April 2013

KAPSTREAM CAPITAL

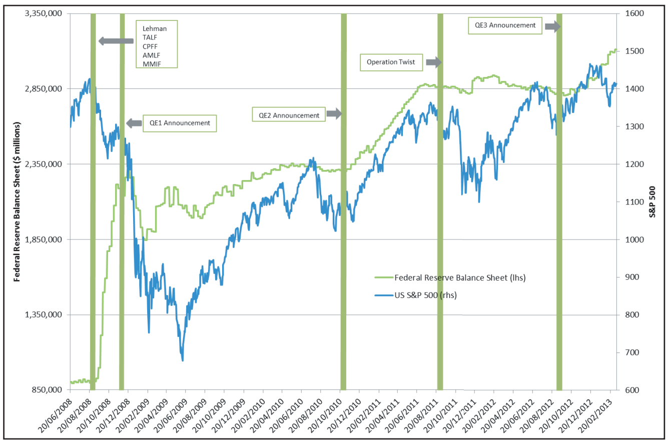
Pandora's Box

According to Greek mythology, Zeus ordered Hephaestus, the god of craftsmanship, to construct a woman. Hephaestus built the first human woman, Pandora. The gods gave her gifts; Athena gave her clothes, Aphrodite gave her beauty and Hermes gave her speech. But Prometheus (mankind's benefactor) stole fire from the heavens and gave it to humans without Zeus' approval. As punishment, Zeus presented Pandora to Prometheus' brother, Epimetheus. Zeus gave Pandora a box with a lock on it and gave Epimetheus the key and told them to never open it. While Prometheus had the power of thinking ahead and warned his brother not to accept gifts from Zeus, Epimetheus had only the ability of afterthought. Zeus knew curiosity would eventually lead to the opening and one day Pandora stole the key and opened the box. Inside the box were all the evils known to man, which quickly escaped before she could close the box. When she reopened the box, there was only one thing left: the Spirit of Hope.

In opening Pandora's Box through an approximately $10 trillion dollar expansion of global central bank balance sheets, policymakers have made an enormous bet that the evils unleashed are less damaging than the Spirit of Hope will be in aiding the restoration of global growth and employment. We'd like to believe that unlike Epimetheus, our policymakers have the ability of forethought and understand the evils of opening central bank balance sheets, but we've seen little mention of the evils and more of a focus on the Spirit of Hope.

The continuing weakness in global growth through the first part of 2013 has led to added policy responses from central bankers in the form of lower rates and further expansion of the money supply. While this continuation of easy money is detrimental to the world's savers, it has propped up global risk assets, especially equities. The S&P and Dow Jones industrial indices both posted fresh records in April. In Japan the Nikkei has rallied an impressive 32% since the 2013 announcement of a 2% inflation target by the Bank of Japan. US equities are up between 10 to 15% so far this year, European equity indices are up anywhere between 5 to 10% and the Australian ASX is up 12%.

Quantitative easing has worked in terms of propping up risk assets as it is quite clear that increases in central bank balance sheets have been highly correlated to rallies in equity markets, proving the Spirit of Hope is alive and well.



More monetary policy action appears likely for the foreseeable future. Reacting to continuing stagnation in employment, growth and inflation, the European Central Bank (ECB) cut its key interest rate by 0.25% to 0.50% and ECB president Draghi suggested that a negative deposit rate was possible after earlier comments to 'do whatever it takes' to save the European Union. The US Federal Reserve continued to promise to do whatever was necessary to spur growth and inflation, including continuing bond purchases at $85 billion per month for

15254/0513

the foreseeable future. In Australia, the Reserve Bank (RBA) reduced rates by another 0.25% to 2.75%, bringing a total of 2.00% in rate cuts over the prior 18 months.

Like equities, corporate bonds and 'risky' European sovereign peripheral bonds (Portugal Italy, Greece and Spain) continue with impressive rallies. Spanish 10 year bonds now yield below 4% – for the first time since 2010 and Italian 2 year bonds trade below 1% – a new record. Even the borrowing costs of the German and US government continue to hover around historical lows. Corporate bonds continue to rally; in both Australia and the US, investment grade corporates now on average yield just 1.3% more than governments, down from over 4.0% in 2009.

The continuing easy money story remains the key driver for global asset prices. However, growth and employment continue to disappoint as the easy money hasn't flowed into the real economy. Banks aren't lending and consumers and businesses aren't borrowing. The global financial sector, although slowly improving, remains fragile and many banks, particularly in Europe, are continuing to reduce their balance sheets. There are clear signs of a large credit crunch in both the UK and Euroland. US banks remain on a slow recovery pace, having written off bad loans and raised new capital over the past 5 years and now are modestly lending for housing and student loans. However, an unstable political situation and lack of clarity on fiscal reform and future taxation make business planning and future expansion more difficult.

