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A Giant victory

Super Bowl XLVI

In what was the most-watched television show in US history[1], the New York Giants defeated the New England Patriots in Super Bowl XLVI by a score of 21-17. At the start of the season, the Giants' odds of winning the Super Bowl were 25-1, similar to our expected probability of European policymakers getting ahead of their growing economic problems.

The ECB comes to the party

Like the New York Giants, European policymakers beat long odds in (at least for the moment) getting ahead of their problems, mainly due to the actions of the European Central Bank (ECB), who finally decided to join the global liquidity party. With one big move, the ECB probably proved the Mayans wrong for 2012.

In December, the ECB conducted its first 3-year long term repurchase operation (LTRO), providing €489 billion in funding to the banking sector at a rate of 1%. And, like a Giants running back walking untouched into the end-zone, this operation allowed banks to finance their high-yielding sovereign debt and collect the spread between sovereign yields and their new 1% borrowing cost. Free money, what a gift!

The ECB also announced plans to continue auctions in late February. Markets now understand the power behind these operations as sovereign yields in Italy, Spain and Ireland fell dramatically. And global risk assets rallied as stock markets around the world gained 4 to 5% in January. Commodity-linked currencies like the Australian dollar, the Canadian Dollar and the New Zealand dollar gained as investors no longer feared capital loss with the ECB providing the liquidity back stop.

In the meantime, policymakers continued implementing other longer-term plans such as The European Financial Stability Fund (EFSF) and the European Stability Mechanism (ESM), which would provide an additional 'firewall' for sovereign debt. But the problem with these programs is their lack of funding. Without leverage and/or more upfront cash the firewall just reverts back to Germany and the higher quality Northern countries. That leads to a larger push for wider involvement by the 27 EU countries, which the UK famously refused in December 2011. Notwithstanding significant challenges, these programs, combined with IMF participation, may lead to a €1.5 trillion firewall fund – another reason for markets to continue their bullish tone.

We at Kapstream have turned more bullish in recent weeks as a result of these events. However, we recognise that significant challenges remain which will cause us to retain a cautious approach in the months ahead. Firstly, historic fiscal constraint in much of Southern Europe will mean severe growth challenges for much of the region. Lower growth will translate into lower tax revenues, higher unemployment, even greater fiscal austerity and moderating corporate profitability. Rating agencies have already begun to reflect these factors into their declining sovereign ratings. Secondly, banking activity will decrease as the banks' main source of funding turns to the ECB. As borrowing costs (away from the ECB) remain at elevated levels, lending activity will decrease further, particularly while sovereign bonds remain an attractive investment. Thirdly, the significant 2012 issuance requirements of European sovereigns make us wonder who will buy this new debt, particularly as ratings downgrades continue. Notwithstanding these significant headwinds, the European situation has dramatically improved and the

[1] While unverifiable, globally an estimated 1 to 4 billion people watched the Opening Ceremonies of the 2008 Summer Olympics in Beijing, FIFA estimated the 2006 World Cup was watched by 715 million people and the Guardian reported the 2011 Cricket World Cup semi-final between India and Pakistan was watched by 1 billion people, none of whom were likely American.

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potential negative impact on global growth has been muted.

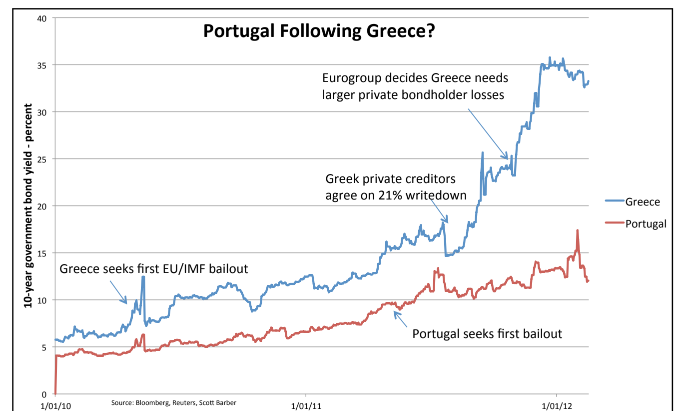
Fitch joined Moody's and Standard and Poors in downgrading more of the eurozone sovereigns.

