June 2014

Razzle Dazzle 'em

Imagine Janet Yellen and FOMC voting members singing the lyrics to Chicago, the musical:

BILLY (spoken)
Roxie, you got nothing to worry about.
It's all a circus, kid. A three ring circus.
These trials- the whole world- all show business.
But kid, you're working with a star, the biggest!

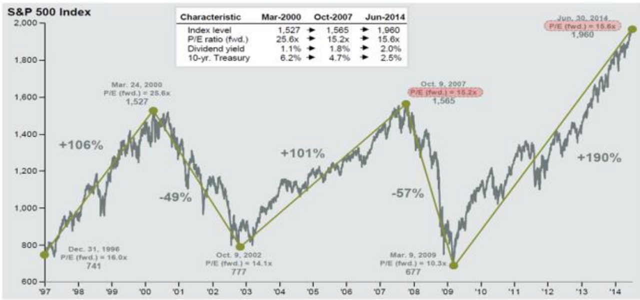
(singing)
Give 'em the old Razzle Dazzle
Razzle Dazzle 'em
Give 'em an act with lots of flash in it
And the reaction will be passionate
Give 'em the old hocus pocus
Bead and feather 'em
How can they see with sequins in their eyes?

What if your hinges all are rusting?
What if, in fact, you're just disgusting?

Razzle Dazzle 'em
And they'll never catch wise!

Give 'em the old Razzle Dazzle!

Free money has propelled risk assets (particularly equities) to record highs. Everybody loves a party with free drinks… but there's always a hangover:



(Source: BT Advance)

There have been three US stock market rallies and two busts over the past 17 years, all driven in large part by the Razzle Dazzle of the US Federal Reserve (Fed). The first boom-bust occurred in the so-called Dot.com era of the late 1990s and early 2000s.

This was followed by the boom in leverage and housing finance in the mid-2000s (the 'Greenspan Put' – remember him?), leading to the spectacular bust of the more recent global financial crisis.

The current third boom, characterised by a 190% equity market return from the depths of 2009, was propelled by government balance sheet expansion and virtually free money from global central banks. But for how long will global central banks continue to Razzle Dazzle the markets? Can anything derail this party? What would cause it?

On the surface, all markets look expensive. But with good reason. Markets have become desensitised to geopolitical risks in the Middle East, China, Africa, Gaza and the Ukraine. And rather than launching the requisite missile over Japan, even North Korea now takes its Seth Rogan complaints directly to the UN. If only we at Kapstream had such luxury.

Now is the time for patience and caution. So long as the Fed party remains a constant flow of libation, risk assets will continue to perform well. While it's hard for us to identify the timing of the removal of easy central bank policies, we know it will eventually come. Maybe not today, maybe not this year, maybe not next, but eventually it will come. Risk markets have provided a good ride. We have recently started taking some chips off the table by reducing corporate positions and moving into higher allocations of cash, government and agency securities.

Outlook & Strategy – Is tomorrow the turning point?

Nonetheless, over the remainder of 2014 the combination of deflationary forces and further central bank support will likely continue to provide a cap on global bond yields. We expect to maintain a 0.75 year interest-rate duration exposure, focused in 2 to 5-year maturities in Australia and the US, given our expectations for central banks to remain on hold much longer than markets currently anticipate.

However, we foresee a continuing moderate recovery in the global economy over the next 12 months.

In the US, we expect continuing slow improvement in economic data and we remain biased toward an eventual rise in global long-term bond yields as:

- Growth continues to recover in the US (housing, jobs, and consumer confidence);
- The market prices in a monetary policy 'exit';
- Real yields normalise from alarmingly low levels.

However, rate rises may still be years away as low global inflation and moderate jobs growth create a cap on bond yields in the near-term. We believe bonds are fairly priced in today's environment and expect rates near today's levels over the coming months. We don't believe taking large interest-rate positions is warranted in this environment as the information ratio is low and interest-rate volatility will remain high. 10-year US Treasury yields in the 2½ to 3% range and Australian government yields in the 3½ to 4% 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.

While US growth is improving, the pace will remain fairly muted and well below the 3.4% average pace for the period following WWII through 2007. Despite occasional hiccups, employment gains will continue in the 200,000/month + range, which could bring the unemployment rate down below 6% by year-end 2014. The US has now regained the 8.6 million lost jobs over the 2008 – 2009 period.

