KAPSTREAM CAPITAL

Guidance, the only bullet left

The US Federal Reserve

Janet Yellen has officially taken over from Ben Bernanke as the head of the US Federal Reserve (the Fed). The task of controlling monetary policy for the largest economy in the world has never been easy. In the 1970's, Paul Volker dealt with runaway inflation – and raised rates to historical highs to combat it. Later, Alan Greenspan dealt with the 1987 stock market crash, the 1992 savings and loan crisis and the 2000 dot.com bust. More recently, Ben Bernanke faced the global financial crisis and a near-collapse of the US and global financial systems.

Janet Yellen now takes over a central bank which has maintained Interest rates at close to zero for the past 6 years while ballooning its balance sheet to a record $4.1 trillion dollars. Despite the unknown future consequences of such unprecedented actions, the short-term benefits of recent Fed policies include a stock market at record highs, a housing market recovery and an unemployment rate improving from a high of nearly 10% to the most recent 6.6%.

While considerable debate remains over whether the fall in unemployment is due to people leaving the work force and therefore no longer being counted as unemployed, we view the 7.8 million in real jobs created since 2010 as an important piece of the success in the US recovery story so far.

But the Fed's ability to further aid the US recovery is diminishing. With 3 rounds of quantitative easing, a $4.1 trillion balance sheet and short-term rates at 0%, the only bullet remaining is 'forward guidance' or signals on the timing of future interest-rate hikes. In each of Federal Reserve's prior two meetings, it was decided to taper some of the quantitative easing (QE3) by cutting $10 billion in monthly bond purchases (to a current $65 billion in monthly bond purchases), thus maintaining a well-telegraphed plan for the gradual withdrawal of Quantitative Easing. Markets now forecast further $10 billion/month reductions in bond purchases in each of its next meetings, potentially ending Quantitative Easing by the 2nd half of 2014.

While this means that the Fed will not be expanding its balance sheet as rapidly as it used to, it implies they are more confident in the sustainability of the economic recovery. It also implies the Fed believes it has finally helped to re-engineer a sustainable US recovery and the risks of another US financial system collapse are well behind us.

We at Kapstream remain more wary. Recent economic data should have the Fed concerned on the long-term sustainability of this recovery. Despite recent improvements in US data, December and January jobs data disappointed as the economy added only 74,000 and 113,000 jobs respectively, down significantly from the 182,000 monthly average over the past few years.

The Fed's tapering program will continue to cause unintended consequences and headaches in other markets as these record levels of liquidity are withdrawn. In attempts to stem the capital outflows resulting from the past easy money, emerging market economies have been forced to raise rates (India, South Africa, Argentina) even as their economies slow. Currency markets are in dislocation as the USD$ strengthens against once booming commodity exporters. The Australian dollar, the Canadian dollar and the Japanese Yen have fallen nearly 20% against the USD$ over the past 12 months. In the long-run, this will prove beneficial for the manufacturing and exports sectors of these economies, but short-run market volatility has increased, creating challenges for financial markets.

Guidance – what has the Fed told us?

With their tapering plans now reflected in market expectations, future Fed policies will predominantly be driven by forward rate expectations, rather than other actions, which in today's world have become extremely limited. Adjusting current interest rates is no longer an option and further balance sheet expansion or contraction brings about a widening set of new risks.

With limited options, the Fed will remain more careful in telegraphing its message. While in May of 2013 the Fed spooked markets by announcing a quicker tapering than expected and then waited until December to actually reduce its bond purchases, we believe it will be more careful in attempting not to tarnish its more recent clarity in tapering plans.

However, Ms. Yellen enters the Fed chairmanship in a challenging position, as prior messages indicated a complete unwind of QE could come when unemployment reached 6.5%. Given the last unemployment print was 6.6% and we are still in January, it is likely the Fed's QE programme will be terminated by mid-year at the latest.

The only tool the Fed will have left in its arsenal will be forward guidance or the future path of short-term rates. This will not be an easy task as future economic data, emerging market liquidity crises, currency wars and geo political risks may force the Fed to back track on its policy plans. We believe 2014 will prove to be a more volatile year than markets currently expect.

Outlook and Strategy

Despite these challenges, the global recovery looks to be taking shape, albeit at a moderate pace. While 2014 news headlines will remain focused on a hard landing in China and risks in the 'shadow banking' sector, we foresee further liquidity, improving reforms and a continuation of growth in the 7.5% range. Over 2014 we forecast a measured but steady rise in global long-term bond yields (ten year maturities and beyond) over 2014 as:

- Growth continues to recover in the US (housing, jobs, and consumer confidence);
- The likelihood of a hard landing or debt spiral in China dissipates;
- The market continue to price in a monetary policy 'exit'; and
- Real yields normalise from alarmingly low levels.

