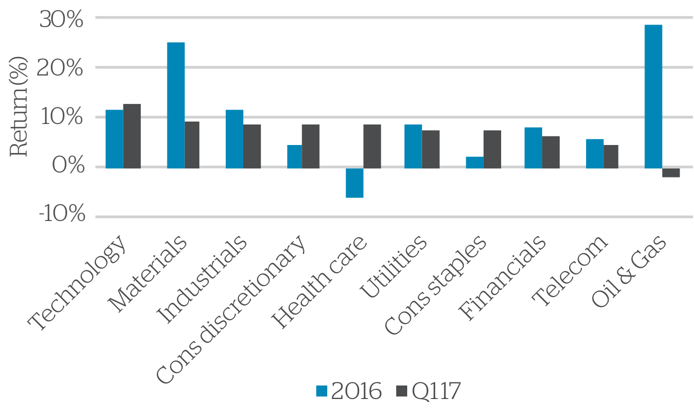

Figure 1: US dollar-denominated global equity market performance by sector to 31 March 2017.
Source: Thomson Reuters Datastream

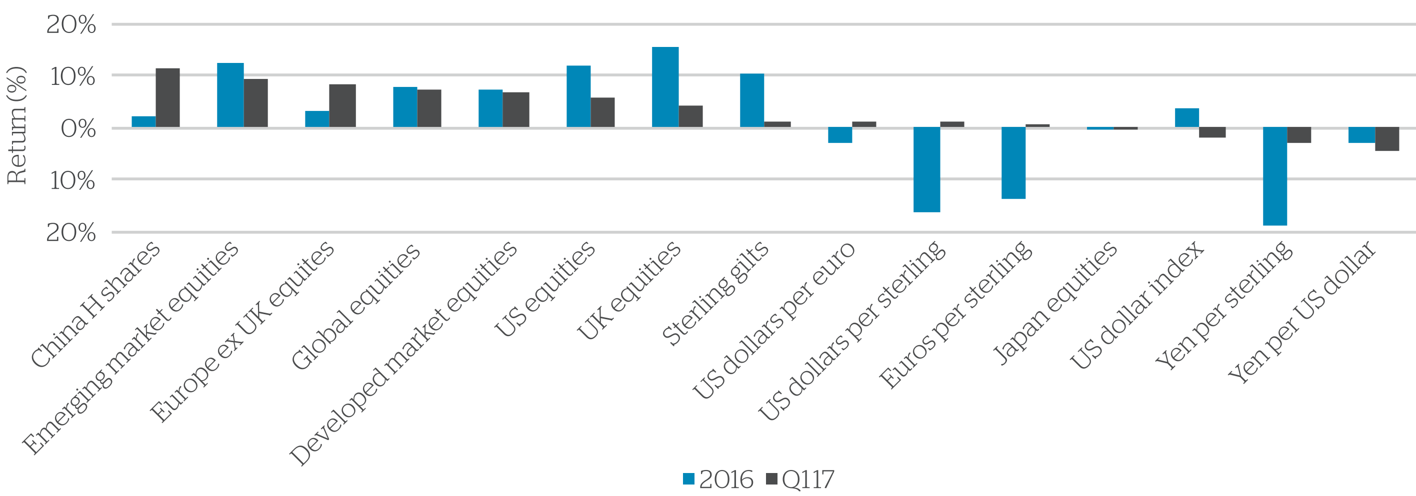

Figure 2: Local-currency market performance to 31 March 2017, total return performance figures.
Source: Thomson Reuters Datastream

The US

The US economy continues to progress well, underpinned by further strengthening of the labour market. Continuing unemployment claims reached 15-year lows during the quarter amid greater workforce participation, while wage growth is also accelerating. This helped consumer confidence improve to levels last seen in 2000 *(Figure 3)*, while business sentiment has also risen as a result of optimism surrounding Donald Trump's pro-business policy agenda.