Country	S&P	Fitch	Moody's
Austria	AA+	AAA	Aaa
Belgium	AA	AA	Aa3
Finland	AAA	AAA	Aaa
France	AA+	AAA	Aaa
Germany	AAA	AAA	AAA
Greece	CC	CCC	Ca
Ireland	BBB+	BBB+	Ba1
Italy	BBB+	A–	A3
Netherlands	AAA	AAA	AAA
Portugal	BB	BB+	Ba3
Spain	A1	A	A3

Source: S&P, Moody's, Fitch, MNI. Red ■ means negative outlook.

Who is still at risk?

While we have become more bullish (or at least less negative) on European recovery, Portugal and Greece continue to be at risk for some form of debt restructuring and/or haircuts on their debt. These events have more or less already been priced into current markets. But the bigger problems of Italy and Spain are solved, at least in the short-run. We believe the markets can easily handle restructurings by Portugal and Greece with minimal contagion impact to the rest of the region.



The US – stronger economic data.

Meanwhile, the US economy continues to show further signs of improvement. While typically a volatile month with considerable seasonable adjustments, in January non-farm payrolls increased by 243,000, confirming the ongoing US recovery. Last year's monthly jobs gains averaged about 160,000/month while the 4th quarter averaged over 200,000 jobs per month. Although at this pace it will still likely take many years to regain the 8+ million job losses incurred in 2008-2009, momentum has moved to the right direction. Other positive data includes, the January ISM manufacturing survey, which increased to 53.9 from 52.7 showing signs of improvement in the manufacturing sector. Confidence in the economy is also improving with the University of Michigan confidence survey which rose to 74 from 69.9 in December. There are also signs of the housing market improving, with existing home sales rising to 4.61m units from 4.42m units in December.

While we expect the US economy to continue its slow recovery, we anticipate the Federal Reserve will keep rates near 0% for the foreseeable future. We anticipate the gradual US recovery to be a net positive contributor to the global growth story and lead to continuing demand for 'risk-on' assets.

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Australia

Australian markets continued to benefit from the global risk on environment as the AUD gained 6% versus the US dollar in January, again moving toward a record high. Australian economic data remained mixed. Housing, retail sales and job growth slowed, partially driven by higher bank funding costs, a higher Australian dollar and a moderate slowdown of the Asian economies. However, the Reserve Bank surprised markets by leaving rates unchanged in February at 4.25%. The market continues to price in additional rate cuts of 50 to 75bps over the next 12 months. We remain pessimistic over the extent of rate cuts markets continue to expect, given the stronger global growth story.

Portfolio implications

1. The ECB LTRO action is a **game changer in the short run**. It takes the pressure off both the daunting 2012 sovereign issuance calendar and the banking sector, who can now collect an attractive spread between their 1% borrowing cost and the 5%+ yields on their sovereign holdings over the next 3 years. Future LTRO actions are only icing on the cake for Europe.
2. With peripheral funding issues contained, Italian and Spanish debt looks more attractive, although we will continue to avoid Europe for the foreseeable future due to higher volatility and more attractive risk/return opportunities elsewhere.
3. With US data remaining positive, we expect to reduce the portfolio's high cash allocations as we seek attractively-priced assets. We intend to maintain positions in the US banking sector, which will continue to benefit from low US short-term rates.
4. Asian corporates remain attractive due to a combination of appealing yields and the continuation of a 'risk-on' global environment.
5. With continuing US recovery and less risk of negative European contagion, we believe the extent of rate cuts priced into Australian markets is unlikely. We will continue to favour floating-rate assets due to more attractive yields in an inverted yield curve environment.

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