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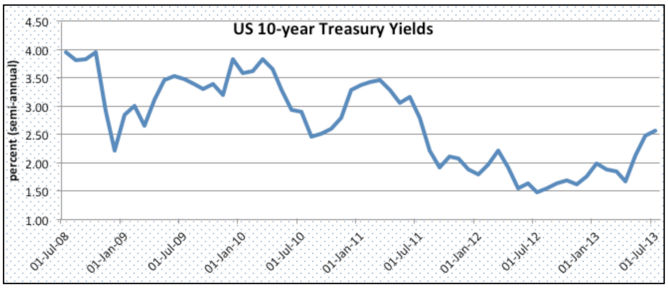
KAPSTREAM CAPITAL

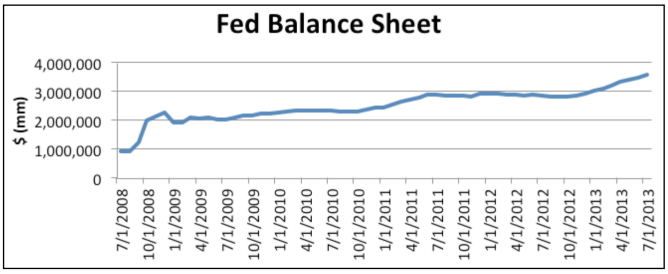
Gone too soon

Recent economic data has increased market belief in an early ‘tapering’, or reduction in the size of the US Federal Reserve’s (the Fed) current $85 billion per month asset purchase programme. On the back of these expectations, 10-year Treasury yields reached fresh 2-year highs, as the Fed’s continuing massive support for government bonds comes into question.



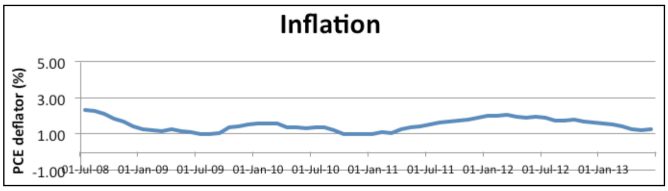
More evidence of US recovery and the nearer tapering of quantitative easing will remain the financial market’s biggest story over the next month. Recent data showing US jobless claims dropped to the lowest level in about 6 years further fanned the flames of tapering expectations. With markets now expecting the tapering to begin in September, the big question now is more the size of the tapering, rather than the timing of the tapering. Markets have even begun to speak about Fed rate hikes in 2014.

The reversal of the Fed’s 3 rounds of quantitative easing and a balance sheet which reached a record $3.65 trillion will be challenging, with critics claiming it will be impossible without serious damage to the economy.

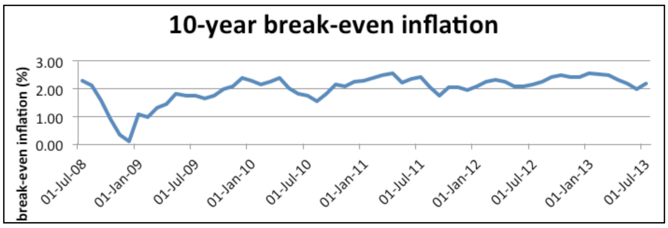


This criticism of the Fed’s policy has come from all corners of the world, ranging from economists who claim quantitative easing does nothing for the real economy, to politicians who claim huge inflationary risks. Senator Robert Corker called Chairman Bernanke the biggest dove since WWII. Mr. Bernanke responded by explaining his inflation record remained the best since any Fed chairman since WWII. The surge in the Fed’s balance sheet has actually meant little for inflation. By purchasing Treasury bonds from securities dealers, the Fed’s reserves sit in the dealer’s accounts, not in the real economy. While ample money supply exists to feed investor and consumer demand, their currently weak demand and the economy’s spare capacity has created a cap on inflation.

In fact, inflation has averaged only 1.9% (as measured by the Fed’s preferred data source, the personal consumption expenditures price index) since February 2006, when Bernanke took the reins as Fed Chairman.



And just as importantly, the historical inflation numbers aren’t any statistical quirk, markets expect future inflation will remain low for a very long period of time. Markets expect break-even inflation (or the average inflation rate) to be 2.17% over the next 10 years, very close to the Fed’s 2% target.



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With little inflationary pressure, the low quality of the jobs gains (temporary and low-paying) and the lack of significant consumer credit growth, we believe it's far too premature for a substantial tapering of quantitative easing. The Fed's real risk now is that higher rates act to stem the current recovery story.

And this will be the main challenge facing the Fed over the short-run, how to balance the risk of rising yields cutting consumer demand, versus allowing markets to push yields toward normal levels in the face of a growing, albeit slow recovery.

While tapering may begin in September, we remain on the more dovish side, the Fed could wait until 2014, given the predominance of temporary and low-paying jobs in the employment gains and the lack of both inflation and significant consumer credit growth. If the Fed does begin tapering, we believe it will be on the smaller side, a reduction of something less than $25 billion/month. Rate hikes remain years away, in our view.

Nonetheless, we expect to see a measured but steady rise in long-term global bond yields (ten year maturities and beyond) as:

- Growth slowly recovers in the US (housing, jobs, and consumer confidence);
- The likelihood of a hard landing in China dissipates;
- The market prices in an earlier monetary policy 'exit'; and
- Real yields eventually normalise from alarmingly low levels.

But deflationary risks still remain, particularly in Europe, despite being out of the news over recent months. The European Central Bank (ECB) may continue to play lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues, but they will eventually reach their limit. Despite recent (temporary) success in Greece, peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term. The rationale the ECB has used to continue supporting peripheral countries, i.e., promises of fiscal austerity, is quickly deteriorating. We foresee significant European financial shocks over the course of the next 12 months, leading to more volatility for global markets.

In Australia, the Reserve Bank of Australia (RBA) should continue reducing rates, despite the currency doing much of the RBA's work. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD.

Australian domestic data has remained muted as unemployment rose to 5.7%, its highest level since 2009. Other recent weak data included declines in building approvals, consumer confidence and business conditions. The government cut is growth estimate for this fiscal year to 2.5% from 2.75% and said unemployment would likely rise to 6.25% by the middle of 2014. While the declining Australian dollar is welcomed by the RBA, they will continue to signal that the current interest rate easing cycle is unlikely to have reached its conclusion. With 2.25% in cuts over the past 2 years, we continue to forecast further RBA cuts in expectation of sluggish growth as mining investment fades.

While we expect considerable volatility in the coming months, we believe credit markets will continue delivering solid returns. You still get paid to take the default risk inherent in investment-grade corporate bonds. We favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets, as in rising rate environment, fixed assets will lose more value. We prefer Australian/Asian and US corporate names with noteworthy allocations to the financial sectors in these regions. Low interest rate environments should continue to support the financial sector. We continue to favour lower rated debt of Australian big 4 banks given their profitability and high probabilities these deals will be called upon their call dates.

We have begun to slightly decrease our cash reserves, which were increased to over 25% during the recent crisis. Expect to see approximately 20% cash in the coming month. We have decreased our overall portfolio duration to 0.75 years.

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