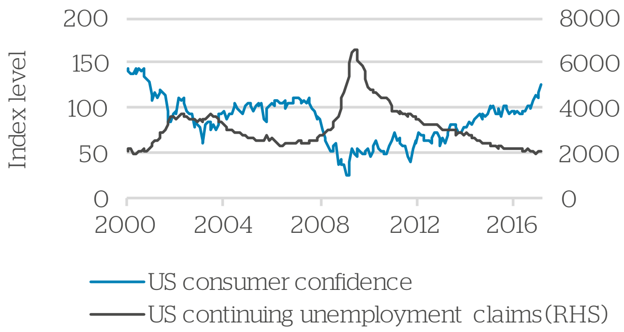

Figure 3: The US labour market continues to strengthen, supporting consumer confidence.
Source: Thomson Reuters Datastream

Together with accelerating inflation, the strength of the US labour market justified the Federal Reserve's (Fed) decision to implement a third interest rate hike this cycle in March. However, the Federal Open Market Committee (FOMC) members' consensus rate expectations also converged towards a conservative two further hikes over the remainder of the year, rather than three, potentially reflecting concerns that the expansion in economic activity may slow. We note that the various purchasing managers' indices (PMIs) suffered minor declines during the period, despite remaining firmly in expansionary territory.

After the new president's inauguration on 20 January, markets began to focus on his ability to implement policies, rather than the policy changes he has promised. Towards the end of the period, his inability to raise enough support to repeal and replace Obamacare suggested that there is some infighting within the Republican Party and raised questions over his ability to fulfil his other campaign pledges. Despite the hitherto failure of his health care bill, we consider his pledge to reduce tax rates as far more important for the broader equity market and will be watching progress in this area closely.

Against this backdrop US equities made solid gains, reaching all-time highs as data indicated the US corporate earnings recession has ended *(Figure 4)*. Within US equities, the technology sector led the market, benefitting from its attractive valuation and growth prospects, while healthcare outperformed after lagging in 2016. Treasuries ended the period roughly flat, following heavy losses in the latter half of last year, but US corporate bonds did slightly better, boosted by the strength of the materials sector. Meanwhile, the US dollar gave back some of its late-2016 gains amid some cautious rhetoric on inflation from members of the FOMC.

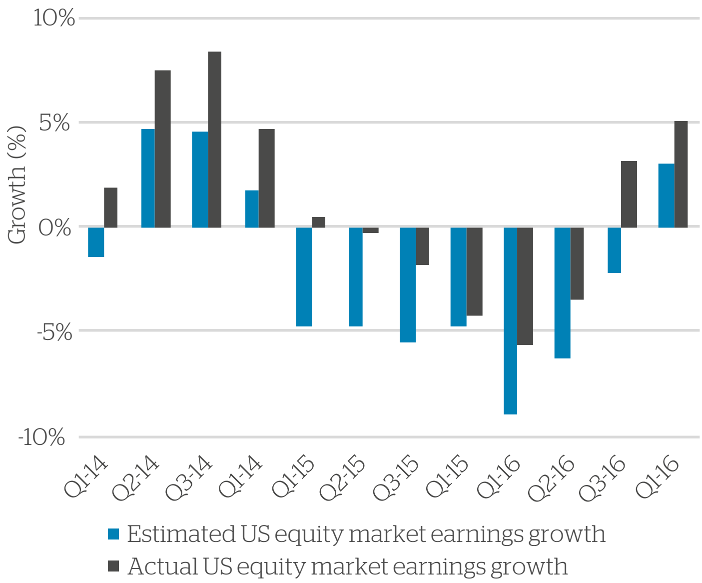

Figure 4: The US corporate earnings recession has ended, with equity market earnings growth positive amid reduced drag from the energy sector.
Source: Thomson Reuters Datastream

The UK

In the UK, expectations surrounding Brexit again dominated investor sentiment over the quarter. Ultimately, the government invoked Article 50 of the Lisbon Treaty in the final week of March, as expected, thereby beginning the formal exit process from the EU. This is expected to last for at least the next two years, which should keep uncertainty elevated. We note that the Prime Minister has said it will be "a challenge to reach a comprehensive agreement" during this timeframe.

