CAVE'S QUARTERLY

Q4 2017 ROUND-UP

The last quarter bared much resemblance to the earlier nine months of 2017, characterised by ostensibly 'stretched' valuations and low levels of volatility, as a variety of political, financial and economic issues failed to exert any significant influence, with movements across most financial markets subdued (ignoring cryptocurrencies!) and steadily trending upwards.

Here in the UK, Brexit negotiations seemingly made 'sufficient progress' on three key divorce issues; the financial settlement, Ireland's borders and citizens' rights, insofar as discussions can now move on to the next round of talks on trade and transition in the new year. Fuelled by such optimism, the pound climbed to its highest level in two months against the dollar. As for the UK economy, growth surprisingly accelerated in the final quarter of 2017, with GDP on track to post a 1.8% increase over the year, down marginally from the 1.9% recorded the year prior though much firmer than the slowdown to 1.2% economists initially predicted last year. An easing of the squeeze on real incomes, as wage growth picks up and inflation moderated, plus recent order numbers suggesting something of a recovery in construction output, helped to prop up consumer confidence and economic growth.

After CPI hit 3% the Monetary Policy Committee did, as they were expected to, raise interest rates by 0.25% to 0.5% in November; the first UK rate hike in over a decade! The 7-to-2 vote in favour of an increase signalled the end of close-to-zero rates, however markets were reassured that only two further 25 basis point rises are currently pencilled in before 2020, underlining the gradual path along which the Bank of England wishes to wean the domestic economy from ultra-accommodative monetary policy.

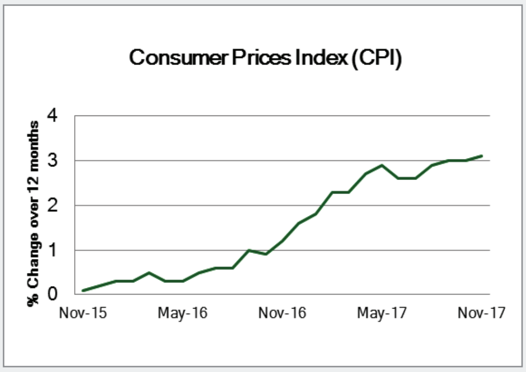
The European economy consistently beat expectations throughout 2017, leading to upgrades from policymakers and economists alike, shifting consensus growth estimates from 1.7% to 2.4% for the year. The manufacturing purchasing managers' index (PMI) posted its strongest month since before the creation of the euro, hitting 60.6 (any figure above 50 indicates expansion over the month). This confirmed the single currency blocs best annual performance on record and, while national-level data pointed to broad-based growth, Germany, Ireland and Austria were stand-out areas all reporting record growth, and Greece enjoyed its best results for over a decade. The ECB has, thus far, stood firm on monetary policy awaiting inflation, however recent surveys have indicated inflationary pressures were 'elevated' as the sustained run of growth has put increasing pressure on supply chains.

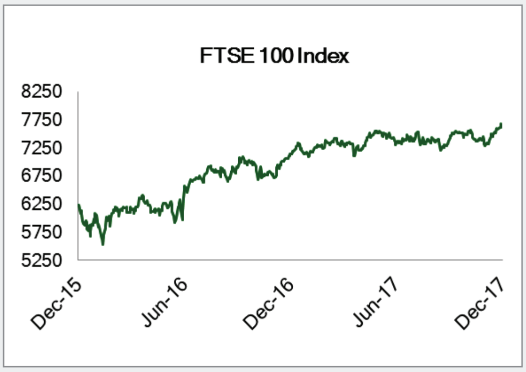
Despite initially being played down as improbable, Catalonia's drive for independence remains a possibility after pro-independence parties won a narrow majority in the December election. As a result, thousands of businesses have scaled down their operations in Catalonia, leaving European states with strong nationalist movements watching nervously. Spain's Economy Minister has put the cost of the crisis, so far, at around €1bn, slowing fourth quarter growth in the region from 0.9% to 0.4%. The Italian general election, scheduled for March, is not currently considered too considerable a threat as, with Eurozone support growing stronger in the country, it would be unlikely for the challenging political parties to look to win votes on an 'EU exit' initiative.

