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CAVE'S QUARTERLY

Q3 2017 ROUND-UP

Global equities posted their sixth consecutive quarter of growth in September, a feat last achieved in 1997! Although an assortment of political, financial and economic drivers have pointed to higher levels of market volatility, we are still yet to experience any significant downward pressure as movements have been subdued, despite catastrophic weather conditions in the US, nuclear 'sabre rattling' from either side of the Pacific, and hints at a more-aggressive return to normalisation by the world's most powerful central bankers. Though there have been episodes of instability, these have been short-lived and most major markets have been range-bound on an upward trajectory.

Now over a quarter of the way into the two-year negotiation timeline for exiting the European Union (as triggered by Article 50 in March), little is still known on how smooth the divorce process will be, or exactly what a post-Brexit Britain will look like. However, in Florence, Theresa May announced that a transition period after 2019 could last a further two years, during which access to the single market will continue on current terms. Just how much the exit bill totals and future status of EU citizens living here are primary sticking points, whilst David Davis & Co. are seeking to develop a separate financial services regulatory framework in an effort to secure a long-term competitive advantage for the City and its banks, fund managers and insurers for once the country leaves the bloc.

After CPI hit 2.9% in August, UK inflation is thought possible to break through 3% before the end of 2017. All eyes will be on the November Monetary Policy Committee meeting as we could see a withdrawal of monetary easing, through either a minor uptick in interest rates or, perhaps less likely at this stage, an unwinding of the Bank of England's balance sheet. Hints at such a move in the last MPC meeting minutes sent the pound on a tear to its highest level against the dollar since the EU Referendum.

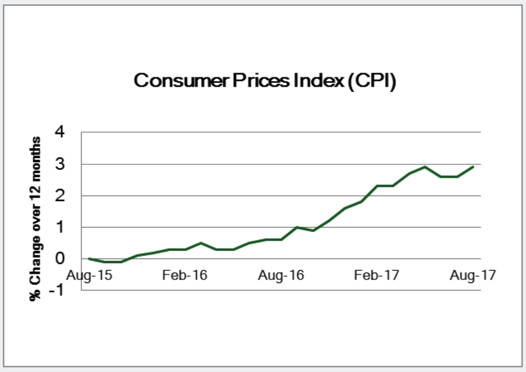
The Eurozone economy continues to fire on all cylinders, as GDP increased by 2% year-on-year, well above the long-term trend growth of 1.2%. Labour markets have improved, interest rates remain very low and bank lending terms have loosened, which have meant stock markets have remained supported. However, rather unexpectedly, the policital landscape across Europe once again looks unsteady. Through modernising her party and moving into the political centre ground, Angela Merkel was re-elected for a fourth term, though the populist right-wing AfD (Alternative for Deutschland) saw a surge in support on their anti-imigration initiative, winning seats in the Bundestag for the first time. Merkel has conceded that her controversial refugee policy had 'polarised' Germany and subsequently weakened her grip on power. The leading European politician, as she is considered by many, now faces complex domestic negotiations to form a new coalition, together with her efforts to steer the European Union.

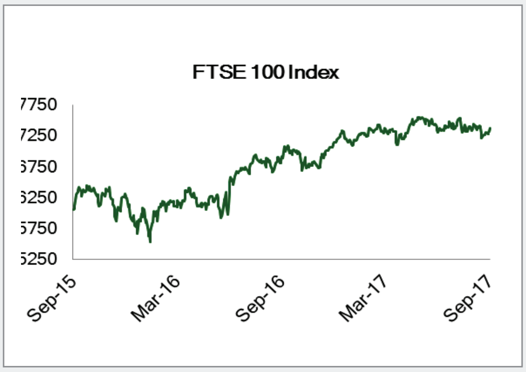
According to Citigroup, the Catalan Referendum could develop into a Spanish 'constitutional crisis', though the European Commission has dismissed it as an 'internal matter' in an effort to play down its importance on a wider scale. The Italian elections, likely to take place in May next year, are not currently considered a menace as, with Eurozone support growing stronger in the country, it would be unlikely for the challenging political parties look to win votes on an 'EU exit' initiative.

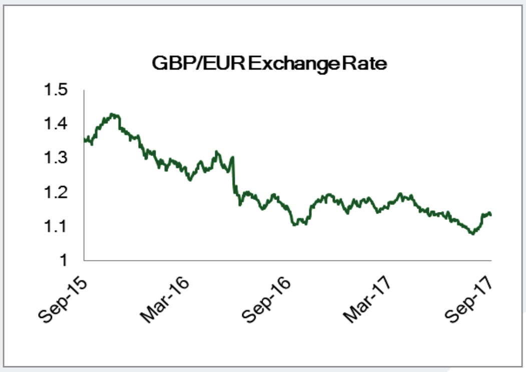
Despite a series of disastrous storms battering the Gulf of Mexico, and the Trump Presidency being long on grandiloquence and short on any real substance or deliverables, US markets and the economy have shown an unwavering resilience. According to the Federal Reserve, economic conditions have actually improved; hiring is strong, consumers continue to spend and business investment is 'picking up'. Stagnant inflation has been responsible for the Fed holding firm on interest rates over the third quarter, though at September's meeting markets were guided to expect one further hike before the end of the year and a balance sheet reduction agenda to begin in October. This pivotal moment marks an end to almost a decade of quantitative easing, which has seen the Fed amass $4.5 trillion of assets. Janet Yellen announced the shrinking of the balance sheet is to begin at rate of $10 billion per month in October, and likely to gather pace in months to come. However, with her term expiring in February next year, it will be down to the President to reappoint her to oversee the programme thereafter.

