February 2013

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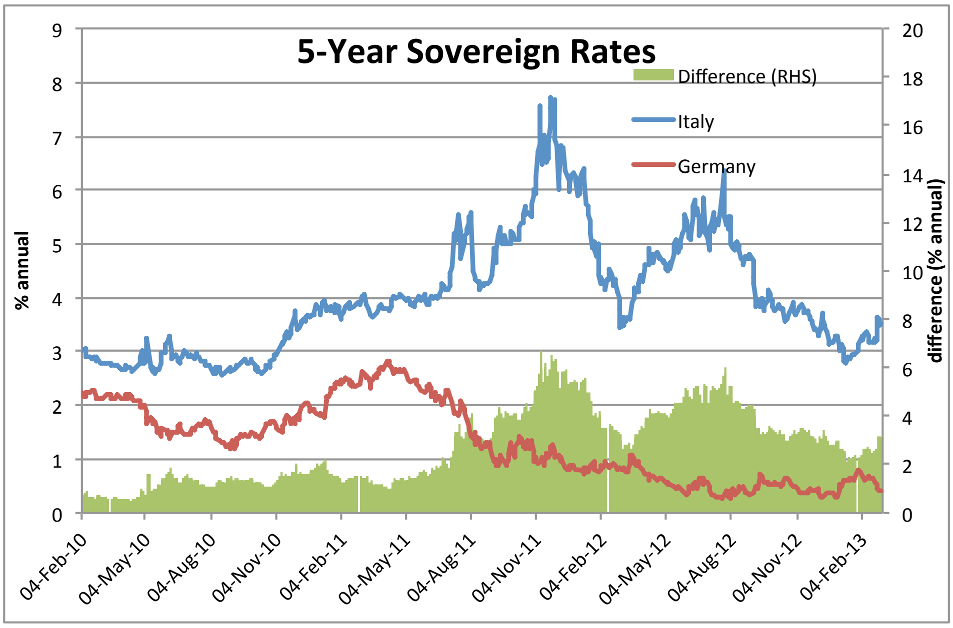
In an environment of lower yields and narrowing corporate bond spreads, the search for returns has become more challenging. While we still believe you get paid to take the default risk inherent in corporate bonds, you just don't get paid as much as you did last year. The main question facing investors today is whether we will remain in a 'risk-on' world where corporate bonds and other risk assets continue to perform well or whether continuing austerity and the corresponding drag on global growth will bring the world economy back into recession, ushering in a 'risk-off' world.

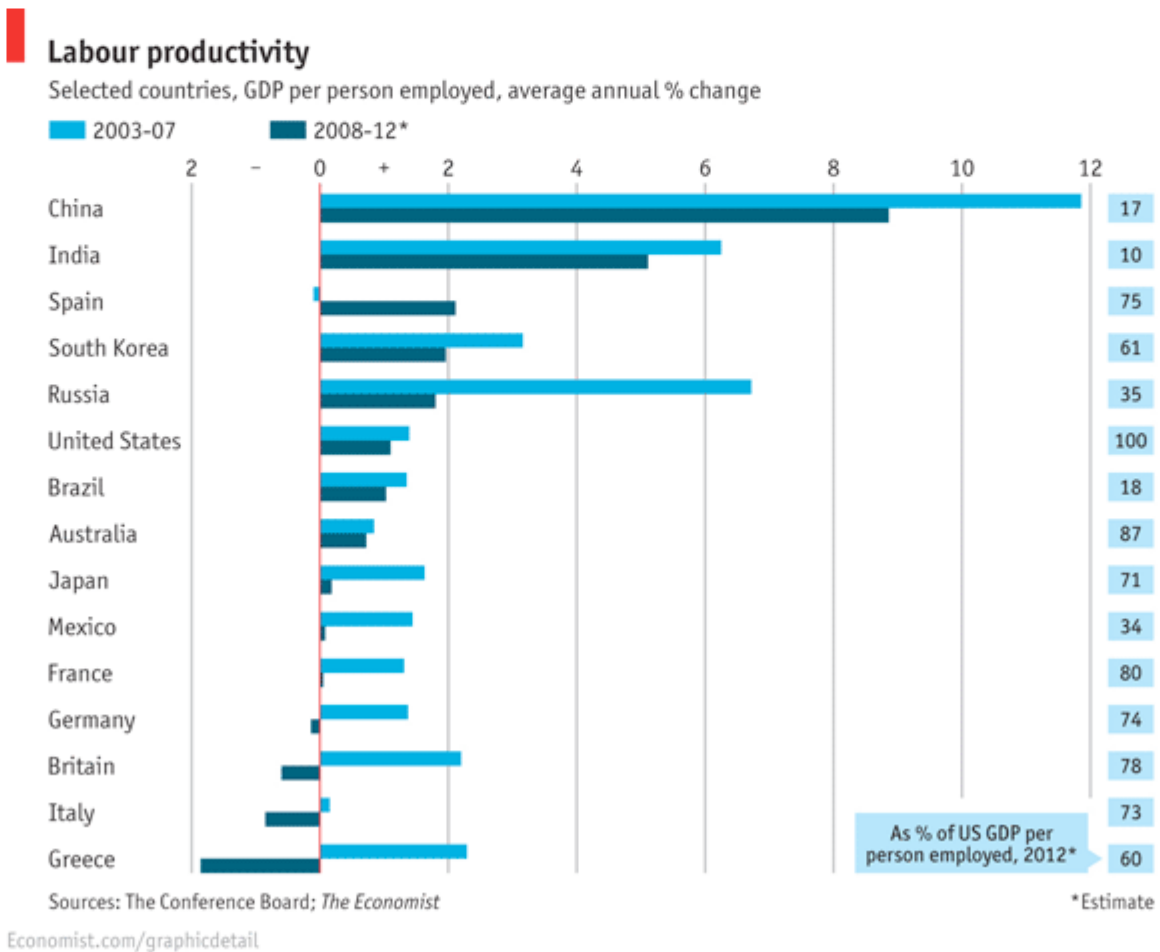
Bob Savage of Track Research asked in a recent article whether (central bank) easy money can fix what austerity can't. In other words, can global central banks continue delivering easy money to keep markets optimistic about economic growth, despite the developed world's growing fiscal problems? With the US Federal Reserve (Fed) balance sheet above $3 trillion, the European Central Bank (ECB) balance sheet above €3 trillion and the Bank of Japan beginning quantitative easing as it passes a $1 trillion balance sheet, central banks have become the key driver for risk assets. Global developed market central bank balance sheets have now reached $10 trillion.

