KAPSTREAM CAPITAL

Chicken Little

In the story of 'Chicken Little', Chicken Little (or Henny Penny) believed the sky was falling after an acorn fell on his head. He ran to tell the king and along the way he gets Ducky Lucky, Goosey Loosey, and Turkey Lurkey to join him. There are various endings to the story, but one popular one has the group running into Foxy Loxy, who leads them straight to her den and eats them. While there are various interpretations of the moral of the story, the most popular relate to not believing everything you're told or mass hysteria is often related to mistaken beliefs.

Recently, both the US Federal Reserve (the Fed) and financial markets having been playing their own game of Chicken Little by continuing to warn of the Fed's imminent removal of its $85 billion/month quantitative easing programme (QE). Much of the global economic growth that has been achieved over the past 5 years has been supported by easy monetary policy and the heavy lifting done by Central banks around the world. This has led to higher home prices, higher equity markets, higher bond markets and generally higher risk assets as the Fed and global central banks encouraged greater risk taking.

But in somewhat of a surprise, the Fed decided against beginning 'tapering' despite preparing the markets for the past few months. Those who bet on rising interest-rates and falling equity markets were led straight into Foxy Loxy's den as equity markets reached new highs and bond yields fell to two-month lows.

We at Kapstream have always believed the road toward the quantitative easing exit was going to be rough and volatile. Federal Reserve Bank of New York president William C. Dudley recently said 'Exit from these unconventional set of policies is certainly feasible – but, we do have to be a bit humble about what we don't know.' He went on to add that the Fed will face 'communications and operational challenges' and 'unexpected consequences' when it eventually begins to unwind the record stimulus. If the last few months were any indicator of those challenges, financial markets are in for a rough ride over the next year. Over the past few months, it's been hard for us to take large interest rate positions (too long or too short) as the information ratio, or risk/return trade-off associated with managing interest-rate risk, has been deemed less attractive than versus other fixed-income strategies. As a result, we have maintained fairly low and stable interest-rate durations of around 0.70 to 0.85 years.

While most indicators point toward a slow, gradual economic recovery, rising bond yields and the associated increase in borrowing costs for the consumer and business threaten the sustainability of the recovery. More recent data has indicated that rising borrowing costs have begun to pull back spending, particularly in the housing sector. Add in the complete breakdown of the legislative process and ability of Congress to fund the ongoing operations of the US government and it was little surprise the Fed continued down its quantitative easing path.

We at Kapstream continue to believe the beginning of tapering of the Fed's quantitative easing program is at least few months away, unlikely to begin in 2013 and probably not in the first half of 2014. And more importantly, the actual rise in Fed short-term rates is at least a few years away. Look for the Fed to temper their tapering message in the near-term.

FOMC: A revolving door?

Another surprise was the withdrawal of leading candidate Larry Summers for consideration as the next Fed chairman. Mr Summers was considered more of a hawk – who would have allowed for a faster unwind of QE. Janet Yellen, who became the new front runner to replace

Ben Bernanke, is considered more of a dove – keeping rates lower for longer, as she worked under previous chairmen Allen Greenspan and Ben Bernanke. With markets now believing in a longer delay in removing tapering, bond yields fell over September and equity markets reached new records.

Debt ceiling: Deja vu

The US debt ceiling debate grabbed headlines again. US Treasury Secretary Jacob Lew reading from the well-prepared and well-worn script decided another letter to Congress may help this time:

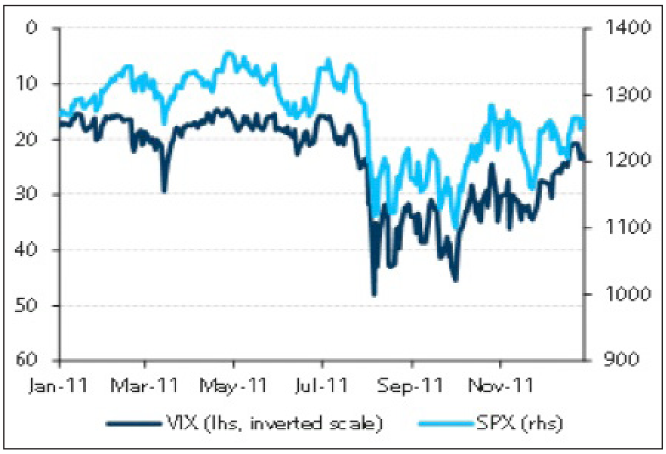
'Since August, we have received quarterly corporate and individual tax receipts and additional information regarding the activities of certain large trust funds, including military retirement trust funds. Treasury now estimates that extraordinary measures will be exhausted no later than October 17. We estimate that, at that point, Treasury would have only approximately $30 billion to meet our country's commitments. This amount would be far short of net expenditures on certain days, which can be as high as $60 billion. If we have insufficient cash on hand, it would be impossible for the United States of America to meet all of its obligations for the first time in our history.' Expect to see this letter again and again over the next few years.

