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A JANUS CAPITAL Group Company

July 2016

I can't live if living is without EU…
I can't live, bonds can't give anymore…

The Brexit vote

The United Kingdom European Union membership referendum, known within the United Kingdom as the EU referendum and the Brexit referendum, was a non-binding referendum that took place on *Thursday 23 June 2016* in the UK and Gibraltar to gauge support for the country's continued membership in the European Union. The referendum saw 72% of those entitled to vote turn out – over 30 million people. Whilst prior forecasts were close, on balance the expectation leant marginally towards a 'remain' outcome. Instead, unexpectedly, just over half of those that voted – 51.9% – voted to leave the EU. The result was split between the constituent countries of the United Kingdom, with a majority in England and Wales voting to leave, and a majority in Scotland and Northern Ireland, as well as Gibraltar, voting to remain. In order to start the process to leave the EU, which is expected to take several years, the British government will have to invoke Article 50 of the Treaty on European Union, but it has not yet done so.

Membership of the EU and its predecessors had long been a topic of debate in the United Kingdom. The country joined the European Economic Community (EEC, or "Common Market") in 1973. A referendum on continued EEC membership was held in 1975, and was approved by 67% of voters. In accordance with a Conservative Party manifesto commitment, the legal basis for a referendum was established by the UK Parliament through the European Union Referendum Act 2015.

'Britain Stronger in Europe' was the official group campaigning for the UK to remain in the EU, and 'Vote Leave' the official group campaigning for it to leave. Other campaign groups, political parties, businesses, trade unions, newspapers and prominent individuals were also involved, and each side had supporters from across the political spectrum.

Political fall out

David Cameron the UK Prime Minister resigned immediately post the referendum, followed by the resignations of Boris Johnson and Nigel Farage, leader of the anti-EU UKIP party, and both vocal campaigners for 'Vote Leave'. David Cameron was succeeded by Theresa May on July 13, whose early mandate will be to work through a resolution to reflect the will of the people.

But perhaps the true will of the people should not be assumed by the outcome of the referendum. And there is, after all, ample precedence across Europe for ruling parties to override the results of referenda. History is littered with 'will' simply being ignored.

Financial markets

Financial markets reacted negatively to the outcome. Investors in global stock markets lost more than the equivalent of 2 trillion US dollars on 24 June 2016, making it the worst single-day loss in history, in absolute terms. The market losses amounted to 3 trillion US dollars by 27 June. The value of the pound sterling against the US dollar fell to a 31-year low. The UK's and the EU's sovereign debt credit rating was also lowered by Standard & Poor's. However, at the time of writing, equity markets had already shrugged off their earlier losses and returned to growth.

Rise of Geopolitical Risks

The horror of another terrorist attack – this time a truck and gunman killing 80 plus in Nice France - dominates the news and highlights the fragility of life. Markets don't know how to react in such times and that alone makes the disconnect of trading risk almost meaningless to the larger picture of global trouble. France reacted by extending its anti-terror measures another 3 months – this is the 7th attack in 18 months – and so the damage to tourism, domestic spending, EU confidence also continues.

In the last two years alone, 278 people have been killed in attacks by Islamic extremists in several European capitals, including London, Paris and Brussels. Racially aggravated civil unrest appears also to be on the rise. While not exhaustive, here are just some of the violent events of the past 18 months affecting the 'civilised' world:

January 7 2015 – Paris, France – 12 killed, 11 injured
Nov 13 2015 – Paris, France – 137 killed, 368 injured
July 14 2016 – Nice, France - 84 killed, 202 injured
March 22 2016 – Brussels, Belgium – 35 killed, 300 injured
July 7 2016 – 5 police officers shot dead in the US city of Dallas
July 12 2016 – attempted coup in Turkey, many hundreds killed
July 13 2016 – 3 police officers shot dead in the US city of Baton Rouge

Sadly, this is not a complete chronology.

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Political Uncertainty

It is impossible to identify the single factor that has given rise to what feels like much greater political uncertainty. Indeed it is likely due to a confluence of factors – the global portability of religious fanaticism, the developed world struggling to get back onto a more buoyant economic growth footing, increasingly centrist political parties – just to name a few. Usually expected to be rather more the situation across the developing world, a 'changing of the guard' appears to be occurring more frequently in developed economies, with or without the will of the people it seems; an unexpected change of Prime Ministers in the UK (Cameron out, Theresa May in), in Australia Malcolm Turnbull clinging on by his fingertips as Prime Minsister, and on the horizon in the US the impossible to predict outcome between Trump and Clinton. All distracting and obstructive to progress in the near term.

Negative Yields

Recently 10 year German government bond yields went negative. Below is a table of the yields and coupons on benchmark Bunds. There are few things very obvious to investors.

1. **Most coupons are '0'**
   A zero coupon bond means, very simply, that investors don't get paid any interest on their bonds.
2. **Most bond prices are above par**
   On maturity of the bonds investors will get back 100c on the Euro if the German government does not default. But as you will be paying more than par for the bonds today, you are guaranteed to lose money!
3. **All bonds are at negative yield except the 30 year**
   You have to invest your money for the next 30 years at a paltry 0.52% – anything shorter than that you will lose money!
4. **Rising rates = guaranteed loss of principal**
   If interest rates rise all currently held bonds with fixed maturity will lose capital – the longer the maturity the greater the loss. A simple way to think about this is a 1% rise in rates will cause a 5% loss of capital on a 5 year bond, a 10% loss on a 10 year bond and a whopping 30% loss on a 30 year bond!!

German Government Bonds[i]

Tenor	Coupon	Maturity	Price	Yield
3m	0	10/12/2016	100.16	-0.71%
6m	0	01/11/2017	100.30	-0.62%
1yr	0	06/28/2017	100.57	-0.59%
2yr	0	06/15/2018	101.57	-0.65%
5yr	0	04/09/2021	102.64	-0.55%
10yr	0	08/15/2026	104.64	-0.45%
30yr	$2\,^1/_2$	08/15/2046	154.62	0.52%

How to invest in an increasingly uncertain world with zero rates

While the fallout from Brexit will take months if not years to become clear, what is assured is the level of ongoing uncertainty that pervades. Brexit highlights just one example of civil dissatisfaction targeted towards policymakers, but ultimately permeating through financial markets. With more and more sovereign issuers in the developed world paying none, or negative interest, the game is perhaps less about where to invest to make money, and rather more about where to invest not to lose money!

Fortunately there remains ample opportunity for those (like Kapstream) who do not follow conventional issuance-based benchmarks in the way they invest (that force ownership of 'guaranteed loss' type bonds). However no one is under the illusion that we are in anything other than a period of generationally low and relatively lacklustre investment returns that we must all adapt to. For how long is difficult to predict as the world navigates through unprecedented change.

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[i]Source: Bloomberg

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