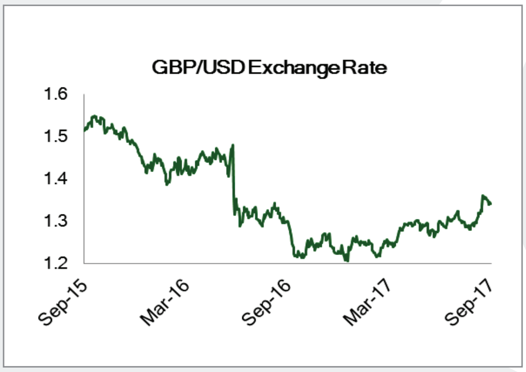
Having so far failed to deliver on his election promises, expectations are low with tax reform next on Trump's agenda. His suggested framework, which includes several pro-business initiatives such as cutting corporation tax to 20% from 35% and a 'one time' repatriation tax to tempt company profits back to US shores, has been ratified by congressional Republicans, though is at this stage far from a piece of legislation on which law makers could vote. It is not clear how Trump plans to fund such cuts, however a reduction in spending or further increasing the deficit would seem likely. Any suggestions that Trump will succeed in passing such reforms will surely be a positive for US stock markets.

Rising tensions over North Korea's nuclear capabilities have dented investor enthusiasm towards Japan, as institutional investors holding overweight Japanese equity positions tumbled from 20% to 12% from August to September, according to a poll conducted by Bank of America Merrill Lynch. Despite this, the Nikkei 225 has held firm, as the heavy buying of exchange traded funds by the Bank of Japan provided support to the tune of $42bn of inflows year-to-date. This policy divergence with other central banks has though put pressure on the Yen, pushing it down to $112. Under Shinzo Abe, although Japan has not achieved its price inflation targets, the economy has expanded for six straight quarters.









The Prime Minister pledged in September to implement 'daring policies' targeting taxes, the budget and regulations to promote domestic investment, in a bid to offset a dwindling population and other challenges facing the world's third largest economy. Abe has also called a snap general election, which is expected to take place in October, to allow him to capitalise on approval ratings and disarray in the political opposition (sound familiar!?). A victory would put him on track to become Japan's longest-serving premier.

Chinese equity funds have been the best-performing asset class for UK investors in the year-to-date, as fund managers have been excited about long-term prospects, particularly as the country's stock market opens its doors to overseas investors. Risk-loving stockpickers would argue any upside potential could be huge. However, after warning of a potential cut in June, S&P Global Ratings Agency downgraded China's sovereign credit rating as the country's 'de-risking' drive to reduce debt build-up has not worked as quickly as expected and credit growth is still too fast; as a percentage of GDP, total debt only fell to 268% from 269% in the second quarter. Whilst the agency recognises the country is deleveraging, the pace has been far too gradual, though China's finance ministry disagrees, calling the downgrade 'a wrong decision'.

Emerging market euphoria persevered in the third quarter, driven primarily by technology stocks continuing their advance. Both the Vanguard FTSE Emerging Markets ETF and the iShares Core MSCI Emerging Markets ETF reached new 52-week highs, as neither a new North Korean rocket fired over Japan nor a rise in oil prices sufficiently raised investor risk alarms. Despite trending higher, the investment case for emerging market assets can still be argued on valuations grounds, relative to their developed markets counterparts, and now also on falling inflation. Aggregate EM inflation fell to 3% in July, its lowest level since the 1970s, primarily lead by commodity exporting countries. Typically, an environment of low and declining inflation leads to a pickup in economic activity, and so provides an attractive backdrop for riskier assets, such as equities and high-yield debt.

Much consideration will remain on political tensions with North Korea, as sentiment hinges on Trump's handling of the matter. We would however consider the end of ultra-loose monetary policy a more pertinent risk to investors, as central banks begin to raise interest rates and scale back the assets on their balance sheets. It may be only then that the unintended consequences of a decade of quantitative easing begin to be understood, as unreasonably low bond yields have driven 'false' valuations across all asset classes. Stock markets have been subsequently bid higher by 'yield tourists', whilst corporates awash with cheap cash have indulged in stock buybacks, further inflating their share prices. While the implementation of any tightening will be gradual and indicate a welcome move back towards 'normality', it could generate headwinds for the global economy in both the near term and for the foreseeable future.

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