

June 2015

Lift Off

Whilst the term 'lift-off' has varying meanings, it is most often associated with the first moments of flight. Lift-off requires both engineering, physics and the cooperation of Mother Nature. In launching rockets, NASA established a well-defined launch procedure which includes weather guidelines to ensure limited turbulence during the critical first few minutes as cruising altitude is reached. Similarly, commercial airlines implement like methods to ensure the safety of aircraft and passengers, and plan a route that is most comfortable for its passengers and conducive to safe arrival at their destinations.

The US Federal Reserve (Fed) is contemplating a lift-off from ZIRP; or the 'zero interest rate policy' implemented nearly eight years ago following the global financial crisis. Over the past eight years the zero interest rate policy has unarguably aided US economic recovery. The recovery has proceeded slowly, but steadily so far. The unemployment rate has fallen from nearly 10% to 5.4% and the 8 million jobs lost during the crisis had been recovered more than a year ago, plus an additional 2 million jobs have been created since. The US is moving closer to a balanced budget with forecasts even calling for an eventual budget surplus, the first time in more than 13 years. Spurred by low interest rates, asset prices have risen strongly, stock markets have gained nearly 220% from their lows in March 2009, while the USD has approached record levels versus trading partners, showing confidence in the US recovery. Home prices also continue their ascent.

The Fed's 'lift-off'

In preparing markets for an eventual lift-off, Fed Chair Yellen stated in her recent semi-annual monetary policy testimony that "measures of job market health are trending in the right direction." She also noted improvements in the under-employment rate, i.e., declines in the number of discouraged workers. Signalling that wage inflation may soon return, she saw "tentative signs that wage growth has picked up". Still, she said, "there is some slack in labour markets", adding, "...while labour market conditions have improved substantially, they are, in the Federal Open Market Committee's judgment, not yet consistent with maximum employment."

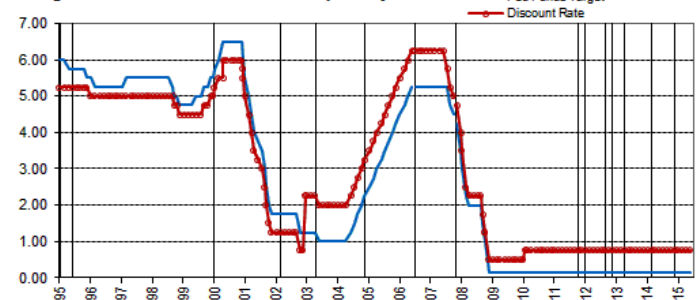
Under these conditions, Yellen implied that lift-off remained further down the road and "a high degree of monetary policy accommodation remains appropriate", at least for now. She echoed the FOMC statement of June 16-17

about the conditions under which the Committee would decide on the first rate hike, and anticipated that "economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target, thereby beginning to normalize the stance of monetary policy." Thus the Fed has provided financial markets with their weather forecast of when it will be sunny and clear so as to move away from their zero interest rate policy.

Transparency

During her testimony Yellen also emphasized that policy normalisation will be a long, slow process. "A decision by the Committee to raise its target range for the federal funds rate will signal how much progress the economy has made in healing from the trauma of the financial crisis. That said, the importance of the initial step to raise the federal funds rate target should not be overemphasized. What matters for financial conditions and the broader economy is the entire expected path of interest rates, not any particular move, including the initial increase, in the federal funds rate. Indeed, the stance of monetary policy will likely remain highly accommodative for quite some time after the first increase in the federal funds rate in order to support continued progress toward our objectives of maximum employment and 2 percent inflation." She emphasised that significant effort has been made to improve the communication and transparency of the Fed so as not to cause any disruption to financial markets when lift-off eventually happens.

Federal Reserve Rate Actions and Changes in Procedure to Promote Transparency



Source: Stone McCarthy Research.

