Discretionary Portfolio Service

Market Commentary for the Period 1st April 2018 – 30th June 2018

Global equity markets were divided over the quarter with gains across developed markets and weakness among Asian and emerging markets in broad terms. Political uncertainty was widespread with escalating tensions from the US over trade tariffs, an uneasy coalition government in Italy, the Spanish Prime Minister being forced out of office and close voting between ministers in the UK over Brexit. Fixed income markets were largely influenced by changing expectations over interest rates. Government bonds generally held up well relative to those issued by corporates indicating investor preference for safety.

US equity markets delivered strong returns over the period despite escalating political tensions. The Trump Administration enforced sanctions on 24 Russian oligarchs and 12 companies to punish the country for actions in Crimea, Ukraine and Syria as well as attempting to overthrow Western democracies. President Trump later withdrew the US from the Iranian nuclear deal which imposed a range of restrictions on Iran's nuclear activities. He also re-imposed the highest level of economic sanctions on Iran. Conversely, Trump and Kim Jong-un signed a brief declaration on denuclearization in their joint summit. Trump confirmed that US sanctions would remain in place until North Korea removed their nuclear activities. He later implemented trade tariffs consisting of a 25% tariff on steel and 10% tariff on aluminium imports. The European Commission confirmed that they would look to impose rebalancing measures and take any necessary steps to protect the EU market from trade diversion. Further trade tariffs were implemented against China due to alleged intellectual property theft to which the Chinese government vowed to respond with retaliatory measures.

The US Federal Reserve raised interest rates by a further 0.25% over the period marking the 7th interest rate hike from the lowest point. In their most recent statement the central bank acknowledged that the labour market had continued to strengthen and economic activity was rising at a solid rate. Policymakers projected a further two hikes by the end of 2018. US first quarter GDP fell to 2% q/q (annualised) which was revised lower due to weaker than expected personal consumption and business inventories. Inflation rose to 2.8% y/y in May marking the highest rate since February 2012 driven largely by rising fuel and shelter costs. Unemployment fell to 3.8% which was the lowest rate on record since April 2000.

UK equity markets produced significant gains, recovering the losses from the previous quarter. MP's debated and voted on 15 amendments to the EU Withdrawal Bill. They voted to reject an amendment which would have allowed parliament to block a 'no deal' Brexit. The Bank of England maintained interest rates over the quarter although one extra member of the committee voted for a rate rise which brought forward market expectations for the next hike. The central bank commented in their statement that policy tightening would likely be appropriate to lower inflation to its target range. That said, any future interest rate rises would be gradual and limited. UK first quarter GDP fell to 0.2% q/q partially driven by lower business investment. Inflation remained at 2.4% y/y in May and unemployment was unchanged at 4.2%, the lowest rate in over 42 years.

European equity markets ended flat after a period of political volatility and loosening monetary policy. Following months of political deadlock, populist parties the League and Five Star Movement agreed a coalition government in Italy. The coalition announced Giuseppe Conte as the country's next Prime Minister. Initially, the ruling President Mattarella vetoed their choice of finance minister which the coalition later changed. The Spanish Prime Minister Rajoy was forced out of office by a no confidence vote in parliament and Socialist leader Sanchez took over as Prime Minister.

The European Central Bank made no changes to policy but did confirm that they would reduce their quantitative easing program from September to December, at which point it would end. In their statement, they stated interest rates would likely remain unchanged at least through the summer of 2019. European first quarter GDP fell to 0.4% q/q with net trade detracting from overall growth. Inflation rose to 1.9% y/y in May driven predominantly by higher oil prices. Unemployment fell to 8.5%, the lowest rate since December 2008.

Japanese equity markets posted strong returns amid an environment of mixed economic announcements. The Bank of Japan left policy unchanged reiterating that their stance of monetary easing would remain until inflation was sustainably above their target rate. Japanese first quarter GDP fell to -0.2% q/q which was the first contraction recorded since the fourth quarter of 2015. A rise in business spending was more than offset by an unexpected decline in household consumption. Inflation rose to 0.7% y/y in May led by higher costs for food and transport. Unemployment fell to 2.2%, the lowest rate since October 1992. The number of jobs available to each applicant reached its highest level since January 1974.

Emerging market equities suffered losses with foreign capital flows experiencing a sharp reversal. Interest rates were raised across a number of emerging economies including Mexico, Turkey and India with the aim of either supporting the domestic currency or tackling higher inflation. Argentina's central bank raised interest rates for the third time over eight days to 40% in an attempt to support the falling peso currency. The IMF later agreed to provide a $50bn loan over a 3 year period to Argentina to provide financial support and bolster market confidence. China's central bank announced that they would be reducing their reserve requirement ratio (money required to be kept on hand by banks) releasing around $108bn of funds to use the day before US trade tariffs would be implemented on China.

