KAPSTREAM
A JANUS CAPITAL Group Company

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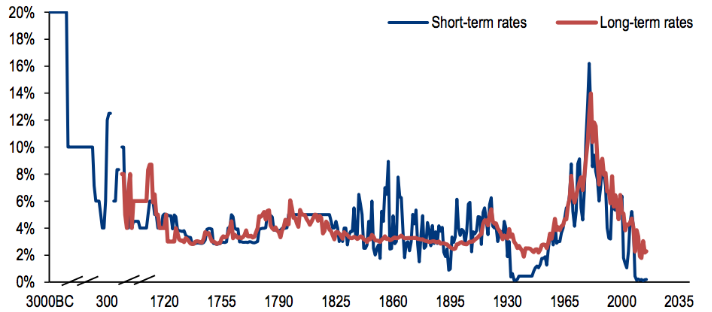
I wouldn't buy a bond with your money!

As the world reaches a *5,000 year* low in global interest rates, value in the bond world continues to deteriorate.

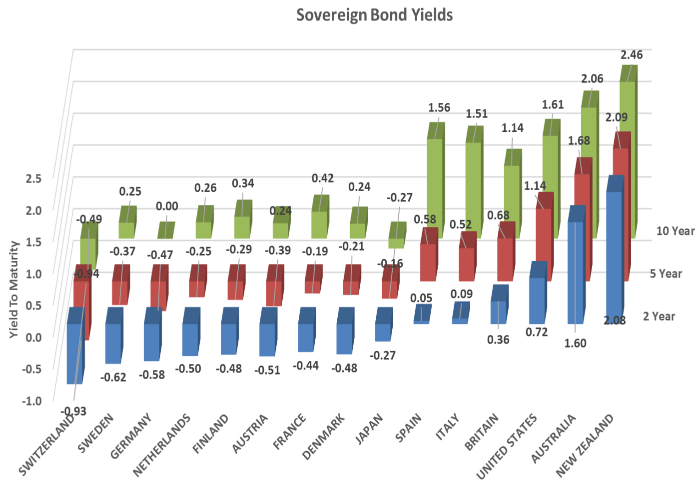


Sources: Bank of England, Global Financial Data, Homer and Sylla 'A History of Interest Rates'
Note: the intervals on the x-axis change through time up to 1700. From 1700 onwards they are annual intervals. Full methodology available upon request

	Year	Rate
Mesopotamia	3000 BC	20%
Babylon, Code of Hammurab	1772 BC	20%
Persian Conquest	539 BC	40%
Greece, Temple at Delos	500 BC	10%
Rome, Twelve Tables	443 BC	8.33%
Athens/Rome Punic Wars	300-200 BC	8%
Rome	1AD	4%
Rome, under Diocletian	300 AD	15%
Byzantine Empire under Constantine	325 AD	12.50%
Byzantine Empire under Justinian	528 AD	8%
Italian cities	1150 AD	20%
Venice	1430 AD	20%
Venice (Leonardo Da Vinci)	1490 AD	6%
Holland	1570 AD	8.13%
England	1700 AD	9.92%
US, West Florida annexed	1810 AD	7.64%
US, circa World War II	1940 AD	1.85%
US, Reagan Administration	1980 AD	15.84%
US, Alan Greenspan, Ben Bernanke	2015AD	0.25%

Today, more than a third of global government bonds trade at negative yields and almost two thirds yield less than 1%[1]. This month, German 10-year government bonds joined Switzerland and Japan in trading at negative yields, guaranteeing investors 10 years of losses!

Even more paradoxically, a handful of corporate issuers (e.g. Nestle) have managed to issue bonds with negative yields, meaning investors are also paying for the privilege of lending corporations money. It appears that many of today's bond investors are more concerned with the return of their money rather than the return on their money.



The expansion of global central bank balance sheets (printing money) in order to purchase debt securities has led to lower rates and lower government and corporate borrowing costs. Monetary policy goals were intended to stimulate corporate borrowing, consumer spending and risk-taking.

In theory, these policies would eventually lead to greater business and consumer activity – as people move into more productive assets and consumption increases. The virtuous circle rationale centred on increased consumption leading to more demand for goods and services, leading to greater corporate profitability. Greater profitability leads to higher share prices and more tax revenue. With increased taxation income, the government pays down debt and the central bank starts to normalise rates – at least that is what is expected – if everybody behaves rationally and as expected! However history shows that this is not always the case…

