Discretionary Portfolio Service

Market Commentary for the Period 1st October 2018 – 31st December 2018

Global equities were negative over the period with China and other emerging markets generally performing better than developed market equities. Rising concerns of a global slowdown, further interest rate hikes, rising geopolitical concerns, and the removal of stimulus from central banks, all contributed to a sell-off for risk assets. The slowdown in China was a key theme in the period as economic growth and a number of other key indicators slowed. Pressure remains on China from the trade dispute with the US and also from a strong dollar. President Trump lost control of the house to the Democrats in the US mid-term elections meaning further fiscal stimulus in the US would be less likely. The Federal Reserve (Fed) continued along its path of raising rates and quantitative tightening which have been a headwind for markets. Fixed income markets were negatively impacted by expectations for interest rates.

US equity markets ended the period in negative territory despite macroeconomic indicators remaining fairly strong. Concerns of the sustainability of US growth started to set in as earnings reports began to disappoint while the Fed continued with monetary tightening. The segment of growth stocks that have driven US markets higher in recent years fell heavily on concerns they would not meet investor expectations following a decline in their outlook. President Trump publicly criticised Jay Powell, the chair of the Fed, stating policy was too tight and that further rate hikes would be a "mistake" threatening the US economy (and by implication the uptrend in US stock markets). There were further developments on the trade war with China at the G20 summit in Buenos Aires in December as President Trump met with General Secretary Xi Jinping. The US agreed to a 90 day deferral in planned tariff increases to allow more constructive negotiations to take place. China outlined its intention to buy a 'very substantial' amount of agriculture, energy and other goods from the US to reduce the trade imbalance. In December, a dispute between Democrats and Trump over funding for a border wall led to a partial US government shutdown.

The Fed hiked interest rates by 0.25% to 2.50% in the quarter despite heavy criticism from President Trump. This was on the back of solid economic growth and a strong labour market. But forecasts for 2019 saw the expectation of two further rate rises rather than the previously estimated three. Quantitative tightening continued in order to reduce the size of the Fed's balance sheet. US third quarter GDP was reported slightly lower at 3.4% with net trade dragging on growth more than initially estimated. Inflation fell to 2.2% y/y in November making it the lowest reading since February. This followed falls in the price of oil and gasoline which offset increases in costs of shelter, used cars and trucks. Unemployment remained at 3.7% in November, a 49-year low.

UK equity markets closed the period in the red with Brexit uncertainty continuing to deter investors. Sterling has remained volatile through Brexit developments and ended the period back to recent lows against the US Dollar. Prime Minister May finally concluded a draft withdrawal agreement with the EU but postponed the House of Commons vote until the New Year as a defeat seemed likely. Dominic Raab resigned from his post as Brexit Secretary citing concern over the regulatory regime proposed

for Northern Ireland and the planned "backstop" arrangement. Tory backbenchers initiated a vote of no confidence in the Prime Minister which she won decisively. At year end, the position was therefore that the Article 50 period expires on 29th March 2019 with May's withdrawal agreement, or an amended version of it, being ratified, or the UK exiting the EU with "no deal". But the UK Parliament had been increasingly vocal in seeking out other possible solutions.

The Bank of England held its rate at 0.75% by unanimous vote in their December meeting. They stated that uncertainty around Brexit had intensified considerably and that the near-term outlook for global growth had softened with inflation expected to fall below the 2% target in coming months, primarily due to the falling oil price. UK third quarter GDP was confirmed at 0.6% q/q. Household spending and exports were the main drivers of growth while business investment had fallen over three consecutive quarters. Inflation fell to 2.3% y/y in November, the lowest rate since March 2017, mainly due to the cost of transport, food and non-alcoholic beverages. Unemployment remained at 4.1% in October, with the number of job vacancies near an all-time high. Average weekly earnings also saw their biggest rise since July 2008.

