Discretionary Portfolio Service

Market Commentary for the Period 1st October 2017 – 31st December 2017

Global equity markets were strong over the quarterly period, in broad terms. In the US, President Trump passed substantial tax cuts benefiting businesses and the majority of the American people at the expense of widening the budget deficit. The UK made further progress with Brexit negotiations although the divorce bill was much higher than planned. Political tension rose in Spain following the Catalonian vote on independence, while in Japan there was a solid victory for the incumbent Prime Minister in a snap election. Fixed income markets varied following rising interest rates and a general reduction in stimulus from the major developed economy central banks.

US equity markets performed well with the market grinding higher consistently over the period. Senators passed President Trump's tax cuts bill, marking the largest tax overhaul since the 1980s. The changes saw a sharp cut in corporation tax which the Senate committee expected would add around $1 trillion to the budget deficit. The Democrats were quick to criticise stating the cuts only benefited big businesses and the wealthy.

The Federal Reserve raised interest rates by a further 0.25% in their December meeting. This marked the fourth and final interest rate rise over the year and the central bank forecasted a further 3 interest rate hikes over 2018. Multiple improvements in the economic backdrop were mentioned in their statement including; a strengthening labour market, rising economic activity, expansion in household spending and growth in business investment. US third quarter GDP rose to 3.2% q/q (annualised), the highest growth rate in over 2 years, with government spending revised much higher than expected. Inflation rose to 2.2% y/y in November led partly by rising energy prices. Unemployment was unchanged at 4.1% in November, remaining the lowest jobless rate since early 2001.

UK equity markets produced attractive returns, with the market particularly gaining traction over the month of December. Prime Minister May and the European Commission agreed in principle on a "divorce bill" of between €40 billion and €60 billion, significantly higher than the original €20 billion stated by the Prime Minister in September. It was also agreed that EU citizens living in the UK (and vice versa) would have their rights to live, work and study protected. UK Brexit Secretary David Davis announced that MPs would get to vote on the final deal before the UK leaves the European Union, meaning that the terms of exit would need to become law via new legislation.

The Bank of England raised interest rates by 0.25% in their November meeting, marking the first rise in over 10 years. This adjustment was widely anticipated by the market following earlier comments from the Governor around the risk of building inflation pressures. The bank noted that the decision to leave the EU was having a noticeable impact on economic growth and that this would be taken into consideration with future decisions from the central bank. UK third quarter GDP rose to 0.4% q/q following a boost in household consumption. Inflation rose to 3.1% y/y in November marking the highest rate since March 2012. This was driven mainly by rising prices for transport, leisure activities,

restaurants, hotels, housing and food. Unemployment was unchanged at 4.3% in October remaining at a 42 year low.

European equity markets were broadly flat over the period following disruption in the Spanish region of Catalonia and elections in Germany. In Spain, around 2.3 million people voted illegitimately on the independence of Catalonia with around 90% voting in favour. The Catalan President was eager to work towards a unilateral declaration of independence shortly following the vote, however the Spanish Prime Minister Rajoy triggered article 155. This allowed the Spanish government to assume direct rule over any of the country's autonomous regions in a crisis scenario. A number of regional ministers were held in custody for rebellion, sedition and misuse of public funds. Catalonia then held regional elections where 3 separatist parties won a slim majority vote causing further disruption. In Germany, Chancellor Merkel failed to secure a coalition government following a breakdown in negotiations with the Free Democratic Party due to disagreements on policy. A coalition government is yet to be formed.

In their October meeting, the European Central Bank agreed to reduce the level of monthly stimulus from January 2018 and to continue at the new level until at least September. The Central Bank President Mario Draghi commented that this was a reflection of their growing confidence that inflation was returning to their target and took into account broad based economic expansion. European third quarter GDP fell to 0.6% q/q, held relatively steady by household consumption, fixed investment and exports. Inflation rose to 1.5% y/y in November, with energy costs rising at a faster rate. Unemployment fell to 8.8% in October marking the lowest rate since January 2009.

