KAPSTREAM CAPITAL

July 2014

Long and wrong

The secular bull bond market began in 1981, when 10-year bond yields reached almost 16%. It was a different world back then, one in which we witnessed;

- The Premier of The People's Court, Dynasty, Raiders of the Lost Ark, and Cats;
- The release of the US hostages in Iran;
- Muhammad Ali's last fight (he lost to Trevor Berbick);
- The shooting of US President Reagan and Pope John Paul II;
- The opening of The Sydney Tower;
- The invention of the computer mouse;
- Blondie and Adam Ant on the top of the charts;
- The release of John Lennon's 'Woman' (posthumously);
- The marriage of Princess Diana and Prince Charles;
- The US debt ceiling hitting $1 trillion (vs. $17.2 trillion today).

Paul Volcker was in his second year as Federal Reserve (Fed) Chairman. Having hiked short-term rates by almost 10% over his first 2 years (to a high of 20% in May 1981), US inflation began to fall from the 1980 high of 14.8%. However, the unemployment rate climbed to over 10%, prompting widespread protests as the effects on the construction and farming sectors were hardest felt. Farmers drove their tractors onto the Fed's front lawn in protest.

But as inflation fell, Congress installed some fiscal 'integrity' (which was the last time this word could be used in conjunction with 'Congress'), by balancing the budget (through the 1985 Gramm-Rudman-Hollings bill), thus helping to usher in a long period of price stability and low inflation.

Bonds responded. After 10-year US Treasury yields reached a high of almost 16% in September 1981, they steadily fell over the next 30+ years, eventually reaching a record low 1.39% in July 2012. And while today global rates remain close to record lows with 10-year Treasury yields currently hovering around 2.40%, the bond bull market has so far failed to reach its 33rd birthday this year.

Over the past 30 years, fixed income managers have had it fairly easy, too easy. Steady exposure to intermediate and long dated bonds has proven to be consistently fruitful, allowing managers to neglect the inevitable need to adapt, mainly because they did not need to (although regular colourful commentaries regarding macro changes, security selection, politics and global thinking always formed a part of all bond managers' repertoire). But in reality, adopting a 'lazy long' (interest-rate) exposure to bonds provided relatively stable and positive long-term returns with very few exceptions – you had to be a really bad bond manager to underperform over the long run!

In fact you only had 3 years of negative returns from owning bonds during this period 1994 (-2.2%), 1999 (-0.82%) and 2013 (-2.02%)[1].

However, compared to the past three decades, the bond market has reached levels where the potential risk/return trade-off to being overweight bonds (duration) is not as attractive as it once was. Never have investors faced an environment where yields and cash rates have been so low for such an extraordinarily lengthy time – and rarely have they faced the risks of the eventual unwinding of central bank policies, which led to the current low rate levels.

[1] As measured by the Barclays global aggregate bond index, hedged in US$.

Holding on to outdated overweight bond strategies can become painful at some point in the near future. The protection (or yield pickup) that longer dated fixed income once provided is no longer available, and the upside is very limited. Rates can only go to zero! (Possibly negative as in some cases as in Japan and Switzerland)

Albert Einstein once said; "Insanity is doing the same thing over and over again and expecting different results." He will eventually be proved right in the bond market. With bond markets looking to end a 30+ year bull run and yields re-approaching historical lows, industry asset allocation changes have been surprisingly minimal. While much press has been written of bond outflows, we have yet to see a meaningful shift away from conventional fixed income portfolio management, most of which can be tracked back to the early days of the now waning bull run.

Do you really want traditional fixed income now?

Global growth is rebounding, particularly in the United States, inflation is gathering some momentum (albeit at a moderate pace) and markets are pricing in Federal Reserve rate hikes to about one percent per year starting in 2015.

We at Kapstream believe the rate hikes will be further in the future than what the markets currently predict, given a moderately improving US economy, but the bond bull market is still near the end of its run, notwithstanding global turmoil in the Middle East, Ukraine and China.

In this new secular environment of less liquidity and eventual rises in rates, we believe bond managers will need to develop different/better skillsets to deliver value to clients. Managers will need to focus on protecting capital as their primary goal, rather than comparing returns to a bond index, which will inevitably be negative at some point in the near future. No one likes to lose money, benchmark or no benchmark.