But the Euroland situation appears dire. The arguments for why banks in Europe aren't lending revolve around two key points – 1) loans are still too highly priced for companies and consumers – this is particularly true for the corporates in peripheral countries, which carry their home country sovereign baggage and must borrow at rates 2-3% over German and French companies. 2) Unlike the rest of the world, European banks have resisted in writing down poor performing assets and haven't raised enough new capital, making a substantial supply of new loans all but impossible. Add the lack of labour and product market reforms and the long-term European situation looks even worse.

We at Kapstream aren't quite sure how this all ends, but we do know that over the shorter-term horizon of 2013 central banks will continue to support risk assets despite how stretched their balance sheets become. The true evils of cheap monetary policy and zero interest rates for extended periods of time will eventually show their face, but for the short-term we believe hope will continue to dominate investors' beliefs.

Winners and losers in April

Equities beat bonds in April with the MSCI all-country World index up 2.9% and the S&P500 up 1.8% and at a new high. The Japan Topix ended the month near 14 year highs, up 37% on the year. Bonds rallied as well – just not as much, with the Bank of America/Merrill Lynch Global Index up 1.1% – the best performance since last July. The biggest bond winner, Spain, was up 8.1% on the year with Japan the surprise April loser – as JGB yields rose despite the Bank of Japan's April 5 surprise monetary policy shift.

The biggest asset-class loser was commodities with the S&P/GSCI off 4.7% – the worst decline since last May. Oil was a key driver, off 6%, with the middle of the month printing a new yearly low for West Texas Intermediate at $85.61. Gold fell 7.7% on the month slipping into a bear market with an April 15th plunge of 9.3%, the worst one-day since 1980. Copper also fell 6.4% on the month reflecting concerns about inventory build ups and weaker China demand.

The disconnect of bonds and commodities – where markets price in continued economic weakness – versus outstanding equity performance – leaves many worried about the potential for a May pullback. In the last 3 straight years, 2nd quarter equity performance has been negative with the MSCI World Index down an average of 6.5%.

Bond yields

With US 10 year bond yields at 1.77%, markets expect the Federal Reserve to continue to facilitate low interest rates. 10 year Treasury yields have moved from 1.66% in December 2012 to 2.08% in March 2013 and back down – the full circle reflects the significant doubts over sustainable global growth. These doubts spring from weakness in Europe, doubts over China and an ongoing muddle-through recovery in the US. However, as global economic data on balance demonstrates greater probabilities of global recovery, markets begin to price in the eventual end and reversal of quantitative easing, causing bond yields to rise. This remains the primary bond market fear and something that matters more today than ever in the past given the current low level of yields. There is a balancing act and we expect interest rate volatility to remain high for the foreseeable future.

Asia slowing

Asia economic growth has turned for the worse. Japan saw weaker than expected retail sales and industrial production, Australia saw weak credit demand and New Zealand saw housing approvals plummet. Chinese 1st quarter GDP came in at 7.7%, while previously markets expected growth to be around 7.9%.

Australia

In Australia – the government is having a difficult time in bringing the budget back to a surplus. The market expects the RBA to lower interest rates by at least another 0.25%, bringing rates to new historical lows. Meanwhile, the low interest rate environment is pushing up bank profitability (big 4 banks posted record profits for 1st half 2013) and equity markets are on the rise.

The trick for the RBA and the government is the transition from a once in a generation commodity lead boom which is slowing, to an economy which is less reliant on a single sector. This will be a difficult balancing act.

Portfolio implications

While we foresee much volatility in the coming months, we believe credit markets will continue delivering solid returns as monetary policy remains accommodative, supporting risk assets. US and Asian economic data appears on balance to be improving and focus will be placed on the global recovery which looks to be taking shape.

Over the near-term (next 6 months), we expect short-term bond rates in developed markets (US, Germany, Japan, UK, and Australia) will remain at relatively low levels as 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 remains stronger than 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. The RBA's 0.25% rate cut bringing rates to historical lows may be the last cut for some time and the RBA will not deliver the scope of rate cuts still 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 slightly less than 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.

We continue to prefer corporate assets over sovereign assets and we favour floating rate bonds over fixed rate bonds as interest-rate volatility will remain high.

We will maintain conservative exposures to subordinated debt of the big 4 banks and hold select Asian issuers, particularly those fully or partially owned by sovereigns. We will retain selected holdings US issuers in our portfolio, particularly those of the too-big-to-fail US banks. We do not expect significant additional contraction in the credit spreads of corporate bonds – but will take the gains when we get them.