CONCEPT
VERMÖGENSMANAGEMENT

Its not all about the United Kingdom

Mid-year report

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ITS NOT ALL ABOUT THE UNITED KINGDOM

No issue has dominated the newspapers more since 24 June than the Leave! vote delivered by the British people. By striking a blow for freedom, the United Kingdom's voters are daring to conduct an interesting experiment. While the official representatives of the European Union permanently strive to expand the number of member states and never tire of calling for "More Europe!", the UK is looking to again rely on the strength of the sovereign nation and the self-healing powers of freedom.

The exact consequences of the referendum and how it will affect the UK, the EU and global trade remain uncertain in the longer term. There is widespread speculation in this regard and thoroughly reputable authors from various camps provide scenarios ranging from "scary" to "wait and see with a cup of tea". As usual in such situations, bad news reports (or forecasts), in particular, seem to sell well. It would be inappropriate for us to now add yet further analyses to the already existing statements regarding the British nation, the European Union or the actions of the central banks. At the same time, we have to draw our own conclusions in order to be able to derive recommendations from them. Our conclusions based on the current situation are:

The implementation of Brexit is uncertain.

We applaud the courage of the prime minister in putting this question to the general public and we believe the vote of the British people reflects the state of our European Union, which has changed dramatically from being a community of common interests into a community of purpose. But the British seem surprised by their vote themselves; there was a state of shock in British politics during the week after the referendum. It is perhaps understandable that David Cameron did not want to put his signature to an Article 50 declaration. But even the staunchest advocates of an EU exit either disappeared from view or at least recommended that calm was required and that one should not press ahead too quickly. The manoeuvring has begun to determine the cost for both sides of withdrawal or the retention of certain benefits associated with the union. There are signs of worry among the voters about the courageous decision they have made and a number of them want to have the opportunity to review their decision or even submit a vote for the first time. Many young people only realised after the decision had been made that you have to participate in democracy for it to exist. But even advocates of Brexit are disappointed at how quickly the promises of the campaign leaders have been broken. One week after the referendum, 50,000 Britons staged a demonstration in London to support staying in the EU. People want their voices to be heard and it is not impossible that, with new elections, a face-saving gambit may be found in order, with one fell swoop, to put the whole issue up in the air again.

Brexit is expected to affect Europe and the world economy only indirectly.

The UK is the second largest economy in the EU and the fifth largest worldwide. As a result, the door won't just be slammed in the face of Downing Street. Despite some clumsy statements, there is no denying that immediately after the referendum senior government officials across Europe expressed an interest in keeping the distribution paths to and from the UK as unimpaired as possible. Exports to the UK face greater price competition in the event of a weaker pound. However, it may turn out that a balance is achieved due to the reduced personnel costs for manufacturing plants in the UK resulting from the exchange rate.

For the UK, Brexit could act as an economic stimulus program.

Many pundits now expect the UK to experience a recessionary shock and are predicting that the economy will go into a holding mode until the political conditions are clarified. Based on experience, the economic agents will not allow the situation to remain that way for long. As long as a hard exit does not seem imminent - and we presume that such an exit will not happen - the stakeholders in the markets will identify opportunities and ways to maintain flows of goods, services and capital. Beyond Europe, an exit may even result in a more flexible partnership for the UK, for example with the USA, Canada or China, than would be possible within the EU. British goods and services are made cheaper on foreign markets by a pound that is at a 35-year low, which could give a significant boost to foreign trade. The large and very export-oriented public limited companies listed on Britain's FTSE 100 index have coped best with the Brexit decision, and the index is now 5% higher than it was before the referendum. The market participants probably believe that a withdrawal from the EU could also result in opportunities for British companies.

Europe needs to undergo structural change.