The Congressional Budget Office estimated the government would run out of cash to pay all of its bills between 22 October and 31 October.

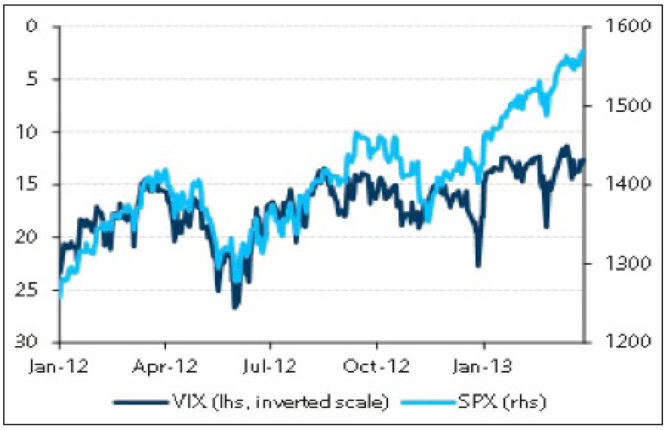
There are two distinct risks in the current budgetary stand-off, and there is historical experience to evaluate both of them. The first is that Congress is unable to agree to fund the Federal government beyond the September 30 fiscal year-end. The second is that an inability to agree on an increase in the statutory debt limit inhibits the US government's ability to service its debt. In the event of a government shutdown, functions of the federal government that are considered 'non-essential' cease, while 'essential' functions continue.

Previous bouts of failure to increase the debt ceiling in 1995/1996 as well as in 2011 caused equity markets to sell off initially and bond yields to fall until it was resolved.

July 2011 – debt ceiling stand-off



Dec 2012 – Fiscal Cliff



Source: Bloomberg, Barclays Research

Investment implications

We remain bearish on the US Congress' ability to overcome the funding and debt ceiling stalemates and come to a long-term budget solution. While the government shutdown has already begun, the real question is how long it will last and whether the imminent debt ceiling challenge leads to an eventual sovereign default. While a temporary solution is probable, we believe the ideological divisions between the Democrats and Republicans ensure this problem will be raised again and again over the next few years. The best markets can hope for is temporary relief, which will eventually come. The only question is how much pain and damage will be done to the US economy as the situation progresses. The worst-case scenario in terms of growth (if there is a long-term shutdown, which isn't very likely), is a detraction of about 1.5% from the 4th quarter growth.

This stalemate will be one of the issues (Europe being the other) which will provide some support for US Treasuries over the 4th quarter. A longer stalemate means 10-year Treasury yields could fall well below 2.5%, perhaps even testing 2% if the situation disintegrates further. We foresee much volatility in the coming months as the market balances the bad news of political impasse versus the good news of US recovery, which looks to be taking shape. However, by 2014 we forecast a measured but steady rise in long-term bond yields (ten year maturities and beyond) as:

- Growth recovers in the US (housing, jobs, and consumer confidence)
- The likelihood of a hard landing in China dissipates
- The market begins to price in a monetary policy 'exit'
- Real yields normalise from alarmingly low levels

We remain on the more dovish side in terms of tapering, the Fed could wait until 2014 and the change of chairmanship, given the predominance of temporary and low-paying jobs in the employment gains, the lack of both inflation, slow consumer credit growth and the current risks of the political impasse in Europe and the US. If the Fed does begin tapering in 2013, we believe it will be on the smaller side, a reduction of something less than $10 to $15 billion/month. Rate hikes remain years away, in our view. We don't believe taking large interest-rate positions are warranted in this environment as the information ratio is low and interest-rate volatility will remain high.

Other reasons for our belief in a cap in government yields is that other global deflationary risks still remain, particularly in Europe. The European Central Bank (ECB) may continue to play lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues, but they will eventually reach their limit. Despite recent (temporary) success in Greece, Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term. The rationale the ECB has used to continue supporting peripheral countries, i.e., promises of fiscal austerity, is quickly deteriorating. We foresee significant European financial shocks over the course of the next 12 months, leading to more volatility for global markets.

In Australia, the Reserve Bank of Australia (RBA) should continue reducing rates closer to year-end, particularly as the currency isn't doing as much of the RBA's work as it had a month ago. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD. The economy is still functioning at below trend in terms of jobs and sentiment. However, the housing market has improved, the labour market isn't doing too poorly, and we've seen a boost in consumer and business confidence following the elections. While equity markets reached new record levels, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures which will put more pressure on the labour market and non-mining domestic growth. The downward pressure on wages has kept disposable income levels extremely low.

While we expect considerable volatility in the coming months, we believe credit markets will continue delivering solid returns. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals still look attractive, the technical surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. We favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets, as floating rate assets will outperform in a secular environment of increasing rates.

Kapstream Capital Pty Ltd ABN 19 122 076 117 Level 7, 39 Martin Place, Sydney NSW 2000 Phone: +61 2 9234 0000 www.kapstream.com

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