However, inflation will remain under control, still below the Fed's 2% target given the enduring slack in the labour market in the form of lower paid and temporary jobs.

Globally, other deflationary risks still remain, particularly in Europe. European quantitative easing may take longer than currently expected, but we eventually expect the announcement of a €1 trillion programme mainly focused on sovereign debt closer to year end. However, the rationale the European Central Bank (ECB) has used to continue supporting Peripheral countries, i.e., promises of fiscal austerity, has deteriorated over the past 12 months. Despite marginal improvements, Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term, but we view this as a 2015-and-beyond problem, given the ECB's continuing support.

In Australia, the Reserve Bank of Australia (RBA) will remain on hold although the currency isn't doing as much of the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower Australian dollar. 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 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.

While equity markets continue to hit record highs, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures, keeping disposable income levels extremely low. While we foresee further Australian dollar weakness, the currency is more likely to be driven by US Fed action and US economic data rather than by anything in Australia. As US QE3 concludes towards the 4th quarter of 2014, it will provide some relief to the Australian dollar, although it's hard to see a dramatic fall, particularly as the interest-rate differential between the US and Australia will continue to support financial flows into Australia. With moderately attractive real yields, we like Australian interest-rates relative to the US and the rest of the developed world.

We expect US dollar weakness to continue its reversal in 2014 as the ending of the Fed's quantitative easing programme, combined with stabilising growth, supports the US dollar over the remainder of the year.

Markets will continue to worry about China, but while concern over the risks of a Chinese hard-landing disappear, caution remains over the growth of Chinese local municipal debt and risks in the 'shadow banking' sector. Yet we believe this to be another red herring and unlikely to bring about a major debt crisis in 2014. This growing debt may represent China's largest economic problem, however, we would be surprised if central government did not intervene if it became a real threat. China's overall total debt at 56% of GDP still compares favourably to most developed countries, and we expect Chinese growth to remain in the 7½% range over 2014, continuing to support the global growth story.

While Asian fundamentals appear fairly solid in both the corporate and sovereign world, a rising rate environment will prove challenging for inflows, similar to the 2nd half of 2013. Sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world, particularly Europe. We will remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e. those with deteriorating budgets, current accounts and reserves. India will remain a top Asian story as weaker fundamentals will provide a challenge to maintaining its investment-grade rating. We will continue to favour investment grade corporates in lower-beta (less volatile) countries such as Korea, China, Hong Kong and Singapore. We expect to hold 10% to 15% of the portfolio in this region over the course of 2014.

Summary

Overall, the theme of extremely low global central bank rates and more liquidity will continue through 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the equity and risk market gains of 2013 amidst a steady but moderate growth environment While we expect continued volatility in the coming months, we believe risk markets will continue delivering solid returns, particularly investment-grade credit, which we expect will also have lower volatility. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals remain attractive, the technicals surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. Although more recently we have reduced overall corporate exposure (in favour of cash, government and agency securities) we continue generally to favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets which will outperform in a secular environment of increasing rates. We particularly like short-maturity, defensive securities (less than 5-year maturities, high-rated global banks, conglomerates and quasi-sovereigns) which are both held in more solid hands and less sensitive to moves in interest-rates. We are maintaining our small position in Spanish and Italian sovereign bonds with expectations for further ECB liquidity, providing both support for Peripheral economies and a back-stop against major yield rises.

Again the lyrics from Chicago come to mind:

BILLY AND COMPANY
Razzle Dazzle 'em
Give 'em a show that's so splendiferous

BILLY
Row after row will crow vociferous

BILLY AND COMPANY
Give 'em the old flim flam flummox
Fool and fracture 'em

BILLY
How can they hear the truth above the roar?

BILLY AND COMPANY
Throw 'em a fake and a finagle
They'll never know you're just a bagel,

BILLY
Razzle Dazzle 'em
And they'll beg you for more!

We question whether the FED can continue to Razzle Dazzle the market forever.

Given current valuations and weakening bond market liquidity, we have increased exposure to cash, government, agency and supranational securities, which now total more than 25% of the portfolio's market value.