Invesco Perpetual

Monthly Market Roundup – covering May 2017

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We review global market developments in May, highlighting the best and worst performing sectors globally.

Global overview

- Company earnings growth supported optimism in the global economy
- Financial markets shrugged off controversies surrounding the US president
- Potential headwinds to the global growth story remain

Global equities ended May just shy of a record high as strong company earnings growth supported optimism in the global economy. All the main regions reported their strongest first quarter earnings growth in nearly six years, helped by a rebound in global activity. Yet potential headwinds to the global growth story remain. Elections in the UK, Germany and Italy are looming as Brexit negotiations begin, while in the US President Trump's ability to implement spending and tax-cut plans is far from certain.

The latest in a series of political controversies in Washington triggered a bout of short-term risk aversion in financial markets mid- month. The S&P 500 index retreated after President Trump came under fire for dismissing former FBI director James Comey amid speculation that he was motivated by the FBI's probe into his electoral campaign's ties to Russia. The concern was that controversies surrounding the US president would affect efforts to push ahead with plans for tax cuts, infrastructure spending and deregulation, all of which were seen as boosting economic growth and corporate earnings. Yet markets soon shrugged off the scandal to bid stocks higher.

With France's presidential election now behind us, European equity markets continued their advance in May. Stocks performed strongly in the first half of the month as the victory of pro-Europe centrist Emmanuel Macron resolved uncertainty about the outlook. European equities pared some of the advances in the second half amid a swift upward move in the EUR/USD exchange rate. Meanwhile, eurozone economic data continued to show signs of improvement. For example, a closely watched business survey showed manufacturing activity in the region is now at its highest level since April 2011.

Japan's equity market also benefitted from an increase in general investor risk appetite following Emmanuel Macron's victory in the French presidential election, as well as solid corporate earnings results.

In the UK the blue chip index reached a record high, buoyed by weakening sterling and strengthening commodity prices. The index surged again into month end as the pound came under pressure following a study from pollster YouGov, which suggested that the upcoming general election could result in a hung parliament.

It was a positive month for emerging equity markets too as they outperformed their peers in the developed world for the fifth month in a row. Emerging Asia was the strongest performing region with all the equity markets in the area gaining ground. South Korea led the gains driven higher by robust first quarter earnings and receding leadership and political concerns. China also performed well - seemingly unfazed by a sovereign ratings downgrade by Moody's. The MSCI China Index rose as the People's Bank of China signalled that steps taken to reduce financial risks would not negatively impact market liquidity. In addition, currency strength dampened fears surrounding capital flows and currency depreciation.

Equity performance in the EMEA (Europe, Middle East & Africa) region was more mixed with weakness in Russia being offset by strength in Greece and Hungary. Latin American equity markets were dragged lower by Brazil following corruption allegations against President Temer. Fears that Brazil's economic recov could be undermined by a widening corruption scandal in the country had a dampening impact on m confidence. Outside of Brazil, there were gains for the equity markets of Peru, Colombia and Mexic fresh political scandal in Brazil comes at a time when the economy is finally showing signs of expansi after being in recession for a couple of years.

A combination of on-going improvement in the eurozone economy, a supportive European Central Bank (ECB) and reduction in political risk helped European corporate bonds to outperform government bonds through May.

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US

- US equity market boosted by strong jobs report and a rise in consumer spending
- Shares in energy companies declined when OPEC members agreed to extend, but not deepen, oil production cuts
- Amazon joined a small group of US companies with shares worth more than US$1,000 each

The US equity market eased back to end the month in positive territory. May started on an upbeat note, after a strong US jobs report pointed to further economic growth ahead. The US is coming close to full employment after adding jobs at an average monthly pace of 174,000 over the past three months. The jobs numbers were welcomed by the market as a sign that consumer spending, the mainstay of the US economy, was unlikely to diminish. Indeed, data on consumer spending released later in the month revealed that it grew at a quick pace in April. The good news was compounded by the US economy growing more strongly in the first quarter than previously thought. This raised the prospect that the US Federal Reserve would increase interest rates next month with the US once again poised to lead a global recovery.

By 15 May the US equity market closed at a new record high after oil prices rallied strongly on news from Saudi Arabia that Russia was ready to join OPEC (Organisation of Petroleum Exporting Countries) in extending supply cuts to reduce a persistent glut. The share prices of energy stocks received a short-term boost, after concerns about rising supplies of oil had negatively impacted the performance of the sector for much of the year. However, the rally was not to last. Energy stocks were hit by a fresh drop in oil prices and it was the worst performing sector over the month. Share prices dipped amid disappointment from the market that OPEC members eventually agreed to merely extend, but not deepen, production cuts. While the deal was widely expected by the market, many had hoped that OPEC would take a more aggressive stance against the chronic oversupply of oil.

