momentum

Viewpoint

Monthly market update

July 2016

global investment management

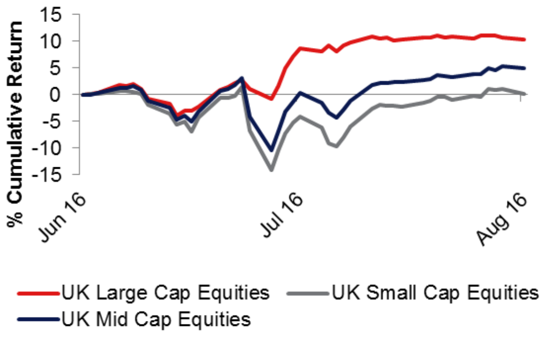
Contents

1. Market commentary

Fortunately, the Brexit vote proved to be anything but the globally systemic shock that many had predicted. Within weeks most equity markets had recovered all and more of their immediate post-referendum falls as it became clear that the only lasting impact on markets globally was to delay any prospect of monetary tightening into the long distant future. Lower for longer has become received wisdom as yields on government bonds, which fell sharply after the vote, have stayed at record low levels as investors anticipate further easing by central banks in the UK, Europe and Japan, as well as a deferral of interest rate rises in the US. Equity markets quickly recognised the over amplified Brexit fears and enjoyed a strong month, with the MSCI World index up 4.2% in the month and Global Emerging Markets up 5%, with nearly all markets participating in the rise and some, notably the US, moving to new all-time highs.

Arguably the biggest surprise was in the UK: the index of the largest shares by market capitalization, dominated as it is by overseas earners, benefitted from sterling's sharp post Brexit falls, and moved to well above its pre-poll levels. Of most surprise was the performance of the domestically biased mid cap stocks which broadly recovered all the 15% lost in the immediate post Brexit sell-off. In general, companies with high foreign currency earnings, either from overseas businesses or exports, benefitted, as did sectors largely immune from trade with the EU or from a broad slowdown in the economy. Whilst sectors exposed to a slowdown, such as commercial property and construction, as well as financials which suffer weaker profitability outlook from lower long term interest rates, have been weighed down post Brexit.

Figure 1: UK Equities bounce back

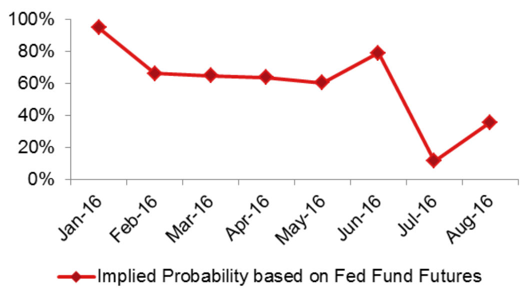


Despite this stock market recovery, as well as the early election of Theresa May as the new PM (which was well received by markets), there has been a short term knock to confidence in the UK, especially in the business sector, and leading indicators in the month post Brexit have fallen significantly. The Bank of England reacted by cutting interest rates to 25 basis points and by new term funding and asset purchases programmes, the latter amounting to £60bn in gilts and, for the first time, £10bn in corporate debt. The government has also indicated that it will ease its previous fiscal deficit reduction plans over the next 4 years and is likely to provide some fiscal stimulus to the economy in the forthcoming autumn budget.

Elsewhere the long awaited Euro area bank stress tests were published and showed resilience in terms of capital across nearly all of the banks tested. As is well known, the Italian banks are the most vulnerable and sizeable capital raising is necessary. However the markets were unimpressed with the severity of the tests and continue to focus on the damage to bank profitability from the European Central Bank's (ECB) long-terms negative rates policy. So far this year European banks' share prices are down over 30% and are signalling that all is not well in the system.

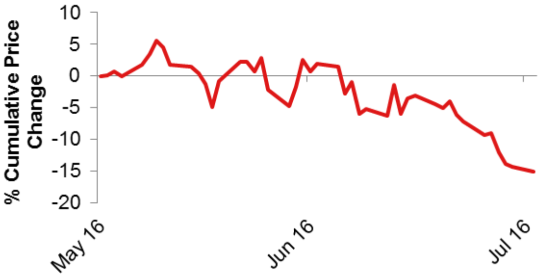
In the US strong data on employment and other leading indicators was nullified by uninspiring Q2 GDP growth of only 1.2%, well below expectations. The US Federal Reserve (Fed) kept open the possibility of a rate rise this year. However against a background of sluggish global growth, inflation below the Fed target, central banks continuing to ease policy, and considerable risks to the outlook from China's slowdown, Europe's banking woes and UK Brexit implications, not to mention the possibility of a Trump presidency, a rise in rates before the election in November seems highly unlikely.

