July 2012

KAPSTREAM CAPITAL

Financial Olympics

In the 12 years since the Sydney Olympics, Asia has made many strides in both economic and sporting evolution. Looking at the final 2012 Olympic medal count, Asian countries won 152 medals, 43 more than in the 2000 Sydney Olympics. Western European countries earned 220 medals, or 48 less than in the 2000 Olympics. And like Olympic medals, global growth is moving out of Western Europe and into Asia. Asian countries learned many lessons from their economic crises of the late 1990's and acted to fix their problems. They increased foreign currency reserves, improved their fiscal situation, running budget surpluses and re-tooled their economies, developing a middle-class consumer and became less reliant on export growth. As evidenced below, they also committed more to developing their athletes.[1]

Country/Region	2012 Medal Count	2000 Medal Count	Change	2013 GDP forecast[2]
Australia	35	58	-40%	+3.1%
USA	104	94	+11%	+2.0%
UK	65	28	+132%	+1.3%
Asia[3]	152	109	+39%	+6.5%
Western Europe[4]	220	268	-18%	+0.3%
Eastern Europe[5]	198	219	-10%	+2.5%

The remainder of the developed world could have learned similar lessons over the past few years as it has now been almost 4 years since the collapse of Lehman brothers and the initial launch of the developed world's financial crisis. In our view, policymakers in the US and Europe have not learned the same lessons and judging by the European medal count, have committed as much to athletic training as to fiscal austerity.

While the history of the crisis will continue to be written and re-written, greed, fraud, leverage, deregulation and huge public and private debt accumulation all played starring roles. The unwinding of these excesses (and the failure to address some of the causes, particularly in Europe) has led to frozen financial markets, increased regulation, greater volatility and resulted in a dramatic slowing of global growth. Global central banks have reduced rates and added record levels of liquidity, but we are still far away from declaring victory.

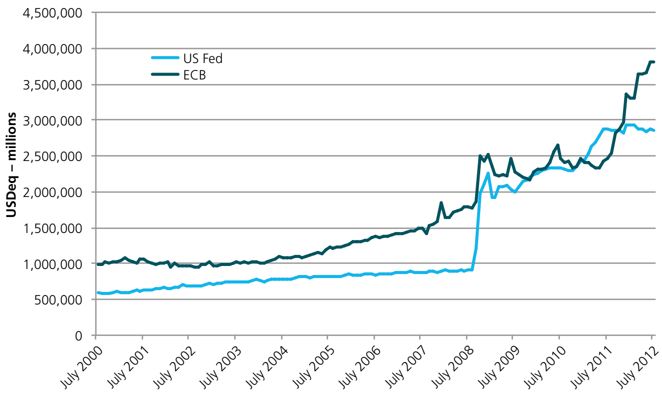
Global central banks and international regulators have done much work in providing added short-term stability to global financial markets, but markets still question whether the current set of Band-Aid solutions can hold together or whether a stronger dose of medicine is needed.

The US Federal Reserve has retained a 'zero' interest rates policy since December 2008. It has also injected massive

[1] Maybe with the exception of Australia. However, various studies conclude that the host country routinely takes home more medals, which may somewhat explain Australia's 2000 medal tally and the UK's 2012 medal tally. See for example: http://www.npr.org/2012/08/08/158448843/
[2] Economist, 11 August, 2012 forecast. GDP-weighted for Asia, Western Europe and Eastern Europe
[3] China, South Korea, New Zealand, North Korea, India, Thailand, Taiwan, Malaysia, Indonesia, Singapore, Hong Kong
[3] Germany, France, Italy, Netherlands, Hungary, Spain, Czech Republic, Poland, Denmark, Sweden, Ireland, Switzerland, Norway, Belgium, Finland, Greece, Portugal, Cyprus, Austria
[4] Russia, Ukraine, Khazakhstan, Belarus, Azerbaijan, Romania, Georgia, Croatia, Turkey, Lithuania, Slovenia, Serbia, Uzbekistan, Slovakia, Armenia, Latvia, Estonia, Bulgaria, Moldova, Montenegro

amounts of money/liquidity in the form of two Quantitative Easing's (QE1 and QE2) over the past four years, buying assets and debt in various forms, increasing its balance sheet to a record of almost $3 trillion. Similarly, the ECB injected record amounts of liquidity, increasing its balance sheet to a record of over three trillion.

