KAPSTREAM
A JANUS CAPITAL Group Company

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Chinese (Don) Yuan

One of the many compromises of marriage requires you occasionally to do something you dislike with your spouse. For example, admitting that you're wrong (and they're right) is only slightly higher on the unpleasant list than going to the opera for at least one Kapstream staffer. Not too long ago, the Sydney Opera House staged a performance of Don Giovanni, a Mozart comic opera which tells of a ladies' man/rapist/murderer who seduces a nobleman's daughter and kills the nobleman, but eventually pays the price. At least that's what my wife said happened, and in the great scheme of things it was fair repayment for the countless action movies and Top Gear episodes she has endured over the years.

Mozart's Don Giovanni was based on the legend of Don Juan, the fictional character developed by Spanish dramatist Tirso de Molina. Don Juan manoeuvers through life and women, taking pride in his sinful ways, until his untimely death, when he is denied salvation. The moral of the Don Juan legend is that eventually everyone pays for their sins. Written early in the 17th century, de Molina intended to challenge people who maintained sinning lifestyles in the belief that as long as they repented before death they would still enter heaven.

Chinese Yuan

Earlier this month, the Chinese (Don) Yuan was allowed to float against the US dollar – like Don Juan floated freely amongst the women of his day. On August 11th the Yuan weakened by 2% versus the US dollar, its first major devaluation in over 20 years. The risk of the Yuan causing the destruction of a Don Juan has now moved to centre stage.

The Chinese Central Bank further freed market forces to dictate the level of the Yuan. The Bloomberg chart to the right shows the exchange rate movement between the Chinese Yuan and the US dollar since 2000. The currency has been stable or appreciating vs the US dollar over the past 8 years. In fact since 2010 it has appreciated nearly 12% vs the US dollar. The small upward change at the end of the chart shows the 2% devaluation in August.

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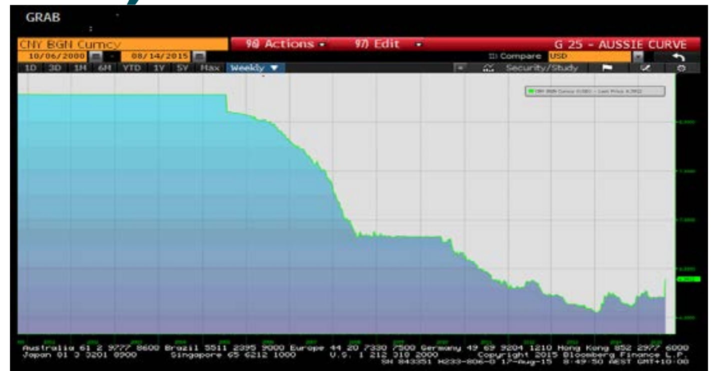
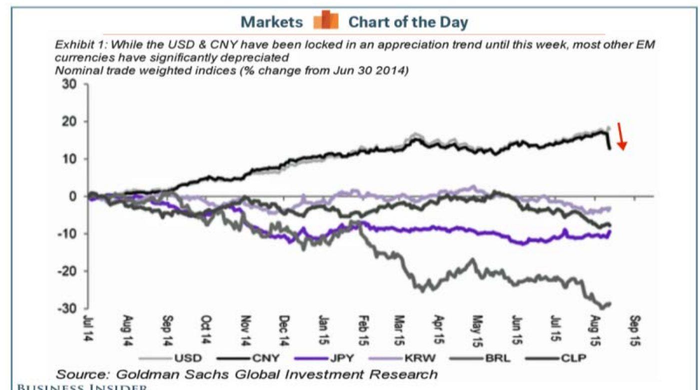


Source: Bloomberg

Much of the world was already playing the same game. Over the past year-and-a-half most emerging market currencies have been depreciating vs. the US dollar. The Business Insider chart below shows countries such as Japan, Korea, and Brazil with weakening currencies vs. the US dollar. But the Yuan was appreciating.