European equity markets also posted negative returns over the period. France saw the rise of its own populist movement, the "Yellow Vests", protesting against inequality in the country as support for President Macron reached new lows. The European banking sector suffered over the period due to its exposure to emerging markets and further money laundering scandals, with Danske Bank and ING being punished by the regulators. The populist government in Italy proposed an increase in its budget deficit to 2.4% of GDP causing friction with EU authorities. The European Central Bank (ECB) maintained interest rates but confirmed they would commence the reduction of stimulus at their most recent meeting with quantitative easing stopping at the end of 2018. The ECB also highlighted they expect rates to remain at record low levels until at least mid-2019. European third quarter GDP fell to 0.2% q/q due to a negative contribution to external demand, making it the weakest growth rate since Q2 of 2014. Inflation fell to 1.9% y/y due to a broad based price slowdown making it the lowest inflation rate in six months. Unemployment remained at 8.1% in September remaining the lowest jobless rate since late 2008.

Japanese equity markets also declined over the period. The Bank of Japan left its interest rate unchanged at its December meeting and maintained their upbeat view on the domestic economy. Japanese third quarter GDP fell to -0.6% q/q, with natural disasters having weighed on personal consumption and capital investment more than initially estimated. Inflation declined to 0.8% y/y in November due to slower growth in food prices, cost of transport and housing. Unemployment increased slightly in November to 2.5%.

Emerging market equities were mostly negative over the period. The strengthening dollar, concern arising from the ongoing trade dispute between China and the US, and signs of a slowdown taking hold in the Chinese economy, impacted returns over the period. Agreement to talks between US and China in early 2019 raises some hope of progress on resolving trade issues. Brazil outperformed other emerging markets over the period as the market rallied following the election of President Bolsonaro with the Brazilian Real strengthening on the result. Bolsonaro is seen as market friendly given his agenda to simplify taxes, privatise state-owned enterprises and implement pension reform, which should see Brazilian debt decline. Interest rates rose across a number of countries, including Russia and Thailand, which saw rates rise by 0.25% to 7.75% and 1.75% respectively. Mexico saw a greater increase of rates over the quarter of 0.5% to 8.25%

In fixed income markets, bond yields fell for a number of developed economies. This was despite a rate rise from the Fed as fears of a global slowdown and mild inflationary pressures drove safer government bond yields, including US treasuries, down from recent peaks. The US yield curve flattened over the period causing speculation that the US economy may be on a path to recession, although not supported by current data. Italian government bond yields declined from their recent

spike after a climb down by the Italian government in budget deficit discussions. Sterling suffered over the period amidst further disagreement around Brexit, the Dollar maintained its strength and the Euro was volatile around a variety of political issues across the member states, notably France and Italy. Yields on UK, US and German 10 year bonds ended the quarter at 1.21%, 2.69% and 0.18% respectively.

Portfolio Activity

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

The Investment Committee launched two new ethically orientated discretionary portfolios in early October to suit those clients with a higher appetite for risk. These portfolios broadly emulated the existing Balanced Ethical portfolio whilst introducing two new funds to better diversify existing UK and global equity fund exposure. This included the Liontrust Sustainable Future UK Growth fund which is an established fund with a strong long-term track record also demonstrating a clear and robust investment process outside of the traditional screening approach. The WHEB Sustainability fund was also added which adopts a highly active approach orientated around impact investing and therefore looks to make a measurable positive impact alongside generating an attractive investment return.

The original Balanced Ethical portfolio was rebalanced to include the two new funds which also included a marginal decrease in overseas developed market equity exposure and increase in UK and emerging market equities. This was based on divergence in regional returns and greater disparity in market valuations.

