Discretionary Portfolio Service

Market Commentary for the Period 1st July 2016 – 30th September 2016

Global equity markets delivered strong returns over the quarterly period, recovering from the aftermath of the EU referendum result. The IMF downgraded global growth in both 2016 and 2017 citing that the UK's decision to leave the EU had 'thrown a spanner in the works'. Changes in the political landscape was a clear theme for the period. This included developments ahead of the US election in November, a new Prime Minister in the UK, the failure to form a majority government in Spain, an incumbent win in the election for the upper house in Japan and the official removal of President Temer in Brazil after being found guilty of fraud. Towards quarter end, OPEC members agreed to limit oil production marking the first agreed deal in 8 years. Fixed income markets posted attractive returns, particularly in sterling bonds following the changes announced by the Bank of England.

US equity markets delivered modest returns over the period despite growing uncertainty over the US election. Markets dropped early in September as presidential candidate Hillary Clinton was reported as being treated for pneumonia after fainting at a 9/11 ceremony in New York. This raised questions over why she didn't disclose her health conditions earlier and led to concerns over her ability to proceed with the campaign. Later, Donald Trump was victim to anonymously leaked tax returns which revealed how he used aggressive accounting tactics to avoid tax. The US Federal Reserve agreed not to raise interest rates at their most recent meeting. The central bank acknowledged that the case to raise rates had strengthened but yet still wanted to wait for further evidence of progress towards their objectives. US second quarter GDP rose to 1.4% q/q annualised driven by exports and the first gain in business investment in 3 quarters. Inflation rose to 1.1% y/y in August driven by rising shelter and medical costs. US unemployment remained at 4.9% in August, unchanged from the previous month.

UK equity markets performed strongly, rebounding from the dip experienced following the result of the EU referendum. After the resignation of David Cameron, Theresa May was appointed as the UK's second female Prime Minister, marking one of the shortest campaigns in British history. The Bank of England announced an array of measures designed to support growth and achieve a sustainable increase in inflation. The members agreed unanimously to cut the bank rate from 0.50% to 0.25% marking a record low in the central bank's 322-year history. The bank also announced an increase of asset purchases of government bonds as well including corporate bond purchases. At their most recent meeting, the bank added that the majority of members would be supporting a further rate cut in November, if the outlook then is consistent with projections. UK second quarter GDP rose to 0.7% q/q encouraged by household spending and fixed investment. Inflation remained at 0.6% y/y in August. Transport prices rose further and the cost of food fell at a slower pace, although lower prices for housing and clothing weighed on inflation. UK unemployment remained at 4.9% in July while the employment rate was the joint highest since comparable records began in 1971.

European equity markets posted decent returns, despite the central bank disappointing on its announcement on potential monetary stimulus. The European Central Bank left interest rates and its stimulus program unchanged at its recent meeting. President Mario Draghi commented on the resilience of the European economy amid global and political uncertainty, but reiterated that, on balance, risks were tilted to the downside. In the Spanish election, Prime Minister Rajoy failed to form a majority in a hung parliament. It is possible that a new election will have to be held on Christmas day, should the political leaders not succeed in forming a government. Eurozone second quarter GDP fell to 0.3% q/q as investment stalled and an inventories drag weighed on growth. Inflation remained at 0.2% y/y in August as price rises in restaurants & cafes and fruit & vegetables were offset by declines in transport fuels and heating oil & gas. Eurozone unemployment was unchanged at 10.1% in August, remaining the lowest rate since July 2011.

Asian equity markets experienced large gains following better than expected market data and accommodative stimulus across Australasia. Chinese second quarter GDP remained at 6.7% y/y. This marginally beat market expectations driven by a greater increase in industrial output, retail sales and new loans. Chinese trade data was also encouraging with imports and exports improving in August. Australia and New Zealand cut interest rates to 1.5% and 2% respectively. Both central banks commented on low inflation being a key reason to reduce rates, with New Zealand in particular citing that a decline in its exchange rate was needed.

