May 2012

Blood sport

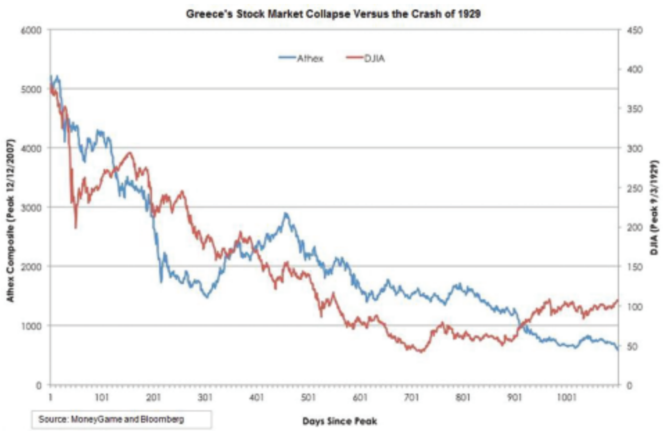
In the final stage of a Spanish bullfight, the matador re-enters the ring with a traditional red cape and sword. While many believe the red cape angers the bull, bulls are in fact colour blind. Just as colour blind as European policymakers' perceptions of the unravelling financial crisis. Like the angry bull facing imminent death, policymakers are oblivious to the likely similar outcome. More recently, financial market matadors have brought Europe toward the final stage, although it has taken nearly three years to get to this point. The piecemeal policymaking approach adopted over the past three years has ignored: 1) the need for federal-level fiscal budget coordination to prevent ballooning deficits in one country being passed onto Euro-wide taxpayers, 2) the requisite federal-level banking insurance required to prevent national bank runs, and 3) necessary stimulus to offset greater fiscal austerity, lower growth, greater unemployment and public backlash. While Portugal, Ireland and Greece were at the forefront of the attack by financial markets over the past few months, Spain is the latest bull to enter the ring.

The recent 100 billion Spanish bank bailout will not be enough. Most market estimates of the true bailout cost are in the 300 to 400+ billion range. And that is just for the banking sector. These costs will ultimately be borne by Germany and Northern European taxpayers. And Europe faces difficult choices ahead: 1) spend trillions of euros and allow the Eurozone break-up, which would likely create large currency appreciation versus peripheral Europe and result in decreasing exports (which account for 40% of German GDP), or 2) spend trillions of euros and create a stabilisation mechanism/fiscal union - give up fiscal sovereignty, coordinate debt issuance and fiscal austerity, federalise taxing authority and federalise bank guarantees, or 3) keep the bull in the final stage of the bullfight until the financial market matadors eventually stick a sword in the plan. Like the bull in the ring, the odds are not good.

We believe option 2, the stabilisation mechanism, is feasible, but requires political agreement, sacrifices and planning. The austerity measures required under any stabilisation plan need much support to aid growth. Infrastructure projects, supported by the World Bank, EIB and other supranationals, similar to the US New Deal during the Great Depression could ease the pain. Additionally, the European Central Bank (ECB) could aid the rescue efforts by reducing rates and conducting another LTRO with even looser collateral requirements. And finally, any restructuring effort needs to reduce the level of debt in the peripherals. A federal level issuer which buys back national debt at levels beyond 60% of GDP, combined with austerity could give financial markets comfort in long-term sustainability and bring private investors back into peripheral bond markets.

However, as policymakers continue to pursue option 3, the European economy shrinks and the bull comes closer to death. But the bull might have a heart attack before he gets the matador's sword. The IMF estimates Spanish growth will fall by 1.8% and its deficit will increase by 6.0% in 2012. Borrowing costs have increased toward unsustainable levels as 10-year government bonds headed over 7.2%, up 1.7% over the past year. Equity markets are down nearly 36% over the past year.