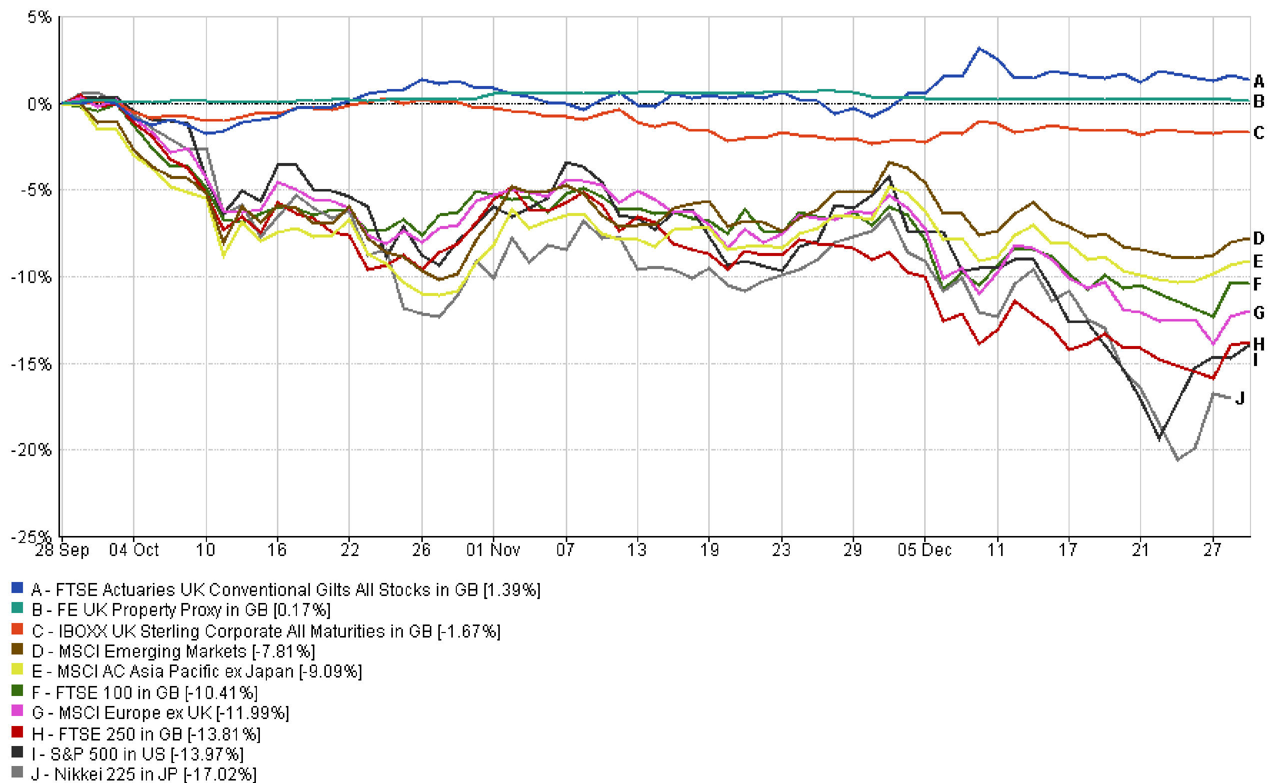
Within the Balanced Income portfolio, positions in the Artemis Income fund were sold largely reflecting capacity concerns, with the size of the fund making it one of the largest in the sector. The Investment Committee felt that the fund’s performance had become increasingly mediocre as its large size constrained its ability to efficiently implement the strategy. The proceeds were invested into the Man GLG UK Income fund which adopts a value-based approach the Investment Committee felt offered a better balance of styles within the overall portfolio. The fund seeks to identify undervalued companies with strong balance sheets representing opportunities for investors. The manager is highly regarded within his particular investment approach known as value investing, having demonstrated long-term outperformance managing similar strategies through his fund management career.

General rebalancing of portfolios was also undertaken where the Committee considered it would be beneficial through marginal reduction in exposure to US equities and topping up of equities in the UK and emerging markets following weakness.

Markets

Financial Markets	Index	28 Sep 18	31 Dec 18	Change %
UK Government Bonds	FTSE Actuaries UK Conventional Gilts All Stocks	174.32	176.74	1.39%
UK Corporate Bonds	IBOXX UK Sterling Corporate All Maturities	100.39	98.72	-1.67%
UK Property	FE UK Property Proxy	1,955.52	1,958.86	0.17%
UK Large Cap Equity	FTSE 100	7,510.20	6,728.13	-10.41%
UK Mid Cap Equity	FTSE 250	20,307.04	17,502.05	-13.81%
US Equity	S&P 500	2,913.98	2,506.85	-13.97%
Europe ex-UK Equity	MSCI Europe ex-UK	1,324.48	1,165.64	-11.99%
Japan Equity	Nikkei 225	24,120.04	20,014.77	-17.02%
Asia ex-Japan Equity	MSCI AC Asia Pacific ex-Japan	583.61	530.56	-9.09%
Emerging Market Equity	MSCI Emerging Markets	57,943.25	53,420.32	-7.81%
Economic Measures		**28 Sep 18**	**31 Dec 18**	**Change %**
Inflation	Retail Price Index*	284.10	284.60	0.18%
Interest Rate	Bank of England Base Rate	0.75%	0.75%	0.00%
ARC Private Client Indices		**28 Sep 18**	**31 Dec 18**	**Change %**
ARC Cautious Private Client Index		182.51	175.84	-3.66%
ARC Balanced Asset Private Client Index		216.63	203.84	-5.90%
ARC Steady Growth Private Client Index		250.49	231.34	-7.64%
ARC Equity Risk Private Client Index		283.47	259.06	-8.61%