The latest in a series of political controversies in Washington triggered a bout of short-term risk aversion in financial markets more broadly. The S&P 500 index retreated after President Trump came under fire for dismissing former FBI director James Comey amid speculation that he was motivated by the FBI's probe into his electoral campaign's ties to Russia. The concern was that controversies surrounding the US president would affect efforts to push ahead with plans for tax cuts, infrastructure spending and deregulation, all of which were seen as boosting economic growth and corporate earnings. Yet markets soon shrugged off the scandal to bid stocks higher.

Meanwhile, companies in the S&P 500 index reported their strongest first quarter earnings growth in nearly six years, helped by a rebound in global activity. Some sectors looked better than others and technology stocks certainly enjoyed solid earnings growth. Indeed, the sector has continued to rally with share prices climbing fast. It was the best performing sector in May – especially tech giants Facebook, Apple, Amazon, Netflix and Google, the 'FAANGtastic five'. In fact, Amazon joined a small group of US companies with shares worth more than US$1,000 each towards the end of the month as market appetite for the online retailer drove its share price past the landmark.

In terms of company news, shares of US financial services giant Blackstone jumped during the mont the firm said it would invest US$100m in infrastructure, with partners that include Saudi Arabia. Th was one of several announced during US President Trump's weekend visit to the Middle East, which b US markets.

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European

- Macron's victory pushed European equity markets higher in May
- Economic growth indicators continued to signal a robust and improving backdrop
- Inflation remained below target, putting pressure on the ECB's tapering plans

European equity markets continued their advance in May. Stocks performed strongly in the first half of the month as the victory of pro-Europe centrist Emmanuel Macron in France's presidential elections resolved uncertainty about the outlook. European equities pared some of the advances in the second half amid a swift upward move in the EUR/USD exchange rate.

On a sector level, utilities and telecommunications were the best performers in May. The domestic nature of these sectors proved appealing to investors amid a strengthening of the euro. Unlike export-oriented industries, utilities and telecommunications were perceived as relatively immune to a major shift in foreign exchange rates. The technology sector also performed strongly in May. Meanwhile, the oil & gas sector led detractors given the large drop in oil prices as more supply is expected to be brought into the market from shale-based production. The industrials sector made positive returns in May, but also lagged the broader market. On a stock level, the French utility firm EDF and German peer RWE were among the top performers. Nokia, the Finnish technology company, also performed strongly after finally settling a legal dispute over technology patents with Apple. The deal will allow Nokia to receive an up-front payment from the iPhone maker and get additional revenue during a multiyear agreement. In terms of detractors, Italian fashion company Salvatore Ferragamo was among the leading detractors after the company confirmed its cautious outlook for this year. Pandora, the Danish jewellery maker, also lagged in May after first quarter figures showed revenues growing at a slower than expected pace.

On the macroeconomic front, economic growth indicators in the euro-area continued to signal a robust and improving level of economic activity. A survey measuring manufacturing output and new orders stood at the highest level since March 2011, signalling expansion in each of the past 47 months. Eurozone unemployment dropped to 9.3% in May, the lowest level in more than eight years, while buoyant sentiment was registered among consumers and businesses. The consensus eurozone annual GDP growth forecast rose from 1.6% to 1.7% in May. In contrast, inflation data remained below target levels set by the European Central Bank (ECB). Euro-area headline inflation dropped to 1.4% in May, from 1.9% in April. Core inflation, a measure that strips out volatile components such as energy and food, fell to 0.9%, and was also weaker than expected. While economic growth data might warrant a relative scale back in monetary policy stimulus, subdued inflation level is putting ECB policy-easing measures schedule further into question among market participants.

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UK

- Sterling weakness and commodity price strength helped the FTSE close at a record high mid-month
- UK manufacturing expanded at its fastest rate for three years
- The Monetary Policy Committee voted to keep UK interest rates at 0.25%

UK equity markets rose strongly through May. Mid-month the UK's blue chip index closed at a record high, buoyed by weakening sterling and strengthening commodity prices. The index surged again into month end as the pound came under pressure following a study from pollster YouGov, which suggested that the upcoming general election could result in a hung parliament.

UK manufacturing expanded at its fastest rate for three years in April, raising hopes that weakened sterling since the EU Referendum will help rebalance the UK economy towards manufacturing, offsetting the impact of a potential slowdown in consumer demand.