As a member of the EU, the UK has traditionally acted as a liberal market economy with a pragmatic approach. The urge to regulate on the part of the commissioners encountered friction in this regard. The British often raised their voices when the collectivisation and harmonisation tendencies went too far for them. The country thus gave the impression of being an uncomfortable partner at times, one which was repeatedly calling for debate. But "We need to talk" was yesterday, and it is now a case of "Do something!". European politics woke up on the morning of Friday 24 June to a fundamental European reality. The nation states are democratically constituted, while it is increasingly the case that the EU is not. Not least during the financial and debt crisis, attempts have repeatedly been made to push through legal standards and regulations without the participation of national parliaments. As if proof of this were needed, the European Commission and its chairman Juncker attempted, just a week after the Brexit vote, to continue in this way regarding the free trade agreement with Canada (Ceta). Many Europeans also have the impression that the influence of their own legislative bodies has been considerably reduced and that ever more laws and regulations are being defined by the EU. In fact, the Distance University of Hagen documented in a report two years ago that, on average, 36% of the laws and regulations passed in the previous legislative period in Germany were initiated by the EU. The fields most subject to EU influence are the environment, agriculture, foreign policy, economy and transport, where the proportion amounts to over 50%. Politically, the need for (even) "more Europe" is often expressed. Given the state of things at the grassroots, this need quite clearly has to be communicated much better, in order to get the general public on board and ensure their support.

MORE POLITICS, LESS CENTRAL BANK!

The idea of unity in Europe is more endangered than ever before.

The euro - once a unifying element for European nations - had its first near-death experience in May 2010. Since then, the patient has been in the palliative care unit. "If the euro fails, Europe fails", stated Chancellor Merkel at that time. Many political stakeholders have apparently decided that the opposite is also true "euro saved, Europe saved". As, although political advisers have stated forcibly and without exception that Europe cannot grow together fiscally without a coordinated economic, financial and tax policy, little has so far been attempted in this regard, and even less achieved. The withdrawal of the UK has now painfully shown that the idea of unity in Europe is more endangered than ever before. In this context, we have often criticised the actions of the European Central Bank, as many of them are not part of its core mission. The ECJ, and more recently the Federal Supreme Court, have now legitimised ECB policy. Judicial decisions that are probably simply to be classified as reflecting the legal framework. Because not everything that is permitted from a legal point of view is also good or, better still, wise. As, with its immeasurable money creation and negative interest rates, the European Central Bank has relieved the pressure on policymakers to sustainably initiate and implement the necessary reforms. The members of the ECB's governing council must have been aware of this. The accusation is even more applicable to the policymakers, who have very quickly made themselves comfortable in the low interest environment, only made reforms half-heartedly and driven debt even higher. A reversal is still urgently required.

ECB expands its bond purchase programme again

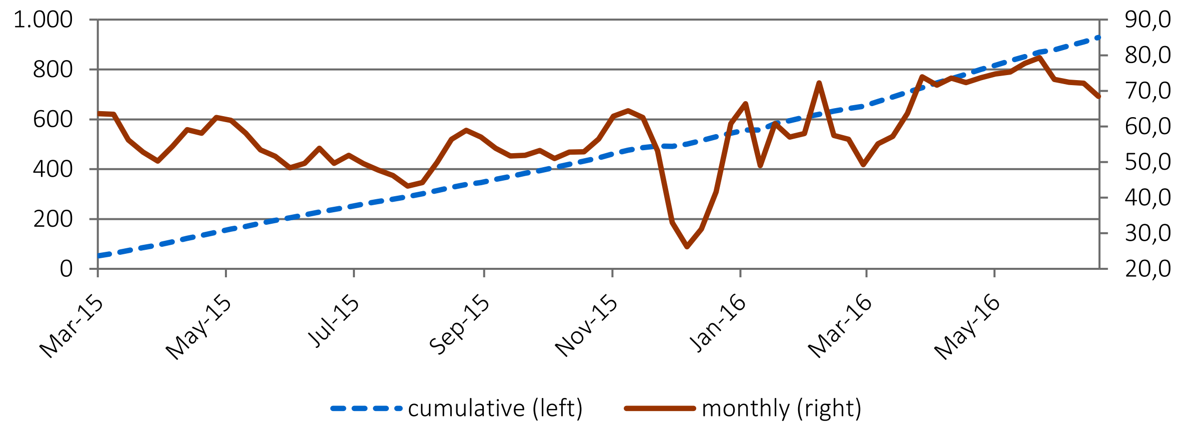

Figure 1 *Source: European Central Bank*

But, based on previous experience, such reform will not be initiated until an increase in interest rates makes the fiscal need obvious.

