CAVE'S QUARTERLY

Q2 2017 ROUND-UP

We leave behind the first half of 2017 still beleaguered by issues that have plagued investors for many months now. Geopolitical tensions govern sentiment, as little is still known on the possible corollaries of a Trump Presidency, a recently-weakened UK government entering into divorce negotiations with the EU, North Korea demonstrating its apparent military strength, and, more recently, Qatar being cold-shouldered by its neighbours on accusations of sponsoring extremist militant groups. Despite this, markets have held firm, so far unperturbed by the ever-growing list of uncertainties.

Theresa May's gamble to call a snap general election in April backfired spectacularly on 8th June, as her Conservative party lost its parliamentary majority and, in turn, has been forced to seek support, in the form of a 'confidence and supply' arrangement with the Democratic Unionist Party (DUP). Although first feared, this has not put a delay on Brexit negotiations, however the UK's bargaining position has almost definitely been weakened, thus increasing the chances of a 'softer' Brexit. Any suggestions of greater political uncertainty will undoubtedly put pressure on sterling which, as witnessed in the aftermath of the EU Referendum, could offer support to UK-listed companies with overseas earnings.

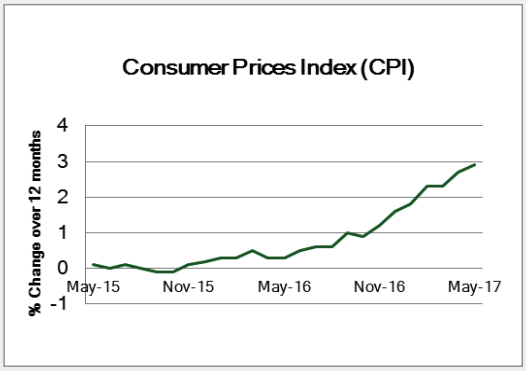
Underlying the political turmoil, UK GDP has slowed as the economy grew by just 0.2% in the first three months of 2017, down from 0.7% in the final quarter of 2016; consumers reining in spending in the face of rising inflation, which rose to 2.9% in May. In response, minutes from the Bank of England signalled an edge towards raising interest rates as a deeper split among policy makers emerged, with three out of eight voting for an immediate rise to keep inflation in check. This was the committee's widest split since May 2011, and suggests we could see a rise from 0.25% to 0.5% before the end of the year.

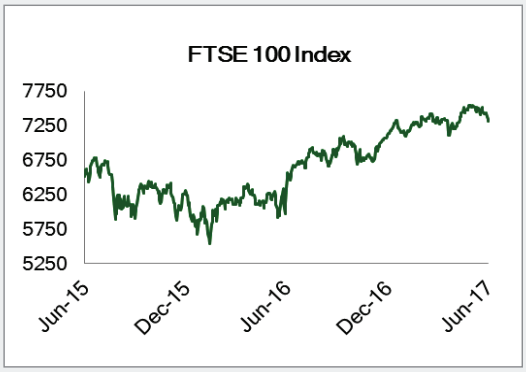
Perhaps the surprise story of the year up to now has been the recovery in the Eurozone. Not only has much of the political uncertainty been removed, as populist movements in the Netherlands and France were outmuscled, economic growth across the single currency bloc was twice as fast in the first three months than in the US. Should the recovery continue and prove self-sustaining, focus will be on the ECB's expected timeline for withdrawing its exceptional stimulus measures. Although history would advise caution with any such moves, many suggest the recovery is built on firm foundations, and has 'shown a remarkable resilience to external shocks', with a broad-based revival across most member countries 'reflecting a convergence of growth rates around higher levels' according to ECB chief economist, Peter Praet. Nonetheless, delays could prevail as the more dovish policy makers will be keen to highlight that unemployment in the region of around 8% is still some way off Anglo-Saxon levels of below 5%, and rises in wages and core inflation have been muted.

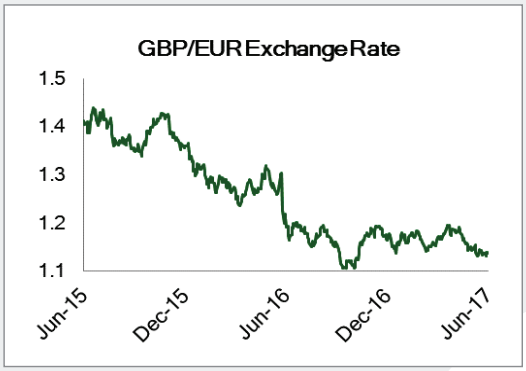
A strengthening labour market and uptick in economic activity led the US Federal Reserve to announce its third interest rate rise in as many quarters in June, pushing the federal funds short term rate up from 1% to 1.25%, with further increases expected, along with an unwinding of the central bank's balance sheet, should conditions evolve in a supportive manner. Despite a rising interest rate backdrop not historically providing support for equities, US stockmarket valuations have continued on a tear as the S&P500 and Dow Jones both trade over 20% higher than at this time last year. Expectations for a speedy implementation of Trump's pro-growth policies (tax reform, infrastructure spending and deregulation) have rather fizzled out, which has meant that hopes of strong earnings growth have been responsible for most of the 'heavy lifting', with projections pointing to a 6.6% rise in year-on-year earnings per share on the S&P500; almost half of which coming from companies in the energy sector. However, as US indices make new highs, scepticism grows as distinguished bond investor Bill Gross blames the Fed's ultra-loose policy for artificially inflating asset prices, "Don't be mesmerized by the blue skies created by central bank QE and near perpetually low interest rates. All markets are increasingly at risk", he warned in a recent note to investors.