The other peripherals are even worse. Portugal's budget deficit stood at –4.5% of GDP, Ireland at -8.5% and Greece at –7.2%. The IMF expects the Portuguese economy to shrink by 3.3%, Ireland to grow by 0.5% and Greece to shrink by 4.7% in 2012. Over the past 12 months, equity markets fell by 40% in Portugal and 62% in Greece. Irish stock markets bucked the trend and are up about 5.0%. But 10-year Irish government bond rates hit 7.25%, while Portuguese rates reached 11.5%, Greek rates increased to 28%. This risk aversion and flight to quality has aided Germany, as borrowing costs have fallen to historical lows of 1.4% for 10-year German bunds.



The flight-to-quality aided US and Australian government bonds. 10-year US treasuries fell 0.36%, reaching a new low of 1.55%, while the Reserve Bank of Australia cut interest rates by 0.25% to 3.5% (after cutting 0.50% in April). Australian 3 year bonds fell a record 0.80% to a record low of 1.97%. During the Global Financial Crisis (GFC) in 2008 the lowest yield on Australian 3 year bonds was 2.97%. The market now expects the Reserve Bank's cash rate to be well below the previous low of 3.0% during the GFC.

Effects of European crisis on the US

Unlike Europe, the US economy continues to be on the mend although data remains mixed. Nonfarm payrolls for the month of May rose by 160k with the unemployment rate rising to 8.2%. Annualised inflation remained steady at 2.3%, but retail sales grew at an anaemic 0.1% over May. Housing starts improved slightly, increasing 2.6% mom after falling 5.8% the previous month. Existing home sales also rose 3.4% during the month, showing important signs of the housing market starting to bottom out in the US. Federal Reserve Chairman Ben Bernanke also hinted of additional Quantitative Easing during the month, if necessary.

While the biggest risk facing the fragile US recovery remains the events in Europe, a recovering banking sector, stronger consumer and bottoming home prices mean the domestic events have formed the foundation for eventual recovery. A European solution would aid the US recovery, but continued failure will only slow the eventual return to growth.

Australia

Recent data show a resilient Australian Economy. The once in a generation commodity boom has helped Australia avoid the pitfalls facing most European nations and its leaders. The Australian economy grew at 1.3% over the quarter, more than twice market expectations. First quarter annualised growth rose to 4.3%, up from 2.3% in the prior quarter. Job growth remained strong in May at +38,000 against expectations of a 7,000 rise. Retail sales rose at an annualised 1.8%. The RBA continued to lower the cost of borrowing by cutting 0.25% in May after a 0.50% rate cut in April, helping to stimulate the retail and housing sectors.

Implications

The odds of a bull winning in the ring are extremely low and we place the same low probability on European policymakers delivering the necessary reforms over the remainder of the year. We believe markets will continue to gyrate between risk on/risk off in the short term as policymakers continue to kick the can down the road, trying to avoid the matador. Election outcomes, ECB action, federal programs aimed at shoring up the system will remain in the headlines for the remainder of the year. Hopefully, the bull survives another year, but the probabilities are decreasing.

At Kapstream, we continue to be defensive in our allocation given the bi-model outcome of solutions. Our cash position is around 15% of the portfolio, we continue to prefer Australian Bank and Asian corporate debt, prefer floating rate assets to fixed rate bonds as markets are overpricing a very dire resolution to Europe. We expect to keep portfolio duration in the 1 year range, focused in Australia and the US. While we have reduced

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the portfolio's high cash allocations from the highs of 2011, we remain concerned over the deteriorating economic situation and will maintain a moderate risk level. However, we intend to maintain positions in US Banks and Asian corporates given their attractive yields.

We are also looking to position for tail risk events in order to insulate the portfolio should the situation in Europe continue to worsen. We have recently implemented a position to hedge the portfolio against deteriorating credit fundamentals in the European financial sector.

Kapstream Milestones

- Absolute Return fund FUM reaches A$ 1.0billion.
- 5 year track record since inception.
- Total Funds under management A$ 4.5 billion.

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