Discretionary Portfolio Service

Market Commentary for the Period 1st April 2016 – 30th June 2016

Global equity markets were mixed over the period with small gains in the US weighed with sharp falls in Japan and much variation between UK equities following events at quarter end. The UK population voted in favour of leaving the European Union which led to the resignation of Prime Minister David Cameron. The result caused much market volatility as investors weighed up the various outcomes. The IMF downgraded its global growth forecast to 3.2% from 3.4% in 2016 and 3.5% from 3.6% in 2017 outlining a widespread slowdown and greater exposure to negative risks. Developed economy central banks were generally more devoted to stimulating economies with the US Federal Reserve holding off any rise in interest rates, the Bank of Japan not ruling out further easing and the European Central Bank buying up corporate bonds for the first time in history. Various central banks in emerging economies cut interest rates by up to 0.50% with all citing low inflation as a factor behind the decision. Bond markets were supported broadly by increased stimulus from central banks and investors seeking safety from uncertainty around the EU referendum.

US equity markets gained some traction over the period, buoyed by a strong dollar currency. Mixed signals from the Federal Reserve over the quarter had a temperamental impact on both investors and markets. In the most recent meeting, the committee reiterated expectations for gradual increases in interest rates which set expectations lower than a previous speech where Fed Chair Janet Yellen suggested the central bank would initiate two interest rate hikes over the year. The case for raising rates has however now been dampened by uncertainty following the result of the EU referendum. US first quarter GDP fell to 1.1% q/q annualised as growth in consumer spending was not enough to offset other downward factors. Inflation fell to 1% y/y in May, lower than the previous months figure and expectations. Price inflation for food and transport services slowed and energy costs fell at a faster pace. US unemployment fell to 4.7% in May, falling considerably from 5% the previous month. This marked the lowest reading since November 2007.

UK equity markets were split over the quarter, largely dependent on the level of domestic exposure on a company by company basis. The UK population voted to leave the European Union with the result revealing 52% voting leave and 48% voting remain. Prime Minister David Cameron announced his resignation shortly after the result and outlined that he would remain in office until new leadership was put in place by the Conservative Party. Credit ratings agencies Moody's and Standard & Poor's cut the country's credit rating by one and two notches citing weakness in the predictability, stability and effectiveness of policy making. Following the result the Bank of England stated that they would not hesitate to take additional measures and that they stood ready to provide £250bn of additional funds to support the functioning of markets. Governor Mark Carney then announced that some monetary policy easing would likely be required over the summer, which translated into expected interest rate cuts and potential quantitative easing from the central bank.

UK first quarter GDP fell to 0.4% q/q as lower than expected business investment and exports was not enough to offset strength in consumer spending. Inflation remained at 0.3% y/y in May, unchanged for the previous month as the rising cost of restaurants & hotels was offset by food deflation. UK unemployment fell to 5% in April marking the lowest rate since October 2005. Meanwhile the employment rate (the proportion of the working-age population in employment) reached the highest level on record. Wage growth (inc bonuses) also rose above expectations to 2% y/y in April.

European equity markets suffered some losses in a volatile end of the quarter. Interest rates and stimulus levels were left unchanged at the recent European Central Bank meeting, although the bank confirmed that they would proceed with previously agreed corporate bond purchases in early June. Economic growth and inflation expectations were raised despite recognition that risks remained tilted to the downside referring specifically to global growth, the EU referendum and other geopolitical risks. The Swedish central bank agreed to expand its asset purchasing programme by 45bn kr in the second half of the year over concerns around uncertainty of global developments and to reduce the risk of the krona currency appreciating faster than forecasted. Eurozone finance ministers agreed to provide €10.3bn in new loans to Greece after an 11 hour meeting in Brussels. A debt relief package was also agreed which will be progressively phased in. The Greek parliament passed new budget cuts and tax rises in order to meet debt repayments. Eurozone first quarter GDP rose to 0.6% q/q as growth was predominately driven by household spending and private investment. Inflation rose to -0.1% y/y in May, higher than -0.2% the previous month as the cost of restaurants and cafes was enough to offset lower energy prices. Unemployment remained at 10.2% in April with youth unemployment falling to 21.2%.