Central Bank Balance Sheets



We anticipate another round of quantitative easing by the US Federal Reserve as the global economy continues to falter. While the Fed could continue to print additional US$ to continue purchasing US Treasuries, mortgages and possibly even corporates bonds in order to lower the cost of borrowing, it is slowly running out of bullets. While improving credit growth is a critical factor for the future US recovery, the twin problems of weak housing and the lack of employment continue to haunt the Fed and the administration. Adding political gridlock in the coming elections and a fiscal cliff in 2013, we believe the US economy will face substantial challenges over the next year.

In Europe

While in our minds the European problem appears to be considerably larger than the US problem, the European Central Bank (ECB) and the European Governments have many more options left in their arsenal. It's just a question of whether there is the political will to use them.

For example, the ECB can:

- Cut interest rates, currently at 0.75%, to zero. While a 0.75% rate cut is unlikely to spur material credit growth, the cut is probably a prerequisite for further quantitative easing;
- Reduce commercial bank reserve requirements;
- Print more money;
- Actively purchase the debt of peripheral countries (amend applicable laws to allow the purchase), especially Ireland, Portugal, Spain and Italy (possibly even Greece) to lower the cost of interest burden in these countries; and
- Conduct another round of long-term repurchase operations which would allow domestic banks to purchase government debt.

European governments can:

1) Create closer fiscal union, which would allow for:
   - The issuance of federal bonds that are guaranteed by a central European authority;
   - The direct federal guarantee of debt of troubled countries;
   - Federal oversight of national budgets and the ability to run larger budget deficits only with federal approval.
2) Bail out the banking sector. The lack of a federal guarantee program, weak balance sheets and deteriorating growth mean many European banks are technically insolvent. While US banks acted to write down their balance sheets and raise capital amidst the crisis, European banks and their regulators continue to pretend nothing is wrong. Today, raising capital for banks is impossible, leaving a large, looming problem for financial markets.
3) Allow countries to default on their Euro denominated debt and leave the European Monetary Union.
4) Remain behind the curve, reacting to market events in the hopes of continuing to kick the can down the road.

Markets do not currently believe policymakers have demonstrated an ability to reconcile the national versus regional interests, which would be required as part of a closer fiscal union. It is becoming clearer to us that Options 1 & 2, tighter fiscal union and a banking bail-out, will be the only solutions which would give investor comfort and allow risk-seeking behaviour to return. As European policymakers vacillate and avoid overcoming the vast political objections of such a union and bailout, we believe market volatility will increase and the risk-off environment will continue into 2013.

Focusing on endless summits, deciding the process by which Spain and Italy will officially ask for aid from the EFSF and/or the ESM, determining whether Greece will get aid money before its August 20 bond redemption are really just sideshows, which dance around the central question of fiscal union and banking bailout. Meanwhile, much of the continent is in recession. Greece, Portugal and Spain are almost in a depression and unemployment is reaching new record highs each month.

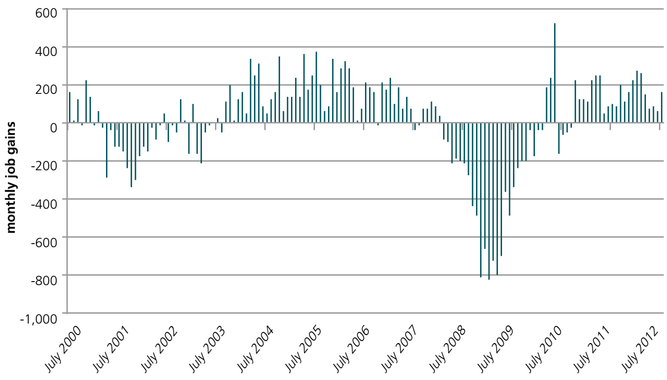
As markets currently believe Options 3 and 4 are the more likely outcomes, safer countries such as Switzerland, Denmark, Germany, United Kingdom, Finland and Austria borrow at sovereign rates around 0.50%, and new record low sovereign rates are here to stay. However peripheral countries currently pay significantly more: Italy (4.75%), Ireland (5.25%), Portugal (8.25%), Spain (5.75%) and Greece (62%). Peripheral levels are unsustainable, which in our view will eventually drive the crisis deeper and the peripheral problem will continue to get worse, perhaps making Option 3 a bigger reality.

In our view the ECB has done a commendable job, although its future options are becoming more limited. In its 2 August 2012 meeting, ECB President Draghi made it clear that they 'will not accept higher sovereign bond yields due to fears of reversibility of the Euro'[6]. Although he did not define what the ECB was going to do to lower the level of rates in these countries, a bond buying program in some form is likely. The ECB has signalled a way for its substantial near-term firepower to support under-pressure sovereigns. It's the longer-term sustainability that becomes a problem as sovereign debt and deficits and the ECB balance sheet cannot grow forever.

