Market Commentary

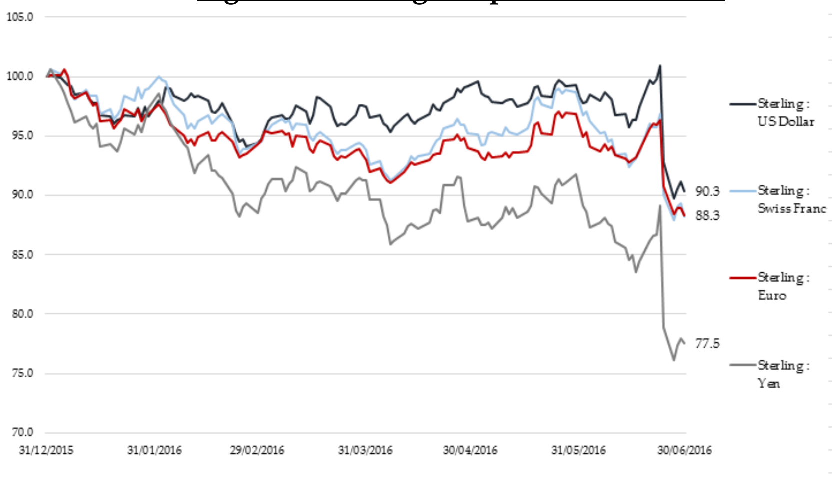
Second Quarter 2016

"We are with Europe, but not of it. We are linked but not comprised. We are interested and associated but not absorbed." "The future of Europe if Britain were to be excluded is black indeed." (Sir Winston Churchill, politician, 1874 -1965)

The first quotation from Winston Churchill is taken from an American newspaper article written in 1930 and the second from a private letter addressed in 1963 to Paul Henri Spaak, one of the founding fathers of the European Union. Churchill was a staunch believer in the Empire and Commonwealth and of close co-operation between the English Speaking Peoples, so the above remarks on Europe should be seen both in that context and of the UK's slowly declining hegemony over the course of the twentieth century. At the outset of the liberation of Europe in 1944, an exasperated Churchill told Charles de Gaulle that if Britain had the choice of either Europe or the open sea, then she should always choose the open sea. De Gaulle subsequently vetoed the UK's first two attempts at entering the European Economic Community, the forerunner of the European Union, before eventually joining in 1973.

While the UK may have historically had a sometimes uneasy relationship with our European neighbours, not helped by the recent economic malaise within many parts of the Eurozone, the 'Leave' referendum result also appears to have been part of a global populist anti-establishment protest. Whatever the reasons, the outcome that a majority were in favour of leaving the European Union was counter-consensus, whether you looked at the ex ante deliberations of market strategists, opinion polls or bookmaker's odds. In the aftermath, financial markets' reactions have been swift to discount the rising political uncertainty and lack of economic visibility. In the week ahead of the vote, the US stock market was near an all-time high and both UK equities and sterling had rallied significantly, as 'Remain' appeared to be the more likely outcome. The immediate panic-driven sale of perceived 'risky' assets was largely indiscriminate, as investors sought out safer havens such as cash, US dollars, government bonds and gold. The pound has fallen sharply; the pre-vote brief rally and subsequent dramatic sell-off against most other major currencies can be seen in figure 1, below. A 'Leave' vote aside, sterling's decline reflects a number of issues: a negative government budget, a large global trading deficit, increased political risk, lower economic growth, interest rate cuts and possible falling foreign direct investment flows.

<u>Figure 1. Sterling's depreciation in 2016</u>



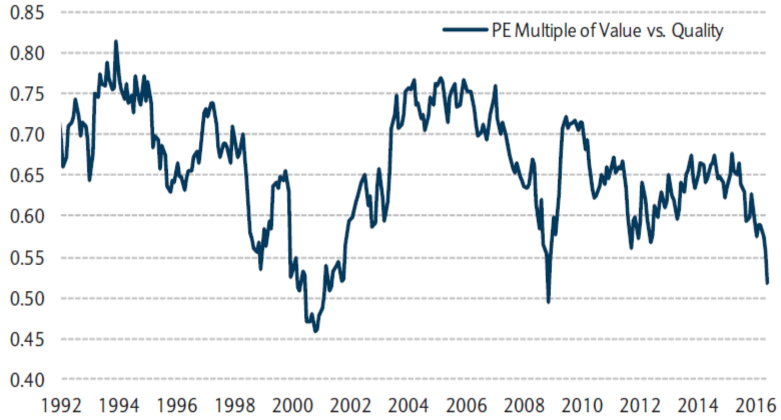
Source: Bloomberg. Past performance is not a reliable indicator of future performance

The corollary of sterling's decline is that international investment assets and UK companies earning a large proportion of their profits in overseas currencies have performed well for a sterling-based investor. For example, while the MSCI World ex UK equity index declined in total return terms by 0.2% in dollars over the first six months of 2016, the same index return in sterling showed a gain of 10.9%. Similarly, the FTSE100 index of leading companies that derives around 70% of earnings outside of the UK gained 6.7% in the first half of this year, compared to the more domestically orientated FTSE250 index, which declined by 5.2% over the same time period. Furthermore, an increase in uncertainty has not only crowded investors towards perceived safer currencies and assets such as gold and government bonds, but also manifested itself in a differentiation within equities towards more defensive sectors with a higher certainty of future earnings, like healthcare and food and drinks manufacturing. An example of this 'price of predictability' in European equities can be demonstrated by figure 2, below. This chart compares the valuations of the highest quartile of 'value' European companies against the top quartile of 'quality' stocks: value stocks are headed towards the cheapest they have been against quality over the past twenty-five years.

We expect the trends mentioned above to persist for some time, as the process of extricating the UK from the EU could be a rather protracted affair and Whitehall is lacking personnel experienced in negotiating bi-lateral trade deals. Recent statements from central bankers have indicated that stimulus policy measures will not only remain supportive, but are likely to become even more so, in order to protect the fragile global economy. Interest rate rises now look to be further postponed into 2017 and markets in the near term appear to have at least stabilised.

For several months now, beginning in the latter half of 2015, we have gradually been reducing risk in portfolios, by increasing cash levels and lowering exposure to more economically sensitive sections of equity markets. There remains a sizeable allocation to more defensive equity holdings, as well as to absolute return funds. We have increased US treasury holdings which, along with the gold allocation, typically perform well in times of heightened uncertainty. Finally, our UK index linked bonds should outperform conventional gilts, if dormant inflationary pressures result from weaker sterling and accommodative policy measures.

Figure 2. 'Quality' stocks have been further re-rated vs 'value' stocks



Source: Barclays Research 7th July 2016

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