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KAPSTREAM CAPITAL

Lights on, lights off

As 2007 began to unfold, global markets looked forward to another encouraging year for global growth and financial asset prices. However, by mid-2007, the US sub-prime mortgage crisis began to take hold and by early 2008 global markets began to witness the collapse of numerous hedge funds and investment banks, plunging financial markets into years of darkness.

The beginning of this year's Super Bowl looked equally as rosy for the Baltimore Ravens, who reached a 28-6 advantage over the San Francisco 49ers by the early second half as Jacoby Jones returned the opening second-half kick-off 109 yards for a touchdown in the longest play in Super Bowl history. And just like the middle of 2007 for the financial markets, the lights then went out in the Louisiana Superdome, causing major confusion. Auxiliary power kept the playing field from going dark, but other areas of the stadium, like escalators, elevators, vending machines, air-conditioning and beer, wine and food concessions, all stopped working. Electricians used back- up generators to keep some of the lights on until full power was eventually restored some 34 minutes later.

Similarly, global central bankers (US Federal Reserve, European Central Bank, Bank of England and the Bank of Japan) were challenged in keeping the lights on in the global economy when it went dark in mid-2007. Like the Superdome's electricians, they used back up methods to keep the lights on, such as government guarantees, asset purchases, expanding balance sheets and cutting interest rates to nearly zero in order to keep a struggling economy going until markets could deliver a self-sustaining recovery.

Despite a gallant comeback by the 49ers after the lights were repaired, the Baltimore Ravens held on to win the game 34-31 and were crowned Super Bowl XLVII champions. And like the Ravens, it now appears global central banks were partially successful as sustainable global growth has finally returned. But unlike the Super Bowl, this game isn't over.

US recovery – Housing, employment and political risks

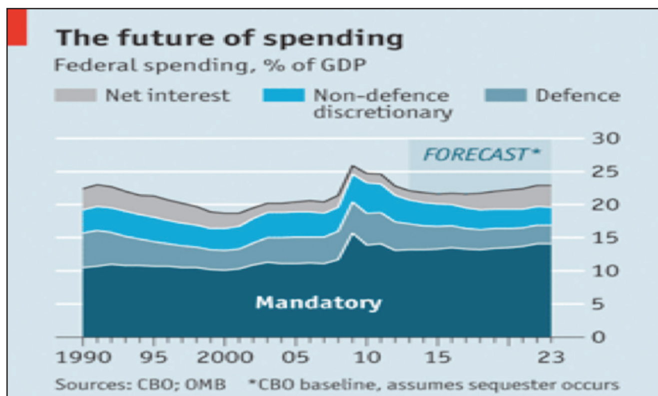
US home prices rose more than 5% (year over year) in November, the biggest increase in 6½ years, according to the Case Shiller home prices index.[1] Home prices have risen for 10 straight months and sales rose 9.2% over 2012. Housing is now expected to positively contribute to economic growth in 2013 as the US Federal Reserve's historically low borrowing rates entice buyers back into the housing market.

After losing 8.7 million jobs over 2008-2009, the US employment story looks considerably better today. In 2010, the US recovered 1 million jobs, and in 2011 and 2012 the US recouped over 2 million jobs in each year. Over the past 2 years, the US employment growth has averaged approximately 180,000 jobs per month, meaning at the current rate it will take another 1½ years to recover the 8.7 million jobs lost over 2008-2009. There is light at the end of the tunnel.

With a housing and consumer recovery well underway, the next piece of unfinished business is arresting the relentless rise in already sky high government debt. There is some good news on this front. The Congressional Budget Office (CBO) forecast the 2013 financial year deficit at $845 billion or 5.3% of GDP, the lowest figure since 2008, and down by nearly half from its peak of 10.1% in 2009.

[1] Case Shiller composite index of home prices in 20 metropolitan areas.

While there are many variables in the CBO forecast, budget deficits eventually dwindle as economies improve. However, policymakers must tread carefully in balancing spending cuts versus tax increases. Recent stock market gains should lessen some of the impact of tax increases, particularly with the end of the payroll tax holiday. Cutting discretionary spending is politically more appealing as it arouses less anger than cutting entitlements or raising taxes. However the timing of cutting the discretionary spending is important as it should not occur at a time when consumers and businesses are reducing their own debt. Thus the battle between the administration and the congress has just begun and the remaining political uncertainty means the US has not yet turned a corner and substantial risks remain.



Meanwhile, the US Federal Reserve is keeping the lights on by allowing interest rates to remain at zero, encouraging both the housing and stock markets. The lights are being kept on at least temporarily until the electricians/politicians can figure out how to fix the fiscal problem on a more permanent basis.

