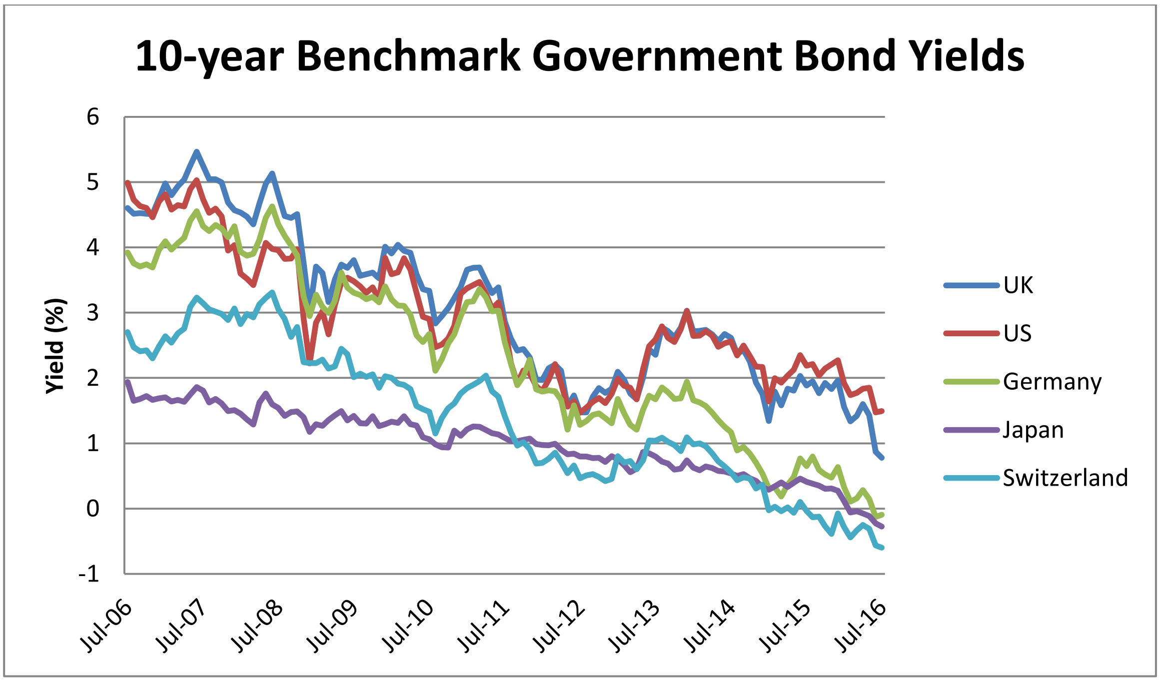
EU Referendum
The impact on Fixed Interest Markets

The first two weeks after the EU vote saw further sharp moves within bond and currency markets driven by the continued fallout from the UK EU referendum. Sterling is now at 1.29 to the dollar, having hit a 31-year low on 5 July. Yields on US treasuries, the benchmark for bonds worldwide, hit record lows out to 30 years duration. The benchmark 10-year bond offers just 1.40% in yield, compared to 2.3% at the beginning of the year and 4% at the end of 2007 before the credit crisis and the onset of extraordinary monetary policy.

UK 10-year gilt yields went below 1% for the first time in history in June and are now at 0.73% (6 July). Extraordinary effects have also been seen in European bonds with peripheral bond yields increasing, for instance 10-year Greek benchmark bonds are yielding 7.7% and for the equivalent Portuguese bonds the yield is 3%. On the other hand the perceived safety of German Bunds was enhanced leading to further price rises and declining yields with the 10-year benchmark bond moving into negative territory once again with a yield of -0.2%.

There is an inverse relationship between the price of a bond and its yield. These historically low yields have all been accompanied by significant price rises for sovereign bonds. The situation was fuelled initially by quantitative easing operations by the major central banks following the credit crisis and has been exacerbated since the referendum by investors seeking the perceived safety of sovereign bonds issued by major developed world borrowers. This is a situation that we find paradoxical when so many bonds are seriously overvalued and are offering either very low or negative yields creating the potential for irrecoverable capital losses. The chart below shows the significant decline in government bond yields for a number of major sovereign issuers between 2006 and 2016.



There is now $11.7 trillion of debt in issue which offers a negative yield, so in effect investors are paying borrowers to hold their money. If held to maturity such debt would also offer a guaranteed capital loss.

For instance, Japanese 10-year government debt has a yield of -0.28% and is priced at 104 Yen, with a maturity value of 100 Yen. Whilst in Switzerland the equivalent bond yield is -0.69% and it is priced at 119 Swiss Francs with a maturity value of 100 Swiss Francs.

The Consumer Prices Index held steady at 0.3% in May. Considering that over a third of the basket of goods used to calculate CPI is imported into the UK and given that the price of imports will increase because sterling has weakened so dramatically following the referendum, inflation is likely to increase in the coming year. This has driven demand for index-linked gilts but we retain our negative view on this debt based on valuation and the fact that some funds investing in these bonds do not pay any yield at present because the real yields on the underlying instruments are currently negative thus causing an insufficient accrual basis for dividend distribution. Due to liability matching requirements for pension and life insurance funds there is still a ready market for this debt, which is an illogical situation when viewed in investment terms.

A significant but often overlooked risk of corporate bonds is their lower levels of liquidity. The fact that companies issue in a variety of currencies, at different coupons and maturities, can hinder an efficient marketplace. For example, Verizon is one of the largest bond issuers in the market with 77 issues outstanding, across three different currencies meaning that substantial analysis would be required to select the best credit on offer for investment. Liquidity has been squeezed in corporate bond markets since the credit crisis and broker dealer inventories of bonds at investment banks have declined as dealers have reduced their balance sheet risks in the wake of regulatory changes and revised solvency requirements. Bond turnover, which is measured as trading volumes divided by outstanding debt, has also declined since 2008. On the other hand record bond issuance has taken place as companies have sought to take advantage of historically low interest rates and bond yields. We continue to have serious concerns regarding liquidity. In the first few hours of trading following the referendum some market makers were unable to price certain corporate bond ETFs in the first few hours of trading, which does not inspire confidence. We recognise that active managers can conduct analysis to identify opportunities within the corporate bond market amongst the many bonds in issue but substantial risks remain due to the untested liquidity of their funds.

Corporate debt in certain industry sectors has been adversely affected by the outcome of the referendum, especially banks, which have also seen large declines in their equity prices. It has become apparent that interest rates are likely to remain low for an extended period of time leaving little room for profit margin expansion and certain banks may also face testing times in an ambiguous political environment. European peripheral banks and subordinated bank debt has been the hardest hit by the UK leave vote and the uncertainty about the future for other members of the European Union that accompanies it. Banks can issue asset-backed securities, senior, subordinated and junior debt, from either the holding company or through an operating subsidiary. This differentiation can hinder liquidity and increases the risks of holding this debt, especially in unsettled markets.

In the two weeks since the referendum the price of supposedly low risk sovereign debt has increased as investors have looked for security at almost any price. We believe these prices are unsustainable and we continue to monitor markets carefully and to have regular meetings with fund managers to inform our views. We will be meeting with a specialist from Invesco Perpetual to discuss fixed interest markets in the next fortnight. We emphasise, however, that at this time we continue to favour equities and cash within our asset allocation.

Georgina Ogilvie-Jones

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