US in a better position

Recent economic data out of the US has been mixed. July job growth was up 163k, slightly above consensus. 2012 year-to-date average monthly job gains reached 150k, but remains well below the 250k/300k long-term gains required to materially lower the unemployment rate. On the positive side, initial unemployment claims have been dropping steadily and recently stood at 350k as of July this compared to nearly 700k in the midst of the global financial crisis in 2008.

US Payrolls



The key measure of manufacturing activity, the ISM, fell below the critical 50 level to 49.7 in July, while retail sales slumped to -0.4%. With mixed US economic data, the question on most investors' minds is whether the enormous amount of money that the FED has pumped into the system has been effective. Or will the US remain in a 'slow growth, no double dip' environment? Employment and income growth has been extraordinarily weak in this cycle. Until those two factors turn, it has hard to imagine the US moving away from the current slow growth environment to one of long-term sustainable growth.

[6] Financial Times, August 2nd, 2012

Asia feeling the effects of the global flu, but recovery will be quick

Rising concerns over the euro crisis and downside risks to global growth will continue to dominate Asian markets, despite domestic economies becoming less reliant on export-led growth. It is domestic led growth, fuelled by a rising middle class which has allowed much of Asia to be insulated against the deteriorating global environment. While we believe this secular transformation will allow for greater longer-term stability, current growth data for most Asian countries has somewhat weakened. However, growth looks to be bottoming out and we project a modest recovery in the second half of the year which will keep downward inflation pressures in check and output gaps relatively small. Second quarter Chinese growth fell to 7.8%, from 8.2% in the first quarter. Growth remains well below previous years when the Chinese economy was growing at an annualised 11 to 14%. Other economic indicators out of China seem stable, with retail sales growing at 14% and Industrial production at 10.5%.

Asian manufacturing has generally weakened over the past quarter. Korea and Taiwan saw their PMIs dip further into sub-50 levels in July, while in Hong Kong it rose to 49.8, registering its first rise in four months. Singapore's PMI exceeded expectations as new export orders and production rose. China's official manufacturing PMI fell marginally to 50.1.

Credit growth is either steady or showing a very slight downtrend in most of the region. Exceptions are China, India and Indonesia, where credit has been rising. Credit growth has moderated the most in Singapore and Hong Kong, the two economies most exposed to stalled global growth, however both remain in double-digits.

Overall, we believe Asian economies are well insulated from the global downturn, having stable fiscal policies, large monetary reserves, solid corporate profitability and a growing middle-class consumer.

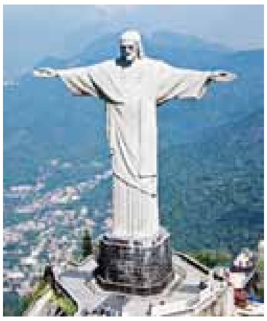
Australia

In Australia the reserve bank of Australia left its interest rates unchanged at 3.5%. Inflation, at 2%, remains at the bottom of the Reserve Bank of Australia's (RBA) 2% to 3% band. Market expectations of long-term inflation as measured through breakeven inflation rates on inflation-protected bonds remain at about 2.6%, well within the RBA's band. While job creation continues to be mixed after falling by 27k in July, 14k jobs were created in August. This has left the unemployment rate steady at 5.2%. Australia is truly a lucky country!

Portfolio implications

Despite large debt overhangs in Europe and the resulting negative long-term consequences, we forsee a 'risk-on' environment over the short-run as ECB and US Fed action will temporarily alleviate market concerns. We are in the process of slightly reducing our cash exposure from nearly 15% to 5%. We are increasing our exposure to Lower Tier II debt of the big 4 Australian Banks to increase the yield of the portfolio. We continue to prefer floating rate debt as opposed to fixed rate assets, as yields have started to rise. We will maintain the duration in our portfolio at 1 year or less. We continue to favour Australian/Asian names in our portfolio. We have limited exposure to AAA Australian RMBS/ABS to 15% of the assets, given the correlation of Bank debt to RMBS as similar.

We continue to avoid European debt and are looking for ways to add to positions that benefit from risk-off scenarios in Europe. Expect Asian countries to surpass core Europe in both medal count and economic growth by the 2016 Olympics!



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