Q3 2016 ROUND-UP

Now three months on from the decision of the UK electorate to leave the European Union, Brexit still dominates the headlines and economic rhetoric as markets attempt to digest and economists foresee the ramifications of a result that will fundamentally transform Europe in decades to come. Perhaps currently more pressing, though, is the divergence in monetary policy of the world's central banks, which continues to drive sentiment as investors hang on every announcement; the US is hesitantly looking to tighten, whilst Europe, Japan, and now even the UK, ease monetary conditions in a bid to aid their respective economies.

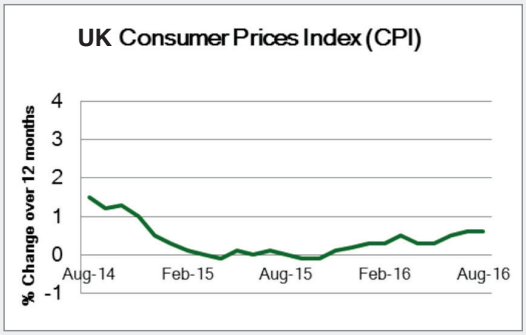
Generally speaking, equity markets in the UK have been supported by sterling weakness and have, thus far, benefitted with indices nearing all-time highs, even across the mid cap space which has rebounded strongly following the initial rout. A number of sectors, namely the housebuilders and UK banks, remain at lower levels plagued by the haziness on the economic horizon here in the UK. With the early market reaction behind us, we are now beginning to witness a drop in confidence, on both a consumer and business level as big ticket purchases are deferred and corporate hiring slows. Uncertainty will dominate in the run up to Prime Minister Theresa May, aided by her newly-assembled strong centre right government, officially triggering Article 50 of the Lisbon Treaty, the mechanism for commencing a withdrawal from the EU, which is now expected to be in the first half of 2017. Access to the single market and immigration are likely to be the two key sticking points, whilst the City maintaining its status as a leading financial centre rests much on the future 'passporting' rights of its services.

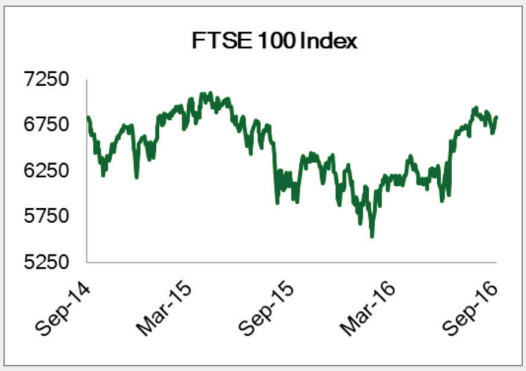
Although Bank of England Governor Mark Carney has markedly changed his tune from the pre-Brexit doomsday predictions, recently stating 'In the light of all the events since the referendum, I am absolutely serene', the actions of his Monetary Policy Committee have not particularly embodied calmness. Interest rates were swiftly halved to 0.25% and the quantitative easing package was boosted by an additional £60bn, of which £10bn was assigned to the purchasing of UK corporate debt. The stated timeline to complete the expansion of its balance sheet was six months, however at the current rate of purchasing it is likely to take over a year, leading some to believe any further monetary easing will not happen before the end of the year, particularly whilst a Brexit has not yet begun.

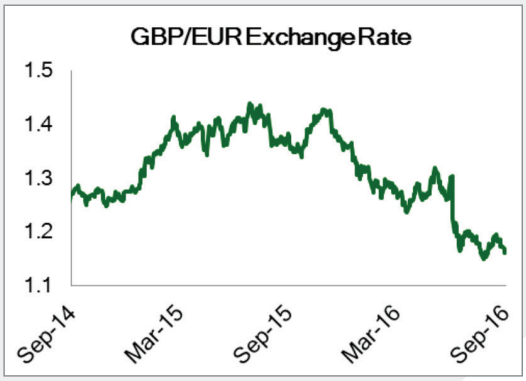
It is expected that third quarter Eurozone growth will come in lower than that achieved by Britain; an outcome few 'Remainers' would have predicted following the referendum. Both France and Italy showed no growth at all in the second quarter, and even recent data from Germany has started to look poor, whilst the British economy seemingly lumbers along as if nothing has happened. It is also not as if the single currency bloc has been without its tailwinds; the ECB has cut interest rates below zero and flooded the economy with newly printed money, the euro has been devalued, and disposable incomes received a monumental boost through a lower oil price. It is difficult to foresee how the Eurozone crisis will resolve itself. Analysts suggest the single currency has been kept alive for far longer by political will, rather than economic reason, and that the region is fast approaching a tipping point which Brexit is very much a part of. However, economic issues aside, immigration and terrorism feature higher on the agenda of Europe's political elite at this current time.

