Discretionary Portfolio Service

Market Commentary for the Period 1st January 2018 – 31st March 2018

Global equity markets suffered with most regional markets flat or negative over the quarterly period. Much of the financial press was focused on President Trump's plans to enforce tariffs on a number of countries, later sparking concerns of a potential trade war with China. Whilst this was certainly an adverse market event, the prospect of multiple central banks raising interest rates faster than expected was a discreet development encouraging market volatility. Fixed income markets were not immune to the wider market declines, as bond prices adjusted to higher interest rate expectations.

US equity markets held up well on a relative basis despite a number of unfavourable announcements in the region. Speaking at his first semi-annual monetary policy testimony, the new central bank Chairman Jerome Powell signalled that the central bank could hike interest rates by a greater extent taking note of strong economic growth and need to control inflation. President Trump announced plans to impose tariffs on steel and aluminium imports. Canada and the EU (where the US imports most steel from) responded by bringing forward their countermeasures. Much of the attention was drawn to China where tariffs of up to $60bn on Chinese imports would be enforced. This was after the Trump Administration determined the country was encouraging theft and transfer of intellectual property from US businesses. China responded by saying they would look to apply tariffs of up to $3bn on US imports. Days later, Trump's Economic Adviser resigned noting that he was an advocate of free trade. Fears of a potential trade war outbreak had a negative impact on markets.

The US Federal Reserve raised interest rates by 0.25% over the period with the central bank commenting on continued strength in the labour market and rising economic activity. They raised their economic growth forecasts for 2019/20 leading the market to raise expectations for further interest rate rises. US fourth quarter GDP fell to 2.9% q/q (annualised), despite being higher than market expectations. Inflation rose to 2.2% y/y in February led by rises in fuel oil, transportation services, energy and apparel. Unemployment was unchanged at 4.1% for the fifth consecutive month, remaining a 17-year low.

UK equity markets suffered fair losses over the period with the market failing to recover from the end of January sell-off. One factor working against the UK market was the strength in pound sterling, particularly against the US dollar. This is due to the amount of revenue the UK market earns from overseas, which is worth less when converted back into sterling. Prime Minister May rejected the EU's draft legal agreement which proposed keeping Northern Ireland in a customs union, effectively creating a new border in the Irish Sea. The UK and EU later agreed on a transition deal which would lead to the orderly withdrawal of the UK. The deal included EU citizens' rights, detail on trade, fishing policy and Northern Ireland to stay in parts of the single market and customs union.

The Bank of England maintained interest rates and stimulus over the quarter. They outlined in their most recent meeting that inflation was expected to ease in the short-term but remain above the 2% target. They upheld their view that further interest rate rises would be necessary to tame inflation,

although this would be a gradual move. UK fourth quarter GDP fell to 0.4% q/q following slowing business investment and fall in net trade. Inflation fell to 2.7% y/y in February, the lowest rate since July 2017. UK unemployment fell to 4.3% marking the lowest rate in 42 years.

European equity markets ended the quarter lower, in line with broader equity markets. The populist 'Five Star Movement' achieved around one-third of the votes in the recent Italian general election. There were discussions around the party joining forces with the other populist 'Lega Nord' to form a majority, although sceptics outline the ideological differences between the two parties. In Germany, a coalition deal was agreed between Angela Merkel's CDU party and the SPD ending five months of political deadlock.

The European Central Bank left interest rates unchanged and reaffirmed that current stimulus levels would continue until the end September. The central bank did however remove one reoccurring line from its statement which outlined that they would be 'ready to increase the asset purchase programme in terms of size and/or duration'. They felt the outlook for growth to be greater than previously expected in the near term and inflation will move towards the 2% target in the medium term. Key risks to the growth outlook include primarily global factors, including rising protectionism and FX/other financial market developments. European fourth quarter GDP fell to 0.6% q/q following softer growth from Germany, Italy, Greece and Latvia. Inflation fell to 1.1% y/y in February marking the lowest rate since December 2016 driven largely by lower costs for food, alcohol and tobacco. Unemployment was unchanged at 8.6% in January, remaining a 9-year low.