Earlier in the period, the Chancellor of the Exchequer had focused his Spring Budget on "investing in Britain's future" and although he was able to upgrade the government's 2017 growth projections, this was at the expense of growth in future years. Consumption is expected to be impacted by Brexit-related uncertainty, with concerns over job security and rising inflation impacting people's propensity to spend; nevertheless, retail sales have so far remained fairly resilient amid further strength within the UK labour market *(Figure 5)*.

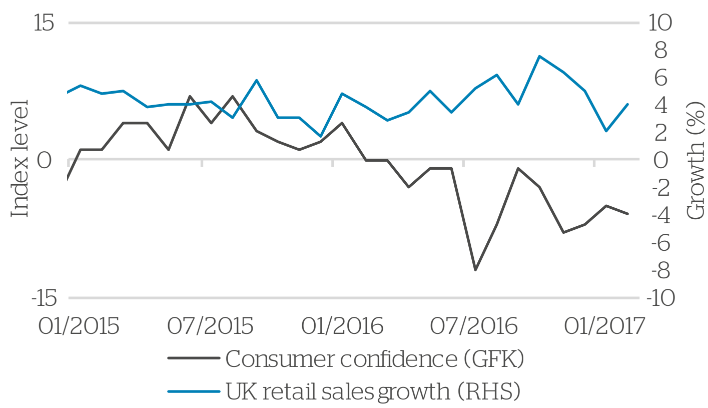

Figure 5: UK consumer confidence fell sharply following last year's referendum. Although it bounced back in the following months as the UK's political situation improved, it has declined again as workers are increasingly concerned about job security and consumers are facing higher prices as a result of sterling's decline. Both of these factors are likely to weigh on consumption, a major driver of the UK's growth in recent years.
Source: Thomson Reuters Datastream

Although UK PMIs have been declining, they remain in expansionary territory and industrial production growth remains positive. As opposed to consumption expectations, business optimism has been boosted by sterling's decline and export growth has been robust since the currency's devaluation in mid 2016. This helped UK equities reach new all-time highs during the period, with mid-cap UK companies outperforming their large-cap peers. However, Brexit-related uncertainty continues to weigh on businesses' investment intentions *(Figure 6)* and this is an area we will be watching closely for signs of a more protracted slowdown. Longer-dated gilt yields fell over the period in reflection of lower medium-term growth expectations, while shorter-dated gilts remained relatively flat amid some volatility linked to expectations of the government's borrowing plans.

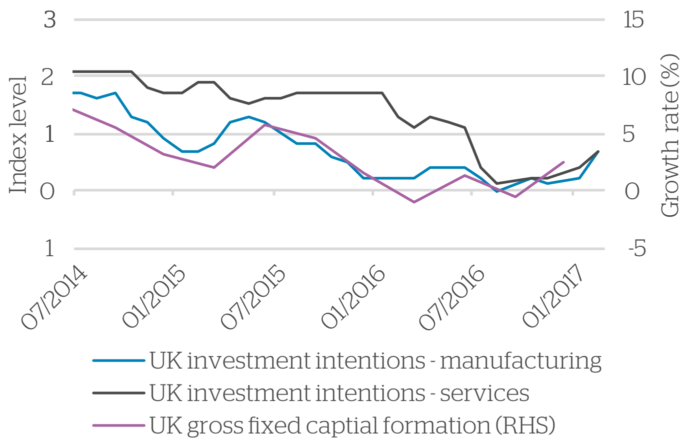

Figure 6: UK investment intentions surveys fell dramatically following last year's referendum. Business investment, as measured by gross fixed capital formation, remains subdued and our central case is that there is unlikely to be a full recovery as long as uncertainty relating to the UK's secession from the EU remains elevated.
Source: Thomson Reuters Datastream

Scotland's parliament voted to allow First Minister Nicola Sturgeon to begin the process of holding a second independence referendum. Likewise, there were calls for Northern Ireland to hold a similar vote and potentially re-unite with Ireland. We see scope for news surrounding both of these events to impact UK market sentiment in the coming months.

