James Hambro & Partners

Market Commentary

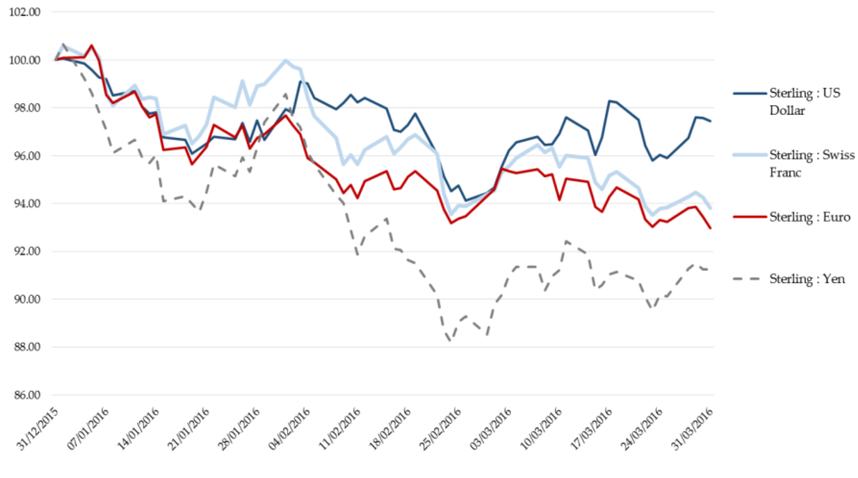
First Quarter 2016

"In saying that we wish to join the EEC, we mean that we desire to become full, whole-hearted and active members of the European Community in its widest sense and go forward with you in the building of a new Europe" (Sir Edward Heath, politician, 1916 - 2005)

Edward Heath was speaking as Prime Minister prior to the 1973 British entry into the European Economic Community (EEC), the forerunner of the present European Union (EU). He was a firm supporter of European membership for the UK. As Lord Privy Seal in Harold Macmillan's Conservative government, Heath was responsible for negotiating Britain's first attempt to join the EEC, ultimately vetoed in 1963 by Charles de Gaulle, the French President. In the intervening decade, Harold Wilson's Labour government had in 1967 lodged the second British application for EEC membership, again vetoed by de Gaulle. The latter's fall from power and Heath's general election victory in 1970 paved the way for British entry into the EEC at the third attempt. None of these European membership applications were preceded by referendums by the electorate, but Wilson's 1974 Labour Party general election manifesto included the pledge to renegotiate Heath's accession terms and hold a consultative referendum. Wilson's return to power led to a tour of European capital cities and extensive talks with his counterparts, after which he claimed a significantly better deal for Britain. Although the ruling Labour government was divided, with ministers campaigning on both sides of the argument, support from the Conservative opposition meant an overwhelming House of Commons' majority in favour of remaining in the EEC. In June 1975, the UK electorate voted 67% 'Yes', to 23% 'No' to the referendum question, 'Do you think the United Kingdom should remain part of the European Community (the Common Market)?'

This all sounds vaguely familiar. David Cameron's 2015 Conservative election manifesto contained a pledge to 'negotiate a new settlement for Britain in the EU' and then hold a referendum on UK membership of the EU based on these new terms. Like Wilson before him, Cameron held discussions with European leaders, before setting a referendum date and recommending that Britain should remain within the EU. A divided cabinet, uncertainty over the June 23rd vote outcome and the economic and political consequences all contributed towards sterling's weakest quarter in over seven years, as shown in figure 1, below.

<u>Figure 1. Sterling's depreciation in the first quarter of 2016</u>

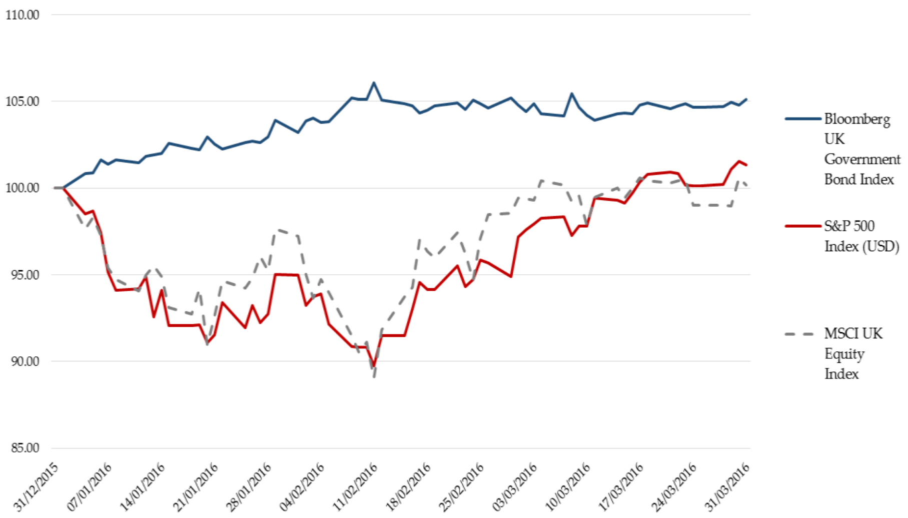


Source: Bloomberg. Past performance is not a reliable indicator of future performance

While the possibility of a British exit (Brexit) from the EU was, and is, likely to continue to be a major cause of domestic market uncertainty in 2016, there were also continued worries of a Chinese economic slowdown, weaker corporate earnings, low inflation and the diverging path of global interest rates to contend with. In January, the price of oil reached an eleven year low before starting to recover and the Dow Jones US equity market index moved by greater than 1%, either up or down, on more trading days than in any other January over the past one hundred years. Equity markets then fell sharply during the early days of February, before investors realised that the US economy is at least stable, after the US Federal Reserve's soothing policy language calmed frayed nerves and the central banks of both Europe and Japan announced further stimulus packages. Figure 2, below, illustrates the wild gyrations within equity markets this year. Although both the UK (dotted line) and US (red line) equity markets had fallen around 11% by the second week of February, they had recovered their 2016 starting values at the end of March. By comparison, UK government bonds (blue line) moved steadily higher, as investors sought out more stable assets and another traditional safe haven, gold, gained more than 19% in sterling terms over the quarter.

Looking ahead, the outlook is likely to remain uncertain, not least because of the EU referendum vote and the US presidential election in November. Market valuations are neither conspicuously expensive nor obviously cheap, particularly after the recent recovery and some 'catch-up' by assets that had underperformed in 2015: emerging markets, Asia Pacific, crude oil and mining shares for example. Bond-like proxies, such as the regulated utility and telecommunications sectors have also performed well, perhaps indicating the nervousness of investor sentiment, but also highlighting the continued attraction of income in a low interest rate environment. Central banks are unwilling to allow the gradual global recovery to falter by raising rates too quickly and we therefore continue to hold financially sound equities, offering good dividend growth prospects, at the core of our portfolios. However, as insurance against a possible deterioration in the economic and political outlook, we have sought to preserve capital by modestly reducing our equity weighting and adding to US treasuries, index-linked bonds, absolute return funds, gold and cash. At present it appears too close to call between the 'Remain' or 'Leave' voting outcome to the question, 'should the United Kingdom remain a member of the European Union or leave the European Union?'

Figure 2. Asset class total returns in the first quarter 2016



Source: Bloomberg

7th April 2016