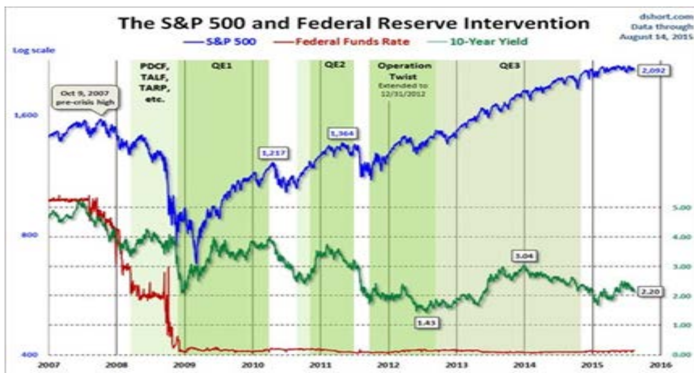
Source: Business Insider

With much of the developing world realising that domestic, consumer led growth was unlikely to remain a large driver of growth, a return to what historically worked was inevitable – export led growth or 'beggar thy neighbour' policy. A key driver for export led growth is a weaker currency. China's growth rate averaged an annualised 9% over the past 20 years, aided by exports as policymakers moved 10 million people into the employment sector annually. With almost half a billion people added to the labour force over the past 50 years, moving people from farming into the manufacturing sector, developing a middle-class and building domestic demand remain key tenets of economic policy. To support a growing middle-class, stable and growing equity markets are a fundamental requirement. Despite the recent 27% correction, Chinese equity markets are still up 45% over the past year.

But social stability remains crucial, particularly as growth slows. With thoughts that domestic demand won't be enough to maintain growth and employment rates, export-led strategies have again moved to the forefront. A weaker Yuan, particularly in the face of weaker Asian currencies, was inevitable and we foresee continuing pressures on the currency.

The Fed

In the US, the Federal Reserve has been hinting at removing the low interest rate environment it has had since December 2008. The chart below shows that equity markets (S&P) have risen nearly 200% since their low in March 2009, while 10 year bond yields have been steady and range bound during this period. US unemployment now stands at 5.3% vs nearly 10% in 2008. US inflation as measured by CPI has also been low at 1.6% during this whole period.



Source: dshort.com

The question for financial markets continues to be that once the Fed decides to 'lift-off' – see last month's newsletter for further reading on this subject – from near zero interest rates, how quickly do they normalise rates and what level of interest rates are considered normal? The answer depends on what the blue line above does – or the expectation from the S&P and the green line which is the US 10 year treasury yield – how much does it rise? We should know the answers in the next few months.

At Kapstream we continue to believe that once the Fed moves away from zero interest rates that future rate rises will be slow and well-advertised. *The Fed does not want to surprise markets*. The current market expectations of nearly 1% higher in rates both in 2016 and 2017 seems reasonable with a terminal Fed Funds rate somewhere between 2.0% and 2.5% by the end of 2017/beginning of 2018.

Australia

Australia's exploits in being a commodity driven economy came to a crashing halt as a fall in commodity prices and a slowing of growth in China caused domestic financial concerns. The government, predicting a return to a budget surplus, had to quickly abandon this for as far as the eye can see, and the central bank sprang into action by cutting interest rates to historical lows – currently at 2%.

The Australian dollar has fallen nearly 35% from its peak (1.10 to the US dollar to 0.73), hopefully aiding the export sector. Unemployment in Australia has steadily climbed over the past few years, currently at 6.1%. The only sector showing any signs of growth – property! Some argue whether we are in a 'bubble' given valuations.

Portfolio positioning

Despite ongoing volatility, at Kapstream we consider that recent major macro risks (Greece, China and the Fed) have dissipated and are mostly behind us, at least in the short run, and consequently, we:

- have a portfolio with very low interest rate risk/duration (in anticipation of eventual rise in rates) – currently 0.8 years;
- continue to prefer holding assets in Australia/Asia and Europe;
- prefer investment grade corporate bonds to sovereign assets;
- hold 50% of our portfolio in fixed rate bonds and the other 50% in floating rate assets;
- have been reducing our liquid bucket from 25% to 20% as we find value.

Capital preservation remains a cornerstone theme in our portfolios and over the near term our focus is firmly on *not losing capital in a rising rate environment*.

Just as the manipulative and self-centred cad Don Juan sought to secure the affections of women, showing little regard for repercussions (but ultimately paying the price), one could draw uneasy parallels with Central bankers seeking to maintain the romance between investors and markets through their own interventionist techniques. Mending or meddling? Only time will tell if their actions are remembered as fiscal successes, or unwarranted manipulation akin to de Molina's fictional lesson in fate.

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