Cave's Quarterly

Edition 13, Q1 2019 Round Up

Cave&Sons

Stockbroking & Investments Since 1906

How the tables have turned...

Following a rotten end to 2018 and a rocky opening few weeks of 2019, investor sentiment has since been buoyed by a combination of a considerably more dovish US Federal Reserve, constructive US-China trade talks, the reduced risk of a 'no deal' Brexit and the implementation of Chinese stimulus. Even though the previous declines are yet to be fully recovered, the environment is generally more positive than just three months ago. Global equities, as measured by the MSCI World Index, have gained 12% so far in 2019 – the strongest start to a year in two decades.

Brexit uncertainties persist

The Office for Budget Responsibility cut its UK growth outlook for the year from 1.6% to 1.2%, to reflect a sharp slowdown which was largely due to weakness in business investment as Brexit uncertainties continue to slow executive financial commitments. 'Meaningful vote' has almost become part of everyday vocabulary here in the UK, whilst, ironically, also becoming less and less 'meaningful' to those outside of parliament as each vote passes.

The deal the Prime Minister agreed with the EU and returned to parliament with has now been voted down on three separate occasions, the last of which was on 29th March (the day we were supposed to officially leave the EU). Parliament did, however, overwhelmingly vote against the UK leaving the EU without a trade deal in place, which saw sterling rally from $1.26 at the start of the year to over $1.32, making the pound the best performing major currency against the dollar so far in 2019.

Should we seek to avoid leaving without a deal, an extension is now largely priced in by markets. Although, at the time of writing, just how long this will stretch is unclear; a 'short' extension could see the UK's withdrawal go ahead in the second quarter, while a long postponement could run into 2021.

Equity markets in the UK have pushed higher, particularly the domestically-orientated FTSE 250, which has added over 11%. The FTSE 100's 8% climb was capped as sterling strength impacted its constituents' overseas earnings.

It is easy to get caught up in the headlines and political drama, though, as investors we must focus on the fact that there is not a majority for a no deal and there is a clear majority for a soft Brexit, meaning the most likely result is a continuing close economic partnership between the UK and EU. The potentially volatile journey before arriving at this destination, we believe, will test the nervous investor though should provide opportunities for those with a long-term focus.

The economic outlook across Europe remains far from rosy. As ECB chief economist Peter Praet cautioned, the slowdown across the eurozone has been 'broader and more persistent' than expected and suggested the ECB may discuss the need for new liquidity instruments to assist the banks. With few domestic catalysts for a turnaround, it is suggested that it could take a rebound in demand from the emerging world to improve prospects across the bloc as much of the weakness can be attributed to net exports. Populism also remains a significant risk across Europe, as the protests of the "gilets jaunes" caused significant disruption in France, sending the French composite purchasing managers' index into negative territory. The European Parliament elections will come under close scrutiny in May as we learn whether Eurosceptic parties have garnered significant support. In Germany, the new emissions testing regulations have seen the autos industry struggle, hampering industrial production and weighing significantly on growth. However, after a sluggish few months, German auto production has shown signs of picking up, which could offer a much-needed near-term boost to growth.

Fed Put still alive

US markets have been driven higher by the Fed's reluctance to tighten monetary policy. Investors were spooked in the final quarter of last year, as the pace of hikes (25bps-per-quarter) seemed set to continue into 2019. January saw an admission of nervousness from the FOMC as Jerome Powell signalled that rates may be rising too quickly, and then half way through March we were told that no further rate rises are pencilled in for the year. Alongside this dovish shift, the Fed also brought an end to quantitative tightening (the reduction of its balance sheet). A partial US government shutdown ended in the final days of January, as Trump signed a bill funding the federal government through to September. This did not, however, include the funding required for the border wall with Mexico, which led the President to declare a state of emergency to unlock the funds. The shutdown had served to lower both household and corporate sentiment in January, however both bounced back in February.

The corporate earnings season in the US was relatively solid, with 70% of S&P 500 companies beating expectations and economic growth still remains above trend (GDP +2.6% in fourth quarter of 2018), however, the flattening and recent inversion of the US yield curve (a bond market indicator that has predicted every recession since the last world war) has caused some investor unease with US markets looking expensive on a relative basis.

US-China relations improve

Whilst negotiations between the US and China have at times been rocky, Trump's stance softened as he agreed to push back the March deadline for increasing tariffs on $200bn of Chinese exports to 25% from 10%, which signalled progress seemingly being made. Officials from each country will make their respective visits in early April to resume face-to-face talks aimed at ending the trade war between them. Through his favoured form of communication, Twitter, Trump explained the two sides were "very, very close" to reaching an agreement, though such agreement has not yet been forthcoming. Should a deal be agreed with all tariffs avoided, we would expect to see a positive market reaction on a global scale.