Meanwhile, the ECB has expanded its monetary policy measures in spite of the fact that the previous measures have had no effect in terms of the associated goal - which is to generate inflation. Based on the motto "the more the better", not only government bonds but also corporate bonds have been purchased since the beginning of June. However, according to a survey initiated by the ECB itself, only 10% of entrepreneurs have financing difficulties, while about a third are more worried about weak demand from their customers. It thus seems like the ECB is once again

It seems that the ECB is exerting its power against the wrong opponent.

exerting its power against the wrong opponent, without having any measurable effect on the real economy. At the same time, the high demand in a single location has resulted in a further drying up of bond markets - with the remaining instruments in which one can invest becoming more expensive and yields continuing to fall in a downward spiral of interest rates. 45% of European government bonds now have negative yields, as do 75% of German bunds and all Swiss government bonds. In terms of new issues, the Swiss Confederation recently issued a bond priced at CHF 103, for which investors will receive CHF 100 back in thirteen years. During this period, not a centime of interest will be paid. Nevertheless, investors are naturally forced to look for profitable investment opportunities. This leads to increasing risk appetite and

Negative interest on many government bonds (in %)

Country \ Term Years	1	2	3	4	5	6	7	8	9	10	15	20	30
Switzerland	-1,03	-1,05	-1,09	-1,04	-0,99	-0,90	-0,84	-0,72	-0,63	-0,58	-0,35	-0,21	-0,07
Japan	-0,31	-0,33	-0,32	-0,34	-0,35	-0,35	-0,35	-0,33	-0,31	-0,25	-0,12	0,04	0,10
Germany	-0,60	-0,65	-0,65	-0,62	-0,55	-0,52	-0,44	-0,36	-0,24	-0,11	-0,04	0,16	0,42
Finland	-0,59	-0,57	-0,56	-0,46	-0,42	-0,30	-0,22	-0,10	-0,01	0,15	0,40	0,47	0,56
Netherlands	-0,60	-0,58	-0,57	-0,55	-0,41	-0,39	-0,28	-0,16	-0,04	0,08	0,17	0,23	0,55
France	-0,55	-0,54	-0,52	-0,46	-0,36	-0,30	-0,20	-0,10	0,05	0,18	0,51	0,76	0,93
UK	0,22	0,16	0,24	0,31	0,38	0,52	0,63	0,75	0,81	0,85	1,36	1,53	1,66
USA	0,42	0,55	0,66	0,78	0,97	1,12	1,24	1,32	1,39	1,43	1,77	1,98	2,22

Figure 2 *Source: Goldman Sachs, 1 July 2016*

distorted pricing, particularly in the bond market, but also on the markets for real estate and stocks. Central banks have a dilemma, as there is no pain-free route of withdrawal. The only question is whether or not we should continue to run at full speed in the wrong direction, despite being aware of this fact.

The Fed is at a loss and is not providing the market with a tangible outlook.

The US Federal Reserve (Fed) recognised the dilemma and tried, with a first rate hike in December last year, to get "ahead of the curve" in order to fully bring the recessionary phase to a close. In step with an improving economy, the bank wanted to raise rates in order to free up sufficient resources to mitigate the next downturn. We note soberly that the experiment has not worked, and further steps in the same direction have been quickly discontinued. Unfortunately, there is now a degree of helplessness, which is in turn reflected in the communications issued by the Fed, which do not provide market participants with a tangible outlook. One thing we can safely assume is that the rate hike implemented in December last year will not be reversed. This would completely erode confidence in the central bank and send a pessimistic prophecy to the economy that could then quickly be self-fulfilling. However, we think that a further rate hike by the Fed is also unlikely. This would increase the divergence between central bank policies even further and potentially weaken the USA's foreign trade, due to the resulting stronger US dollar.

WHAT DIRECTION WILL THE MARKETS TAKE NEXT?

Optimists are rare. But risk tolerance is increasing.

The first months of the year have spectacularly demonstrated the volatile market tendencies. The nail-biting associated with the British referendum has also affected the equity, bond, currency and commodity markets. On 30 June, the Euro Stoxx 50 was down 12%, the DAX was 10% in the red, and Japan and China had dropped more than 15%. Only the US markets remained strong. This is particularly interesting, as the US Federal Reserve was the only central bank that raised interest rates, which is often interpreted as being negative for the stock markets. In an environment of insecurity, the crisis metal made a comeback; the price of gold rose by 20% when calculated in euros. In our previous report, we predicted that market fluctuations would increase. But even we were surprised by the extent of these fluctuations. The VDAX, which measures the volatility of the DAX index, rose to 35 - a level last seen in the summer of 2012 (at that time there was speculation about a Greek exit from the EU and Cyprus hung by a thread). The aforementioned data demonstrates the underlying scepticism among the market participants. Optimistic voices are quite rare, but many investors have been increasing their risk tolerance, quite simply because they have no other choice. But the risks are still quite clear and it seems sensible to be aware of them.

