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CAVE'S QUARTERLY

Q1 2017 ROUND-UP

Global equity markets have had a buoyant start to the year, holding firm at elevated levels. The MSCI World Index (which tracks 46 of the world's leading indices) hit an all-time in February, driven by the optimistic outlook for the global economy, expectations of higher inflation and widespread participation in the Trump 'reflation trade'. Towards the end of the three months, however, an apparent absence of substance in Mr Trump's key pro-business reforms and the realisation of Article 50 officially being triggered in the UK have left markets range-bound and led investors to question the foundations on which recent rallies have been established, as we brace for a potentially drawn-out period of uncertainty.

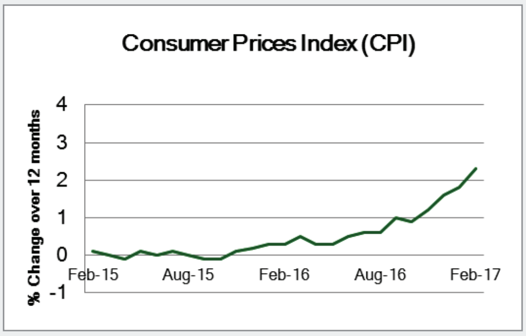
Recent revisions have shown UK GDP added 0.7% in the final quarter of 2016, demonstrating the post-referendum resilience of the UK economy, as a fall in business investment has been offset by an increase in consumer confidence and household savings hitting all-time lows. It is a concern that living standards in Britain could fall as the pace of wage growth is now being outstripped by rising prices. For the first time in three years inflation spiked above the Bank of England's 2% target, to 2.3%, as the effects of sterling's fall are perhaps feeding through more quickly than anticipated. Should these conditions persist, it is thought likely the Bank of England will begin to hike interest rates later in the year.

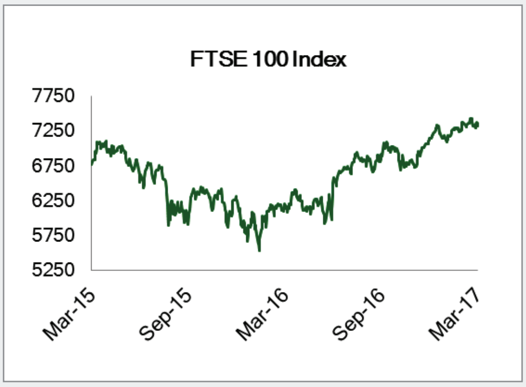
On 29th March, Theresa May's letter addressed to Donald Tusk, President of the European Council, officially triggered the two year timeline for Brexit negotiations to begin. Whilst short-term volatility could undoubtedly be borne out of the developing divorce, it is hoped ongoing and open discussions will generate a less disruptive news flow, making for a more accommodative backdrop for investment markets.

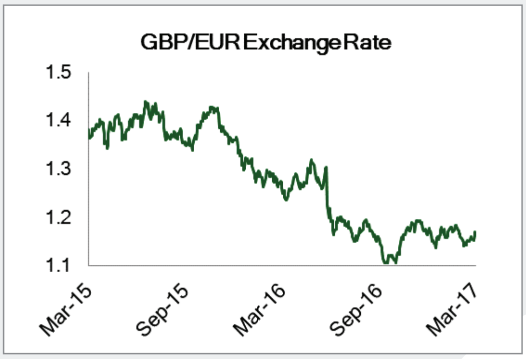
Despite the Greek economic crisis entering its seventh year and a resolution still seemingly some way off, indicators across the Eurozone point towards an economy in recovery mode. Unemployment fell to 9.5% in February, the lowest level since May 2009, whilst the purchasing managers' index (PMI) showed continued expansion in the bloc's manufacturing sector. With the risks of deflation seemingly behind us, pressures are now mounting on Mario Draghi to wind down the ECB's efforts to stimulate the economy. Unsurprisingly, European stock markets have advanced over the three months, and were further supported by political developments as Geert Wilders defeat in the Dutch election did, in part, throw cold water on expectations of further populist movements gaining ground. However, the early stages of French elections will soon come in to focus, the first round of which National Front leader Marine Le Pen is likely to sail through later this month, though consensus expectations suggest she may struggle to progress any further.