The Monetary Policy Committee voted 7-1 in favour of maintaining UK interest rates at 0.25% at its May meeting. Speaking at the launch of the latest quarterly inflation report from the Bank of England (BoE), which marginally revised down 2017 UK growth forecasts, governor Mark Carney said the BoE expects a pick-up in wages and real income growth in the coming years. Into month end, UK growth expectations were revised down to account for continued sterling weakness. The oil price came under pressure in May as growing doubts around OPEC's ability to ease the global surplus pushed Brent crude to its lowest levels since November.

On the corporate news front, UK energy stocks were negatively impacted by the Conservative party's manifesto pledge to impose a price cap on domestic energy bills, with Centrica, SSE and National Grid among the biggest fallers in terms of share price performance. Centrica chief executive Ian Conn warned the move would lead to reduced competition and potentially higher average prices.

The market reacted negatively to an ambitious turnaround plan from telecom and broadband provider Talk Talk Telecom; the company cut its dividend and issued a profit warning for the coming year, but plans to step up spending to expand its customer base. Conversely, pharmaceutical giant AstraZeneca gained US regulatory approval for use of its bladder cancer drug durvalumab; this landmark is a major step forward for the company's oncology pipeline and the next big hurdle will come as the drug is tested in its capacity to treat lung cancer.

May brought better news for companies in the airlines sector; budget airline easyJet issued a positive update on passenger numbers, up more than 10% in April versus the previous year. International Consolidated airlines (IAG), the owner of British Airways, reported a record first quarter on the back of improved demand and pricing in its key long-haul markets; over the bank holiday weekend however, British Airways was hit by a major systems failure leading to the cancellation of all flights out of London.

UK retailers continued to face a tough consumer environment and the month saw mixed results for the sector; Next issued a profit warning, downgraded its full year earnings expectations and announced a sharp decline in sales. By contrast, Marks & Spencer beat analysts' forecasts with its full year results and the market reacted positively to the company's appointment of Archie Norman as chairman.

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Asia Pacific

- Earning revisions in Asia continued to rise
- South Korea’s equity market reached a new high on robust first quarter results and fading political fears
- Japan’s Topix index posts record earnings

The vast majority of Asian equity markets ended the month higher as positive earnings revisions and results of the French presidential election aided global risk. In China, key indices rose as the People’s Bank of China signalled that steps taken to reduce financial risks would not negatively impact market liquidity. In addition, currency strength dampened fears surrounding capital flows and currency depreciation. South Korea’s equity market was the region’s best performing market, driven higher by robust first quarter corporate earnings and receding leadership and political concerns. Earnings benefited from stronger sales growth helped by a gradual global economic recovery and an improvement in cost control. Furthermore, investor sentiment was also supported by expectations that the new President Moon and his officials are likely to urge Chaebols (conglomerates) to unwind cross-ownership structures and adopt a more shareholder-friendly stance. Despite lower than expected GDP growth in the first quarter of 2017 (6.1% vs. consensus 7.1%), India’s equity market rose as investor sentiment was aided by progress on the Goods and Services Tax roll-out and prospects of better monsoons on receding El Niño concerns. Taiwan’s equity market made new highs led by the Taiwanese technology stocks which rose on expectations that the iPhone model cycle will drive the revenue growth of Apple’s suppliers. Finally, the Australian equity market was weak due to a lacklustre reporting season, speculation about a domestic housing bubble and announced of a government levy on the major banks.

Japan’s equity market ended the month higher, benefiting from solid corporate earnings results and the French presidential election result. However, corporate earnings failed to lift share prices significantly. The Topix index posted record earnings per share in the March 2017 fiscal year (FY3/17) and in many cases profits beat expectations, but FY3/18 guidance remained obstinately conservative, as is typical. The achievement of record earnings was accompanied by record high dividends as the trend of improved shareholder returns continued. 30% of companies in FY3/17 raised their pay-out ratios, while 30% also announced share buy backs. However, the pace of share buy backs has slowed, as many firms preferred to invest in capacity or acquisitions, or just keep their powder dry, which is not surprising given that the Topix is trading close to a 10-year peak. It was also encouraging to note that a growing number of firms announced restricted stock compensation schemes for senior managers.

On the domestic front, there were signs of strength in the Japanese economy. Preliminary first quarter GDP growth came in at +2.2% quarter-on-quarter annualised, which was stronger than expected, with monthly data for April supporting evidence of a recovery in consumer spending.