Asian equity markets were largely flat over the period, as developed markets were more impacted by the referendum result. Chinese first quarter GDP fell to 6.7% y/y. Despite the fall, fixed-asset investment, industrial output and retail sales all increased above expectations. The IMF warned on the rising level of Chinese corporate debt which it said would need to be addressed along with a commitment to serious reforms. The organisation commented that 'in a setting of slower economic growth, the combination of declining earnings and rising indebtedness is undermining the ability of companies to pay suppliers or service their debts'. Chinese trade data showed some improvement from recent figures, although poor demand from China's key trading partners continued to translate into lower exports. In India the central bank governor Rajan resigned after 3 years to return to academia. In his time as governor he was praised as a revolutionary figure for the country, putting policies in place to reform the financial system.

Japanese equity markets experienced fairly sharp losses as yen currency strength impacted the export driven marketplace. Japanese Prime Minister Abe announced plans for a new stimulus package as well as an agreement to delay a sales tax hike (for the second time) until October 2019 due to large risks around the global economy. Later comments by the central bank reiterated that additional easing and further lowering interest rates would be considered if necessary to achieve the banks objective. Japanese first quarter GDP rose to 0.5% q/q with higher private consumption countered by business spending falling below expectations. Inflation fell to -0.4% y/y in May which marked the 3rd straight month of declines led by easing food prices and declines in the cost of housing and transport. Japanese unemployment remained at 3.2% in May in line with expectations.

Emerging markets were flat over the quarter amid a fairly busy period for emerging country central banks. There were a raft of interest rate cuts over the quarter including; India, Hungary, Russia and Indonesia. All central banks commented that lower inflation was a key driver to reducing interest rates, in order to buoy prices. Earlier in the period, the International Energy Agency commented that the global oil surplus would ease by the end of the year, having some impact on the expectations around supply/demand dynamics. At both a Qatar summit and OPEC meeting oil nations failed to reach an agreement on a production freeze in order to buoy declines in oil prices.

In Brazil, the lower house of congress voted in favour of the impeachment of President Dilma Rousseff. This is following the discovery that she was using state bank funds to hide the budget deficit ahead of her re-election in October 2014, as well as a potential corruption scandal involving oil major Petrobras. Following the impeachment process, she was suspended by the Brazilian Senate and was later replaced by VP Michel Temer as interim President while she faced trial.

In fixed income markets, government bonds and high yield bonds outperformed as investor demand was split between those seeking safety and others demanding income. The result of the EU referendum pushed yields on UK government bonds to their lowest level in history which was encouraged by investor expectations of a short-term cut in interest rates. Yields on the UK, US and German 10 year bond ended the quarter at 0.86%, 1.44% and -0.13% 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

Within portfolios, positions were sold in Henderson UK Property across the majority of mandates (according to personal circumstances) following increased concerns around liquidity and pricing, largely impacted by a slowdown in flows given the upcoming EU referendum.