Rate hikes remain years away, in our view. However, we don't believe taking large interest-rate positions are warranted in this environment as the information ratio is low and interest-rate volatility will remain high, given the Fed's limited future options. 10-year US Treasury yields in the 2½ to 3% range appear fairly priced, albeit at the lower end of our forecast range, balancing moderate growth and minimal inflation risks versus the imminent end of Federal Reserve support for the Treasury market amidst a more stable jobs environment.

While US growth is improving, the pace will remain fairly muted and well below the 3.4% average pace for the period following WWII through 2007. Despite an improving consumer, private sector deleveraging will continue and put pressure on the recovery in 2014. And business spending will only improve marginally – business sentiment has fallen in recent months. Nonetheless, the private sector will continue with moderate gains over 2014. We expect modest acceleration in personal and business spending as housing and equity markets continue to support wealth, despite increases in mortgage rates which will slow the housing recovery. Despite occasional hiccups, employment gains will continue in the 200,000/month range, which could bring the unemployment rate down toward the 6% range by year-end 2014. We expect to re-gain the net remaining 1.3 million lost jobs over the 2008 – 2009 periods within the first 6 months of 2014. However, inflation will remain under control, still below the Fed's 2% target given the enduring slack in the labour market.

While a continuing US recovery provides our bias for eventual rises in interest rates, we foresee a cap in government yields as other global deflationary risks still remain, particularly in Europe. 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 and continuing rallies in Italian and Spanish sovereign bonds, 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, has quickly deteriorated. While we eventually foresee significant European financial shocks, the ECB may be able to support Peripheral markets through 2014. German constitutional court opinions aside, the ECB currently has both the will and the ability to continue funding the Peripherals (with the aid of domestic banks and insurance companies), so European risks may be beyond our 2014 horizon.

In Australia, the Reserve Bank of Australia (RBA) will remain on hold despite the currency not doing as much of the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD. The economy is still functioning at below trend in terms of jobs and sentiment. We forecast annual 2014 growth around 2.7%, well below the 3.4% long-term average. While the recent 18% fall in the AUD will continue to aid the non-mining and export sectors, these sectors are unlikely to fill the gap created by the fall in mining investment. The RBA will maintain low rates as limited wage growth will stem inflationary pressures and allow continuing support for the housing market.

Despite equity markets reaching record levels at year-end, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures which will put more pressure on the labour market and non-mining domestic growth.
The downward pressure on wages has kept disposable income levels extremely low. While we foresee further AUD weakness, the currency is more likely to be driven more by US Fed action and the speed of QE3 unwind rather than by anything in Australia. We expect QE3 will conclude toward the end of 2014 and provide some further relief for the AUD, although it's hard to see a dramatic fall, particularly as the interest-rate differential between the US and Australia will continue to support financial flows into Australia. With moderately attractive real yields, we like Australian interest-rates relative to the US and the rest of the developed world. We expect USD weakness to continue its reversal in 2014 as the ending of the Fed's Quantitative Easing programme combined with stabilising growth support the USD over the year.

Markets will continue to worry about China, but as the 2013 headline stories of the risks of a Chinese hard-landing dissipate, the 2014 story will centre over the growth of Chinese local debt and risks in the 'shadow banking' sector, another red herring in our view. This burgeoning debt of Chinese municipal localities, used to finance infrastructure projects, is unlikely to bring about a major debt crisis in 2014. This growing debt may represent China's largest economic problem, however, material defaults are unlikely and ultimately the central government will allow more tax revenues to flow to localities to pay construction debts. While a recent report showed this debt alarmingly increasing over the past 2½ years, reaching $3 trillion, China's overall total debt at 56% of GDP still compares favourably to most developed countries. We expect Chinese growth will remain in the 7½% range over 2014, allowing China to continue to support the global growth story. We expect eventual liberalisation of deposits rates combined with necessary deposit insurance, although this may take considerable time. Small scale defaults in the shadow banking sector, mainly the trust sector and predominantly impacting high net worth investors are unavoidable, but unlikely to create systemic banking risks.

While Asian fundamentals appear fairly solid in both the corporate and sovereign world, a rising rate environment will prove challenging for inflows, similar to the 2nd half of 2013. From a fundamental perspective, sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world, particularly Europe. We will remain more cautious

in Asian sovereigns with weaker fiscal fundamentals, i.e., those with deteriorating budgets, current accounts and reserves. India will remain a top Asian story as weaker fundamentals will provide a challenge to maintaining its investment-grade rating.

Overall, the theme of extremely low global central bank rates will continue in 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the equity and risk market gains of 2013 amidst a steady but moderate growth environment. While we expect continued volatility in the coming months, we believe risk markets will continue delivering solid returns, particularly investment-grade credit. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals still look attractive, the technicals surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. We favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets, as floating rate assets will outperform in a secular environment of increasing rates. We particularly like short-maturity, defensive securities (less than 5-year maturities, high-rated global banks, conglomerates and quasi-sovereigns) which are less sensitive to moves in interest-rates.

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