Already in our last issue, we discussed how the economic cycle in the trend-setting USA had come a long way and that it was reasonable to expect a slowdown. On the other hand, no previous upswing has been accompanied by a prolonged period of such low interest rates. Many comparisons with past experiences are thus currently going astray, because there have never previously been similar conditions, there has never been so much debt spread around the globe and never before have interest rates been so low.

Increase in international debt 2000-2008-2015 (as % of the respective gross domestic product)

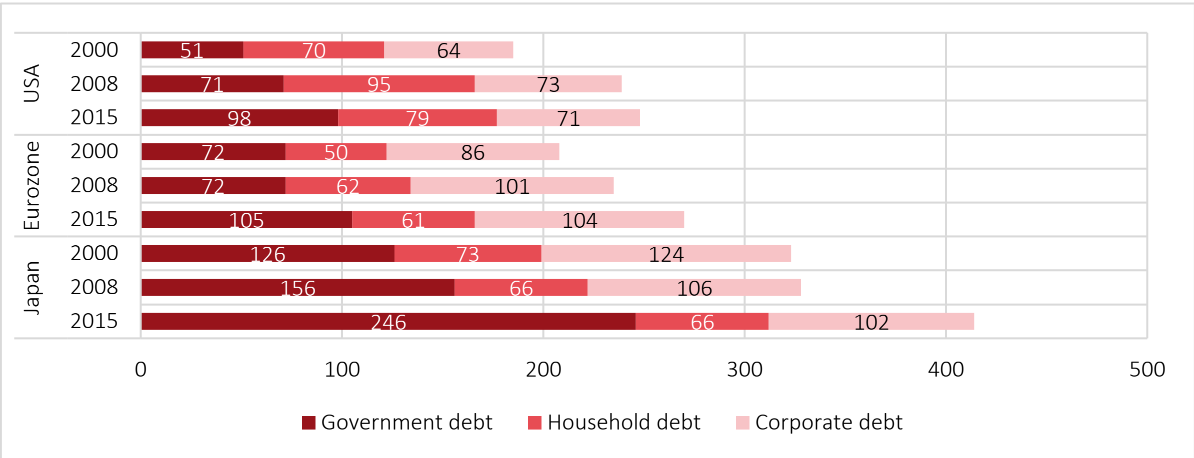

Figure 3 *Source: Bank for International Settlements*

The current hot topics: US election, bank problems in peripheral Europe, the oil market, China, EU, monetary policy, the refugee crisis and terrorism.

This powder keg, which one would like to keep at a sufficient distance from an open flame, is however framed by current hot topics such as the US election, bank problems in peripheral Europe, the oil market, China, the EU situation, monetary policy, the refugee crisis and terrorism. We have already provided detailed opinions on these key aspects in previous issues. So here we add just a few key points: (1) Further tendencies of the US polls towards Donald Trump becoming president are unlikely to calm stock markets, and if he is actually elected they are even less likely to become calm. But at least he is considered pro-business, which is why the stock markets would probably get over this event quite quickly. (2) Italian banks are being discussed again - their 360 billion of bad loans have risen to the surface and the institutes have been requested to raise 180 billion in equity over the next three years. Prime Minister Renzi has, however, already identified loopholes in the EU treaties put together during overnight sessions, which would allow the state to provide assistance. It is also suspected that British banks will struggle with Brexit. The main aspect that currently seems apparent is that their business models will have to be adapted to their impending location outside the EU. (3) The oil price seems to have stabilised at a level around USD 50. Renewed weakness that could be discussed if even more fracking companies return to the market would reignite the emerging markets discussion. (4) China is a perennial issue among the main sources of anxiety on the stock exchanges. Yes, the Chinese growth curve is flattening out. But there is still a huge, centrally controlled and growing (demand) market. (5) The abrasion wounds in the European Union are still open, and scars will remain. But it is essentially policy that is required here. But we do not see any economic distortions that would exacerbate the financial chaos caused by the damage done since the 2010 crisis. Instead, we assume that the rest of the EU, which is dependent on exports to the UK, will make efforts to keep the transfer paths viable. (6) Monetary policy in the EU and in the world as a whole remains a dominant topic for stock exchanges. We think the headlines will be that the Fed will not make any further rate hikes, but will not back-pedal either, while the expansionary monetary policy in the EU and Japan is likely to continue. This divergence will be resolved at some point, although exactly when and in what direction remains unclear. (7) The mismanaged refugee crisis encourages voters to move towards political extremes. But this is more a political challenge than an economic one.