Japanese equity markets were strong over the period as markets took positively to a win by Japan's incumbent leader. Japanese Prime Minister Shinzo Abe claimed a major victory in an election for the upper house of parliament. This re-affirmed confidence in Abe's plans for aggressive financial stimulus. Later in the period, the Bank of Japan increased its equity purchase program and doubled lending to local companies. The bank then approved a ¥13.5 trillion fiscal package which would be invested into projects such as infrastructure including a new magnetic levitation railway line from Tokyo to Osaka. In a later meeting the bank adjusted its quantitative easing program to allow for more control and also committed to carry out necessary policy to meet the inflation target. Japanese second quarter GDP fell to 0.2% q/q. Although lower than the previous quarter, this was announced higher than expected boosted by private consumption and public investment. Inflation fell to -0.5% y/y in August marking the sixth consecutive month of deflation driven by the falling cost of housing and transport as well as lower food price rises. Japanese unemployment rose to 3.1% in August, surpassing the previous month and expectations.

Emerging markets performed strongly over a period of mixed events. Early in the quarter, over 300 people were killed and thousands injured in Turkey as an army faction attempted to overthrow the government in a fight for democracy. The Brazilian senate voted to impeach President Dilma Rousseff following accusations of fraud. This saw her removed from the Workers Party and interim President Michel Temer staying in power until the end of 2018. The Russian and Saudi Arabian energy ministers agreed to work together to stabilise the oil market following a G20 summit in China. This marked a historical moment given their positions as the world's largest oil producers as well as being OPEC and non-OPEC members. Later, OPEC members agreed to limit oil production following an informal meeting at the International Energy Forum. This was the first agreed deal in 8 years and led to a sharp rise in the oil price. The Russian central bank cut interest rates to 10% signalling potential further cuts in 2017 in its assessment of inflation risks.

In fixed income markets, sterling corporate and high yield bonds outperformed demonstrating higher risk appetite over the period. Yields fell across sterling denominated bonds leading to higher prices following the decision by the Bank of England to cut interest rates and buy bonds through its quantitative easing program. Comments from the US Federal Reserve that the case to raise interest rates strengthened had a negative initial impact to bond prices. Yields on the UK, US and German 10 year bond ended the quarter at 0.65%, 1.60% and -0.12% 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 sold positions in Kames Strategic Bond across core and income mandates following a prolonged period of underperformance. It was felt that greater opportunities were available elsewhere in the marketplace.