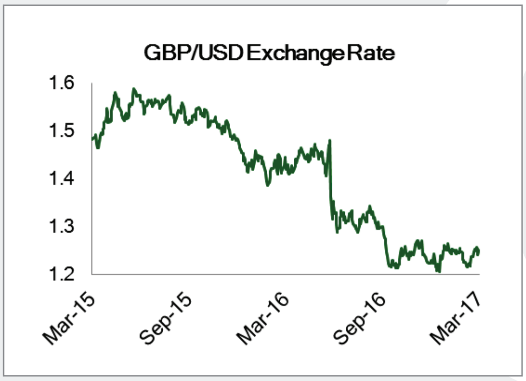
We have witnessed the 'Trump jump' prevail through the first quarter of 2017 in the US. Stock markets have welcomed Trump's attitude towards taxes, infrastructure expenditure and deregulation, pushing the Dow Jones, the S&P500 and the NASDAQ all to new highs. Corporate earnings have also improved, with almost 70% of companies beating consensus estimates, whilst non-farm payroll data confirmed a continued expansion in the labour market, and consumer spending and business confidence measures remained strong. Even Trump's failed attempt to repeal Obamacare was not enough to derail sentiment! In March, the US Federal Reserve announced its third interest rate rise since the financial crisis in 2008 (and second in three months) in an attempt to head off rising inflation and push back towards historically normal levels, with a further two rate hikes pencilled in for this year. Alongside this, the initial meetings between the Fed and incoming administration have so far gone well, as Janet Yellen and treasury secretary, Steven Mnuchin, have both appeared keen to foster relations to support economic prosperity, with a potentially stimulative fiscal approach waiting in the wings.

It has been a volatile three months for Japanese equities. After rallying in unison with other major indices, the Nikkei 225 and the Topix closed out the quarter having erased all of their gains for the year, falling victim of the doubts hanging over the longevity of the Trump reflation trade. This has been the catalyst for the steady appreciation in the yen since the turn of the year, which has advanced to ¥110 against the dollar, and put the 2% inflation target in jeopardy. For now, the Bank of Japan does not appear to be in a state of alarm, and has kept interest rates at -0.1% to cap 10-year bond yields at roughly zero, and maintained the level of government bond buying at ¥80tn a year. External influences aside, Japan's underlying economy has shown signs of strengthening as manufacturing and services PMIs have risen and jobs have continued to be added at a solid pace.









Chinese headline GDP came in at 6.7% in 2016. Through continuing to implement a proactive fiscal policy and maintaining a prudent monetary policy, officials have announced their aim to expand their economy at a marginally reduced rate of 6.5% this year. It is rumoured leaders at the National People's Congress are willing to tolerate slightly lower economic growth, to allow scope to push through reforms designed to deal with the country's worryingly high debt levels and overheating housing market. After a weaker final quarter in 2016, owing to potential trade conflicts and political headwinds from the US presidential election result, stock markets in China have had their most impressive start to a year in over a decade, as investors in the MSCI China Index enjoyed a 13% rally in this first quarter. Market movements from here will, though, be closely linked to the developing relationship between Trump and Xi Jinping, as the integration of the world's first and third largest economies respectively could have repercussions on a global scale.

Focusing more broadly, emerging market equities have also had a stellar start to the year, comfortably outperforming their developed-market counterparts, in no small part thanks to substantial forex tailwinds. Following its capitulation in the wake of the US election, the Mexican peso has recouped almost all lost ground with a 10% jump, as questions are now being asked over feasibility of Trump's agenda, whilst the Russian rouble and the Polish zloty have also strengthened against the dollar. Bonds denominated in emerging currencies have also moved to the upside as economies like Brazil have slashed interest rates, the global growth outlook has markedly improved, and investors' worries have stayed largely dormant.

The global economy has stayed true to its improving course over the first quarter and, whilst it is important to focus on how much of the upturn may now be behind us, political developments over the next quarter will surely mostly dictate direction from here. As the multi-faceted Brexit negotiations move along, the first round of French elections take place and Trump meets with more world leaders, whilst attempting to push his pro-business domestic reforms through Congress, we believe it prudent still to err on the side of caution with markets trading on elevated valuations, as we enter what could be a potentially volatile second quarter.

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