Japanese equity markets were in decline with no major positive data surprises able to elevate prices. The Bank of Japan maintained interest rates and left its stimulus programme unchanged over the period by unanimous vote. The central bank remained relatively upbeat in their statement highlighting increasing exports and business investment, as well as improving corporate profits and business sentiment. They reiterated that highly accommodative policy measures would continue until inflation reached its target rate sustainably. Japanese fourth quarter GDP fell to 0.4% q/q marking the eighth consecutive quarter of expansion. Inflation rose to 1.5% y/y in February jumping to the highest rate since March 2015 following higher transport and food costs. Unemployment rose to 2.5% in February.

Emerging market equities sustained the global equity market sell-off to end the quarter broadly unchanged. Vladimir Putin won a six-year term as Russian President with over 76% of the vote. This victory extended his expected time in office to almost 25 years. There were various changes amongst emerging economy central banks. Interest rates were cut in South Africa, Russia and Brazil by between 0.25 - 0.50% with all citing lower inflation as a key contributing factor. Conversely, interest rates were raised in Mexico by 0.25% amid persistently higher inflation. Chinese GDP was announced at 6.9% over the 2017 period, well above the government's target of 6.5%. Strong industrial growth, higher exports and a resilient property market were all core drivers of economic growth.

In fixed income markets, bond yields were broadly higher as the market priced in further expected interest rate hikes across the US and UK, which had an adverse effect on bond prices. Credit markets were also negatively impacted by the wider risk-off sentiment in the market. Yields on UK, US and German 10 year bonds ended the quarter at 1.35%, 2.74% and 0.49% 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 the M&G Global Floating Rate High Yield fund across low to medium risk mandates taking into consideration capacity. Due to the high level of demand for this type of strategy, the fund reached a point where it was owning a substantial share of the overall market. This led to the fund changing its structure where it was gradually increasing its use of synthetic positions to replicate the strategy. Valuations were also becoming stretched.

The proceeds were invested into the Royal London Short Duration Global High Yield Bond fund. This offers a greater yield whilst also maintaining a high degree of interest rate protection through its short duration strategy and high yield focus. Liquidity is strong given the strategy is essentially self-liquidating as bonds held are close to maturity. The fund was invested at a discounted annual charge, making it very competitive on a cost basis.

Portfolio rebalancing was carried out within ethical mandates and the Investment Committee initiated a number of trades in the process. Positions were sold entirely within the F&C Responsible UK Income fund on a market basis following weaker economic fundamentals and earnings momentum in the UK. On a fund basis, performance had been disappointing and historically the fund provided less diversification benefits to the overall portfolio despite its differentiated approach. Exposure to the AXA Ethical Distribution fund was reduced by around 50% with diversification being a key factor driven largely by its restriction of only investing in sterling, rather than global assets. The fund was also reduced taking into account its large exposure to UK index linked bonds where valuations are rich at this time.