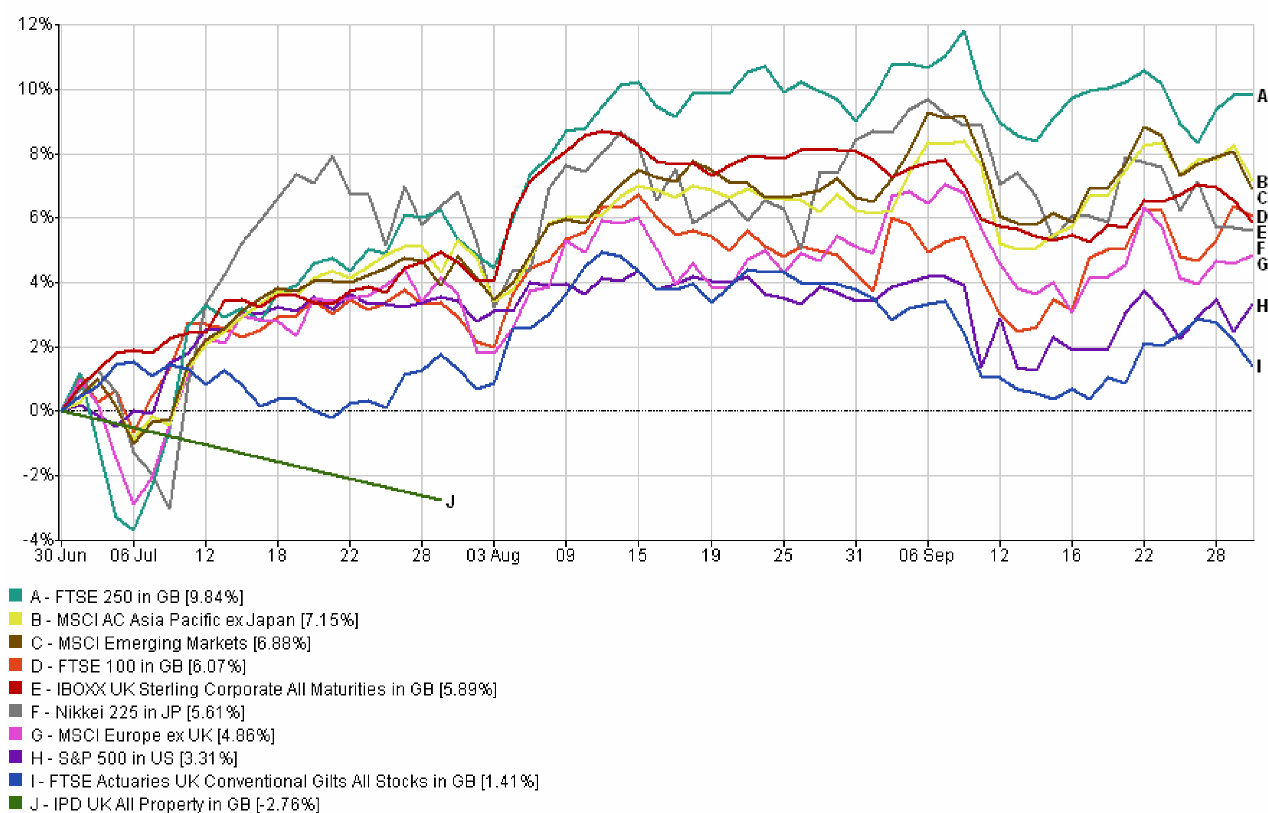
The proceeds were invested into Aviva Strategic Bond which targets top quartile performance by employing both a top-down and bottom-up strategy with a total return approach. Performance has been strong with the manager demonstrating outperformance in both rising and falling market environments. The team are unconstrained offering full flexibility with asset allocation and the fund is very competitively charged.

The Committee continue to hold cash following the disposal of commercial property earlier in the year. Since then both bond and equity markets have been strong, elevating valuations and increasing the possibility of a short-term pull back in markets. At this time, the Committee feel there is an optionality premium associated with cash, where the ability to invest swiftly may prove favourable.

Markets

Financial Markets	Index	30 Jun 2016	30 Sep 2016	Change %
UK Government Bonds	FTSE Actuaries UK Conventional Gilts All Stocks	187.36	190.00	1.41%
UK Corporate Bonds	IBOXX UK Sterling Corporate All Maturities	102.89	108.95	5.89%
UK Commercial Property	IPD UK All Property*	189.86	184.62	-2.76%
UK Large Cap Equity	FTSE 100	6,504.33	6,899.33	6.07%
UK Mid Cap Equity	FTSE 250	16,271.07	17,871.42	9.84%
US Equity	S&P 500	2,098.86	2,168.27	3.31%
Europe ex-UK Equity	MSCI Europe ex-UK	1,091.65	1,144.67	4.86%
Japan Equity	Nikkei 225	15,575.92	16,449.84	5.61%
Asia ex-Japan Equity	MSCI AC Asia Pacific ex-Japan	458.11	490.88	7.15%
Emerging Market Equity	MSCI Emerging Markets	45,420.79	48,547.82	6.88%
Economic Measures		**30 Jun 2016**	**30 Sep 2016**	**Change %**
Inflation	Retail Price Index**	263.10	264.40	0.49%
Interest Rate	Bank of England Base Rate	0.50%	0.25%	-0.25%
FE Adviser Fund Index		**30 Jun 2016**	**30 Sep 2016**	**Change %**
AFI Cautious Index		185.64	196.13	5.65%
AFI Balanced Index		210.81	226.09	7.25%
AFI Aggressive Index		236.53	260.06	9.95%

[Source: FE] *Values between 30th June 2016 and 29th July 2016 as end of quarter figure not yet published. ** Values between 15th June 2016 and 15th August 2016 as this is the most recent published data.



