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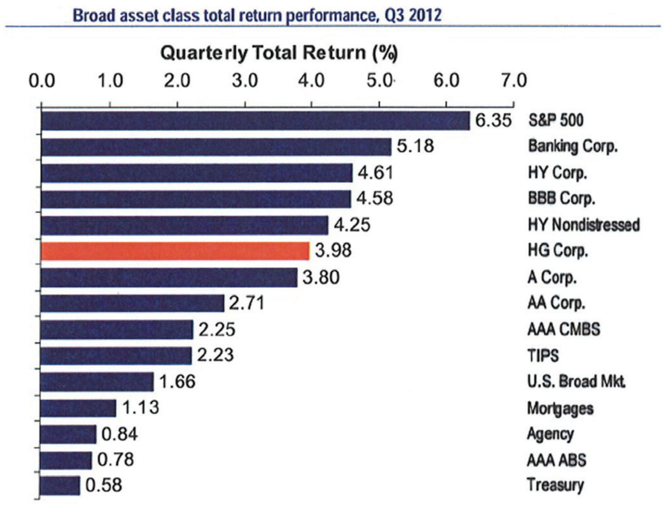
KAPSTREAM CAPITAL

If you're not part of the solution, you're part of the problem

This phrase was a favourite of a respected founder of a large asset manager who always expected to hear potential solutions to problems rather than being brought complaints about existing problems. Additionally, the quote's appearance in the original Die Hard movie makes it a line worth remembering. In Kapstream's view, aside from central bank action, there is little policy work aimed at solutions, rather a focus on what remains wrong and where to place blame. Today's financial news is filled with complaints over the wrong course in central bank action, the level of austerity needed in peripheral Europe, fault for the impact of the upcoming US fiscal cliff, low jobs growth and sputtering economy. Sovereign bond yields remain near record lows as financial markets view necessary policy action to remain mired in political gridlock and inaction over the short-run.

Political gridlock and policy inaction has driven financial market returns over much of the year. So far, only strong central bank action has aided economies and growth. Global bonds again delivered solid positive returns over the 3rd quarter as global central banks added even more liquidity in efforts to stem worldwide recession risks. Concern over deteriorating global growth allowed sovereign bonds to approach record yield lows as 10-year Australian government bond yields fell 15 basis points over the quarter, reaching 3.0%, while 10-year US Treasuries fell only one basis point, reaching 1.64% and 10-year German bunds fell 14 basis points, reaching 1.44%. Despite a deteriorating growth story, corporate bonds performed well as corporate profitability remained solid. Australian investment grade credit default index spreads tightening 26 basis points reaching 1.58%, US investment grade credit default index spreads tightening 7 basis points, reaching 0.98% and European investment grade credit default index spreads tightening 26 basis points, reaching 1.32%.

European peripheral sovereigns had strong gains over the quarter, reflecting market belief in the ECB's newest all-out efforts to stem further peripheral crisis. Italian 10-year yields fell 73 basis points reaching 5.09%, Spanish 10-year yields fell 39 basis points, reaching 5.94% and Irish 10-year yields fell 1.36%, reaching 5.11%. The best performing assets for the quarter were the S&P500, Banks, High Yield, and BBB Corporates, all high beta asset classes.



Source: BofA Merrill Lynch Global Research, Bloomberg.

Similar to the third quarter, we believe fourth quarter asset returns will depend more upon policy decisions (central bank actions, fiscal policy adjustments, European bailout measures) rather than economic fundamentals. Despite recent European Central Bank (ECB) action, funding fears have already returned for Greece, Cyprus, Slovenia and Spain. The Eco Fin and Euro group have started the usual doubts about money distribution for aid to the periphery. The summit was supposed to create a positive spin for financial markets. But, as Greek debts again spiral out of control, continuing aid appears in jeopardy. As doubts about Spain requesting help linger, short-term politics and divisions are the more likely driver for EUR weakness. The confusion on funding requirements and loan disbursements and disagreements between politicians and bankers has kept financial markets on a knife's edge. Any resolution which includes cohesive fiscal union seems far away, in our view, but much of the tail risk has been priced out. In response to further potential European weakness, most western economies central banks have cut interest rates toward zero and subsequently started printing massive amounts of currency to prop up risk assets.

China has also remained a central financial market headline story for much of the year as markets worry whether China has a hard or a soft landing. The World Bank recently cut its growth forecasts for China and rest of East Asia to 11 year lows. The World Bank said it is now expecting the Chinese economy to grow 7.7% in 2012, compared with its previous 8.2% growth forecast. The downward revision reflects China's weak exports and lower investment growth; though the World Bank said it expects China's economy to expand by 8.1% in 2013. The World Bank has also revised down its growth forecast for the East Asia and Pacific region to 7.2% for 2012; down from previous forecast of 7.6% made in May, and expects the region's economy to grow 7.6% in 2013. In light of the downgrades in growth, we continue to view Asia's economies as half full compared to half empty. Both the Chinese and Indian economies are showing tentative signs of bottoming out which when combined with positive data in the US should help alleviate concerns of a sharper slowdown in the region. Similar to what happened post the GFC, we can foresee a situation where Asian Central Banks back away from further rate cuts for the time being and start shifting attention back to targeting inflation.

The markets are clear that the only way out of the debt mess is growth. Europe implicitly understands this story but the conflict between the required austerity versus additional spending to support growth creates a difficult environment. The Portuguese debt swap at the end of September offered some hope for the austerity leading to growth story – but the evidence of capital flight continuing overwhelms as banks borrowed further from the ECB to finance outflows. The real market focus remains on Asian growth and US recovery. We do not believe that Asian growth will be enough to compensate for the problems in the US and Europe, which begs the question: how will global growth return? The World Bank's diagnosis and remedy isn't entirely satisfying – improve labour productivity. To US companies that means producing the same amount of goods with less workers. To Asia it may mean keeping the same number of workers and paying them less. Inflation is the risk that remains with food and energy going up for them while the terms of trade of the manufactured products fall.

Over the next quarter, we believe market action will remain dominated by policy decisions, particularly in Europe, where ECB action and prospects for greater fiscal integration/budget coordination will continue to create much volatility. Continuing political gridlock in the US over fiscal austerity measures will also add to market fears. While Asian growth will slow, the region will remain the globe's growth engine as domestic demand and less export reliance will allow for a softer landing than markets currently expect.

Investment implications – Global Central Bank 'Put'

- With Central Banks sending an implicit message to markets that they are intent on supporting asset valuations – carry should be king. We do not expect monetary policy tightening in the US for at least another three years. In this environment risk asset should do well, particularly as the Asian growth story continues;
- We continue to prefer corporate bonds over sovereign assets. Within the corporate space, we prefer assets in Asia and Australia over Europe;
- We continue to favour all forms of debt of the big 4 Australian banks (NAB, Westpac, ANZ and NAB);
- We have decreased cash and increased exposure to higher beta assets however we remain nimble should the economic situation deteriorate further.

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