Destination

At Kapstream we continue to believe that the Fed is preparing the market for an eventual lift-off from zero interest rates. By a small majority, market participants believe that the Sep 16-17, 2015 meeting will be the first in a series of Fed rate hikes. We are in the camp that the Fed can afford to wait till the 1st quarter of 2016 to remove the zero interest rate policy.

Whether you listen to the market or Kapstream, does it really matter when the Fed actually goes, whether it is September 2015 or March 2016? The answer is NO. Will an early or late rate hike be a major surprise to the markets? Again the answer is a resounding NO as we have all been sufficiently warned and should be prepared.

What's really important once the Fed starts the process of normalising interest rates, is the messaging in their communication as to the future path of interest rates. How quickly and how far do they go? Do they raise rates by 25 bps in 17 consecutive meetings like in 2004? Or do they raise rates by 1% to 2% over the next few years? The true future path of interest rates will be dependent on data and a host of other global macro risk factors – does Greece leave the Euro, do Chinese equity markets collapse, do we have a currency crisis that de-rails economic recovery, do equity markets/risk assets panic and sell-off, etc. The answer to those risks are unknown and unpredictable. A safe assumption can be made that any future rate rises will be slow and subject to all those factors combined.

Kapstream believes that once the US lift-off happens, future rate rises will be gradual, well-advertised and slow. European economies are still struggling to grow despite the ECB continuing to print money to stimulate. The Chinese economy is slowing, and commodity prices have fallen, negatively impacting the growth of commodity producers such as Canada/Australia who remain somewhat dependent on commodity prices and demand, for their own economic growth. Japan continues to print money to keep its economy afloat. Outside the US, economic growth remains questionable, and therefore it is doubtful anywhere else in the world can 'weather' any form of lift-off from current low policy rates.

Australia/Europe/Asia

While growth and employment still surprise to the upside, the Australian economy will continue to struggle, with the non-resource sector of the economy fighting to pick up the slack of a slow-down in the resource sector. In response, the RBA has lowered interest rates to a record low of 2%. Markets anticipate that rates will remain at these levels for the next 12 to 18 months or lower.

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The future of Australia is highly dependent on the fortunes of China. With bubbles building as China aims to continue to grow new jobs at an annual rate of 1 million per month, the recent equity market turmoil (down 35% over the past month, despite a 150% rise over the prior year) was the latest challenge to authorities. We remain convinced that Chinese policymakers can manage any contagion before these bubbles threaten the broader domestic economy. Greece came close to leaving the Euro, but true to form at the last minute managed to get a reprieve and avoid a major market default.

Kapstream portfolio

A key tenet behind our investment philosophy is that you don't get paid to take interest-rate duration risk. Put another way, no one knows the future path of interest rates. Therefore, we expect to continue to take little of our portfolio risk in positioning for eventual Fed moves. If we're right and the Fed waits until 2016 to begin hiking rates, our portfolios will do a little better. And if we're wrong, they'll do a little worse, but importantly our interest-rate positioning on the back of the Fed's expected moves won't drive portfolio returns.

Nonetheless, given current global macro risks, we continue to hold about 20% of our portfolio in our 'liquid bucket' (mainly sovereign, semi-government, cash) to protect against potential capital losses arising from the Fed hiking sooner than anticipated, or the continuing deteriorating liquidity inherent in global bond markets today.

We prefer owning floating rate assets over fixed rate assets given their limited exposure to interest-rates, and prefer corporate bonds over government bonds as you still get paid to take corporate default risk.

Kapstream news

On July 1, 2015 Janus Capital Group acquired a 51% majority ownership interest in Kapstream. In the process we believe our clients will gain the wisdom and experience of, in our opinion, the world's most renowned fixed income investor, Bill Gross. Importantly, there will be no changes to our approach in managing portfolios; the people and processes involved before remain the same today. The new union provides Kapstream with a very welcome 'lift-off' of its own as we continue to develop our burgeoning US business.