China's debt build-up has been a concern for nearly a decade now, though the financial crisis many anticipated has yet to arrive. This has largely been put down to a high national savings rate and a low level of external debt, alongside the role of state-owned institutions as lenders and borrowers to provide stability and help stressed firms to avoid defaulting. However, many now feel that these tools may no longer be sufficient should credit continue to rise at such a pace. A disappointing 2018 plagued by US trade war anxieties resulted in Chinese policymakers launching fresh rounds of monetary and fiscal easing, as Beijing's focus appears to have shifted from controlling debt to supporting growth. Whilst this should be a positive for investors in the region in the short-term, the long-term health of the economy will no doubt come back into question as the debt-to-GDP ratio returns to 'uncomfortable' territory.

A more dovish Fed leading to a weaker dollar, combined with Chinese stimulus, has resulted in increased investor appetite for emerging market assets. This is despite activity weakening according to the composite PMI reports. As Chinese officials fuel growth, total social financing (a key measure of lending) touched record highs in January and local government bond issuance increased, raising funds intended for infrastructure development. While Chinese stimulus lifted Asian equities, the new Brazilian president has seen sentiment towards Latin American equities improve. With ambitious pension reforms, it is hoped his party could solve Brazil's fiscal problems and lower government debt. The ability of emerging market central banks to cut rates in light of a weaker dollar, has been compromised in some regions as weaker currencies have seen elevated levels of inflation persist; core inflation in India remained above 5%, while in Turkey inflation has climbed above 20%.

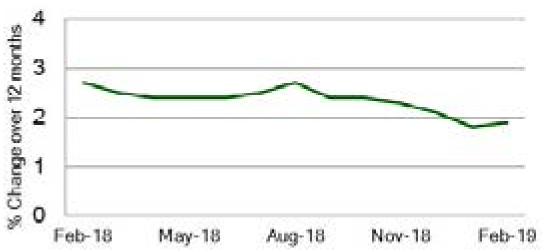
Inflation elusive

Japan is experiencing the biggest outbreak of consumer price rises in 27 years. Products such as Coca-Cola, Nissin Cup noodles and even Starbucks are all pushing higher (between 4% and 8% higher!) as intense labour shortages have raised the prospect of an escape from on-and-off deflation. However, even an economy running red hot is yet to push inflation towards the Bank of Japan's objective of 2%, as core inflation only ticked up 0.4% year-on-year in January. The BoJ's problem is that, not only are Japanese customers extremely price-sensitive and disappear as soon as prices rise, the region's recent entry into the Trans-Pacific Partnership and EU-Japan free trade deals have exerted downward price pressures and led to price drops on various imports, such as wine from France and Italy. Meanwhile, the Topix index has had a positive opening three months to the year, adding 10% aided by a docile Yen and fears of a global slowdown abating.

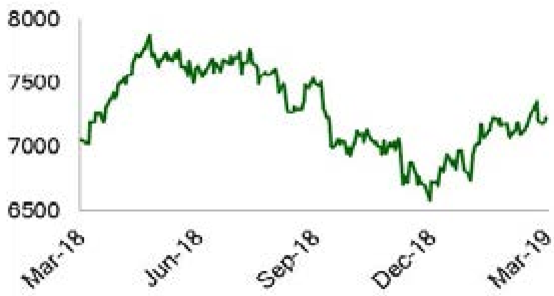
As market assessments of US-China trade wars and Fed policy swung from extreme pessimism to extreme optimism, risk appetite and stock prices have improved considerably. For the rally to continue, markets will need evidence of a resolution between Washington and Beijing. The UK's withdrawal from the EU will undoubtedly continue to weigh on domestic equities until any clarification on the matter is achieved. Until then, we expect the ensuing volatility to persist, yet remain cautiously optimistic.

A year in numbers

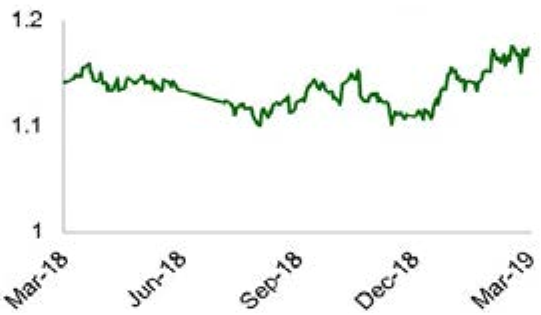
Consumer Prices Index (CPI)



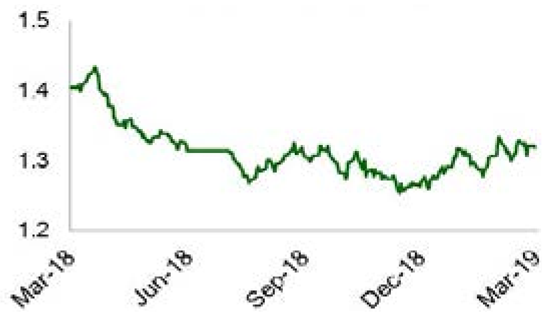
FTSE 100 Index



GBP/EUR Exchange Rate



GBP/USD Exchange Rate



Cave&Sons

Stockbroking & Investments Since 1906

Head Office Lockgates House, Rushmills, Northampton NN4 7YB
Tel: 01604 621 421 **Fax:** 01604 234 335
Email: info@caves.co.uk **Website:** www.caves.co.uk