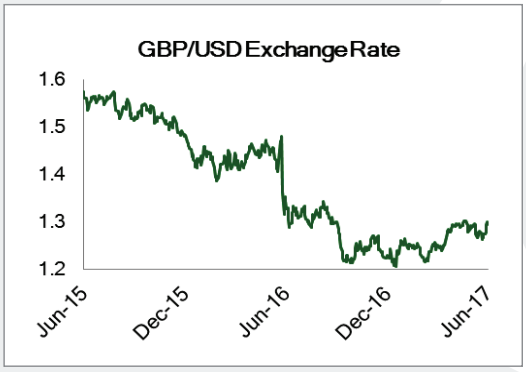
On a 'price to book' basis, the Japanese stock market is one of the more attractively valued; looking cheap compared to the US and UK, particularly given the current policy and economic tailwinds. Since October 2010, when the Bank of Japan (BoJ) extended its efforts as part of a broader monetary easing scheme through purchasing exchange-traded funds, the central bank has become a leading shareholder in nearly a quarter of the country's listed companies, making it the third largest shareholder of Japanese shares, with a portfolio now worth an estimated ¥17 trillion; a purchasing programme which, so far, has shown no signs of abating. The BoJ claims it has succeeded in propping up stock prices, and lifted the Nikkei by as much 2,000 points, whilst also bolstering household and business sentiment. Management of such companies involved are, broadly speaking, pleased as the BoJ is a proven loyal and undemanding shareholder, though others caution of the adverse repercussions should they begin to sell shares in their respective companies. The wider economic indicators have also been positive, with inflation coming through at 0.5% (a marked improvement for a country so dogged by deflation in recent years); GDP growth ticking up, unemployment down to 2.8% and manufacturing and services PMIs on the rise.

'Stability' has been set as the Chinese government's key economic focus this year. The new 'normal' range for GDP growth of between 6.5% and 7% is, although the slowest witnessed in 26 years, an indicator that the policy to resolve structural imbalances in









the economy has succeeded so far. Debt levels are, though, still a concern. Government direct debt, which at less than 40% of GDP, is modest by Western standards and not the problem. It is the debt held by 'state owned enterprises' (SOEs) and local governments which really has economists worried, but with foreign currency reserves of more than $3tn and an annual current account surplus of $200bn, it is hoped China has deep enough pockets to deal with any impending crisis internally. In June, mainland Chinese shares (commonly referred to as 'A' shares) hit the headlines as, after three years of rejection, it was announced that they were to be included in the MSCI Emerging Market Index as of May 2018, which is tracked by some $1.6tn of investment funds. Not only was this an important milestone in the integration of China's stock markets with the rest of the world, it is estimated the world's second largest stock market could see $500bn of foreign inflows as a result.

When emerging markets are approached with caution, a strengthening dollar and rising US interest rates are often cited as the foremost threats to growth. Now it is argued that most emerging markets are in a better fiscal position to withstand a tightening cycle in the US, and also less reliant on foreign funding and thus less exposed to sudden outflows. Valuation grounds would also appear supportive, as emerging market equities trade on a 45% discount to US stocks based on their 10-year cyclically-adjusted price-earnings (CAPE) ratio, and local currency government bonds in emerging markets on average yield six times more than Eurozone corporate debt of any investment grade.

Looking ahead to the next three months, geopolitical tensions will likely dominate newsflow. In continuing to practice-launch missiles, North Korea is not only testing their long-range nuclear warhead capabilities, but also the patience of the US, with Secretary of State Rex Tillerson warning that Washington 'will never accept a nuclear-armed North Korea', and as Pyongyang's main economic ally, China are expected to act as mediators. Whilst in the Middle East, the divide between the two contrasting Arab worlds has been blurred as Qatar was cut off by neighbouring countries on accusations of supporting jihadi movements. Should a resolution not be reached in short order, the risk of conflict and economic damage from the blockade could have widespread consequences.

Investors will, however, not only take direction from political developments; central bankers are likely to play an integral role in guiding global markets as unwinding the last 8 years of unprecedented intervention carries substantial risk. In the US, a third 2017 rate rise is likely to run in tandem with efforts to shrink the Fed's balance sheet, whilst in Europe, despite inflation moving higher, it would seem the ECB will continue to offer substantial support. Furthermore, it is hoped the expected tapering of credit expansion in China will be an orderly process. As a firm, we remain cautious with global markets currently trading at elevated levels, and although we anticipate central bankers will exercise appropriate caution, it is important to recognise we are in uncharted territory.

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