Europe

In Europe, politics continues to dominate the investment backdrop. The quarter's major event was the Dutch election, which ended with Mark Rutte's incumbent Volkspartij voor Vrijheid en Democratie (People's Party for Freedom and Democracy) defeating Geert Wilders anti-EU Partij voor de Vrijheid (Party for Freedom). This result provided reassurance for markets, given the potential negative implications Wilders' victory could have had for the eurozone.

Meanwhile, polls have shown that Emmanuel Macron, the pro-European leader of the En Marche! (Forward) political party, is likely to become France's next President, despite the first round of voting being closely contested by the Front National's (National Front's) Marine Le Pen. In Germany, Angela Merkel is also engaged in the tightest leadership contest she has faced in over a decade against Martin Schulz's Sozialdemokratische Partei Deutschlands (Social Democratic Party of Germany). However, in March she won a convincing victory in a regional election in Saarland, which was seen as a litmus test of her wider chances of success.

Despite the positive political developments, Italy's anti-EU Movimento 5 Stelle (Five Star Movement) continues to gain traction, providing some cause for concern. It is likely that the country's next general election will now be held in early 2018. Furthermore, the UK government's decision to formally begin the process of seceding from the EU increased medium-term political uncertainty on the continent, with European Council President Donald Tusk stating that "damage limitation" is the EU's primary goal.

Away from politics, the eurozone's economic recovery is gaining momentum. The progress being made by the region's various underlying economies continues to vary, but the recovery is broadening and the dispersion between their annual growth rates is now at the lowest level since the turn of the century. European PMIs are generally strengthening, in both the manufacturing and service sectors, while industrial production continues to increase. Meanwhile, unemployment continues to fall and wage growth is accelerating, albeit from a very low base in the weaker economies. Likewise, inflationary forces continue to grow; headline inflation is being supported by overseas factors and although core eurozone inflation remains relatively stable around 1%, accelerating producer price inflation is likely to provide a tailwind to price growth in time.

These positive trends were sufficient to allow some ECB policymakers to suggest that interest rates could be raised before the central bank's asset purchase programme has ended. Despite this, Europe's central bank remains reticent to undermine the region's strengthening recovery and we expect monetary policy to remain highly accommodative for an extended period. This should allow credit growth to continue to support investment and consumption.

The subtle shift in ECB policy, generally positive political developments and the improving economic backdrop all provided support to the euro over the period. Despite the stronger currency, European equities moved higher, with German equities approaching all-time highs; however, they still remain attractively valued relative to their US peers *(Figure 7)*. Meanwhile, European bonds lagged as investors began to anticipate less-accommodative policy from the ECB in time; we note that from April it will reduce the value of its monthly asset purchases.

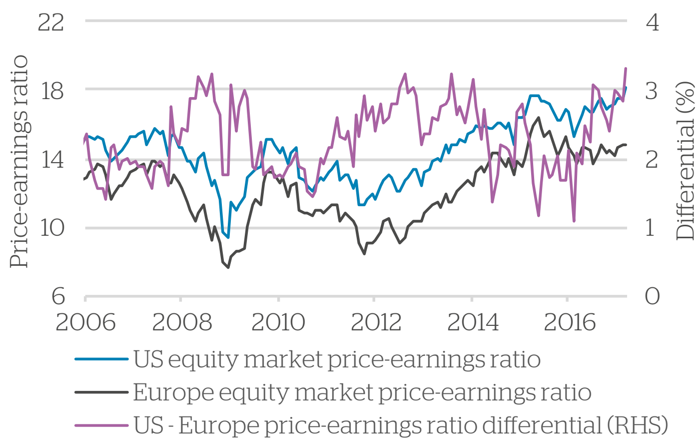

Figure 7: The valuation differential between US and European equities has reached the top of its decade-long trading range, despite the eurozone showing significant economic improvement amid positive political developments.
Source: Thomson Reuters Datastream

The emerging markets

The emerging markets led market performance in the first quarter of 2017, in terms of both equities and fixed income. The region benefitted from encouraging economic performance in a number of its underlying countries amid strengthening demand from the developed world, a weakening of the US dollar and stability in industrial commodity markets.