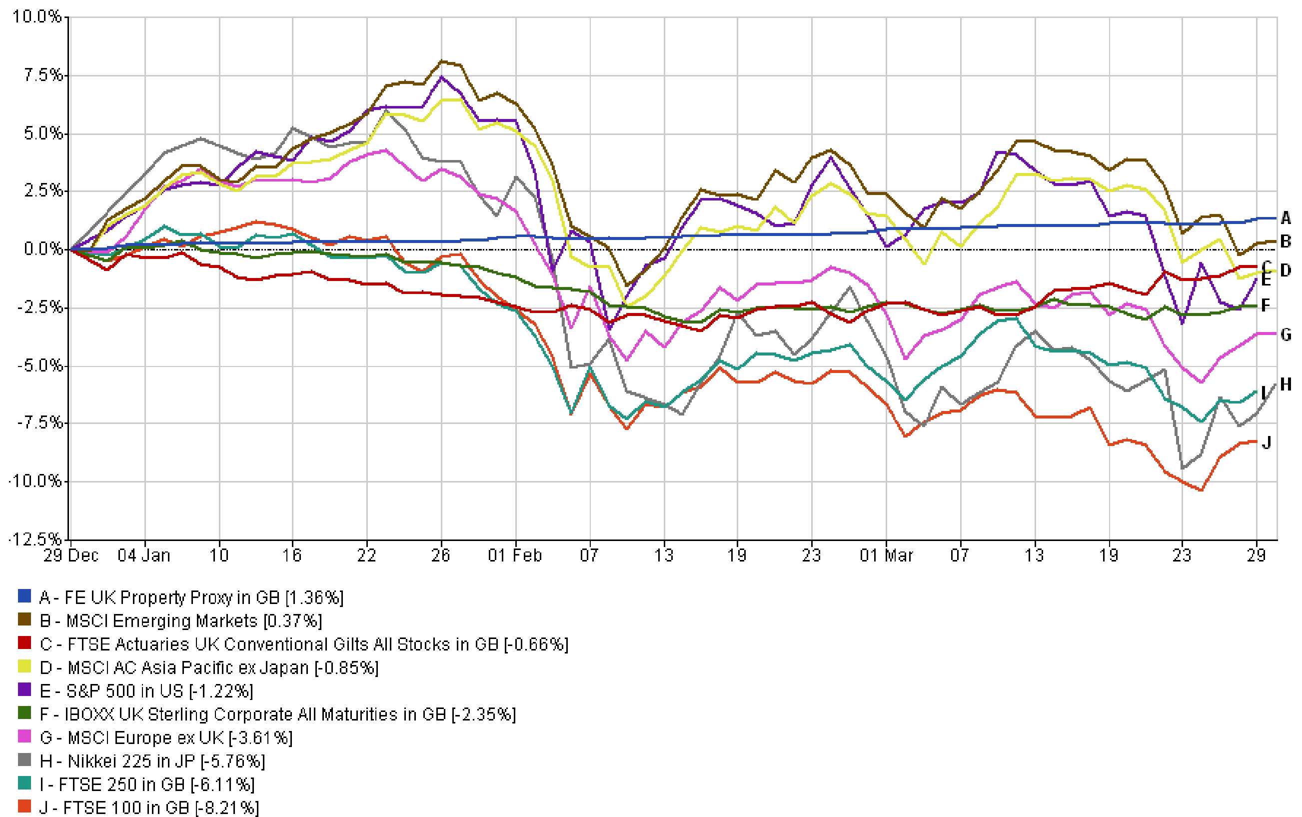
The proceeds were invested into two new positions within the mandate. Firstly, the EdenTree Amity Short Dated Bond fund which aims to preserve capital as well as produce a small regular income to investors. To achieve its objective, the fund invests in short dated bonds issued by companies making a positive contribution to society. Given the funds focus on short dated bonds, the fund will have a much lower sensitivity to interest rates.

Secondly, a position was initiated in the recently launched VT Gravis Clean Energy Income fund which invests in global listed securities primarily across hydro, wind and solar energy sectors. The fund aims to provide a regular income yield, capital growth and an element of inflation protection. There is also an emphasis on capital preservation throughout market cycles. Finally, exposure was increased marginally to the Stewart Investors Global Emerging Markets Sustainability fund given attractive relative valuations within broader EM equity markets as well as an improving macroeconomic backdrop.