Japanese equity markets were strong driven in part by political stability following a favourable election result. Shinzo Abe won a large majority on behalf of the Liberal Democratic Party in the general election, allowing him to proceed with aggressive economic policy measures. In their latest meeting, the Bank of Japan maintained interest rates and existing levels of stimulus. In their statement they re-iterated the expectation of a moderate expansion in growth, as well as an increase in inflation towards their 2% target. Japanese third quarter GDP fell to 0.6% q/q. This was the seventh straight quarter of growth buoyed by exports and increasing business spending. Inflation rose to 0.6% y/y in November driven largely by an increase in transport costs. Unemployment fell to 2.7% in November marking the lowest rate since late 1993.

Emerging markets performed well following a large rise in the oil price and a number of changes implemented by central banks. OPEC agreed to extend the existing 1.2 million barrels a day of production cuts until the end of 2018. The decision was expected to further tighten the oil market and is seen as an upside factor for oil prices generally. Chinese third quarter GDP fell to 6.8% y/y dragged lower by a much weaker rise in fixed asset investment. Multiple central banks across emerging economies altered interest rates. Rates were cut by 1.25% and 0.75% respectively in Brazil and Russia in order to combat low inflation and support their economies. Conversely, rates were hiked in Mexico by 0.25% given a rise in inflation to a near 16 year high.

In fixed income markets, both the UK and US central banks increased interest rates over the period, although bond yields shifted in opposite directions, falling in the UK and rising in the US albeit only marginally. There was however some disparity in the statements from both central banks with the US Federal Reserve broadly positive on the economic backdrop and the Bank of England hesitant on growth taking Brexit into account. Yields on UK, US and German 10 year bonds ended the quarter at 1.19%, 2.41% and 0.43% respectively.

Our comments below relate to our general approach to portfolios over the period. Actual activity on trading accounts may differ from this depending on personal circumstances, and timing of investment. Please refer to your Valuation and Transaction Statements for details.

Portfolio Activity

The Investment Committee initiated a portfolio rebalancing exercise over the period within core and income mandates. Following movements in markets over the period invested, the process trimmed positions which had become overweight and invested the proceeds into underweight positions, re-aligning portfolios to preferred weightings. Whilst carrying out the rebalancing exercise, a number of position changes were also implemented as follows.

Firstly, JPM Global Macro Opportunities was reduced within the majority of mandates holding the fund. This was following a period of strong recovery after its disappointing performance over the second half of 2016, when the fund experienced a higher than expected drawdown taking into account its capital preservation objective. The proceeds were invested into Lazard Emerging Markets taking a more optimistic view on emerging market equities based on valuations and an improving macroeconomic backdrop.

