KAPSTREAM CAPITAL

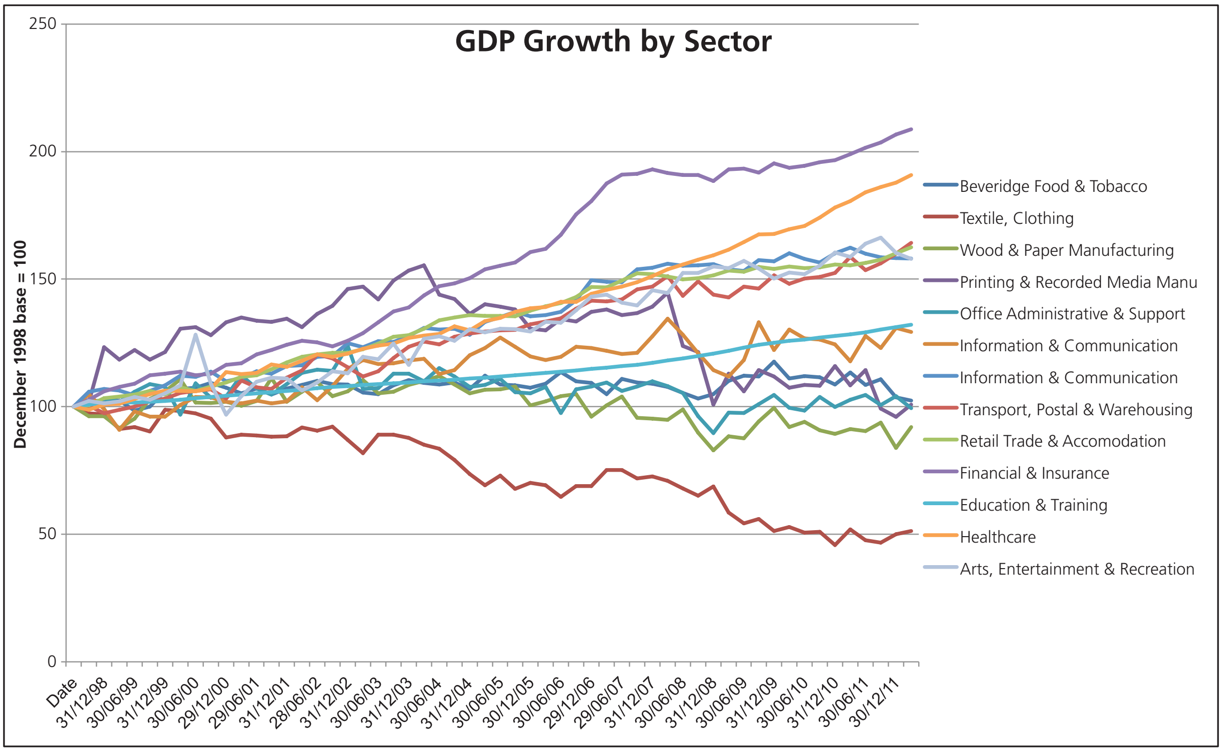
Do you feel lucky?

Over the past few years, we have seen a handful of overseas analyses describing Australia as a region plagued by bubbles and imbalances that will inevitably lead to a financial and economic ruin. Jonathan Tepper of Variant Perception recently penned the latest article entitled 'Australia: Running out of Luck Down Under.' In the article, Tepper argues that the Australian economic growth has been dependent on two huge bubbles: 'a domestic housing market that is one of the most overvalued in the world', and on 'the Chinese fixed investment craze.' Tepper goes on to argue that both of these sources of growth are now coming to an end which will eventually lead to economic ruin.

These arguments have been rehashed by numerous people over the many years. While someday they may be proven correct, as Australia is certainly not impervious to the risks of a global or domestic slowdown, we believe the conditions which allowed for Australia's 20+ year expansion look unlikely to significantly change over the next few years. Most of the arguments made today could have been made 20 years ago. And most importantly, following those arguments would have likely led to poor performance over almost any period. In any case, we again look at some of these arguments in more detail:

1. 'Australia is a classic case of the Dutch Disease'

The argument states that the huge loss of competitiveness in the manufacturing and industrial sectors was due to the crowding out by resource/ commodity boom and the overvalued real exchange rate. Maybe, but while overall the manufacturing sector isn't doing great, it's pretty far from dead:



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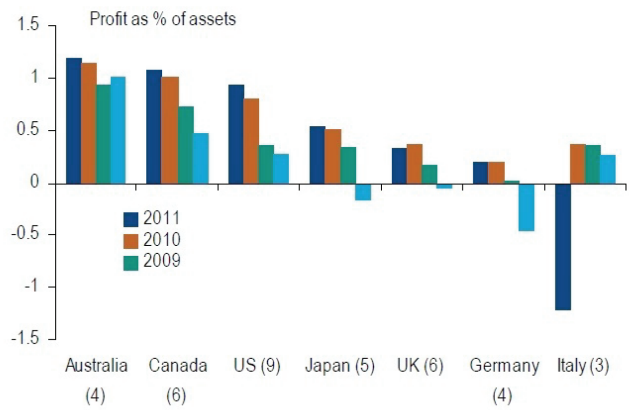
Like most of the developed world, the financial industry's share of growth has increased dramatically and textile/clothing has decreased, but we view these changes as structural in nature and not a reflection of an overvalued exchange rate. Some industries win, some lose. This is not Dutch disease, this is the result of greater global integration. We believe the Aussie manufacturing industry has certainly taken a hit as a result of the strong Aussie dollar, but the data shows it's clearly surviving, having learned how to live with a strong currency.

2. Australia's external debt levels and a China hard landing

The second argument states that Australia's net external debt levels resemble those seen in the 'economic basket case' European periphery in large part due to the foreign funding requirements of both the government and the Big 4 banks. The argument further states that the Reserve Bank of Australia (RBA) will be forced to prop up banks/conduct quantitative easing to stave of financial crisis as China slows. We rarely see significant analysis beyond 'China's structural growth rate is likely to fall significantly in the coming years.' Yes, China cannot grow at 8 to 10% annual growth forever, but it is a stretch to argue that because China will grow at less than 8%, the Australian financial system will collapse due to so much foreign ownership. There is no doubt that a serious slump in China's economy would harm Australia's economy. We view the idea of a hard landing in China as remote given that China is more than willing to undertake further stimulus measures to counteract any significant slowdown. Recent data has shown that this is part of a normal cyclical slowdown, not a sudden slump akin to 2008.

While it may be correct that 80% of new government issuance is bought by foreigners (and foreign ownership can lead to greater market volatility), there is a good reason foreigners buy Australian debt. When one looks around the developed world, Australian bonds make a lot of sense, much more sense than US Treasuries or German Bunds. Australia is the only developed country with positive real yields, a AAA rating and fiscal credibility. Similarly, the Big 4 banks enjoy strong global investor demand: AA credit quality, strong balance sheets, robust domestic operations, little global expansion risks. Australian banks are among the highest rated banks in the world, a theme due in large part to a focus on traditional banking as compared to that of the US and European counterparts, which focused on global expansion. The bulk of the profits attributed to the Australian banks have been a direct result of local lending. In a world where the financial sector continues to deteriorate in credit quality, Australian banks stand out. They are well ahead in implementing capital requirements for the upcoming Basel III regulatory changes, while much of the global banking world either ignores their existence or lobbies policymakers for loopholes. Global bond investors like issuers who face reality and avoid loopholes. Furthermore, Australian banks have listened to the criticisms of ratings agencies and investors and acted to reduce their reliance on overseas borrowings - from a peak of almost 25% of total liabilities in early 2007 to 17.5% as of mid-2012. It is no wonder Australian bank debt retains such strong global demand.

Australian banks profitability versus global peers



Source: Bank for International Settlements (BIS) 82nd Annual Report, June 2012. BofA Merrill Lynch Global Research. Parenthesis indicate number of banks included in the data set for each country.

Oddly, while we disagree with the end-outcome for the Australian economy and financial sector, we agree with Mr. Tepper's recommendation to remain overweight government bonds. We believe global investors will continue to support this market and a slowing global growth story will eventually allow the RBA to continue to cut rates. High real yields will continue to attract global investors.

However, we strongly disagree that investors should buy credit default protection on Australian banks. This is 'The Trade' that global investors who missed the US mortgage market short in 2008 have been looking at for their chance at fame and profit. Since it's almost impossible to short the Australian mortgage market (maybe one of the benefits of a smaller derivatives market), some investors have used credit default swaps on the Big 4 as a surrogate for taking short positions on the Australian mortgage sector. Aside from the negative carry on these high-yielding issuers, strong domestic profitability and a solid loan book have made this a painful position over many years.

3. The Australian housing bubble

Tepper argues that Australian growth has been dependent on a domestic housing market that has benefited from a mining boom and low interest rates. He argues that it is one of the most overvalued housing markets in the world and the bubble is now in the process of deflating.