Markets

Financial Markets	Index	29 Dec 17	29/30 Mar 18	Change %
UK Government Bonds	FTSE Actuaries UK Conventional Gilts All Stocks	180.73	179.53	-0.66%
UK Corporate Bonds	IBOXX UK Sterling Corporate All Maturities	105.47	102.99	-2.35%
UK Property	FE UK Property Proxy	1,889.79	1,915.50	1.36%
UK Large Cap Equity	FTSE 100	7,687.77	7,056.61	-8.21%
UK Mid Cap Equity	FTSE 250	20,726.26	19,460.47	-6.11%
US Equity	S&P 500	2,673.61	2,640.87	-1.22%
Europe ex-UK Equity	MSCI Europe ex-UK	1,345.33	1,296.77	-3.61%
Japan Equity	Nikkei 225	22,764.94	21,454.30	-5.76%
Asia ex-Japan Equity	MSCI AC Asia Pacific ex-Japan	609.91	604.74	-0.85%
Emerging Market Equity	MSCI Emerging Markets	60,878.90	61,106.70	0.37%
Economic Measures		**29 Dec 17**	**30 Mar 18**	**Change %**
Inflation	Retail Price Index*	278.10	278.10	0.00%
Interest Rate	Bank of England Base Rate	0.50%	0.50%	0.00%
ARC Private Client Indices		**29 Dec 17**	**30 Mar 18**	**Change %**
ARC Cautious Private Client Index		182.74	179.47	-1.79%
ARC Balanced Asset Private Client Index		214.88	209.12	-2.68%
ARC Steady Growth Private Client Index		245.36	237.33	-3.27%
ARC Equity Risk Private Client Index		275.38	264.47	-3.96%

[Source: FE] *Values between 15th December 2017 and 15th February 2018 as this is the most recent published data.



House View

While market movements over the previous quarter had an adverse effect on returns, it was a gentle reminder that stock markets are subject to fluctuations and short-term falls are a function of markets. Over the previous two years quarterly market returns have not only been broadly positive, but also remarkably high when looking back further in history. Broader market volatility has also been favourable to investors, having reached record lows in recent years.

The combination of higher than average returns and lower than average market volatility is a dynamic that cannot persist indefinitely. An environment where the world's key developed central banks are either withdrawing stimulus and/or raising interest rates will inevitably apply pressure on the return outlook. Despite this dynamic we believe the outlook remains broadly positive and there remains sufficient opportunities to deliver investors attractive returns over the medium to long-term.

Within fixed income, the Investment Committee have taken the approach over recent years to shift away from core bond holdings such as government and investment grade bond funds and more towards strategic and global bond funds. These funds permit greater flexibility to the fund manager which we believe will be more pertinent within the current market environment of rising interest rates. We have invested more into 'short duration' or 'short dated' strategies of late given that they are a means to access fixed income markets with reduced sensitivity to changing interest rates.

Alternative holdings such as absolute return funds have delivered positive returns over the medium to long term, but shorter-term performance has been somewhat broadly disappointing. It is important to note that the purpose of these funds is not to keep pace with more traditional equity funds. They are held predominately for capital preservation and diversification purposes where we expect some exposure will help to mitigate losses in more adverse market conditions, as demonstrated in this quarter.

It is fast approaching two years since the EU referendum result which had a significant impact on funds investing within the UK commercial property market. Following a substantial withdrawal of investor capital, most funds experienced a series of sharp daily falls and later gated redemptions meaning that investors were unable to exit their investments until further notice. There has been a slow gradual improvement in flows into property funds but more time is required to assess the sustainability of this with liquidity remaining a key risk to this asset class.

Despite recent market volatility, the equity market proceeds on its path as the third longest 'bull run' since the great crash of 1929. Markets have more recently been supported by a broad improvement in global economic growth, general pick up in corporate earnings and strong investor sentiment. Market valuations have eased somewhat as prices have driven more by earnings of late, thus making them more fundamentally justified.

While this narrative sets the scene for a positive market backdrop, it is important to reiterate earlier comments around the change occurring currently where the world's principle central banks are withdrawing liquidity. The challenge for portfolio managers at this time is that the environment we are experiencing is unprecedented. We are not able to look back in history and draw parallels between the current market backdrop and analyse the characteristics of asset prices. At this time the Investment Committee place much emphasis on diversification and continually assess the market outlook.

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4th April 2018

Contacts

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