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Emerging Markets

- Gains in emerging equity markets led by the Asian region
- China unfazed by sovereign bond ratings downgrade
- Interest rates cut in Brazil but raised in Mexico

It was a positive month for emerging equity markets as they outperformed their peers in the developed world for the fifth month in a row. Emerging Asia was the strongest performing region with all the equity markets in the area gaining ground. Korea led the gains followed by China with the latter seemingly unfazed by a sovereign bond ratings downgrade by Moody's. Equity performance in the EMEA (Europe, Middle East & Africa) region was more mixed with weakness in Russia being offset by strength in Greece and Hungary. Latin American equity markets were dragged lower by Brazil following corruption allegations against President Temer. From a sector perspective, consumer discretionary and technology stocks were the strongest performers with energy and materials being the laggards. Most commodities, including oil, ended the month lower.

The Russian equity market struggled to gain ground in May as a backdrop of falling energy prices - natural gas fell by 8.4% and Brent crude dropped by 3.1% in May – dented enthusiasm. However, news on t economy was more encouraging with GDP for the first quarter of 2017 rising by 0.5% year-on-year, improvement from the previous quarter's growth rate of 0.3%. In keeping with its downward trend, R annual inflation rate edged down to 4.1% in April. Equity performance elsewhere in the region was more positive with Greece leading the way with double-digit returns. Sentiment towards Greece was enhanced by positive progress on bailout talks with creditors. Turkey's equity market continued its uptrend given steady improvement in earnings growth expectations for 2017. In central Europe, economic data from Poland and Hungary was generally robust with retails sales increasing at a healthy rate in both countries.

Fears that Brazil's economic recovery could be undermined by a widening corruption scandal in the country had a dampening impact on market confidence. Outside of Brazil, there were gains for the equity markets of Peru, Colombia and Mexico. The fresh political scandal in Brazil comes at a time when the economy is finally showing signs of expansion after being in recession for a couple of years. The economy grew by 1% during the first three months of the year compared to the previous quarter. From a 12-year high of 10.7% recorded at the beginning of 2016, the annual inflation rate dropped to a 10-year low of 4.1% in April. Brazil's central bank reduced interest rates from 11.25% to 10.25% but signalled that future rate cuts may not be as aggressive. Interest rates were also reduced in Chile – down 25 basis points to 2.50% - and in light of moderating inflation, cut to 6.25% from 6.5% in Colombia. By contrast, Mexico raised their benchmark interest rate by 25 basis points to 6.75%, its highest level in eight years.

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Fixed Interest

- Emmanuel Macron was elected President of France.
- Political risk increased in the US and Brazil.
- The Greek government met with creditors to discuss potential debt relief.

A combination of on-going improvement in the eurozone economy, a supportive European Central Bank (ECB) and reduction in political risk helped European corporate bonds to outperform government bonds through May.

The month began with the perceived market friendly candidate, Emmanuel Macron beating far right candidate Marine le Pen in the French election to become president. His win in the first round of the election had reduced much of the political risk that was suppressing French bond prices and so there was only limited impact on markets from his second round win. Meanwhile, eurozone economic data continued to show signs of improvement. For example, a closely watched business survey showed manufacturing activity in the region is now at its highest level since April 2011. Nonetheless, European Central Bank (ECB) policy remains accommodative. This was underlined by ECB President, Mario Draghi's comment to the European Parliament toward the end of the month in which he stated "the ECB remains firmly convinced that an extraordinary amount of monetary policy support, including through our forward guidance, is still necessary."

Political risk has however not disappeared, rather it has moved across the Atlantic, with uncertainty increasing in the US and, significantly for emerging markets, Brazil. A series of scandals surrounding the new Trump administration increased political uncertainty in the US. The impact on bond markets has been limited though, with economic data, which has remained positive, the more important driver of returns. This is underlined by the minutes of the US Federal Reserve's latest meeting, which stated that most participants responsible for setting interest rate policy view the US economic outlook as strong enough to warrant further policy normalization.

In Brazil, allegations of corruption against new President Michel Temer, led to speculation he might be impeached. Citing concerns that this political uncertainty could forestall economic reform, ratings agency Standard and Poor's have put Brazil's long term bond rating on negative watch. This move is intended to signal that Brazil's current BB bond rating may be lowered. Brazilian government bond yields rose sharply higher following the announcement, but they have since retraced around half of their losses.

Toward the end of the month, Greece (which has €7bn of debt maturing in July) met with its creditors to discuss debt relief. The talks ended without agreement. However, there have been subsequent reports of a compromise plan put forward by the IMF that would provide funds for the summer, but delay the more sensitive talks on debt relief. These plans are widely expected to form the basis of discussions when creditors regroup on June 15th.

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