KAPSTREAM CAPITAL

Fork in the road

'When you come to a fork in the road, take it' – Yogi Berra

After 6 years in business, Kapstream's funds under management hit $6 billion in April, as our historical return profile coupled with low volatility looked increasingly attractive to our investors. However, over the past few years, global central banks' cheap money supply and sovereign asset purchases provided such a prop to risk markets that it was hard for managers focusing on corporate credit to lose money. Short-maturity corporate debt combined with conservative interest-rate exposures were the primary drivers of our consistent returns over the past 6 years.

But we increasingly worry the easy corporate game is coming to an end as quantitative easings become less effective and new, growing risks appear on the horizon. Historically, we have managed 'risk-off' environments by selling our corporate holdings and moving into cash – at the height of the global financial crisis in 2008, we moved to 60% cash. While we don't place any meaningful probability on another global financial crisis, we believe the recent periods of easy returns in corporate markets are a thing of the past.

Aside from cash and investment grade corporates, fixed-income markets offer other high-quality opportunities, including sovereign, covered and senior securitised bonds. The key is determining when and how much to shift.

We appear to be approaching a fork in the road: Interest-rates will eventually rise and corporate spreads will eventually widen, although it's unlikely both will happen simultaneously. We spend much of our days worrying about the timing of these events. Like in the 2008 crisis, our challenge over the coming months is determining when to take the fork in the road and reduce our exposures to corporate credit risk.

However, so far, corporate bonds have performed well for our investors as there have been little surprises to financial markets while global central banks continue to supply the world with cheap money. Risk markets had responded accordingly, and reached new highs by quarter-end. The US S&P 500 gained 10.0% over the 1st quarter of 2013, the German DAX was up 2.4% and the UK FTSE increased 8.7%. Even the perennial low growth markets of Switzerland and Japan knocked the lights, up 14.53% and 19.27%, respectively, over the quarter.

And until recently, US economic data continued to respond positively to policy measures, with non-farm payrolls up 119k and 236k in January and February of 2013, continuing a positive trend of about 160k/month in jobs growth over the past 3 years. The unemployment rate fell from 8.0% to 7.7%. Housing data also continued to show improvement with both existing home sales and new home sales showing signs of improvement. The Case Shiller index of home prices was up 8% over the prior 12 months.

Also benefitting from continued cheap money were 'risk-on' higher-yielding currency markets such as the Mexican peso, up + 4.23% versus the USD over the 1st quarter, Brazil real, up + 1.47% and New Zealand dollar, up +1.1%. However, 'risk-off' lower-yielding currency markets fell as the Japanese Yen fell - 7.93% and the Swiss Franc fell - 3.56% versus the USD for the quarter. With the election of a new central bank governor and a new inflation target/mandate of 2%, the Japanese yen continued to weaken, having fallen approximately 25% over the prior 12 months. So far, Japanese government bonds haven't responded, remaining near record lows.

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While not benefitting from easy money to the extent of other developed markets, Australian financial markets continue from strength to strength, buoyed by commodity exports and the Asian growth story. The Reserve Bank of Australia has left interest rates unchanged at 3% since last November and the Australian dollar has stabilised at an impressive 1.04 to the USD. The ASX 200 was up over 8% in the first quarter. And employment numbers remain strong, surprising on the upside in February when 71,000 jobs were created vs. expectations of 10,000.

Despite the positive global economic story, risks are growing and today they are centred in Europe. The Euro fell –2.83% over the first quarter as peripheral markets continued to struggle as overall data remained weak given political stalemates and lower growth resulting from austerity measures detracted from growth prospects.

Europe's latest crisis focused on Cyprus (in contrast to the quarter's earlier crisis focused on the Italian elections). Despite Cyprus' need for a relatively small 10 billion euro bail-out package, the appearance of a precedent-setting bail-in by bank depositors highlighted the continuing lack of political progress on a federal deposit insurance program and increased the near-term risks for a Euro-wide banking run.