Rather than stubbornly sticking to what has worked for the past three decades, we encourage investors to abandon their 'lazy longs' and adopt more innovative approaches so that the same purposes for fixed income within overall portfolios – capital protection and income generation – can be achieved. We thought that the events of May/June 2013 would serve as a major wake up call, as the Federal Reserve hinted at the end of its quantitative easing plans. And while it did cause some investors to rethink their bond allocations, it did not convey just how dangerous the current low rate environment will eventually become.

Past performance is not indicative of future results

As mentioned earlier, since 1980, US fixed income (as defined by the Barclays Aggregate Index) has posted an annual negative return in only three years. Similarly, since 1989, Australian fixed income (as defined by the UBS Composite) has posted an annual negative return only twice[2]. However, given the low level of yields, we expect longer dated bonds will be more vulnerable to negative returns – the new reality. Below are examples of how vulnerable a bond can be to modest moves in interest rates over the short-run.

The current 'on-the-run' US 10 year Treasury has a yield of about 2.50% and the current 'on-the-run' Australian 10 year government bond has a yield of 3.40%. If over the next year 10-year bond rates rise by more than 0.29% in the US and 0.40% in Australia, their net returns will be negative.

Historically, interest-rates move up or down within an approximate +/-1.00% range of current levels over a year about 2/3 of the time (a 1 standard deviation event). Effectively this means there is a 2/3 probability that 10-year US Treasury yields will be between 1.50% and 3.50% this time next year[3].

[2] Bloomberg; About.com Bonds (http://bonds.about.com/od/bondinvestingstrategies/a/Stocks-And-Bonds-Year-By-Year-Total-Return-Performance.htm)
[3] There are a few assumptions behind this statement – primarily that 1% is the correct annual volatility of 10-year rates and yield movements are normally distributed - and some of these may not hold!

And following these statistical assumptions, there is a 47% probability of US 10-year Treasuries posting a negative return over any 1-month period and a 45% probability of Australian 10-year government bonds posting a negative return over any 1-month period[4].

The past thirty-plus years of declining interest rates has produced a generational bull market in fixed income assets. With this tailwind likely over, long-term investors need to reconsider the composition and role of bonds in their portfolios. Our belief is that it is unlikely that the shifts in economic data and Fed expectations will lead to a bond market crash. Rather, we expect bond yields to gradually move higher over time which will result in capital losses and eventually offsetting coupon income. We believe that with the onset of higher yields, further emphasis will need to be placed on a manager's ability to achieve a desirable return in a low yield environment, minimize the impact of duration, and yet still serve as a defensive anchor.

Outlook and Strategy

While the global economy continues its moderate growth, we anticipate maintaining an interest rate duration at or near 0.75 years, focused on two to five year maturities in Asia, Australia and the US. Further supporting this our expectation remains for short-term rates to be on hold longer than the market expects, providing a cap on yields over the shorter-run and excellent opportunities for carry and roll down. We have never been big believers in taking large interest rate positions, and feel this environment is no different. US 10-year Treasury yields in the 2.50% range and Australian government yields in the 3.50% range appear fairly priced, 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.

Commencing in June, we began to increase the overall quality of our portfolios in order to tactically mitigate corporate bond underperformance and to protect against worsening liquidity in the investment grade corporate space, to the extent that our 'liquid' bucket[5] now comprises over 25% of our portfolios.

While the US economic recovery has been tepid, it has been validated by various data releases, particularly GDP, employment, and commentary from the Federal Reserve. Second quarter GDP came in at a whopping 4% with upward revisions to the previous quarter of 0.8%. Furthermore, while slightly lower than expectations, the employment figures were still highly respectable, pushing the 3 month, 6 month and 12 month moving averages to 245,000, 244,000, and 214,000 respectively. Finally, the Fed remains committed to a slow removal of accommodation with 'tapering' expected to end this quarter. Globally, other deflationary risks still remain, particularly in Europe. After a very successful Portuguese debt auction in April, trouble hit the banking sector after it was announced that Portugal's central bank released a plan to rescue the country's second-largest lender by breaking up Banco Espírito Santo and pumping in billions of euros of state money. Given the peripheral's track record, it was unsurprising to many that only a few weeks prior the Bank of Portugal stated that Banco Espírito Santo had enough capital to weather shocks coming from its parent, a Luxembourg-based conglomerate that encountered difficulties due to accounting irregularities.

