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CAVE'S QUARTERLY

Q4 2016 ROUND-UP

Along with the loss of much-loved artists, 2016 will surely be assigned to the history archives as a year of political upheaval, producing unexpected results that are likely to reshape the geopolitical landscape for years to come. June left us digesting the potential ramifications of the Brexit vote for the remainder of the year and pollsters were once again wrong-footed in November by another astonishment as the rancorous 'election of extremes' in the US came to a head, with an outcome that few thought possible; billionaire property mogul and media celebrity, Donald Trump is to become the 45th president of the United States of America later this month.

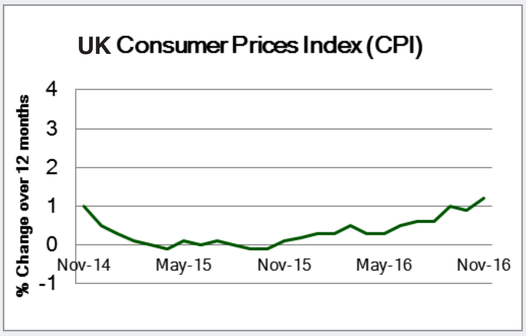
The final months of the year saw UK equity markets continue to push higher, as the FTSE100 traded through the 7,000 level. Unlike the EU referendum aftermath, where markets found support in a weaker pound, the latter months were considered less of a sterling weakness story, and more the result of higher inflation, a firmer oil price, and the potential of a pro-business President-elect favouring huge fiscal measures, all coming through. GDP has also proven resilient, ticking up 0.5% in the third quarter. Though it is still thought Theresa May will trigger Article 50 by the end of Q1 2017, a recent High Court ruling stated this is a decision that needs Parliament's backing, which could add further delays. Once formal exiting negotiations have begun, the UK Brexit committee will be hoping to retain the freedom of movement in goods, services and capital, whilst looking to abandon an element of the current 'revolving door' policy regarding the movement of people.

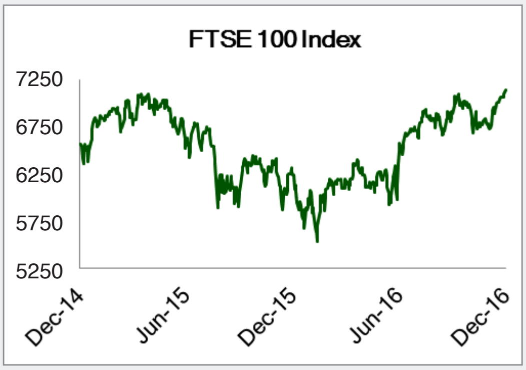
While still too early to properly understand the full effects of the US election result, an incoming President intent on cementing trade deals with the post-Brexit UK could prove favourable for business, particularly as the departing Obama was vocal in his support for us remaining within the single trading bloc, cautioning that the UK would be at the 'back of the line' should we choose to leave.

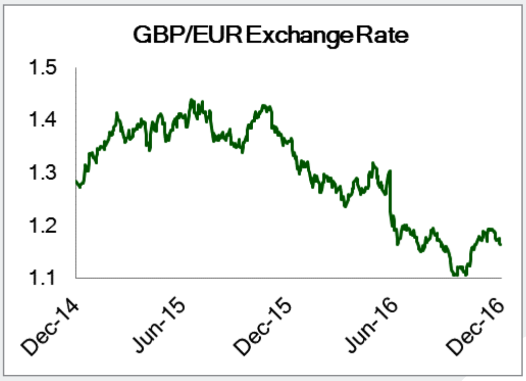
Eurozone third quarter GDP remained steady at 0.3%, suggesting the bloc's recovery has not, so far, been knocked off course by Britain's vote to leave the EU. Improvements were seen in both the French and Austrian economies, while growth in Belgium slowed. This does, though, lag behind the progress made in the UK. Euro weakness, or perhaps dollar strength, has led many analysts to predict the EUR/USD exchange rate will break through parity in the New Year, and with short-term, lower-yielding debt still eligible for inclusion in the ECB's QE programme, the disparity between US and European yields could still widen. As for politics, with Renzi losing in December's constitutional referendum in Italy, it is feared the rise of the populist vote could have severe implications for the forthcoming elections in Europe next year and fuel support of anti-establishment/anti-Euro parties that could destabilise the Eurozone project altogether.