Over the past 18 months we've been believers in global central banks' ability and willingness to continue quantitative easing in order to push investors into risk assets. On the back of this belief, toward the middle of 2012, we implemented a long position in three and five-year Italian sovereign bonds. With 5-year Italian BTPs trading at + 4% to 6% over German bunds, the 6%+ Australian hedged yield looked fairly attractive, considering the implementation of credible austerity measures and just as importantly, ECB support[1].



1 We unwound this position one week prior to Italian elections with the view that election uncertainty delivered too much risk relative to expected returns for these bonds.

If any country looked to be the poster child for both the fiscal challenges faced by the developed world and the opportunities for investors in terms of attractive yields, it was Italy. And Italy has its challenges. Namely, labour and product market regulation and a corresponding lack of growth. As a result of the lack of reform of labour and product markets, the real economy has grown little over the 13 years since European monetary union (EMU), making Italy the worst-performing country in the eurozone in terms of growth. In fact, per capita GDP has shrunk over the 13 years since EMU. Add the need to borrow €300+ billion per year and outstanding debt/GDP at over 120% and there was a good reason Italian sovereign debt was trading at such a large discount to Germany. Despite Italy's structural problems, it had managed to live with these record debt levels for more than 20 years, and while poorer, it had mostly lived within its means. Italy's underlying problems stemmed from rising labour costs and falling productivity which undermined competitiveness and exports. In contrast, over the same period, German productivity reached record after record as it slashed labour costs and opened product markets. Fast forward 13 years and Italian unemployment rose to a record 11.2% and youth unemployment reached 36%, while German unemployment fell to 6.9% and youth unemployment fell to 7.9%. Italy's labour participation rate fell to 63% in 2012, vs. 81% in Germany. Italy's low participation rate reflects allowances for early retirement, low female participation and a dual labour market where long-term employees are virtually impossible to fire and newcomers are forced to settle for temporary jobs.



Not surprisingly, the Italian economy has been in recession since mid-2011, and is projected to shrink by 0.5% in 2013 after shrinking 2.7% in 2012.

However, there are many positives for Italy. Italy's foreign liabilities are only about 20% of GDP, vs. approximately 100% in Ireland, Portugal and Spain, making Italy less vulnerable to international investor sentiment and volatility. Despite isolated negligence (Monte dei Paschi di Siena), Italian banks have been more cautiously managed than much of Europe and have considerably less balance sheet risk. But in our minds the biggest positive for Italian bonds was a mid-2012 statement by ECB president Draghi (and the former governor of the Bank of Italy), stating he would 'do whatever it takes' to save Europe. We interpreted this message to mean that as long as Italy continued down a path of fiscal reform, the ECB would continue supporting Italian government bonds through large purchasing operations. And to answer Bob Savage's question, easy money might fix what austerity can't, but in Italy you were getting the best of both worlds.

