Q1 2016 ROUND-UP

With the lighter evenings now providing a welcome reminder (to us at least!) that there is life after the 4.30pm market close, the first three months of 2016 rather calmly draw to a close. After a particularly hazardous start to the year, financial markets staged something of a recovery as the downturn, which was initially driven by concerns over the state of Chinese economy and the tumbling oil prices, has ostensibly abated. Underlying this, central banking policies and the path of interest rates remain under intense scrutiny, whilst politics are taking centre stage with the upcoming US presidential election, developing ructions across Europe, and the UK's 'Brexit' referendum will soon come into sharp focus.

In the UK, interest rate expectations have moderated owing to inexorable market volatility and a more uncertain economic outlook. GDP grew at an annualised rate of 2.2% in 2015, which was much softer than the 2.9% recorded in 2014, whilst the Bank of England has indicated it will commit to keep interest rates at the record lows, as oil prices pin inflation close to zero; CPI came in at 0.3% in January and February, up from 0.2% in December.

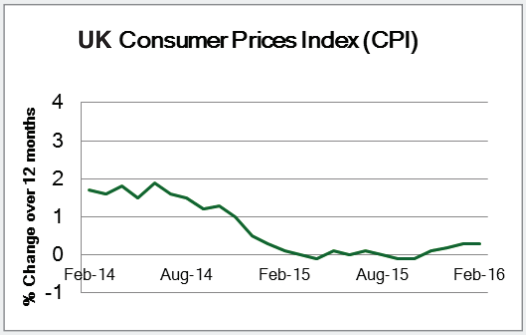
The persistence of lower commodity prices has meant that the oil, gas and mining sectors have restricted any upside potential for the UK's leading index. Consequently the FTSE100 sits 0.8% lower than it did at the turn of the year. Despite this there have been a number of high quality businesses, namely utilities, which have held up well as investors in search of 'bond proxies' found comfort in reliable dividend paying stocks. The upcoming 'Brexit' vote has given rise to another threat, and whilst the eventual outcome of a move either way is difficult to foresee, the resultant uncertainty is almost guaranteed to unsettle markets; as evidenced with Boris Johnson publicly backing the 'out' campaign, which saw the Pound suffer its biggest fall against the Dollar in seven years.

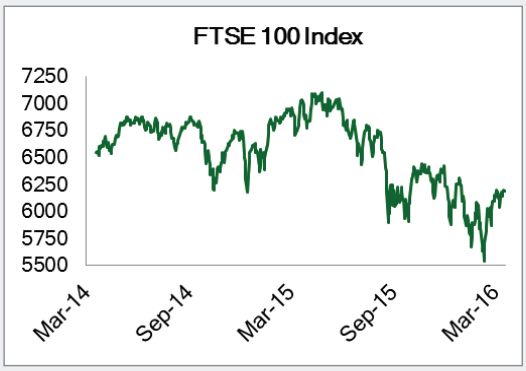
Deflation has once again descended on Europe as consumer prices fell sharply to minus 0.2% in February, which part-catalysed the raft of additional stimulus announcements from the ECB, including an expansion of its bond buying programme from €60 billion to €80 billion a month (to now include corporate credit) and moving its deposit rate further into the negative unknown. Fragile growth in the region is forecast throughout 2016, although the weaker Euro should continue to benefit competiveness and demand for exports, while the lower oil price will also be supportive through a positive impact on household's disposable income and maybe increased consumer spending. Europe's exposure to underperforming emerging markets does pose a minor risk to the relatively benign anticipated growth, but the domestic issues of the migrant crisis, internal political fragmentation, and the questionable health of some of its major banks are a greater threat to the region's economic stability.

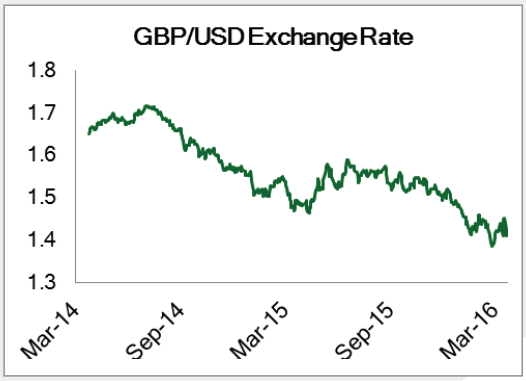
In the final days of 2015, the US took its first step towards a 'normalisation' of interest rates when it announced a 0.25% uplift in rates. At the time, it was projected we would see a further three or four hikes over the course of 2016, however recent market turbulence and a weaker global growth narrative has led to the Federal Reserve scaling back its forecast (into alignment with market expectations) to just two quarter-percentage-point rises this year. Their economy has, though, continued to expand despite the hazards from overseas, as inflation has picked up and the labour market has strengthened. A more gradual path of interest rate increases has been favourable for US equity markets; after it was feared they had slumped into a bear market earlier in the quarter, the major indices recently notched their fifth straight week of gains to land in positive territory for the year, making the initial fears of a US recession now look exaggerated. US government bonds also rallied, spurred by the Fed's dovish hesitancy.