In China, the government reduced its annual growth target to 6.5%-7.0%, with the economy having expanded by 6.7% in 2016. Although the Chinese economy is expected to resume its longer-term structural slowdown over the course of the year, key trade, investment and activity indicators have pointed to strong growth in the first quarter. This allowed the People's Bank of China (PBoC) to keep the renminbi stable during the period, easing concerns over capital flight from the country and boosting sentiment across Asia.

The PBoC also raised short-term interest rates to reduce the rate of new credit creation within the country's rapidly expanding banking sector. China's authorities also vowed to apply further controls on credit creation within the property sector to combat the build up of housing bubbles and contain risk. Credit expansion in the country continues to outpace economic growth and we remain concerned that this is unsustainable over the longer term *(Figure 8)*, especially as the latter has been supported by large fiscal stimulus measures in recent quarters.

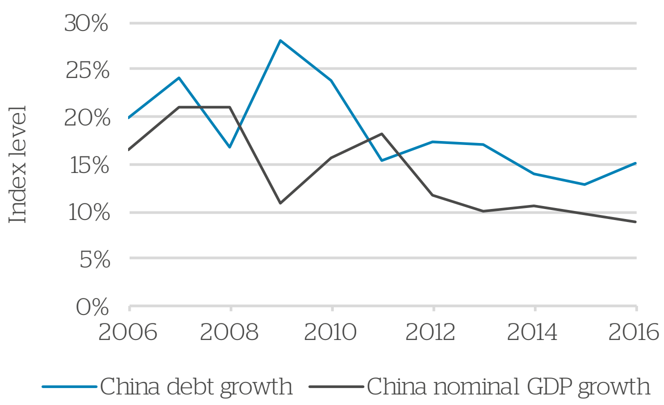

Figure 8: The rate of debt creation continues to outpace the rate of nominal GDP growth within China. We are concerned that this is unsustainable over the longer term and once the cyclical tailwind of credit creation declines we expect China's economic growth to slow further.
Source: Thomson Reuters Datastream

Outside of China, the members of the OPEC cartel (and Russia) continued to reiterate their commitment to limit oil production and run down inventories to support prices. However, the market began to question their ability to do so, given US shale oil producers' emergence as a new global swing producer, and this weighed on oil prices. Meanwhile, Indian Prime Minister Narendra Modi registered a sweeping election victory in Uttar Pradesh, the country's largest and most populous state. His victory was seen as a vote of confidence in the government's recent demonetisation exercise and should help the incumbent administration push through domestic reforms. This helped Indian equities deliver some of the strongest returns generated within the emerging markets over the quarter.

Japan

Japanese economic data showed some positive signs over the quarter, with the closely-followed Tankan business conditions survey bouncing back from weakness in the final quarter of 2016, industrial and manufacturing growth steady at encouraging levels and various PMIs continuing to indicate expanding activity. However, these trends largely reflect an improvement in overseas demand relating to the decline in the value of the yen since the middle of last year.

Despite the Japanese unemployment rate falling to a 22-year low during the quarter amid high levels of job availability, wage growth remains weak as many of Japan's large corporations are reticent to raise pay levels due to concerns over rising costs and the prospect of increased trade protectionism. Weak wage growth is weighing on consumer sentiment and has been a key factor keeping household consumption in contraction since early 2016, with consumers continuing to show greater propensity to save than spend.

With domestic demand weak, overall growth remains uninspiring. However, producer price growth has accelerated into positive territory, while core inflation has also become positive for the first time since early 2016. Nevertheless, inflation remains well below the Bank of Japan's (BoJ) target rate of 2% and it maintained its monetary policy stance during the quarter. Against this backdrop Japanese government bonds also ended the period roughly flat, with the central bank having moved to control yields in the market last year. Meanwhile, the yen strengthened, which held back Japanese equities.

Important information

The performance indicated for each sector should not be taken as an expectation of the future performance. Investors should be aware that the price of investments and the income from them can go down as well as up and that neither is guaranteed. Past performance is not a guide to the future. Investors may not get back the amount invested. Changes in rates of exchange may have an adverse effect on the value, price or income of an investment. Investors should be aware of the additional risks associated with funds investing in emerging or developing markets.

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