In response to President Trump's sanctions, Iran prepared to restart uranium enrichment, a process key for the production of nuclear energy and weapons. The oil price rose sharply following the announcement on supply concerns. Conversely, South Korea and North Korea agreed a peace treaty to work towards de-nuclearization of the Korean Peninsula after a summit between leaders. This followed over 30 years of North Korean missile tests and over 10 years since a presidents' meeting.

In fixed income markets, bond yields across developed markets changed to largely reflect expectations on interest rates leading to mixed returns. In the UK, yields fell taking account of a large shift earlier in the quarter where a combination of weak economic data and comments from the Governor extended out expectations for rate rises. On the other hand, the US central bank raised interest rates with policymakers expecting two further hikes this year. Bond spreads rose leading to losses which could be interpreted as investors having a preference for the safety of governments rather than corporates. Yields on UK, US and German 10 year bonds ended the quarter at 1.27%, 2.85% and 0.30% 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.

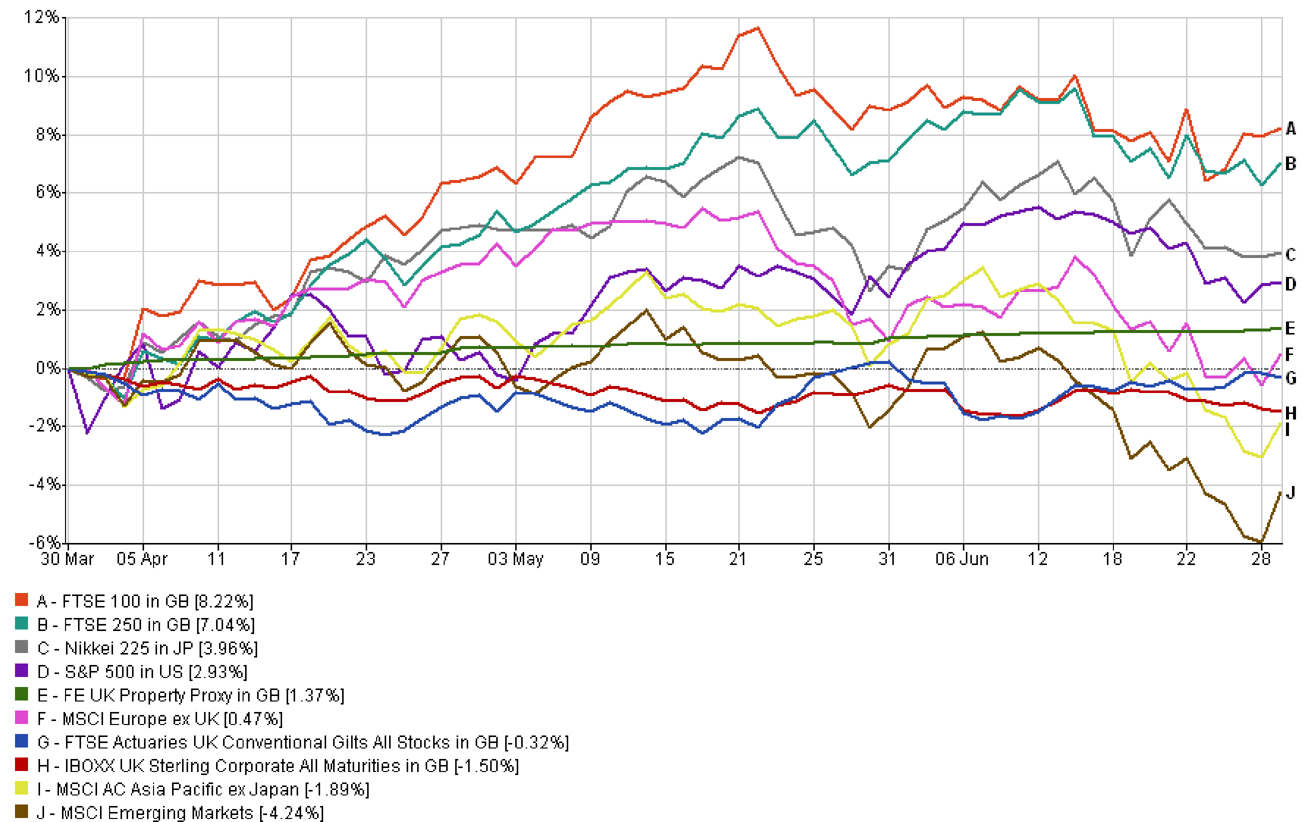
Portfolio Activity

No portfolio changes were made over the quarterly period although the Investment Committee are in the process of reviewing portfolios with changes expected shortly.