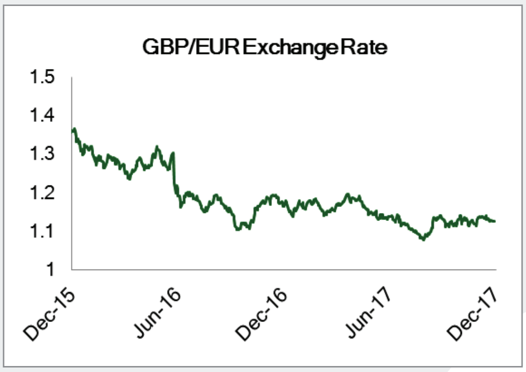
Donald Trump's first legislative triumph came early into his second year in office, as his Republican party managed to pass the most sweeping overhaul of the US tax code in thirty years. Trump signed the bill into law after it passed through both houses of congress just before Christmas. The centrepiece of the package is a huge plunge in corporation tax, moving the income tax rate down from 35% to 21%, bringing the US broadly into line with rest of the developed world. US equity bulls hope to see this filter through to corporate earnings, potentially offering the next leg up for stock markets stateside, though bears would suggest these hopes have been 'baked in' to share prices trading on already frothy valuations. For individuals, analysts predict the long-term winners would be the richest Americans, with the middle-classes, which Trump has insisted are his priority, seeing significantly less benefit. After the third 25 basis point hike of the year in December, Fed minutes showed that despite officials expressing growing confidence in the strength of the labour market and the economy, it was debated whether the tax cuts might require them to raise interest rates more aggressively this year.

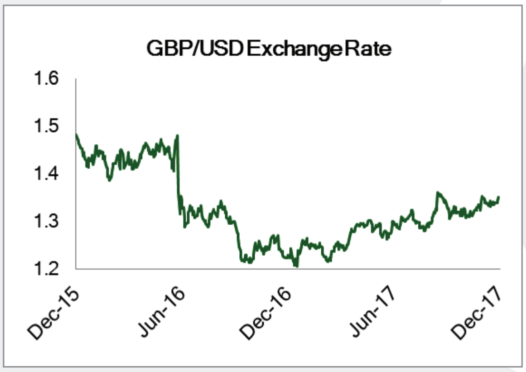
Attention now turns to the US debt ceiling, as lawmakers come under pressure to pass a spending bill by the 19th January to avoid a government shutdown. Long term solutions are required for the Children's Health Insurance Program and disaster relief packages for areas hit by storms Harvey, Irma and Maria, and while Republicans and Democrats agree on a bipartisan agreement for raising spending caps, they disagree on how it should be done.

Japan's Nikkei 225 and TOPIX have been among the best-performing major stock indices worldwide this year, as Shinzo Abe's government remains dedicated to pulling the world's third largest economy out of its low-growth, deflationary environment. Snowballing asset purchasing efforts from a combination of the Government Pension Investment Fund (GPIF) and the Bank of Japan, to the tune of $1.9 trillion so far, has seen 'Abenomics' driving stock market returns. Zeroing-in on corporate behaviour also seems to have benefited stock valuations, pressuring corporations to avoid stockpiling cash (an ingrained habit of Japanese management teams), increase economic and shareholder value, and to become more transparent in reporting.









As for tackling economic headwinds facing the region, Abe has pledged to implement 'daring policies' targeting taxes, the budget and regulations to promote domestic investment, in a bid to offset a dwindling population. He also called (and subsequently won) a snap general election, which took place in October, allowing him to capitalise on approval ratings and disarray in the opposition party.

The 19th National Congress of the Communist Party of China saw President Xi Jinping elevated to the same status as Mao Zedong, suggesting that he'll probably have more control over economic policy, and setting the agenda for Chinese business. Yields in the region have continued to rise, the 10-year bond touching 4% in November, with commentators suggesting this tightening has been driven by President Xi's increased focus on deleveraging and addressing tail risks in the economy. Stocks prices were further boosted as the Caixin-Markit purchasing managers' index rose as its fastest pace in four months in December, and, although 2017 was an impressive year for Chinese equities, the divergence between Hong Kong-listed equities and the mainland A-shares was considerable, as the Hang Seng added 38.7% while the CSI 300 rose by 23.5% over the twelve months. However, this gap could narrow as 222 A-share companies are to be included in the MSCI Emerging Markets index in 2018.

Investors poured into emerging market stocks last year. The overall strength of the world economy, moderate tightening from central banks in the developed world, plus a softer dollar and firmer commodity prices, all made for a supportive backdrop for developing equity markets. Subsequently, years of underperformance versus their advanced peers came to end, as the MSCI Emerging index beat the MSCI Developed index by 15 percentage points. Many emerging currencies also strengthened, with the South African rand recording double-digit annual gains for a second straight year, while the Czech crown and Polish zloty were both up almost 20% against the dollar and 5% versus the euro.

Notwithstanding Kim Jong Un's best efforts to antagonise the US into nuclear confrontation, as well as an assortment of wider geopolitical tensions, we continue to consider the prospect of a global synchronisation in tightening monetary policy a more likely disruptor to investment markets. Given the bullish growth outlook, the Federal Reserve have pencilled in their next interest rate raise for March, possibly paving the way for others as the Bank of England has begun to follow (albeit gradually), and the Australians and Scandinavians are rumoured to also be planning moves in the same direction. To this end, exercising caution through holding different geographical exposures is as central to our process as holding a diversified blend of asset classes and, we would consider, the most effective way to protect against potential market turbulence.

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