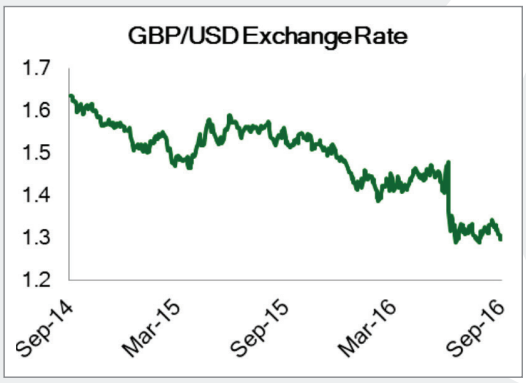
After recovering from the short-lived sell-offs prompted by news of the European trading bloc potentially destabilising, US stock markets now test historic highs despite the lacklustre earnings backdrop. The S&P500 currently trades at a fourteen year high, on a forward price-to-earnings ratio of 21 times, leading to predictions that a near term market correction may unfold, with a Federal Reserve rate hike being the most likely catalyst, though the presidential election on November 8th also has the potential to derail sentiment. On the other side of the coin, it is argued that US equities still offer value when compared with the yield-to-maturity on 10-year US treasuries, which trade at historic lows and offer no inflation protection. Markets were saved from surprise in September when the Fed announced that, despite the case for a hike strengthening, interest rates were to be held in check awaiting more evidence of economic progress. At the time of writing, according to CME Group's FedWatch, the market is pricing in a 52% chance of a 25 basis point rise at the December FOMC meeting.

Japan's economy failed to grow on a quarterly basis from April to June this year, with GDP growth coming in at zero, missing already subdued forecasts. The 0.2% annualised growth rate falls dramatically short as the economy persistently disappoints. The Bank of Japan announced in September that they would not, at this stage, take rates further into the negative unknown, but did pledge to cap 10-year bond yields at 0%, essentially promising to buy any bonds offered at this price, which should allow the yield curve to steepen and make Japanese banks more profitable. Stockmarkets have also been supported as the BoJ continues to ramp up its purchasing of exchange traded









funds (ETF), which now includes the broader Topix index, as well as the Nikkei. In addition to this, the central bank has vowed to overshoot its inflation target of 2%, though with the Yen still stubbornly strong, this could be easier said than done.

The economy and financial markets in China have steadied as investors have come to terms with the slower, yet still impressive, growth rate of world's second largest economy as it transitions. There are, though, growing concerns over the country's huge credit binge, which has played a key role in supporting economic growth since the financial crisis. According to global financial watchdog the Bank for International Settlements (BIS), the credit-to-GDP gap hit 30.1% in China in the first quarter of 2016. Any level above 10% is considered an early warning that a crisis is likely to occur in the next three years! Nevertheless, outstanding government, corporate and household debt continues to rise, hitting 255% of GDP in 2015, and thanks to a high domestic savings rate, underdeveloped capital markets and government ownership of the banks, it is thought no one can simply 'pull the plug' on the current credit cycle.

In this low growth environment, investors are increasingly being forced further up the perceived risk spectrum in search of returns, which has predictably been to the benefit of emerging market equity and debt. Dollar weakness, steadying commodity prices and US Federal Reserve hesitation also offered support, and on average emerging markets still trade on a 25% discount to their developed counterparts. Of course, within the asset class there have been stand-out performers; in Latin America, Chile, Peru, Columbia and Brazil have impressed, whilst Vietnam and Indonesia have been strong in Asia. Emerging markets used to be all about commodities and cyclical in nature, now however, some 50% of the MCSI Emerging Market index is made up of 'structural growth drivers' such as technology, consumer, telecoms and healthcare companies, which is leading investors to believe their relative discounted valuations, over time, will come into alignment with those of the more mature nations, particularly as levels of political risk, the historic discounting mechanism, are now just as elevated across many developed economies.

Policymaking will surely dictate market sentiment in the UK. After the brutal rearrangement of government, the task of negotiating an orderly exit from the European Union has fallen on Theresa May and her team of advisers. Politics in the US will also keep investors guessing, as the US presidential campaigns gather pace in the run up to the election. Central bank policy will also undoubtedly remain at the fore. In such tumultuous times as these, we consider diversification to be the greatest insurance policy, and following recent market strength, we are somewhat cautious in our outlook.

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