KAPSTREAM CAPITAL

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Closing Time

With the US economy growing at an annualised 4.2% in the 2nd quarter and the unemployment rate falling to 6.1%, debate over prospective changes to the US Federal Reserve's (Fed) forward guidance has increased, although internal consensus still appears elusive. A key dispute centres around the language of the 'considerable time' that rates will remain low following the end of Quantitative Easing (QE), which is included in the statement after every FOMC (Federal Open Market Committee) meeting.

The 'hawks' (governors who want to raise rates quickly) at the Fed worry that leaving rates at zero for a longer period after the ending of QE will only force a steeper set of rate hikes in the future. The hawks are now calling for the removal of the words 'considerable time' from the FOMC statement and for the Fed to start preparing the markets for rate hikes in early 2015 in the US.

The hawks want the Fed to send a message that 'Closing Time' for zero interest-rates is close at hand. Most single people in the late 1990's will remember the band Semisonic's 'Closing Time' lyrics as the final late night signal for a bar closing *"One last call for alcohol so finish your whiskey or beer…".*

The hawks desire a zero rates 'Closing Time' message for financial markets – heralding a return to risk assets having to be valued upon their own fundamental merits, rather than continuing to be incubated or supported by the womb of the Fed's zero interest rates policy. In our view, when this day comes, many risk assets will look less viable for the long-term. We continue to believe you still generally get paid to take the default risk inherent in investment-grade bonds and a little less in high-yield bonds – even though default rates are low – and valuation levels high. The percentage of covenant-light and weaker documentation deals has increased over the years; markets have very short-term memories and today's high yield market is not the same as what it was a few years ago. Tread cautiously!

Nonetheless, The Fed's 'doves' (governors who want lower rates for longer) worry about still significant excess capacity in labour markets, believing the current environment does not reflect significant progress toward the Fed's ultimate goals of full employment and price stability. While August payrolls increased by a disappointing 142,000, the smallest gain in 2014, the unemployment rate fell back to 6.1%. Fed Chairwoman Yellen has recently stated that "underutilisation of labour resources still remains significant" and Boston Fed President Rosengren said that "significant excess capacity remains in labour markets".

If the doves get their way and leave the Fed's current language, risk assets can remain well supported. If the hawks manage to change the existing language risk assets could face a challenging period for returns.

At Kapstream, we remain optimistic on the gradual but slow US recovery story. August payrolls are traditionally volatile and last month's number will likely be revised upward (as people on summer vacation were less likely to answer employment surveys). Nonetheless, a gradual recovery story with little inflation so far, should in the short run allow the Fed to continue its current message of low rates for a 'considerable time'.

We continue to believe the combination of deflationary forces and further central bank support will provide a cap on global bond yields. We are maintaining a 0.75 year interest-rate duration exposure, focused on 2-5 year maturities in Australia and the US, given our expectations for central banks to remain on hold much longer than markets currently anticipate. We foresee a continuing moderate recovery in the global economy over the next 12 months, but expect significant headwinds to continue to challenge economic growth in Europe and in Japan.In our view, a primary reason rates remain low is due to demand from central banks who want to support their exports by selling their own currency and buying US Treasuries. This is bullish for the US dollar and US assets. The real test will be when the Fed's preferred inflation measure, core PCE, gets closer to 2% (it remains at 1.5% now, but up from 1% in February). At that point real money and hedge fund selling may overwhelm foreign central bank buying. But for the foreseeable future foreign central bank buying will continue to remain a dominating force in the market.

In the US, we remain biased toward an eventual rise in global long-term bond yields as:

- Growth continues to slowly recover in the US (housing, jobs, and consumer confidence);
- The likelihood of a hard landing or debt spiral in China dissipates;
- The market prices in a monetary policy 'exit';
- Real yields normalise from alarmingly low levels.

Globally, other global deflationary risks still remain, particularly in Europe. While some Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term, we view this as a 2015-and-beyond problem, given the European Central Bank's (ECB) continuing support. In this environment we favour Peripherals with improving fiscal fundamentals. We have recently sold our Italian and Spanish sovereign bonds and currently focus on Portugal which we expect will remain well supported by the ECB.

In Australia, the Reserve Bank of Australia (RBA) will remain on hold as the weakening Australian dollar has started to support the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower currency. The economy is still functioning at below trend in terms of jobs and sentiment. While the 15% fall in the Australian dollar (from last year's highs) will continue to aid the non-mining and export sectors, these sectors are unlikely to fill the gap created by the fall in mining investment. While overall Asian fundamentals appear fairly solid in both the corporate and sovereign world, a rising rate environment will prove challenging for inflows, similar to the 2nd half of 2013. From a fundamental perspective, sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world. We will remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e. those with deteriorating budgets, current accounts and reserves. India will remain a top Asian story as weaker fundamentals will provide a challenge to maintaining its investment-grade rating. We will continue to favour investment grade corporates in lower-beta (less volatile) countries such as Korea, China, Hong Kong and Singapore. We expect to hold 10% to 15% of the portfolio in this region over the course of 2014.

Summary

Overall, the theme of extremely low global central bank rates and more liquidity will continue in 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the equity and risk market gains of 2013 amidst a steady but moderate growth environment. While we expect continued volatility in the coming months, we believe risk markets will continue delivering reasonable returns, particularly investment-grade credit. You still get paid to take the default risk inherent in investment-grade corporate bonds.

We worry for the future of financial markets when 'Closing Time' is called!