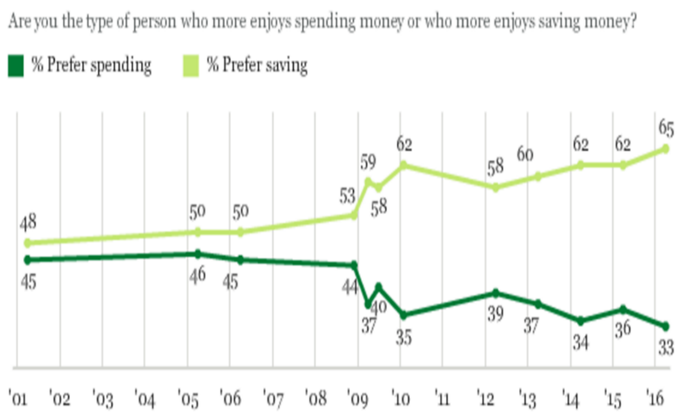
[1]Merrill Lynch Global Government Bond Index

Part of this theory has appeared to work. With such low fixed-income yields, investors have been forced out of some traditional fixed income portfolios into more risk-seeking assets such as equities, high-yield bonds, commodities and other exotic assets in order to deliver much needed returns.

In today's world, there are 4 types of investors who continue to hold government debt:

1. Global central banks
2. Global financial institutions who are forced to hold government debt which regulators deem 'safe' in order to satisfy higher capital requirements
3. Private investors who use fixed income as a traditional hedge in risk-off environments where higher yielding assets perform poorly
4. Private investors who believe things will get worse before they get better, leading to even lower bond yields and negative rates

Somewhat paradoxically quantitative easing hasn't worked entirely as expected; investors have *saved* even more in order to meet their retirement needs in the current low yielding environment. Therefore, consumer spending has yet to reach policymaker goals.



Source: US Gallop Poll, April 2016

It appears to Kapstream that central bank policies of quantitative easing are reaching the end of their effectiveness as consumers now save even more. What is needed now is fiscal policy expansion; run budget deficits, build roads, bridges, rail lines, etc. – invest in productive infrastructure assets for the future.

However, there is little political support for these policies as politicians typically gain support by talking about fiscal *restraint*. We've always thought that government finances were very simple: collect taxes, fees, concessions and other income and spend these receipts on its citizens - welfare, schools, police, defence and infrastructure. In the good years, governments should run budget surpluses and in the lean years run deficits with the long-run goal of a balanced budget. Now is the time to run deficits. But spending should be focused on productive projects.

Switzerland and helicopter money

Switzerland recently voted on the opposite of a productive fiscal project – on whether to provide a universal basic income to all its citizens for life! Free money for the rest of your life and you don't even need to work! The slogan went something like *'what would you do if your income were taken care of?'*

A monthly payment of 2,500 Swiss Francs (A$3,500) would be paid to every citizen, for their whole life, no matter where they live. Is this not an indirect form of quantitative easing – it simply sidesteps the government having to borrow money and redistribute to its citizens via a complicated tax or welfare system. This is indirect lending into the bank accounts of every citizen, in the hope that people will spend it as soon as they see it in their bank accounts. Of course no one has thought about why anybody would want to continue to work! But, that would be tomorrow's problem. The bar is open and drinks are free – worry about the hangover at a later date!

In the end voters rejected this project, believing *"if you pay people to do nothing, they will do nothing"*.

Unsurprisingly, the Greeks have already shown support to such a referendum. Former Greek finance minister Yanis Varoufakis has also leant his support saying *"think of basic income as a foundation, not a net. A floor on which to stand solidly and to be able to reach for the sky."* Who would *not* like free income for no work, especially the citizens of Greece.

Where does Kapstream find value in today's bond markets?

Not in Greece, not in Switzerland, not in Europe or Japan, in general. We continue to favour investment grade credit in Australia, largely due to the attractive real yields and robustness of issuers compared to other developed markets, and continue to have material exposure to Australia, currently at almost two thirds of our portfolio. Favoured sectors remain 1) banking due to attractive yields and greater liquidity, and 2) infrastructure-type assets such as airports and toll roads which offer attractive yields, systemic importance, monopolistic businesses, high regulation and quality underlying collateral.

Globally, we like systemically important, highly rated Asian issuers such as government-related energy, telecom and banking entities and the US 'too-big-to-fail' banks, whose bonds should be supported by an increasingly robust regulatory environment focused on less risk taking and greater capital requirements.

We remain near the top end of our interest-rate duration range at 1 year as we believe global interest rates will remain well contained amidst slower growth and inflation and continuing central bank liquidity. Whilst we believe Australian inflation will remain below the RBA's 2% lower-end target, we expect them to wait for further evidence in 2nd quarter inflation, which will be released toward the end of July. Therefore, in our view potential further cuts would come in August, at the earliest.

We expect to continue to reduce the fund's 'liquidity bucket' of government-related and cash instruments from the current 15% position toward 10% over the coming months, as attractive corporate issuance opportunities continue to emerge. But unlike many bond investors obliged by convention, we will not – as we plough through the depths of this *5,000 year* interest rate lull – lend our clients' money to those whose best offer is a guaranteed loss! Enjoying as we do an unconstrained mandate, we remain focused simply on seeking out the highest quality corporate borrowers wherever they may be, those who still positively value the debt capital provided to them.