In Australia, the currency remains a thorn in the Reserve Bank of Australia's side. Stubbornly high in the low '90s, Governor Glenn Stevens has once again issued statements that it is "uncomfortably high". Data remains generally positive which has in turn led many to start pricing in rate hikes in 2015, yet the economy is still functioning at below trend in terms of jobs and sentiment. Potentially tighter fiscal policy may also drag on the growth story.

We forecast annual 2014 growth around 2.7%, well below the 4.5% long-term average of the past 25 years. While the 15% fall in the Australian

[4] We assume current yields, 1% annual interest-rate volatility, 8.6 year durations and normal distribution.

[5] Cash, government, agency and supranational securities

dollar (from last year's highs) 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.

We remain constructive on Australian and Asian credit given the valuations compared to other developed regions. As per the chart below, investors are receiving a premium compared to US investment grade debt.

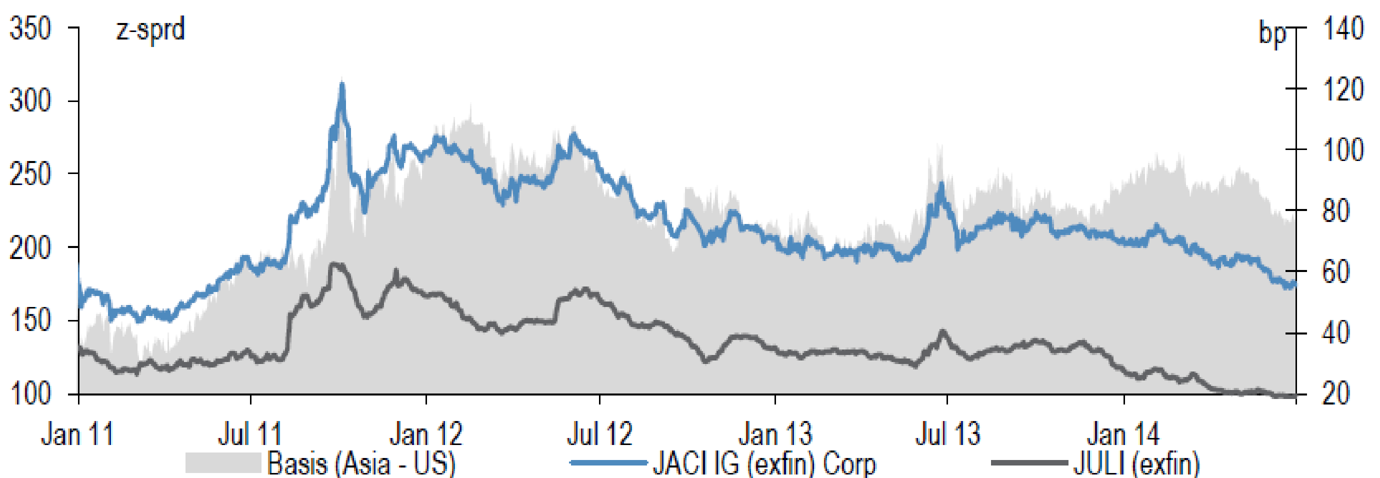
We remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e. those with deteriorating budgets, current accounts and reserves, and focus our attention on investment grade corporates in lower-beta (less volatile) countries such as Korea, China, Hong Kong and Singapore. We expect to continue to hold 10% to 15% of the portfolio in this region over the course of 2014.

Summary

Overall, the 'risk off' move in July has caused us to take a more conservative approach, preferring to maintain higher quality and liquidity, and keeping some powder dry to take advantage of the cheapening of our more favoured positions. We continue to favour corporate assets to sovereign assets with a preference to floating rate securities which will outperform in a rising interest rate environment. We particularly like short-maturity, defensive securities which are less sensitive to turnover and moves in interest rates.

As always, our approach to markets and portfolio management is managing risk first, returns second. Constructing portfolios that adapt to the changing market environment coupled with preservation of capital is essential.

Kapstream is prepared for the new era in fixed income. Are you?



Source: JP Morgan
JACI IG (exfin Corp): JP Morgan Asia Credit Index Investment Grade excluding Financials
JULI (exfin): JP Morgan US High Grade Credit Index excluding Financials

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