KAPSTREAM CAPITAL

Keep calm and carry on

Originally created by the British government in 1939, months before World War II, the slogan 'Keep Calm and Carry On' was intended to boost the morale of British citizens in the aftermath of air raids. Funnily enough, the posters were only distributed in limited numbers and the slogan never used on a public display. In 2000 it was rediscovered and has been used ad nauseam on posters, t-shirts, and to market a variety of products. Changes such as 'Keep Calm and Call Batman'; 'Keep Calm and Eat Cupcakes'; 'Keep Calm and Follow Me (Twitter reference) and 'Keep Calm and Gangnam Style' have all graced the newswires, Facebook pages, and mainstream media. The reality is that for the financial markets, the original is the most meaningful. After a tumultuous January where the ASX/S&P fell over 3.5% following a remarkable 2013, we head into the end of the first quarter with stocks rebounding over 5% and consistently hitting new highs. Investors have stayed calm and carried on and ignored the mixed global economic data and issues in China and Russia/Ukraine. There were some unfortunate losers, like Qantas and Bitcoin (something we still do not understand), but for the most part, markets have rebounded in such swift fashion that January has become a distant memory.

Like most market participants, we expect the current calm to continue through at least the first half of 2014, and we know that new risks will continue to arise. In what seemed like minutes after being on the world stage following the Winter Olympics, Russia and Vladimir Putin set their sights on the Ukraine. This was the first bout of geo-political risk investors had encountered in a long while, yet this relatively regional and contained event was not reason enough for investors to change their stripes on risk assets. Certainly the messy situation in the Ukraine has potential to cause havoc down the track, yet for now, calmer heads prevailed as Russian President Putin decided to back track on their intentions in the country, leaving room for a diplomatic solution, at least so far. As David Zervos from Jeffries commented, 'Putin bought the Ukraine – the naval bases, the gas pipes, the gas contracts, the wheat contracts and the ability to run roughshod over 45 million people. But his investment was wiped out by the Maidan protesters… Putin is not trying to remake the USSR. Putin is not engaging in some grand plan to reignite the cold war. He is angry about his investment losses and he wants something back that he believes he bought.'

Further echoing the 'Keep calm' mantra, investors continue to 'carry on' in the form of buying up yield. The carry game is back with a vengeance with commodity currencies rallying, the USD selling off and investment grade, high yield and mortgage spreads contracting significantly. In an environment where yields are historically low, growth missing expectations, and the US Federal Reserve (Fed) unwinding its stimulus, investors seem content with resident dove Janet Yellen and other global central bankers quelling anything that could destabilise markets.

The Fed has been vocal about its intention to end QE by Q3 2014 as well as to provide forward guidance on the path of interest rates (read Kapstream January monthly **'Guidance, the only bullet left')**, yet it is highly unlikely that the Fed will remain on this path should the data continue to disappoint. Investors are fully aware of the 'Yellen Put' (formerly known as helicopter Ben and the Greenspan Put) and are happy to take advantage of it.

In Australia, the economy continues to sputter along with inflation reaching the top end of the Reserve Bank of Australia (RBA's) band while the mining sector continues to slow. While GDP beat expectations, the components were far less convincing with markets pointing to the

weaker Australian Dollar and exports as the key source. Yet, at 2.5% the RBA feels that monetary policy is loose enough to promote growth and keep inflation in check. The Australian Dollar has weakened to a comfortable level for the RBA, allowing Glenn Stevens to remove the prior easing bias. Problems still persist. Australia remains one of the most expensive places in the world, with Sydney and Melbourne ranking #5 and #8 respectively, according to the Economist Intelligence Unit's latest Worldwide Cost of Living survey.

This will make the transition from mining investment to the manufacturing and service sectors much more difficult than markets and politicians currently expect. Given high operating costs relative to the rest of the world, many employers are in the process of shutting operations, including Holden, Ford and Toyota, while other organizations like Qantas posted significant negative earnings (first half loss of A$250m) followed by the layoff of 5,000 non-essential staff. Auto sector lay-offs alone will cost Australians up to 30,000 jobs over the next few years.

We remain sceptical on the market's outlook for Australian growth over the next few years, particularly as the AUD remains stubbornly strong in the face of growing economic uncertainty. We don't believe inflation will be the long-term problem for the RBA, rather the deteriorating employment situation will be the RBA's main focus in the coming year, making potential rate hikes unrealistic, in our view.

Outlook and Strategy

At Kapstream we believe;

- 2014 will be more volatile than 2013 as we face greater uncertainty from central bank forward guidance.
- Equity markets and risk assets will outperform fixed income markets in much of the developed world.
- USD will be stronger against major currencies as the US economy continues to mend and outperform other developed economies.
- Credit markets (as measured by spread) are fairly priced – you get paid to take the default risk inherent in corporate bonds.
- Interest rates will gradually rise.
- In the developed world, RBNZ (Reserve Bank of New Zealand) and the BOE (The Bank of England) will be the first central banks to raise their already low interest rates.
- The Reserve Bank of Australia will leave rates on hold for the rest of 2014.
- The Fed will complete its tapering program and end QE in 2014.

Portfolio positioning

- Target interest rate duration at 0.75 years as our neutral position (0.50 years from Australia and 0.25 years from the US).
- Invest in positive carry trades as most central banks remain on hold over 2014.
- Prefer corporate bonds to sovereign bonds.
- Position for strengthening USD (vs. AUD, CAD and JPY).
- Limit the BBB exposure in portfolios to 30%, Tier 1 of the big 4 banks in Australia to 4% and Tier 2 to 10% respectively.

KAPSTREAM
CAPITAL

Kapstream Capital Pty Limited (AFSL 308870) is the investment manager of the Kapstream Absolute Return Income Fund ARSN 124 152 790 (Fund). Fidante Partners Limited (ABN 94 002 835 592 AFSL 234668) is the responsible entity and issuer of interests in the Fund.The information has been provided by Kapstream and is for use by wholesale clients only and no other persons. The information is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on any information, you should consider the appropriateness of it and the relevant product disclosure statement having regard to your objectives, financial situation and needs. In particular, you should seek independent financial advice and read any relevant Product Disclosure Statement or other offer document prior to acquiring a financial product. Stated performance of the Fund is since inception 31 May 2007 to the stated month, and assumes reinvestment of distributions and is after management fees and before any taxes at the unitholder level.

Kapstream Capital Pty Ltd ABN 19 122 076 117 Level 7, 39 Martin Place, Sydney NSW 2000 Phone: +61 2 9234 0000 www.kapstream.com

16628/0314