KAPSTREAM CAPITAL

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# Poker Face

Phil Ivey. Johnny Chan. Doyle Brunson. Phil Hellmuth. Janet Yellen?

The explosion of poker over the past decade has resulted in a multi-billion dollar industry, celebrity-like figures, catch phrases, movies and songs, not to mention Kapstream's very own annual Charity Poker Night[1]. A game that used to be the confined to smoky casinos in Las Vegas is now regularly played by millions of people around the world. Kenny Rogers gave us sage advice with "you got to know when to hold 'em, know when to fold 'em", while even Lady Gaga joined the poker phenomenon with her chart topper, although it is arguable as to whether hers is about romance or poker.

Janet Yellen's name isn't typically associated with the poker greats, but maybe it should be. Since the 'taper tantrum' in June 2013, the US Federal Reserve (Fed) has been hinting about the eventual lift off in interest rates. Recently, investors were fixated on whether the Fed would remove 'patient' from their FOMC statement (which they did in March). Yet, the Fed not only lowered its forecasts for growth and inflation but also reduced their rate hike expectations in the future. Which begs the question: is the Fed bluffing on rate hikes in 2015?

Following the weak March non-farm payroll number (up 126k), the door on a June hike has virtually closed. We always knew that the Fed would err on the side of caution so as to avoid any policy mistakes but with the deterioration of economic data, core inflation well below the 2% band, stagnant wage inflation, lingering threats to growth, and the rapid rise in the US dollar, Kapstream's base case of no hikes in 2015 is looking more and more realistic. Further compounding the issue is the global landscape. Since December, more than 20 central banks have cut interest rates. With the rest of the world adopting an easing bias, and many of those same countries grappling with negative yields, it is difficult to imagine a scenario where the Fed moves counter to the rest of the world.

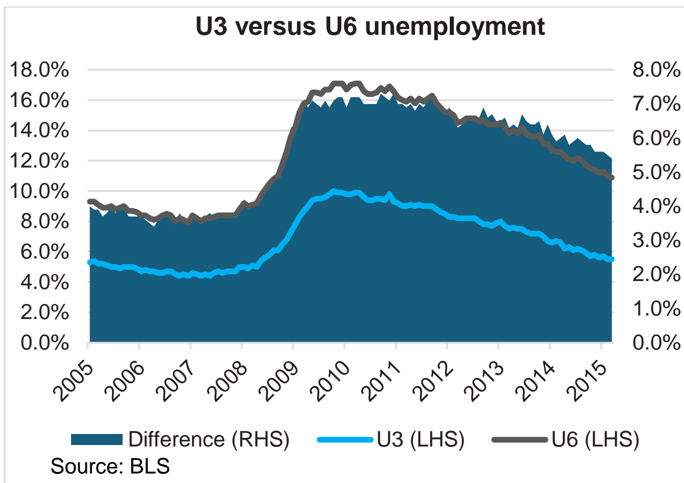
The Fed needs flexibility in its policy action. The timing and extent of rate hikes is data dependent as well as to a certain extent cognizant of (equity and bond) market reaction to rising rates. At the same time equity and bond markets need certainty. You can't have both. A flexible Fed will cause uncertainty in financial markets – leading to increased volatility and decreased liquidity if timing of rate rises are not communicated properly. Everybody starts playing a guessing game. Kapstream believes that in order to provide certainty and adequate liquidity to both bond and equity markets, the Fed will have to sacrifice flexibility by not only broadcasting the exact meeting when they expect lift-off in rates, but also guide the market as to the path of future rate rises and provide guidance on the ultimate terminal level of Fed Funds rate that the economy can tolerate.

## Is the job market really improving?

After posting twelve consecutive months of over 200,000 jobs, the March US non-farm payroll data broke its streak with a lackluster 126,000 jobs (expectations were 245,000). Further compounding matters, February's payroll figures were revised downwards by 30,000 jobs. While one jobs report should be taken with a grain of salt, particularly for such a volatile data point, other factors reveal that the employment situation is not as strong as headlines suggest. The unemployment rate has steadily dropped to 5.5% from 10% in 2009, however the job-finding rate which measures the chances of an unemployed person finding work is deteriorating. Recent reports reveal an increase in the number of long-term unemployed as well as the number of people not looking for work.

A closer examination of the components of the unemployment rate add further fuel to this argument. The graph below shows the official unemployment rate, also known as U3, which calculates the total unemployed, as a percent of the civilian labor force. Unlike U3, the U6 unemployment rate expands on the labor force to include people without jobs who have given up looking for work, people without jobs who would like to work but have not sought employment recently, and part-time workers who would like to be employed full-time. While always much higher than the standard U3 rate, the spread between the U3 and U6 rates remains at elevated levels. Prior to the Global Financial Crisis, the historical spread between U3 and U6 was 3.7%, significantly lower than the current spread of 5.4%.

[1] The Kapstream Charity Poker night has been held for eight straight years and has raised $270,000 for Bear Cottage and VACD.



Source: BLS

**Outside the US**

Across the globe, 'easy' policy remains the consistent theme. With the ECB leading the charge with their €60 billion per month bond buying program, the markets are taking the playbook from the US experience: one that includes QE lasting longer than what the ECB predicts, followed by a run up (artificial?) in European equities and a rapid depreciation in the Euro. This year alone, the DAX is up nearly 25% while the Euro has depreciated 12% versus the USD. Questions remain as to whether QE will eventually result in growth for the region particularly with the sputtering peripheral region.

In Australia, the RBA held firm on interest rates, surprising some. While the RBA didn't cut the cash rate after the March Board meeting, it did say 'further easing of policy may be appropriate over the period ahead, in order to foster sustainable growth in demand and inflation consistent with the target', leading many to believe that cutting rates to 2% is likely.

Over the course of the month bonds struggled early, but rallied strongly in the back half of the month on the back of the dovish Fed and plunging iron ore prices (down 18% over the month).

In China, the Monetary Policy Committee (MPC) continues to signal for additional easing due to rising concerns on growth and disinflation. Lackluster data has yet to set off any alarm bells for the Chinese stock market which is apparently taking cues from the MPC in the form of an economic policy 'put' that easy money can promote additional gains.

Overall we believe the theme of low global central bank rates and more liquidity will continue, compelling investors to hold risk assets. We foresee a continuing currency war as global central banks position for export growth amidst deteriorating domestic environments. The US will remain the only developed market that can tolerate a stronger currency while not playing the currency game as prior structural and banking reform promote greater growth prospects.

Janet Yellen and the Fed, like poker players, for now have to keep their cards close to their chest. While Yellen perfects her poker face, Europe plays snap and Greece plays cheat – only time will tell as to whether the Fed and other central banks "know when to hold 'em, know when to fold 'em, know when to walk away, know when to run…"

**Portfolio Positioning**

1. We continue to hold ~20% in a 'liquid' bucket – comprising government-related bonds and cash
2. We remain overweight the US$ vs. AUD, JPY, EUR
3. Our overall duration is 0.80 years – preparing for an eventual rise in rates
4. A small holding in Portuguese sovereign bonds remains our only sub-investment grade exposure
5. We continue to favour corporate assets in Australia/Asia and certain sectors in the US
6. Prioritising capital preservation while achieving a reasonable risk-adjusted return that outperforms CPI/cash remains our central investment objective

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