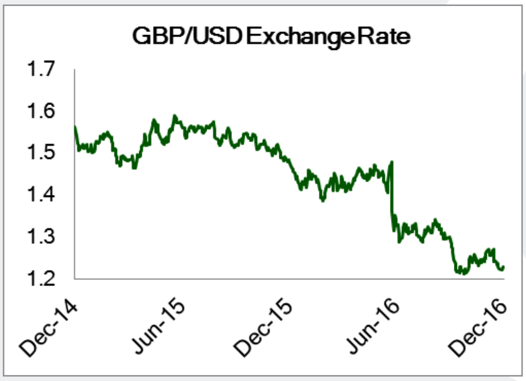
The shock of Trump's success left US investors, at first, unexpectedly sanguine, conceivably somewhat rationalised by still fresh-in-the-mind lessons of the EU referendum. However, although any protectionist moves would be a big negative for the country's key trading partners, at this stage it is difficult to foresee owing to lack of clarity with his policies. Markets have reacted positively to his apparent attitude towards taxes, infrastructure expenditure and regulation, which helped push the Dow Jones close towards the 20,000 mark. The 'reflation trade', which has seen investors switch out of bonds into equities, has bought with it a sharp climb in government bond yields, with US 10-year treasuries now yielding a lofty 2.6%! Market strength, as well as signs of a firmer economic footing, saw the FOMC unanimously decide to raise interest rates in December for a second time in the year, citing anticipations of a swifter return to normalisation throughout 2017, should economic conditions, notably inflation and employment, remain supportive.

Bank of Japan governor, Huriko Kuroda, has said the recent plunge in the country's domestic currency has been a consequence of dollar strength rather than Yen weakness following Trump's victory, and has meant the BoJ has left monetary policy on hold, whilst also upgrading their 2017 outlook; a marked change from September when despairing analysts said the central bank was out of options to stimulate the economy. Unsurprisingly, as a weaker Yen boosts earnings, Japanese markets also have advanced, the Topix and the Nikkei both testing all-time highs, driven by banks and brokers which have benefitted from a rise in global reflationary expectations.









Trump could spell bad news for China, having threatened to slap a 45% tariff on Chinese goods during his candidacy, though whether such anti-trade policies actually pass through remains to be seen. His recent social media outbursts have also done nothing to help foster relations, criticising their currency devaluation, tariffs on US products and the building of a military complex. The economy in China grew at an annualised basis of 6.7% in the third quarter of 2016 and looked set to comfortably achieve the government's forecast of 6.5-7%, buoyed chiefly by higher government spending, a housing rally and record bank lending, which have led to an explosive increase in debt. Despite analysts believing growth is lower than official data suggests, it has been acknowledged the construction boom has given activity an unanticipated boost in 2016. It is thought GDP growth in China could slow to around 6.5% this year, while authorities will likely remain on 'currency watch', with a government-run think tank recently suggesting that a one-off devaluation could be required to stabilize the yuan.

The new US president could be considered both a positive and negative for emerging markets. On one hand, clogging up the flow of international trade coming in to the US will likely hinder emerging economies, however a weaker dollar with firming commodities, huge infrastructure expenditures, and Trump's more benign view of world leaders (most obviously Putin) could in other ways benefit emerging market assets. 2016 saw the MSCI Emerging Markets Index add 12.3%, and the outlook over the twelve months is considered positive, particularly for those nations with improving political climates and less vulnerable to any external shocks arising from higher US borrowing costs.

To the more faint hearted, 2016 has perhaps not been the most convincing advert for global investment markets and, looking ahead, 2017 promises to be eventful from the start, as Barack Obama officially hands over the White House on 20th January and Theresa May's March deadline for triggering Article 30 follows soon after. Stock market bulls will be hoping for the synchronised fiscal expansion hinted at across the stronger-performing economies, however the increased support for populist movements looks set to carry across Europe and, with 41% of EU GDP coming from countries holding elections next year, we are likely to witness heightened levels of volatility across investment markets, leaving us somewhat cautious in our outlook for 2017.

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