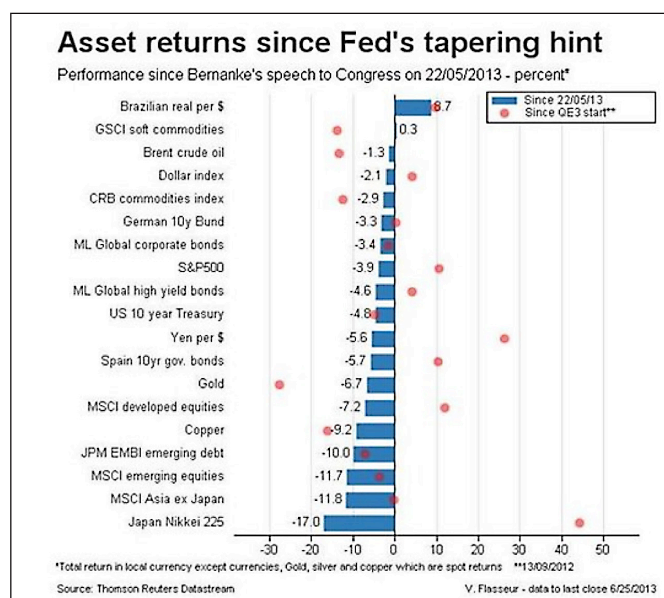
KAPSTREAM CAPITAL

Feral hogs

June 2013 was an ugly month for most asset classes. Ben Bernanke signalled that the Federal Reserve (Fed) might begin reducing its $85 billion monthly bond purchases before the end of the year if economic recovery continues at a reasonable pace. The markets took this to mean that the Fed would end its quantitative easing (QE) program sooner than anticipated and drove up US 10 year treasuries to 2.6%, the highest level since August 2011. This translated into a loss of nearly 5% in US government bonds. As the chart below depicts, since Bernanke's speech to Congress on 22 May 2013 where he hinted at the possibility of tapering, virtually all assets posted negative returns. The S&P500 has fallen 3.9%, gold is down 6.7%, and the Nikkei has fallen 17%.

Most troubling to bond investors has been the sharp rise in global interest rates, fuelling losses in an asset class that has been accustomed to a one way street of consistent, positive returns. Many are calling for a sea change in the debt space, where rising interest rates will lead to massive outflows in fixed income. To put this in perspective, analysts estimate that in the month of June, bond mutual funds were hit with outflows exceeding $60 billion. Yet according to Investment Company Institute, these outflows have not been particularly large, as there is over $3.8 trillion invested in bond funds (less than 2%). Furthermore, they argue that the recent outflows are in line with previous periods of sharply rising interest rate periods.

Are the redemptions in June foreshadowing what is in store for fixed income managers once the Fed winds back its monthly purchases? Yes and no. In order to comply with Dodd – Frank in the U.S. as well as capital standards set by the Bank of International Settlements, financial institutions will need to buy nearly $6 billion in safe assets (including government bonds) by 2020. As yields rise outflows out of bond funds will continue, but it is unlikely that investors will abandon the debt asset class all together. Demand for debt will remain as investors seek out diversification from other asset classes, however that demand will likely come in the form of non-benchmark oriented debt strategies, which aim to shield investors from the losses due to higher yields.



Last call

Richard Fisher, President of the Dallas Federal Reserve, said in an interview with the Financial Times that the Fed had anticipated a lively market reaction to the announcement made by Ben Bernanke, but warned the 'feral hogs' of financial markets against trying to force the Federal Reserve to shelve plans to slow its bond buying. Mr Fisher, a voting member of the FOMC also warned that the markets should not think the Fed would end up propping the economy indefinitely and in so doing, keep inflating asset price bubbles. Mr Fisher went on to add that 'we've had a 30 year bond market rally. These things do not go on forever.'

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While the Fed has yet to commence reducing its purchases, the damage had been done. The feral hogs detected weakness and attacked the markets. But in reality, Fisher is correct. Interest rates were not going to stay this low forever and a normalisation of yields is actually a good thing as the US economy regains its footing. The Fed is not going to eliminate purchases all together, rather they are going to cautiously reduce purchases over an extended period of time. While the month of June was painful to investors, including Kapstream, it is far better to have a little volatility now, then a lot of volatility later.