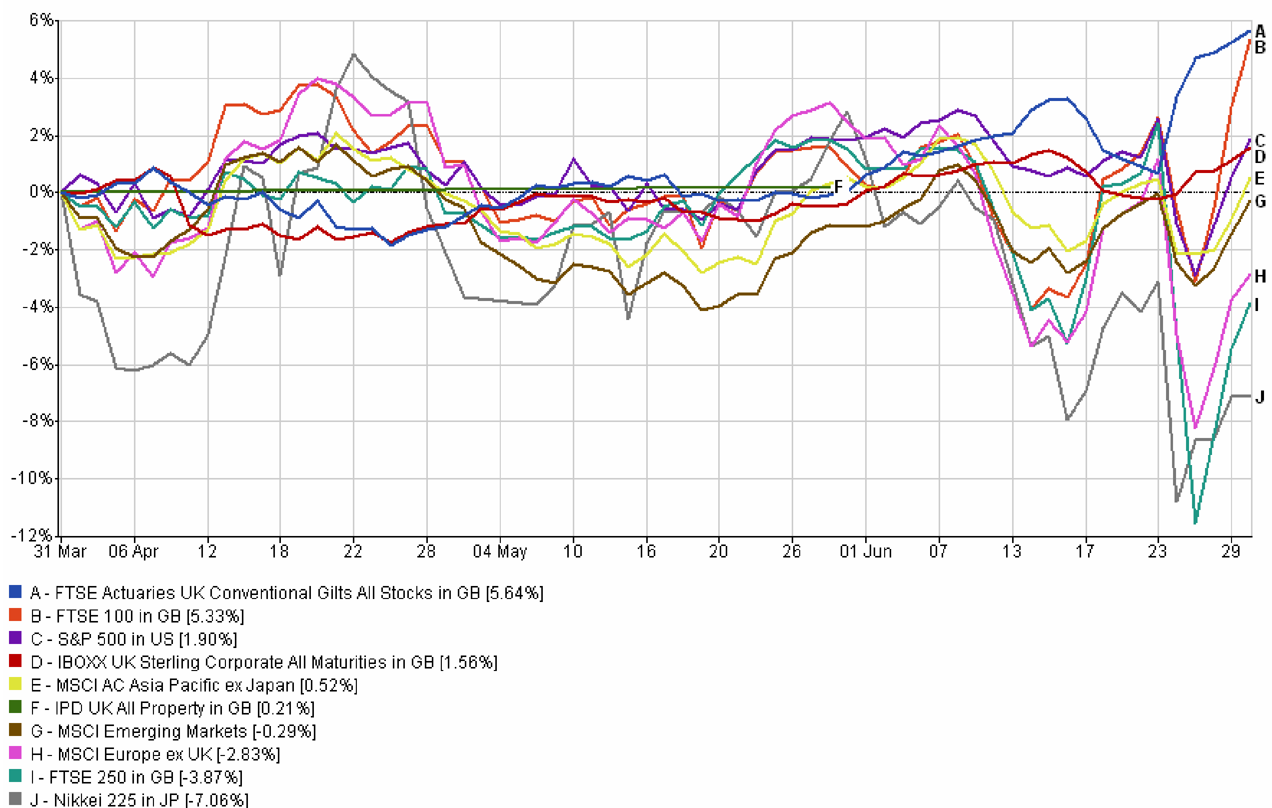
The fund, as well as most other direct UK commercial property funds, operates a dual pricing mechanism whereby the lower price (bid price) deducts disposal costs and the higher price (offer price) adds acquisition costs including stamp duty. Generally, when flows or expected flows are positive funds adopt offer price and when negative bid price is used. The committee were watching flows for some time where a continual slowdown was evident. Positions were sold in increments over a 2 week period to achieve the best price possible before the fund moved to bid price, resulting in around a -4.6% immediate fall in the fund. At the end of the quarter following the result of the EU referendum, the fund applied around a further -5% markdown to reflect the expectation of downward pressure on property prices.

The proceeds were held as cash with the Committee undergoing continuous discussions on re-investment opportunities as well as monitoring flows into the markets leading UK commercial property funds.

Markets

Financial Markets	Index	31 Mar 2016	30 Jun 2016	Change %
UK Government Bonds	FTSE Actuaries UK Conventional Gilts All Stocks	177.35	187.36	5.64%
UK Corporate Bonds	IBOXX UK Sterling Corporate All Maturities	101.31	102.89	1.56%
UK Commercial Property	IPD UK All Property*	179.10	179.48	0.21%
UK Large Cap Equity	FTSE 100	6,174.90	6,504.33	5.33%
UK Mid Cap Equity	FTSE 250	16,926.12	16,271.07	-3.87%
US Equity	S&P 500	2,059.74	2,098.86	1.90%
Europe ex-UK Equity	MSCI Europe ex-UK	1,123.39	1,091.65	-2.83%
Japan Equity	Nikkei 225	16,758.67	15,575.92	-7.06%
Asia ex-Japan Equity	MSCI AC Asia Pacific ex-Japan	455.74	458.11	0.52%
Emerging Market Equity	MSCI Emerging Markets	45,552.52	45,420.79	-0.29%
Economic Measures		**31 Mar 2016**	**30 Jun 2016**	**Change %**
Inflation	Retail Price Index**	261.10	262.10	0.38%
Interest Rate	Bank of England Base Rate	0.50%	0.50%	0.00%
FE Adviser Fund Index		**31 Mar 2016**	**30 Jun 2016**	**Change %**
AFI Cautious Index		185.47	185.64	0.09%
AFI Balanced Index		209.57	210.81	0.60%
AFI Aggressive Index		232.08	236.53	1.92%