Europe – The lights are on, but nobody's home

Europe has made less progress in keeping its lights on, despite the European Central Bank's (ECB) efforts. While almost completely failing to address the structural causes of the current crises in the peripheral markets (such as labour rigidity, federalisation of banking guarantees, fiscal union), central bank policymakers have kept the lights on by dramatically expanding the ECB balance sheet in order to purchase peripheral debt. While this has succeeding in kicking the can down the road, perhaps for another year, it can only work so long as peripheral countries continue to make progress in structural/fiscal reforms.

Recent reforms in Spain and Italy appear at risk due to a changing political environment which threatens to do away with much of the positive austerity measures that have taken place to date. In Italy, former Prime Minister Berlusconi is running on a platform of returning the recent tax increases to the voters while in Spain Prime Minister Rajoy's corruption allegations threatens to bring down his administration.

The only flicker of progress being currently made is in Ireland, which is restructuring the debt received from the ECB during its banking crisis. The problem for Ireland stemmed from the 2010 need for €31 billion ($42 billion) to bail out its banking sector. This debt was issued at very high interest rates of over 8% with initial maturity of 7 to 8 years. Now that Ireland has regained access to the global financial markets, the Irish government (similar to Greece), has replaced the notes with a much longer term floating rate bonds extending the maturity to 34 years and the first repayment of principal on this new debt due 2038. This reduces the debt servicing cost and increasing maturity and allows for the lights to be on for a little longer and gives the government breathing room to tackle the problem at a future date. The generators are functioning at full power in Ireland for now. Unfortunately, Ireland accounts for less than 1% of EU GDP.

Australia – Flickering lights

The lights have been on in Australia and the bulbs are starting to flicker. The bulbs will eventually have to be replaced. The handoff between a slowing resource sector to a consumer sector has become tricky for both the government and the Reserve Bank of Australia (RBA). The budget is swaying between a deficit and surplus dependent upon the prices of commodities and the related taxation of the commodity producers. The RBA is stuck between a rock and a hard place with a

considerably higher Australian dollar which is starting to hurt the export lead industries and a rising housing sector, which again approaches record highs. The recent rate cuts have had less impact than expected as commercial banks have been reluctant to pass on the rate cut as their funding costs are dependent on global financial markets. Hence, the full effects of rate cuts have not been passed on to the consumer.

On a global basis the capital flows into the country are being driven by a stable and growing economy, fiscal discipline, high real rates and attractive corporate profitability. This has allowed the Australian dollar to remain strong both regionally and globally. Australian export driven companies are finding it difficult to stay competitive.

The strength of the Aussie dollar is further assured by the Bank of Japan's recent announcement of an inflation target, implying the Japanese yen has joined the global currency war. The yen has already fallen some 25% against most of its competitors.

Further Reserve Bank rate cuts may have unintended consequences. A re-ignition of the housing bubble and the reluctance of commercial banks to passing on cuts to the consumer will make their job a little harder this time around. A recovery in the US economy and the postponement of risk of default in Europe might save their day.

Portfolio implications

2012 was a good year for most 'risk-on' investments as central banks held rates at historically low levels. The Kapstream Absolute Return income fund delivered nearly 9% for the year. The credit spread rally and a conservative interest-rate position enabled us to deliver another year of attractive returns.

However, we foresee greater global risks and a challenging environment for 2013. Our investment perspective will continue to be driven by the fact that:

- Central Bankers will leave rates low for the balance of 2013 and beyond;
- Currency wars/depreciation will gain momentum in the coming year;
- With cheap financing and funding, risk assets should do well;
- US economic recovery is slowly gaining traction;
- European risks remain, but the ECB has kicked the can down the road for the time being;
- RBA has a difficult job in managing both a rising currency and the handover from the mining sector to the fragile consumer sector. They do not want to reignite another housing bubble.

Our resulting portfolio themes are as follows:

- We prefer floating rate assets to fixed-rate assets on the assumption that monetary policy at some point in the future will have to tighten. Perhaps not in 2013, but at a future date;
- We prefer corporate bonds to sovereign bonds in most regions of the world;
- We continue to prefer credit even though we expect minimum capital gains and credit spread contraction for the balance of the year;
- We prefer Asian names and larger allocations to the region;
- We also prefer the junior debt of the big 4 banks and expect to allocate to Tier 1 and Tier 2 paper of the Big 4;
- We prefer duration of around 1.0 year or less for our Absolute Return portfolios.

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