House View

It has now been over 3 months since Britain decided to leave the European Union and there have been a series of developments over the period. Since the result of the referendum, there has been a significant recovery in equity markets including the UK, and bond markets have rallied. Further gains have been made in investments with foreign currency exposure, given weakness in sterling. Economic data in the UK has been resilient, with many indictors in a better position now than they were before the event. Theresa May's latest comments specified that the UK would begin its formal Brexit negotiation process by the end of March 2017. While the deadline has now been set, the delay in detail has been prolonging uncertainty and left business leaders ambivalent.

Over the next quarter, people worldwide will be closely watching the US election in the battle between Trump and Clinton. Through the campaign the polls have shifted, but have tended to favour a win for Clinton. Historically, equity markets have reacted favourably to an incumbent and/or democratic win, but there is likely to be some disparity in returns on a sector basis with conflicting policies between each candidate. Donald Trump has been a very unorthodox presidential candidate including plans such as building a wall across the southern border, bombing middle-eastern oil fields and the deportation of immigrants. Markets are unlikely to welcome a Trump lead, however much can change over the coming months in what has been dubbed one of the most loathed presidential elections in US history.

With regards to asset allocation, in fixed interest markets the Committee continue to favour funds which are able to act tactically and capitalise on short-term investment opportunities. With historically low bond yields valuations are stretched, but the ability to buy and sell at the margin should help deliver a return to investors. There remains much demand in the marketplace driven by regulation, pension providers and central banks supporting prices. Selective portfolios hold a segment of emerging market bonds which provide a much higher yield and further diversification benefits.

Alternative assets have broadly struggled to deliver much return to investors of late within a challenging and unconventional economic and market environment. That said, all funds continue to deliver on their objectives of low volatility and remaining broadly uncorrelated to core markets. The ability to generate attractive returns over the medium term and hedge a proportion of market risk is favoured by the Committee at this time.

UK commercial property has suffered its most challenging episode since the financial crisis following the EU referendum. Fundamentals of the property market remain intact, underpinned by strong yields and supply/demand dynamics. What has been highlighted in recent months is the challenge for property funds to trade daily within an illiquid asset class. At this stage, the Committee are monitoring further developments before considering re-entering the marketplace.

Developed equity markets have continued to perform strongly in a phase of relentless central bank commitment. That said, this hasn't been matched entirely by an equivalent rise in valuations because a significant portion of the return was made through overseas currency exposure. The Committee acknowledge the host of key global risks across markets at present such as the outcome of Britain's exit from the EU, the upcoming US election and central bank obstacles. However at a company level, fund managers continue to find plenty of opportunities across the marketplace. The Committee blend various manager strategies to reduce style risk in challenging markets.

Emerging equity markets are discounted relative to developed markets where there is a premium associated with a perceived level of safety. China continues to be a key risk across emerging markets with sentiment tarnished by unsustainable levels of debt. The long term case remains, underpinned by attractive demographics and an expanding middle-class which increases the spending capacity of consumers. Active management is key on a regional basis given the levels of variability on currency, central bank policy and oil price sensitivity.

In summary, the backdrop remains challenging in an environment of unprecedented central bank policy which is a result of low growth and inflation. Asset allocation has become increasingly difficult as policy or anticipation of policy changes has been such a dominant factor in the direction of investment returns. In addition to this, short-term trading behaviour can lead to large gyrations in allocation or can radically impact liquidity, as we have seen in commercial property markets. These challenges truly highlight the benefits of diversification and ability to take a broad view within an overall portfolio. Following a further cut in the bank rate, savers can no longer achieve the same interest rates they once could. The financial markets can offer attractive returns in excess of cash rates over the medium to long term, taking on board the additional risks involved.

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3rd October 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:

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