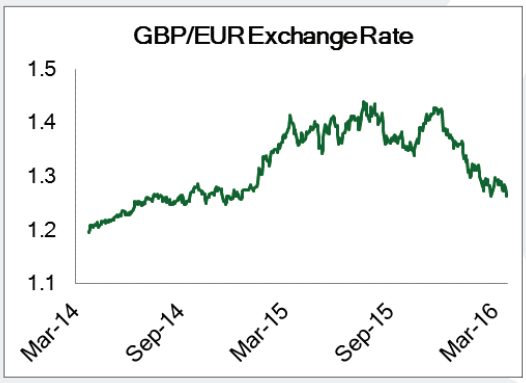
In Japan, the third (or 'missing') arrow of Abenomics, which promised to introduce structural reform sufficient to increase the annual growth rate to an average of 2% over the next ten years, is yet to hit the target as the economy remains unmoved. The other two arrows, of monetary and fiscal stimulus, had helped to create rising profits and a soaring stock market. However, with more Japanese companies now missing forecasts than beating them, and the yen recently staging its biggest weekly rally since 2009, despite the Bank of Japan surprising the world by turning interest rates negative, it appears this formula has lost its potency. This loose monetary policy appears to be becoming a more blunted tool, and investors in the region are now hoping this third arrow will deliver the much-needed and sustaintable drivers of growth, such as government change, a friendlier shareholder culture, increased dividend pay-out ratios and improved equity allocations among government pension funds, to offer Japanese equities more of a solid foundation to advance.

Tremors triggered by slowing economic growth and falling markets in China have continued to disrupt investors across the world, particularly in the earlier part of the quarter. It would, however, appear that the sharp movements in the Chinese stock markets are now (to some extent) being ignored by the rest of the world, and should not be used a fair representation of the health of the domestic economy because the link between the two is not strong; it is estimated that Chinese households hold only 5% of their total assets in the stock market. The devaluation of the Yuan is more likely to have wider market implications.









The once 8% per annum Chinese growth engine has begun to falter, adding 6.9% in 2015 according to official state figures (which have proven to be far from dependable), marking its slowest growth in a quarter of a century, as the government attempts to rebalance with a move towards an economy led by consumption and services, rather than exports and investment. Should a 'slowdown' ultimately prevail over a much-feared 'meltdown', it is hoped global economic growth will manage to avoid veering wildly off course.

After a generally poor 2015, the downturn across emerging markets reversed in the first three months of this year as the MSCI Emerging Markets index added almost 9%. The rally in oil to back above $40 a barrel and a firming iron ore price has helped emerging economies. The slower trajectory of rate rises by the US Fed has also provided some relief to emerging economies, which were fearful following the December rate hike as companies across the regions still have vast amounts of dollar denominated debt outstanding. Along a similar vein, the recent downward move in the US dollar has also aided the lesser economically developed countries. Despite China's economic growth slowing, a number of countries are experiencing economic prosperity. India, for example, is expected to see continued 'firming growth' in 2016, and outpaced China in 2015 as its economy grew at an annualised rate of 7.5%.

Looking ahead to the second quarter, it is likely that the global economy will show further signs of stabilising, although levels of market volatility will remain elevated. In the UK, headlines will undoubtedly be dominated by the referendum debate, as the nation votes on whether or not to remain part of the European Union on 23rd June. In the US, politics (and worryingly 'The Donald' campaign) are gathering pace in the run up to the 58th presidential election in November. Developments in China will still pose a threat, whilst the near-term effects of the ever-creative monetary policies employed in Japan and Europe make for unchartered territory for even the most seasoned of investors. Accordingly, markets will, of course, continue to test participants, but we are confident that appropriately diversified investors, willing to endure the seemingly perpetual volatility and take a longer term view, will be suitably compensated.

Cave&Sons
Stockbroking & Investments Since 1906

Northampton Office

Lockgates House
Rushmills
Bedford Road
Northampton
NN4 7YB

T 01604 621421
F 01604 234335
E info@caves.co.uk
W www.caves.co.uk