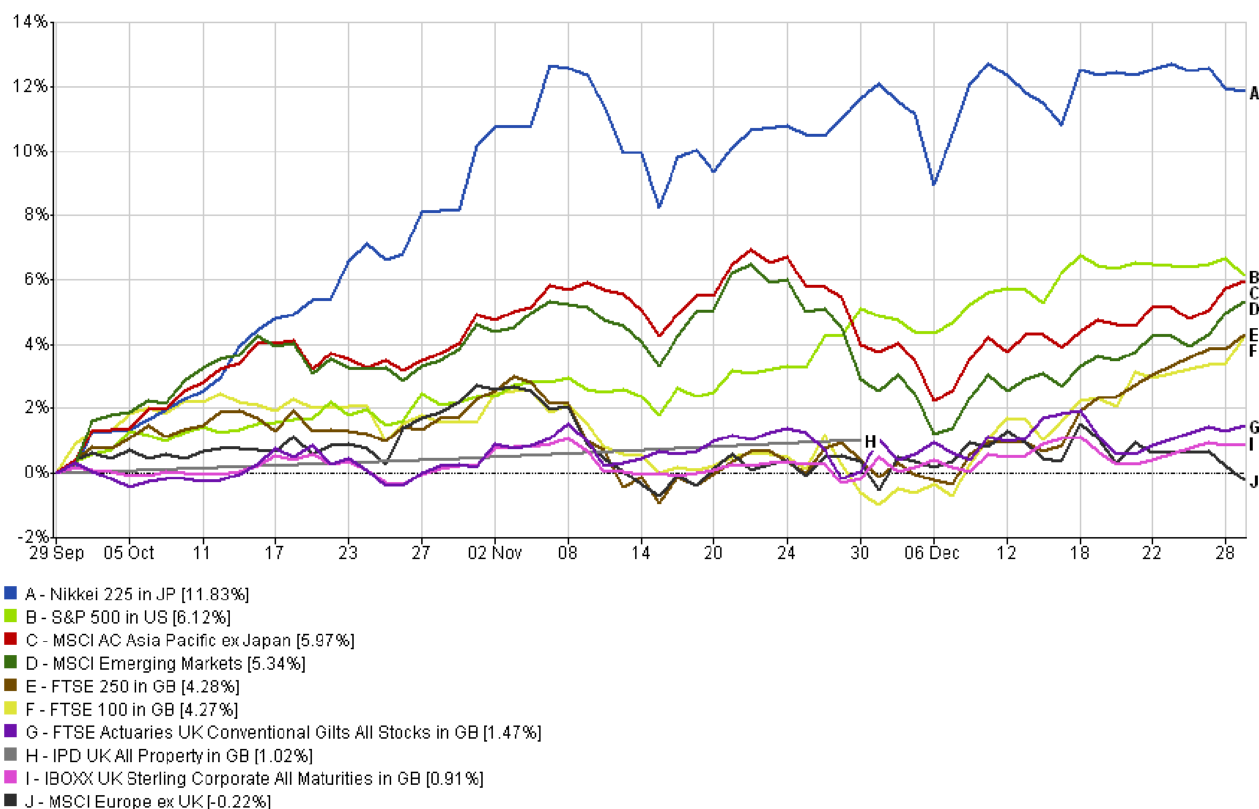
Secondly, UK equity exposure was reduced following an assortment of weak economic fundamental data. This was actioned by reducing positions in Liontrust Special Situations in core mandates taking profits following strong historic performance and noting the high relative valuation of the fund. Within income mandates, positions were reduced in Rathbone Income also taking into account valuations and the higher relative position size of the fund from a risk management perspective. The proceeds were invested into Man GLG Japan Core Alpha taking into account more attractive valuations of the fund and Japanese equity markets more generally. The Japanese central bank remains very accommodative while other developed central banks are scaling back monetary policy.

Thirdly, Threadneedle High Yield Bond was sold in its entirety across all mandates taking into consideration high yield bond valuations. In addition, it was felt that the recently announced reduction of monetary stimulus from the European Central Bank could potentially ease the buying pressure on this market, therefore limiting future prospects for capital gains. The proceeds were invested into M&G Global Macro Bond which offers full flexibility within global fixed interest. The fund manager has an established track record managing the strategy and is supported by a highly regarded fixed interest team.

Markets

Financial Markets	Index	29 Sep 2017	29 Dec 2017	Change %
UK Government Bonds	FTSE Actuaries UK Conventional Gilts All Stocks	178.11	180.73	1.47%
UK Corporate Bonds	IBOXX UK Sterling Corporate All Maturities	104.51	105.47	0.91%
UK Commercial Property	IPD UK All Property*[1]	191.36	193.31	1.02%
UK Large Cap Equity	FTSE 100	7,372.76	7,687.77	4.27%
UK Mid Cap Equity	FTSE 250	19,874.82	20,726.26	4.28%
US Equity	S&P 500	2,519.36	2,673.61	6.12%
Europe ex-UK Equity	MSCI Europe ex-UK	1,348.36	1,345.33	-0.22%
Japan Equity	Nikkei 225	20,356.28	22,764.94	11.83%
Asia ex-Japan Equity	MSCI AC Asia Pacific ex-Japan	575.56	609.91	5.97%
Emerging Market Equity	MSCI Emerging Markets	57,792.54	60,878.90	5.34%
Economic Measures		**29 Sep 2017**	**29 Dec 2017**	**Change %**
Inflation	Retail Price Index*[2]	275.10	275.80	0.25%
Interest Rate	Bank of England Base Rate	0.25%	0.50%	0.25%
ARC Private Client Indices		**29 Sep 2017**	**29 Dec 2017**	**Change %**
ARC Cautious Private Client Index		180.20	182.54	1.30%
ARC Balanced Asset Private Client Index		210.11	215.19	2.42%
ARC Steady Growth Private Client Index		238.22	246.38	3.42%
ARC Equity Risk Private Client Index		266.11	277.37	4.23%

[Source: FE] *[1] Values between 29th September 2017 and 30th November 2017 as end of quarter figure not yet published. *[2] Values between 15th September 2017 and 15th November 2017 as this is the most recent published data.