VOLATILITY REMAINS OUR COMPANION

"Risk off", "Risk on" and back again …

The crisis issues are thus well-known and have already been sufficiently "catered for" by the stock markets. But none of them can be marked as being fully dealt with, so one can expect that the mood on the stock markets will continue to alternate, at unpredictable intervals, between "risk on" and "risk off". The main impetus here is likely to continue to be the central banks and their divergent monetary policy, as well as a verbal lead that has so far been missing.

Continuation of the status quo: "Permanently low interest rates"

The short-term fluctuations in the stock markets remain, as has been the case so far, extremely difficult to predict with regard to their timing and duration. If one examines the MSCI Europe since the introduction of the euro on 01.01.1998 regarding the significance of individual days on the total return, we can see that leaving out the ten best days would result in no return at all being achieved. Trying to skilfully go into and out of the market in order to out-perform it is thus very difficult. It seems more appropriate to look at a longer timeline in order to define a sensible medium-term allocation of assets. All in all, we think that a continuation of the current status quo, with "permanently low interest rates" is a very likely scenario. Taking this into account, there is a continued strong case for maintaining investments in material assets. Shares thus still appear attractive for various reasons. The trend towards the digitisation of almost all value-adding processes increases the productivity potential and new (environmental) technologies open up additional business models. Numerous public limited companies are also in good financial shape, which is why quite attractive dividends can be paid. After months of declining profits on the influential American market, the analysts there are predicting significantly increasing net income in the second half of the year. One always has to make allowances for the tendency of analysts to be over-optimistic; however, the negative trend in corporate earnings could at least be interrupted and the economic growth phase could continue. Europe is also growing weakly, but is at least heading upwards. In our opinion, the fundamental framework data is definitely encouraging with regard to equity investments.

However, in the case of bonds, it is difficult or even impossible to achieve returns. This means that there are still numerous investors clearly faced with the need to reallocate their investments, take more risk and also give more consideration to the stock markets. Last but not least, the scepticism that is palpable in the market is a reason for not looking at shares too anxiously. The risks are numerous, but the stakeholders are aware of them. Thus there has not so far been any euphoria in periods of rising prices. This scepticism keeps potential buyers at bay. Such a psychological state in the market is a good prerequisite for attracting more buyers to the market as soon as the mood lightens at any point.

STRATEGY

Invest in a balanced way, hold liquidity to cater for "surprises" ...

Unlike architects, lawyers or scientists, there are no standards determined by the laws of nature that are available to investment advisors and asset managers and on the basis of which market calculations can be carried out. Our profession must restrict itself to identifying potential developments as comprehensively as possible, estimating their probability and formulating the appropriate strategy for an asset management account by taking into consideration the expected reactions of other market participants. Things can always turn out differently than was originally thought, and the sails should be set in a manner that also ensures survival in the case of changes in the weather. In sailing, reefing lines, preventers and similar safety devices help with this. In the world of asset management, a balanced mix with sufficient liquidity at hand to cope with "surprises", diversification across different countries, industry sectors and issuers, and not least a hefty pinch of

... and keep gold as part of the mix.

"crisis currency" can help even out fluctuations in returns to a certain extent. Given the temporary increase in uncertainties, the gold price has increased significantly, and apparently established itself at approximately USD 1,000. The enemy of gold is safe assets with good yields. The range of such options has thinned considerably in recent years. "Safe" has for a long time not really meant safe and returns are virtually non-existent. This speaks for the inclusion of gold, as it at least does not come with any interest costs. Already in the previous report, we had to leave it open regarding how eruptive the fluctuations could be if a number of the admittedly known risks were, however, to surprisingly impact cumulatively. The inclusion of gold remains a good counterweight for guarding against the occurrence of such extreme events.

Bielefeld, July 2016
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