With a population of only about 1 million, Cyprus came to the verge of bankruptcy as the country ran out of short term funds. Deposits over €100,000, the supposed threshold for deposit insurance, despite Cyprus having no credible insurance fund, were forced to exchange their savings for equity in the banks. Currently, this depositor bail-in equates to an approximately 60% loss. And losses could grow, depending on the eventual wind-up costs. In any case, depositors will wait years to see any cash over €100,000. Not surprisingly, Cyprus's finance minister subsequently resigned after a probe was launched into how Cyprus was pushed to the verge of bankruptcy before having to agree a crippling Eurozone bailout. Having also served as CEO of Cyprus' 2nd largest bank also didn't help.

Market concern that depositor bail-ins would become precedent for future Euro bailouts were exacerbated by Europe's age-old problem of too many policymakers making too many ill-advised comments. Despite the lack of clarity in Euro depositors future risks, markets have so far shrugged off banking-run risks. At least in the first quarter.

Elsewhere, the surprising stalemate in Italian elections left current President Napolitano unable to call for new elections due to a term expiring in May. While he will remain until the end of his term and work with 10 'wisemen' to find a way to form a new government, markets came to a realization that a government was unlikely to be formed over the coming months if not year. However, the continuation of a caretaker government was viewed as less negative than many alternatives pushing Italian peripheral risks to the backburner.

Away from Europe, rising geo-political risks in Iran and North Korea give cause for concern as does another Chinese bird flu season. The risk-on environment we saw over the first quarter of 2013 appears to be moderating. The US growth story appears to be deteriorating, Cyprus matters more than markets believe, European growth will remain sub-par and Asian stability is in jeopardy with a growing nuclear North Korea. The easy times may be behind us.

Portfolio implications and market outlook

In balancing prospective returns in risk markets versus these growing risks, we have to date maintained high average credit quality in the A+ range with no below-investment grade holdings and conservative cash holdings in the 5 to 15% range. While we still believe you get paid to take the default risk inherent in corporate bonds, the upside is becoming smaller. Over the coming months, our portfolios will be managed with the following themes:

1. Cheap funding will continue for the rest of the year in 2013 and short-term global rates will remain unchanged.

2. Competitive devaluations of currencies will remain a theme in 2013.
3. While risk assets will continue to be supported by easy money, there is a limit to how much further they can rally.
4. Corporate bond spreads are close to their limits, very little capital gains remain in global fixed income markets.
5. The following risks are growing:
    a. US recovery at risk – fiscal policy will continue to fail and austerity measures will increase
    b. Storm clouds over Europe
        i. Fall-out from Cyprus debt restructuring will remain a bigger risk than markets currently expect
        ii. Italian Election gridlock won't be a problem in 2013, but will eventually become a problem
        iii. Political issues in Spain will grow in 2013
        iv. Persistent high levels of unemployment in the European region will create bigger challenges
        v. European borrowing costs will increase
        vi. The fiscal/employment drag from austerity measures will create greater political turmoil and new leaders will eventually renounce austerity
        vii. Euro Exit by some member nations
    c. While still small, Chinese Slow down risks are increasing and another bird flu season creates the potential for a bigger downside
    d. Unrest in Asia
        i. Tensions in the Korean peninsula
        ii. Rising unemployment
    e. Risk assets are becoming overvalued and will eventually be due for a correction
    f. Unintended consequences of prolonged easy monetary policy are growing.

Portfolio structuring

- We will maintain interest rate duration around 1.0 year, attempting to balance attractive corporate bond exposures versus their growing risks.
- We still prefer the corporate sector to sovereign sector as corporate balance sheets are far healthier.
- We will continue to avoid Europe (Sovereign and Credit).
- We will maintain investment grade spread duration at around 2.5 years.
- We will limit financial exposure in portfolios to 40%.
- We continue to prefer the debt of the BIG 4 banks in Australia (both senior and subordinated debt).
- It's still too early to move into the covered bond sector.
- We will maintain MBS/ABS to AAA tranches and at about 12% of overall exposure.
- We prefer exposure to Asian corporates in hard currencies, given more attractive yields and better indenture language.
- We expect little capital gains from corporate bonds over 2013.