29/09/2017 - 29/12/2017 Data from FE 2018

House View

The tightening of central bank stimulus was a key theme for the period including a reduction in stimulus in Europe, a further interest rate rise in the US and the first interest rate rise in the UK for over 10 years. The consensus view is that this theme will continue, but the path to 'normalisation' will be a long one. Central banks are wary of tightening policy too fast in a world where low interest rates and large scale stimulus have been at unprecedented levels for such an extended period.

Brexit continues to taint investor sentiment in the UK following a set of weak economic projections from multiple organisations, a divorce bill which is substantially higher than expected and a lack of confidence in Prime Minister May as expressed by her own party. While the UK government is making 'sufficient progress' it is widely expected that the second phase of negotiations covering the outlines of the trade deal will be much more significant.

With regards to portfolio positioning, rising interest rates and reduced stimulus are naturally expected to exert downward pressure on bond prices. That said, if the transition is slow as central banks have communicated, then it is more likely to have only a small and slow impact on prices. It is important to note that there still remains much structural demand for fixed income assets and they provide diversification within an overall portfolio. Portfolios predominately access fixed income exposure through strategic and global bond funds which are more nimble in nature and have an enhanced liquidity profile.

Alternative investments continue to be a key feature within portfolios. The main funds held in portfolios are expected to provide significant diversification benefits to portfolios, as they have done historically. Capital preservation is a primary objective of most funds which is expected to provide some protection, should core financial markets fall significantly.

UK commercial property remains blemished by Brexit uncertainty although net inflows into funds have been improving gradually. Within this segment of the overall portfolio, the Investment

Committee maintain a preference for UK infrastructure assets in a fund which aims to deliver an attractive level of regular income, capital preservation and inflation protection.

Developed equity markets have continued to rise in broad terms. More recently this has been a function of rising corporate earnings, rather than higher valuations which is encouraging. In the UK, the economic outlook has worsened and investor sentiment remains low. Both of these aspects are largely attributable to Brexit and this has been taken into consideration with recent portfolio activity. Despite a more positive backdrop in the US, equity markets in this region remain considerably more expensive which leads the Investment Committee to maintain lower exposure. The outlook within the European equity market appears reasonably well balanced when weighing up the risk/reward prospects.

Further afield, the Investment Committee are more optimistic on the Japanese equity market outlook taking into consideration greater political stability, highly accommodative stimulus measures and attractive market valuations. Emerging equity markets also appear more attractive taking into consideration an improving economic backdrop, discounted valuations and inherent structural growth over the longer-term.

In summary, the Investment Committee have initiated some slight adjustments in asset allocation over the period for reasons as explained above, but the wider investment outlook remains largely unchanged. That is, while the medium to long-term view is reasonably positive, markets have been supported by unprecedented low interest rates and stimulus from central banks for almost a decade. This dynamic has also supported lower levels of market volatility than we have previously experienced and most market corrections have been short-lived. The key message is that the world's principal central banks are reversing these support mechanisms, albeit slowly. While this itself does not necessitate cause for concern, investors should be prepared for a potential slowdown in the rate of returns in the years ahead.

Shane Bennett BA (Hons) IMC
Research Analyst

4th January 2018

Contacts

For issues relating to your financial planning, please contact your usual adviser. For further detailed information with regard to your investments managed within the Discretionary Portfolio Service, please contact a member of the Investment Committee in the Exeter office:

Shane Bennett	shanebennett@cfmltd.co.uk
Tim Ames	timames@cfmltd.co.uk
Neil Gore	neilgore@cfmltd.co.uk
Harry Bailey	harrybailey@cfmltd.co.uk

Past performance is not a guide to future performance. The value of investments and any income from them can fall as well as rise and is not guaranteed. The comments in this Market Commentary are based on our views at 4th January 2018. These views are subject to change. They are for information only and do not contain any forecasts or recommendations.

Cathedral Financial Management Ltd Reg'd Office: No1 Cathedral Court, Southernhay East, Exeter, Devon EX1 1AF. Cathedral Financial Management Ltd is authorised and regulated by the Financial Conduct Authority.