In return for European aid, Italy appointed an Economics professor, Mario Monti, as Interim Prime Minister to promote real austerity and reform. Italians trusted him. He eliminated the budget deficit and by the end of 2013, produced a balanced budget – through a €30 billion emergency package of fiscal adjustments over three years. The austerity measures included a €18 billion tax increase including the re-introduction of a property tax on first houses, which had been cut by Berlusconi. He also included higher taxes on petrol and planned an eventual 2% rise in VAT. Pension reforms were also included, which reduced the pensionable age calculations, effectively increasing the statutory retirement age to 62 for women and 66 for men. A new levy on private boats, aircraft and luxury cars was introduced. There were also tax breaks to encourage the hiring of women and young workers, a liberalisation of shopping hours, €3.8 billion for infrastructure projects, the removal of minimum license fees and measures to encourage new entrants into business.

Monti's reforms were aimed at encouraging greater competition. His 'Grow Italy' measures attempted to open the highly regulated service sectors such as pharmacists, journalists, notaries and taxi drivers. However, lobbying by entrenched business groups still managed to water down many of the measures, proving the difficulty in enacting real reform. For example, while barriers to entry in the pharmacy industry were reduced, lobbying allowed a large reduction in the allowable number of new pharmacy licences. Pharmacy licenses are limited to one for every 4,000 people. These licenses will continue to be passed down for generations, which will block newcomers unless they manage to purchase an exorbitantly priced license on the secondary market.

Despite much compromise, voters still showed their unhappiness with Monti's austerity measures, and his approval rating dropped nine points soon after budget passage. This unhappiness eventually led to late February's election results where Monti managed to receive only about 10% of the popular vote. In what we now view as a potentially 180 degree turnaround in future fiscal discipline, Italians were about equally split between three parties:

1) Cinque Stelle (5 Star party) led by a comedian with little political platform or economic plan other than Italy defaulting on its outstanding debt obligations and a repudiation of the entire Italian political system
2) ex-PM Berlusconi, who remains under indictment for a variety of corruption/bribery charges. While previously bringing the country to the brink of default, Berlusconi's platform now appears to be based upon an anti-austerity, anti-German platform. He's advocated returning to the people the new property taxes paid under Monti's current budget.
3) the centre left, led by a former communist head whose party oversaw the financial mismanagement of a 640 year-old bank which has already cost $5.3 billion in state aid

However, Italy's arcane election laws mean little will change over the short-run. A caretaker government will likely continue running the country until either a new election is called or two of the three parties form an unlikely coalition. The current president, Giorgio Napolitano, can't dissolve parliament and call for new elections due to a rule limiting his powers because he has less than six months left as president. For now we'll wait a couple of more weeks until parliament meets and recognises that they can't agree on anything. The process of nominating a new president and calling for new elections will likely last at least another six months.

In the meantime, Monti or another caretaker will continue running the government, which is a good thing, but with little power and support, only the status quo can continue. The interim government will likely keep existing austerity measures and reform, but little further progress will be made, although little further damage can be made. That's why the markets have so far taken the news so benignly. But the long run looks less optimistic, at least in terms of further economic reform and corresponding growth potential.

To Kapstream, the future will look similar to the 49-year period between 1946 and 1994. Over this period, Italy had 61 governments, although instability was less than expected as the Christian Democrats and their allies dominated ruling coalitions. While the party names may be different today, a series of governments with little popular support, delivering little meaningful policy reform will again become the order of the day. Gridlock forever. We were fortunate to sell our Italian positions.

From a global perspective, Italy may prove to foreshadow the political landscape of much of the developed world. Voter backlash and anger at austerity measures will make it tougher for central banks to continue to credibly support risk assets over the longer-term. While the 'risk-on' rally, supported by central bank easy money may continue over the intermediate term, longer-term risks remain as voters tire of the low growth, low employment, high tax environment that fiscal austerity delivers in the short-run. Meaningful structural reform appears equally off the table.

Despite these challenges, over the near-term (next six months), we expect 'risk-on' to continue as short-term bond rates in developed markets (US, Germany, Japan, UK, and Australia) remain at relatively low levels and quantitative easing continues. We forecast a measured but steady rise in long-term bond yields (ten year maturities and beyond) as:

- Growth recovers in the US (housing, jobs, and consumer confidence)
- The likelihood of a hard landing in China dissipates
- The market begins to price in a monetary policy 'exit'
- Real yields normalise from alarmingly low levels

In Australia the growth picture, while slowing, remains stronger when compared to other developed nations. The positive carry and roll down in Australian yields will marginally offset yield increases, however that 'carry' benefit has eroded over the past year. We also believe that the Reserve Bank of Australia will not deliver the scope of rate cuts priced into the market (terminal cash rate of less than 2.5%).

Our cash holdings remain slightly below average compared to historical positioning, and we will continue to maintain our duration position of approximately 1 year with the average maturity of our assets less than three years.

The ECB will continue to play lip service to easy money and quantitative easing, despite growing fundamental structural issues. Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term. While we remain cautiously optimistic for risk assets, we foresee continued volatility as increasing prospects for sweeping political change and the unwinding much of the recent fiscal progress will continue to drag on global markets.