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KAPSTREAM CAPITAL

Bonds: Back to the future!

With 10-year Japanese government yields at 0.82%, German bunds at 1.45% and US treasury bonds at 1.63%, does it still make sense to continue to hold sovereign debt? Over the past few years, sovereign debt was one of the best performing asset classes, gaining as financial crises and global turmoil led to flights-to-quality to government bonds.

10 year bonds versus equities (annualised returns)	1 Year		3 Years		5 Years		7 Years	
	Bonds	Equities	Bonds	Equities	Bonds	Equities	Bonds	Equities
US Treasuries versus S&P	16.6%	5.4%	8.3%	16.4%	8.2%	0.2%	5.0%	4.1%
German Bunds versus DAX	16.5%	–13.0%	8.0%	10.1%	7.6%	–4.3%	4.1%	4.9%
Japanese bonds versus Nikkei 225	4.8%	–6.4%	3.3%	–1.5%	3.3%	–11.5%	1.6%	–2.1%
Australian bonds versus ASX 200	21.4%	–5.1%	10.2%	7.1%	8.6%	–2.6%	5.8%	5.2%

Over the past three years, equities outperformed bonds in the US and Europe, mainly due to the massive equity recovery beginning in the second quarter of 2009. However, over shorter and longer terms, bonds have done equally as well as equities if not better. But at today's record low bond yields, the biggest question investors face is whether bonds can continue to perform. By our calculations, 10-year US treasuries could only return 14% over the next 12 months if US rates went to 0%, an extremely unlikely event. Similarly, Australian 10-year bonds could return 27% over the next 12 months if rates went to 0%. While we believe these events are unlikely, we have witnessed zero and even negative interest rates in the shorter maturities in both Germany and Switzerland. Bonds may not be nearly as attractive as in the past, but investors still need to hedge against tail events.

While we believe probabilities for 0% rates are low, we think rates will remain lower for longer than markets currently anticipate. And managing fixed-income portfolios will become harder than in the past due to continuing high interest-rate volatility and low current yields. Balancing the long-term negatives for sovereign bond markets: negative real yields, record increases in money supply, deteriorating fiscal fundamentals and political paralysis versus the shorter-term supporters of bond markets: further European turmoil, flights-to-quality, low growth and low inflation is a much tougher job in today's world.

While active duration positions, in theory, are critical in navigating today's investment environment, very few managers have demonstrated the ability to consistently add value through interest-rate positioning over the past few years. This is especially true in Australia where three year bonds have consistently traded below the overnight cash rate. It is hard to lock in your money for three years when overnight cash rates are higher. Hence, managers have been caught being short duration. We believe the optimal way to manage bond portfolios in today's environment is to take small duration positions in shorter maturities, as central banks are extremely unlikely to hike rates over the next few years. Avoiding sovereigns and focusing on shorter-maturity investment-grade corporate issues with strong cash flow and strong collateral will allow investors to capitalise on semi-attractive corporate yields while escaping the eventual losses arising from a rise in sovereign yields.

Kapstream Capital Pty Ltd ABN 19 122 076 117 Level 15, 255 Pitt Street, Sydney NSW 2000 Phone: +61 2 9994 7000 www.kapstream.com

US strategies

In the US, the Federal Reserve has stated that they expect rates to be on hold until 2014. We anticipate they will be on hold much longer and it could very well extend through 2015 or 2016. The Fed will maintain low rates and a relatively steep yield curve as rising yields will stifle any short-term rebound. Plus, the US banking system will continue to benefit from the steep yield curve as banks are able to recapitalise themselves by borrowing at zero and investing at 1-2%. On the corporate side, profitability remains strong, particularly in the banking sector, despite consistently weak-to-moderate housing and jobs data. Short-dated positions in 'too-big-to-fail' banks are a favoured position. The US is on the mend, and while the data of late has been mixed, jobs are being created, housing is looking like it may be rebounding, and corporate balance sheets are in decent shape. However, with job growth in the 100,000 per month range, it will take many years to bring the unemployment rate back toward the 6% level. Hence, a long-term recovery is at least 4 to 5 years away.

Australian strategies

In Australia, sovereign yields have also rallied aggressively. We anticipate that sovereign yields will stay in the 2–4% range for the remainder of the year. While markets had been pricing in a terminal cash rate of 2.5% by this time next year, we believe that the Reserve Bank of Australia (RBA) may cut rates once or at the most twice, barring a global disaster. Following the last rate cut in June, the RBA suggested that there was considerable debate around no cut or a 0.25% cut, whereas half of the economists surveyed predicted a 0.50% cut. Despite our disagreement with how low rates will eventually go, we believe rates will remain depressed for a long period of time. Real rates are still positive, unlike any other developed market, and we expect to see continued international demand for Australian bonds given their credit quality and real yield advantage over other developed markets.

Also worth mentioning is the fact that the target cash rate set by most central banks is losing its relevance as borrowers are unable to borrow at these levels. The real borrowing rate for the Australian economy is a function of where the Big 4 banks borrow money to fund their business. A continuing reliance on overseas funding combined with a still high deposit rates means banks will not always pass rate cuts onto borrowers and will somewhat limit the effectiveness of monetary policy. While this remains a global problem, the Australian economy will remain susceptible given its relatively small depositor base versus funding needs and the larger percentage of loan products tied to short-term rates.

Secular sovereign yields

We do not believe sub-2% sovereign yields are here to stay over the longer time horizon of 4+ years. While Europe has much to do in order to solve their problems, today's sovereign yields are more of a pure risk aversion play as opposed to a secular shift to lower yields. Asian economies are weathering the European storm well. We do not believe that China will have a hard landing, and growth will resume relatively quickly once we can move past Europe. In fact, Asia/Australia will likely be the first region to start hiking rates, similar to the way the RBA first increased rates following the global financial crisis in 2008.

Risks

In the midst of this recent rally, our biggest worry is not that we stay at these low levels for the next secular period, rather we get an environment where yields start rising, hurting bond investor's portfolios. If European policymakers finally solve their short-term liquidity/ solvency problems, markets will eventually focus on the inability of global policymakers to restore fiscal policy to more sustainable levels. Investors will eventually start to demand additional yields as compensation. Investors will do this by increasing the risk premium on the debt of those countries with the worst fiscal positions. This leads to expectations of higher interest rates over the short run as investors start to question the appropriateness of bonds in their portfolios. This problem will be more significant in the US and Europe, but given the massive fall in Australian yields, Australian bond markets are also susceptible to this downturn.

In our view, holding high levels of duration at this time makes less sense than in the past. Unlike equity returns, fixed income returns are finite. The upside is capped and we are at a point where yields are so low that in many cases they have priced in too much economic doom and gloom. Dynamic hedging of duration becomes essential because as yields rise and prices decline, hedging the interest rate risk is necessary to offset any capital losses.

Government and government-related debt now comprise approximately 65–80% of the UBS Composite and Barclays Global Aggregate benchmarks. With fiscal balance sheets poor, investors are now exposed to a great level of sovereign debt and therefore subject to elevated credit risk. In bear markets, a traditional bond fund manager may outperform its benchmark yet still register a negative return. This is because in most cases, managers typically do not deviate largely from the components within the benchmark. Adopting a more absolute return/cash plus approach in this environment is more prudent because the duration and yield curve can be managed more appropriately and managers can freely target investment opportunities and not be restricted by a benchmark.

Portfolio implications

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 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.

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