Australia's residential property market has defied global trends by avoiding the collapse suffered by other countries during the global downturn. To say that housing prices would fall substantially in the event of a hard landing in China simply because that is what happened in other countries with large current account deficits ignores the many differences between Australia and the rest of the world. Australia has strong domestic economy, low unemployment, a growing population and government schemes that have propped up the first homebuyers' market. Additionally:

- Compared to the US, Spain and Ireland, Australia does not have an oversupply of housing. Supply remains limited.
- The majority of household debt is owed by individuals in the top 40% of income distribution.
- Home ownership has not increased over the past twenty years.
- Over 90% of the Australian mortgages are on variable rates meaning that any easing in Central bank policy is immediately passed on to homeowners, lessening the likelihood of a default.
- Loan to value ratios are in the 65% range and new home loans typically require 20% to 30% down.
- Housing repossessions remain extremely low, with 99% of bank held mortgages continuing to be fully serviced in the post 2008 period.

RBA Governor Glenn Stevens also weighed in on the housing market bubble by noting '… it has been said that the housing market bubble, if that's what it is, seems to be taking quite a long time to pop – if that's what it is going to do. The ingredients we would look for as signalling an imminent crash seems, if anything, less in evidence now than five years ago.'

4. The Australian dollar is destined to weaken

This argument usually focuses on a bursting housing bubble, purchasing power parity and a slowing Chinese economy.

We believe a significant slowdown in China would certainly cause the Australian dollar to weaken. However we feel that over the past two to three years, the Australian dollar embodies the characteristics of both safe-haven and high-beta currencies – a relatively unique combination compared with most of its G10, commodity and carry peers. First, the AUD is highly liquid and is one of the most traded currencies in the world. Second, Australia's debt-to-GDP ratio is about 30%, much lower than the G10 average of approximately 110%. Forecasts suggest a 2013 government deficit of just 0.1% of GDP compared with an average deficit in the G10 of 3.4% of GDP. Third, as mentioned previously, the AAA rated sovereign universe has shrunk significantly over the past two years. The risk is that it shrinks further, given that Moody's and/or S&P have a negative outlook on Finland, Germany, Luxembourg, the Netherlands and the UK. If these countries were downgraded by either of these rating agencies the stock of AAA rated government debt would shrink by about USD6.1trn, increasing Australia's share of global AAA rated government debt to about 17.4% from 5.1% currently. Lastly, Australia benefits from a large interest rate differential compared to other developed nations, allowing investors to capture significant carry. While the Australian dollar is sensitive to cyclical global growth risks and commodity price movements, demand for the AUD is likely to remain strong given Australia's safe-haven characteristics, coupled with high yields.

Kapstream global outlook and strategy

Economic data out of Australia has been weaker than previous quarters. Iron ore prices have fallen nearly 50% from their peak and many mining companies have either abandoned projects and or announced layoffs in anticipation of a slowdown in consumption of commodities from China.

We believe this cyclical slowdown is part of the normal business cycle and that the secular uptrend in China and India in modernising their economies will continue. We think it is too early to call an end to the commodity boom for Australia. Asian economies have learned many lessons from the past. Asia continues to develop a middle-class consumer, bringing people out of the agricultural sector into the manufacturing sector and has done much in insulating itself from the cyclicality of the developed world. As we look around the world, Asia still looks attractive relative to the developed world.

In the developed world, we expect more stimulus from the US Federal Reserve and the European Central Bank (ECB). We believe that the US Fed, ECB, Bank of Japan and Bank of England will leave rates near 0 for the next few years. We would even venture out to say that most of hese central banks will not even contemplate a rate hike until well after 2015 and possibly 2016.

The RBA however is in a different camp and is a little harder to predict.

With corporate balance sheets improving and Central Banks likely to remain on hold for the foreseeable future, we believe the recent rally can continue. Much of the tail risks have been priced out of Europe and the US giving investors' confidence that the Central Bank 'put' is in place. In core fixed income, we believe 'carry is king'. We expect to buy assets with a very low probability of default and the safest risk adjusted spread. We intend to hold short-dated bonds, but will hedge some of the interest rate risk as the markets eventually anticipate higher rates as.

We have reduced our cash exposure in our absolute return funds from 15% to 5% as we find value in owning the debt of the big 4 banks and some US financials. We continue to prefer to hold bulk of our assets in Australia/Asia with over 75% of our allocation to the region. We have increased our exposure to Asset Backed and Mortgage Backed securities in Australia to 15% while our BBB and financial exposure remains at 25% and 35% respectively. Our favourite trade continues to be a allocating a small portion of our risk budget to the Tier 1 paper of the big 4 banks.

The duration of our overall portfolio continues to be conservatively around 1.0 year – we continue to avoid Europe and its banking sector as we expect the situation to get worse before it gets better.

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