[Source: FE] *Values between 31st March 2016 and 30th May 2016 as end of quarter figure not yet published. ** Values between 15th March 2016 and 13th May 2016 as this is the most recent published data.



House View

The result of the EU referendum was to the surprise of many, including the book-makers who were firmly expecting a victory by those backing a remain vote. Financial markets were highly volatile following the result, particularly pound sterling which fell significantly and in some cases experienced one of the largest single day falls in recent history. The stock market was divided with larger internationally diverse companies faring well, while more domestically orientated companies suffered. Safe haven assets such as gold and government bonds rose as investors looked to shelter away from uncertainty. Portfolios held up well around the event as losses from domestic UK equities were largely offset by gains in equity and bond funds with international currency exposure. Surplus cash weightings and high allocations to alternatives also helped preserve capital over market volatility.

The UK economy will now be entering an even more uncertain phase as the government takes at least two years to work through negotiations with the European Union and key trading partners. The Bank of England will be faced with a difficult decision on interest rates in the short term as an interest rate cut would support markets whereas an interest rate hike would help control inflation as goods overseas become more expensive due to the falls in sterling. Outside of the UK there is also now greater pressure on the integrity of the EU with other countries likely to challenge the union. As such, there have already been demands for similar referenda from far-right Eurosceptic parties in Italy, France and Netherlands.

With regards to asset allocation, the Committee appreciate the diversification benefits of fixed interest within portfolios, which has been demonstrated particularly well in recent weeks. Yields are low relative to other asset classes, although prices have continued to rise as investors adopt the view that interest rates will be broadly lower for longer and demand will be taken up through purchases from central banks.

Alternative assets have become an increasingly favoured asset class given their general objective of capital preservation and low volatility with greater flexibility. Most of these types of investments also have the ability to buy and sell over a shorter period as well as taking sophisticated measures to hedge against multiple outcomes.

UK commercial property is likely to be adversely impacted by the result of the EU referendum as investors fret over the associated liquidity risk and expect reduced demand from the overseas buyer, which has been such a significant driver of prices in recent years. The Committee will continue to watch the market for any turn in trend as well as monitoring fund flow data.

Developed equity markets broadly trade at around average historic valuations as the setting of ultra-low interest rates and stimulus from central banks has continued to provide some degree of support to market prices. There is now much greater emphasis on corporate earnings to drive share prices. Recent surveys show fund managers are holding the highest levels of cash in around 15 years. While this does highlight some caution among investors, when cash piles are eventually invested this will act as a catalyst for market prices.

Emerging equity markets trade at a discount to developed markets, although this has become more entrenched with longer-term averages. China continues to be a key risk within the marketplace given slowing growth and rising levels of debt. Geopolitical risks have been put to one side with investors focusing on political issues in developed markets, however these risks remain largely unresolved. There is much opportunity for the active investor given current levels of variability among individual markets at present.

In summary, there is much uncertainty surrounding investors, as well as the increasing sense that the ensuing environment of low growth is likely to persist for some time. There are also now many unknowns around the future path of our domestic economy which will be heavily impacted by our ability to negotiate terms of trade and investment, and policies to secure the confidence of businesses and consumers. With historically low interest rates on cash which may now become even lower, there remains a case to invest in financial markets cognisant of risk and taking a longer term view. The Committee continue to seek out investment opportunities across the marketplace and manage diversified portfolios to best mitigate against a range of outcomes.

Shane Bennett BA (Hons) IMC
Research Analyst

1st July 2016

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 1st July 2016. 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.