Figure 2: Probability of a Fed Rate hike in 2016



Aside from the substantial fall in bond yields over the past 6 weeks, one of the most notable moves has been the sharp fall in the oil price, now down by 20% since its peak in early June and back to close to $40 per barrel. Prices are somewhat supported by falling global production, but the headwinds of high stock levels and falling production costs in the US force a cap on the price - which seems set to trade in a range around $40-50 for some time ahead.

Figure 3: Oil prices falter



The strength in equity and bond markets in the past month has taken year-to-date returns to 5% for global equities, 12% for global emerging market equities and 11% for government bonds. Almost half of all developed world government bonds offer negative nominal yields, and 75% provide yields of under 1%; they offer no protection against any rise in inflation and are extremely expensive. Some sectors of credit offer better value, while equities are broadly fairly valued, having mostly tracked sideways for the past two years. Given the considerable uncertainties and headwinds periods of volatility are inevitable but we continue to see these as an opportunity to accumulate positions and to take advantage of a cycle which will prove to be unusually long and sustainable.

Source: Bloomberg. Returns in US dollars unless otherwise stated. July 2016.

2. Market performance

		To 29 July 2016		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	3.6%	7.3%
United Kingdom	MSCI UK NR	GBP	3.5%	10.6%
Continental Europe	MSCI Europe ex UK NR	EUR	4.1%	-4.3%
Japan	Topix TR	JPY	6.2%	-13.5%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	5.6%	8.1%
Global	MSCI World NR	USD	4.2%	4.9%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	1.2%	11.2%
Emerging Asia	MSCI EM Asia NR	USD	4.8%	7.2%
Emerging Latin America	MSCI EM Latin America NR	USD	5.5%	32.4%
BRICs	MSCI BRIC NR	USD	4.8%	9.5%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	5.0%	11.8%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.4%	6.2%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.6%	7.2%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.5%	9.3%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.7%	12.0%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	2.0%	14.4%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	4.2%	11.8%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.8%	6.6%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.7%	5.8%
Euro High Yield	Barclays European HY 3% Issuer Constraint Total Return Index Value	EUR	2.2%	6.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-1.0%	6.7%
Australian Government	JP Morgan Australia GBI TR	AUD	0.9%	7.0%
Global Government Bonds	JP Morgan Global GBI	USD	0.5%	11.1%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.8%	9.2%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	2.6%	1.9%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	0.9%	13.3%

Source: Bloomberg. e denotes estimate

		To 29 July 2016		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	4.2%	17.4%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	5.4%	19.8%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	4.7%	7.9%
Global Property Securities	S&P Global Property USD TR	USD	4.8%	14.1%
Currencies				
Euro		USD	0.7%	2.9%
UK Pound Sterling		USD	-0.6%	-10.2%
Japanese Yen		USD	1.1%	17.8%
Australian Dollar		USD	2.0%	4.3%
South African Rand		USD	6.0%	11.4%
Commodities & Alternatives				
Commodities	RICI TR	USD	-4.8%	5.5%
Agricultural Commodities	RICI Agriculture TR	USD	-2.8%	2.2%
Oil	Brent Crude	USD	-14.5%	13.9%
Gold	Gold Spot	USD	2.2%	27.3%
Hedge funds	HFRX Global Hedge Fund	USD	1.5%	0.5%

Source: Bloomberg. e denotes estimate

3. Asset allocation dashboard

🟢 Positive	🟡 Neutral	🔴 Negative

Asset class	View
Equities	
Developed equities	🟡
UK equities (relative to developed)	🟢
European equities (relative to developed)	🟢
US equities (relative to developed)	🔴
Japan equities (relative to developed)	🟢
Emerging market equities	🟡
Fixed Income	
Government	🔴
Index-linked (relative to government)	🟢
Investment grade (relative to government)	🟢
High yield	🟡
Loans	🟡
Emerging market debt	🟡
Convertible bonds	🟢
Alternatives	
Commodities	🟡
Property (UK)	🟡
Currencies	
GBP	🟢
Euro	🟡
Yen	🟡

For more information, please contact:

David Hansen
Client Services
E: david.hansen@momentum.co.uk
T: +44 (0)207 618 1806

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