[Source: FE] *Values between 14th September 2018 and 19th December 2018 as this is the most recent published data.



28/09/2018 - 31/12/2018 Data from FE 2019

House View

2018 has served as a painful reminder that financial markets do indeed go down as well as up. It has been a year in which conventional portfolio construction strategies designed to deliver returns over the longer term, whilst not suffering the level of falls sustained across nearly all major stock markets, have nonetheless seen significant declines. There have been few places to hide. Of the 37 Investment Association sectors, only 6 ended the year in positive territory with 4 of those by less than 0.5%. The weakness seen in the first quarter was followed by a strong recovery into the summer, but the start of October saw changing financial conditions unsettle markets with the last shoe to drop being US

equities. The S&P 500 posted its worst quarterly return for decades as some of the big tech companies that have led markets up finally sold off from very high valuations. But it still remained among the best performing equity markets across the whole year.

This was all in stark contrast to 2017, a year characterised by exceptionally low levels of price volatility as key equity markets, the US in particular, continued to grind higher with almost no significant interruption along the way. So as we move into 2019, do we view 2018 as a temporary set-back providing a good opportunity to buy into a sustainable global uptrend, or perhaps as more of a harbinger for tougher times ahead? With the tailwind of loose monetary policies (declining interest rates and quantitative easing) that have been supportive of markets in one of the longest economic expansions seemingly now coming to an end, we think the answer is both, for now.

Investors seem to be closing in on the point of maximum pessimism on the key concerns of US monetary tightening, the US/China trade dispute, Brexit, and any positive development in these areas should put markets back on a stable footing. But a worsening in the outlook for global growth, currently seen as a slowdown towards trend levels, remains a longer term concern.

While constitution of individual portfolios will vary according to risk profile, our general approach in light of these challenges remains to seek out and blend strong active fund managers with well thought out and disciplined processes focused on fundamentals that underpin their ability to outperform their sector over the economic cycle. We retain a bias towards value-based rather than growth strategies as we believe this offers a greater margin of safety given the current market backdrop, particularly the still lofty valuations of companies that have led markets up over recent years.

In fixed income, we have limited exposure to the high yield sector and continue to prefer strategic bond funds that can actively adjust their levels of exposure to take account of movements in yields and credit spreads at a time when the forward path of monetary policy remains uncertain in all the major trading blocks. In addition we retain some dedicated exposure to emerging market debt where potential returns better compensate for risk and a macro bond fund offering broadly uncorrelated returns from active management of both bond and currency exposure.

We continue to largely avoid exposure to commercial property preferring infrastructure assets as a means to access strong, inflation protected income streams from assets with greater liquidity and a return profile that is generally complementary to other portfolio assets.

We retain exposure to a range of alternative funds designed to add resilience to portfolios during periods of market weakness whilst also offering the potential for positive returns in their own right over the medium term.

In equities, we remain cautious on the US where markets remain expensive relative to history, notwithstanding a currently robust economy, and we retain broad regional exposure elsewhere, particularly to markets where greater potential is seen over the longer term from current valuation levels.

We do believe greater volatility is now here to stay and stress the importance of investors taking a longer term view through the ups and downs of markets and the noise of a 24/7 media.

Shane Bennett BA (Hons) IMC
Research Analyst

9th January 2019

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
Neil Gore	neilgore@cfmltd.co.uk
Harry Bailey	harrybailey@cfmltd.co.uk

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Cathedral Financial Management Ltd Reg'd Office: Ground Floor, Eagle House, 1 Babbage Way, Exeter Science Park, Exeter, EX5 2FN.
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