Markets

Financial Markets	Index	29/30 Mar 18	29 Jun 18	Change %
UK Government Bonds	FTSE Actuaries UK Conventional Gilts All Stocks	179.53	178.95	-0.32%
UK Corporate Bonds	IBOXX UK Sterling Corporate All Maturities	102.99	101.44	-1.50%
UK Property	FE UK Property Proxy	1,915.50	1,941.73	1.37%
UK Large Cap Equity	FTSE 100	7,056.61	7,636.93	8.22%
UK Mid Cap Equity	FTSE 250	19,460.47	20,830.97	7.04%
US Equity	S&P 500	2,640.87	2,718.37	2.93%
Europe ex-UK Equity	MSCI Europe ex-UK	1,296.77	1,302.84	0.47%
Japan Equity	Nikkei 225	21,454.30	22,304.51	3.96%
Asia ex-Japan Equity	MSCI AC Asia Pacific ex-Japan	604.74	593.29	-1.89%
Emerging Market Equity	MSCI Emerging Markets	61,106.70	58,512.95	-4.24%
Economic Measures		**30 Mar 18**	**29 Jun 18**	**Change %**
Inflation	Retail Price Index*	278.30	280.70	0.86%
Interest Rate	Bank of England Base Rate	0.50%	0.50%	0.00%
ARC Private Client Indices		**30 Mar 18**	**29 Jun 18**	**Change %**
ARC Cautious Private Client Index		179.04	181.00	1.10%
ARC Balanced Asset Private Client Index		208.21	212.59	2.10%
ARC Steady Growth Private Client Index		235.37	243.41	3.41%
ARC Equity Risk Private Client Index		262.26	274.95	4.84%

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



House View

President Trump continued to take a fair share of the financial press over the period with investors fearing a potential global trade war amongst other developments. The period was rife with news of Trump threatening multiple countries with taxes and tariffs which would essentially raise the cost of goods imported from overseas in order to promote the purchase of domestic goods. The trade war has been escalated by these countries responding with retaliatory measures in which case goods become more expensive for all parties and political risk rises.

This has several potential implications for markets. Firstly, as countries increase the rates and/or quantity of goods with tariffs on trade, certain goods are likely to become more expensive which places upward pressure on inflation. Secondly, political tensions increase alongside growing uncertainty. Both of these factors are typically unfavourable for markets. The action and responses to these trade tariffs will inevitably have an economic impact but the ongoing dispute has taken much of the focus away from the shift of monetary tightening under the surface.

Since December 2015 the US central bank has been raising the level of interest rates and from October 2017 embarked on ‘balance sheet normalisation’ which involved a sizable unwinding of its quantitative easing program put in place following the 07/08 financial crisis. The removal of these two support mechanisms will inevitably lower the return outlook and put greater pressure on market volatility. Over the last decade markets have seemingly shrugged off events which once had a material impact on prices, however the removal of this support is likely to mean unfavourable news will have a more prominent reaction among investors in the future.

With regards to our asset allocation views, we maintain our positioning within fixed income. That is a preference for flexible global and strategic bond funds which have the ability to trade tactically in a more challenging backdrop of low/rising interest rates and stimulus withdrawal. Portfolios have an overall low duration and therefore the returns generated from this segment of portfolios will typically have less sensitivity to an environment of rising interest rates in developed markets.

Portfolios continue to hold fair allocation to ‘alternative investments’ with a focus on funds we believe can deliver positive returns irrespective of wider market movements over the medium-term. These provide a high degree of diversification and capital preservation in adverse market events.

The Investment Committee removed exposure to direct UK commercial property ahead of the EU referendum and have since been averse to re-investing largely on liquidity grounds. Property as an asset class provides an array of favourable characteristics such as a typically smooth return profile, strong diversification benefits and an attractive income yield. Liquidity risks however remain higher than pre-Brexit levels and therefore the committee weigh up both factors in their overall investment case.

Within equity markets, the momentum in corporate earnings has been strong in recent years and valuations have reduced slightly. Investors are currently discounting the UK equity market taking into consideration dwindling economic data and Brexit uncertainty. We continue to balance our exposure to the domestic market in a mix of strategies we believe will deliver outperformance over the medium to long-term as well as enhance diversification. The US equity market trades at a premium, but then the economic backdrop is superior when compared to other core developed markets. Taking into consideration higher valuations, monetary tightening and elevated political risks, the committee are comfortable to maintain low exposure to the region.

Emerging equity markets will face downward pressure should the US dollar continue to strengthen as costs rise for many emerging market companies due to borrowing in dollars. That said, market valuations have reduced of late to factor in an element of unfavourable shifts in currency markets.

The longer-term outlook remains intact with factors such as a younger demographic profile and a growing middle class being positive attributes for growth.

Going forwards we do expect more challenging periods over time given the length of the current market cycle and changing dynamics from the world's key central banks. We continue to seek out investment opportunities which can deliver attractive returns within the present backdrop taking account of risk. Diversification remains of key importance ensuring portfolios are not reliant on sole outcomes to generate returns as well as having an element of capital preservation to protect should we experience more turbulent market behaviour.

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4th July 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:

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