Fed actions will be dictated by economic data, specifically employment, housing and growth. On the positive side, the US economy has added an average of 189,000 jobs each month in 2013, the fastest pace since 2005. Similarly, the housing market has rebounded with the Case Shiller index revealing an annualized gain of over 10%, suggesting that not only are home prices increasing, but also the recovery is accelerating. Yet as a result of the rise in bond yields, mortgage rates have jumped nearly 1%, which could potentially curb refinancing and future purchases. GDP growth also remains subdued, with 1Q annualised growth printing 1.8%, well below the consensus figure of 2.4%. The question for Fed as they enter QE taper mode will be how sustainable is the recovery? Positive employment figures will all but guarantee the end of QE as we know it, but the fragility of the US economy will dictate the pace of that exit.

What worries us?

As fixed income managers we are paid to worry. While the US economy is on the mend, the third quarter poses a series of threats to markets.

- Affectionately dubbed the BRICs, Brazil, Russia, India and China face similar constraints as the developed world in the form of managing slower growth, fears around inflation, and less scope for monetary and fiscal policy. In China, not only is the economy slowing, but also the cost of borrowing has increased, evident by short-term repo rates hitting 6.85% in June. Meanwhile, the US and Russian relations are getting mildly contentious as the US looks to extradite NSA leaker Snowden.
- European banks will face challenges as interest rates rise. There are fears that these banks, which own a significant amount of sovereign debt, might require additional capital to meet the regulatory requirements. They will also be forced to write down/mark to market the value of their debt holdings if yields continue to sell off.
- Political uncertainty will plague the European region. The unravelling of Mohamed Mursi's government will lead to further instability in Egypt, while Turkey and Brazil remain on high alert as citizens have taken to the street to protest dissatisfaction with their respective government and its policies. Furthermore, Cyprus's sovereign debt has been downgraded to selective default from CCC after the debt exchange and uncertainty in Portugal raises new concerns around debt sustainability.

Australia

On his first day as Australia's leader, newly elected (and former!) Prime Minister Kevin Rudd told parliament on 27 June that the 'China resources boom is over'. He continued by stating that 'the China trade itself represents such a huge slice of the Australian national economy that we are looking at one huge adjustment for this nation's standard of living in the future unless we continue to act with appropriate policy responses.'

As the country heads to elections, it is facing a slowing economy as the resources boom winds down, a weakening labour market, a falling currency and a budget deficit. The Reserve Bank of Australia (RBA), which last cut rates in April has been vocal about wanting a lower currency. Since the recent peak in mid-April the currency has fallen nearly 14% doing much of the RBA's work in terms of relaxing policy. That said, the RBA maintains an

easing bias and is one of the few developed central banks with scope to cut rates further, something they have indicated they will do if required.

Conclusion

The second quarter of 2013 was largely a bust for financial markets. Stocks, bonds and commodities dropped and the idea of a diverse portfolio protecting investors disintegrated with Bernanke's testimony and talk of tapering QE. Rising interest rate environments spell trouble for bonds and carry trades. With the Fed likely to be exiting as the largest supporter of the bond market, yields have only one way to go – up. We expect this rise to be more gradual than the knee jerk reaction of May and June, with the new range in US 10 year Treasuries somewhere between 2.20% to 3% over the next six months. Constructive economic data will translate into increased consumer confidence and consumption, stronger employment, and positive corporate earnings. This will dictate whether the US can handle a normalisation of interest rates. Eliminating monetary stimulus in an orderly manner is a difficult task and we hope the Fed and other central banks are able to successfully remove the punch bowl before the financial market participants end up with a bad hangover.

Investment implications

The Kapstream Absolute Return Fund had its first negative month of performance in the last 4 ½ years. Our flagship fund was down 0.42% in absolute terms. The last negative month we had was in April 2009.

Despite our best efforts to protect capital in June we fell short of the mark. The mark to market on our portfolio lost nearly 0.90%, while our carry, hedging and alpha strategies managed to claw back 0.48% of the negative write downs. In terms of positioning, cash continues to be king, queen and the whole royal family. We have increased our cash holdings to 20% from 5%, while decreasing the overall duration of our portfolio to 0.75 years. We still favour corporate assets to sovereign assets (specifically in Australia and Asia) with a preference for floating rate assets to fixed rate assets. We expect market volatility to stay high over the coming months, resulting in defensive portfolio positioning.

Our performance is flat over the course of May to June compared to our more traditional fixed income competitors who suffered significantly over the same time period. We believe this validates the benefits of adopting a more non-traditional, benchmark agnostic, absolute return approach.

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