KAPSTREAM
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Rehab? Go, go, go…

In the music industry, a number of artists achieve periods of extraordinary achievement and prolific output which are all too often coupled with an addiction of some type (defined as 'compulsive engagement in rewarding stimuli despite adverse consequences'), be it drugs, alcohol or both. Artists' pinnacle moments of success are all too often capped by odd, uncharacteristic and dangerous behaviour. A period of rehabilitation – literally originating from the Latin meaning 'again, make fit' – frequently follows with the intent of restoring a normal, healthy condition. The list of troubled souls in this category includes arguably some of the most successful and innovative artists of all time; Keith Richards, Ozzy Osbourne, Anthony Kiedis, Eminem, and (RIP) John Lennon, David Bowie and Amy Winehouse.

Like the music industry, global capital markets currently require an ensuing period of sobriety; payback time, a facing of consequences following their record successes of the past few years. As the 7 year rally in equity and risk markets ends, we anticipate a sober period of financial market returns over 2016. The ongoing themes of a Chinese slowdown, falling commodity prices, and further US Federal Reserve (Fed) rate hikes will continue to weigh on markets, despite ongoing aid from global central bank liquidity.

While we don't foresee a risk market disaster that year-to-date performance perhaps implies, increasing concern over equity valuations, and the ability of central banks to indefinitely support risk assets will limit financial returns in 2016. So as markets 'rehabilitate' towards greater normalcy from the easy money that central bank liquidity provided, we expect risk assets to fall short of the impressive returns we have become accustomed to in recent years.

We summarise below the headline market themes we believe will impact the global economy in 2016:

- While markets had priced-in US Fed rate hikes of approximately 1% in each of the next few years, **we continue to believe the Fed will remain on hold for much longer than markets anticipate**, perhaps through the remainder of 2016.

- Despite the recent pick-up in US employment, **we see little prospect for inflation**, which will be contained by muted wage inflation as job gains remain focused in the lower-paying tier of the service sector, and also held back by fragile consumer spending, a stronger US dollar and continuing commodity price weakness.

- **The European Central Bank (ECB) will likely increase the size, scope and timing of the stimulus as European growth and inflation underperform expectations**; high quality European assets should remain well supported in this scenario, despite low yields.

- **The Bank of Japan will turn to even more stimulative measures**, with the probability of increased Japanese Government Bonds (JGB) auction failures as bond yields remain in negative territory.

- **The Reserve Bank of Australia will remain on hold**, despite the economy holding up remarkably well in the face of the global slowdown – with 2015 labour force gains of over 25k/month and inflation approaching the RBA's 2% target, it remains better positioned than other developed central banks with scope to reduce rates should the deteriorating global economy have a greater domestic impact.

- **The world remains in a currency war** as global policymakers look toward export-led growth amidst consumer weakness and deteriorating domestic demand; we expect the USD to continue to strengthen through the year.

- **The expectation of a hard landing in China is overdone**, despite slowing from its impressive 7% annualised growth levels of recent years, and policymakers' will continue to focus on the central goal of social stability and bringing the workforce out of farming and into manufacturing/middle-class; shadow banking sector stresses may grow and structural reform will continue to take a backseat to social stability priorities, but this is unlikely to cause material economic slowing in 2016.

- Despite near record low yields, **sovereign bonds will remain a safe-haven**; Australian, European and US sovereign bond indices are up 1% to 2% so far this year.

- **We remain less convinced that bonds will continue to maintain their traditional role as a hedge against underperforming risk assets**, given limited room for further rallies as rates approach zero; currently more than US$5.5 trillion in global sovereign debt trades at negative yields, including more than 1/3 of all outstanding European sovereign issuance.

- **We continue to believe that bond markets remain fairly priced**, despite near record low yields, balancing a long-term low-growth, low-inflation environment against eventual US Federal Reserve rate hikes.

How do we intend to structure portfolios in this environment?

- As the Fed remains on hold and other global central banks increase stimulative activities, we intend to orient the portfolio to benefit from further non-USD currency weakness; we have maintained a 3% long USD position versus a changing basket of (mainly) Asian currencies including the AUD, NZD, CNH, THB and SGD.
- With global interest rates remaining well contained amidst slower growth and inflation, we will maintain the Fund's interest-rate duration in the 0.85 to 0.95 year range.
- While we believe European stimulus will eventually include the purchase of non-government bonds, we find bond opportunities limited given low/negative yields and too great risks associated with higher-yielding investments; we will continue to maintain a 1% position in each of Spanish and Italian sovereign debt, given the ECB's commitment to continue supporting sovereign bond markets, and will look to add high-quality, systemically important European issuers to portfolios.
- Globally, we like systemically important, highly rated Asian issuers such as government-related energy, telecom and banking entities, plus US 'too-big-to-fail' banks whose bonds should be supported by an increasingly robust regulatory environment focused on less risk taking and greater capital requirements.
- We have long held a positive view on investment grade credit in Australia, largely due to the attractive real yields and robustness of issuers compared to other developed markets, and continue to invest approximately 2/3 of all portfolios in the sector; favoured holdings remain the banking sector for its attractive yields and greater liquidity, and infrastructure-type assets such as airports and toll roads which offer attractive yields, monopolistic business structures, high regulation, quality underlying collateral, and are systemically important.
- The 'liquidity bucket' of our portfolios, consisting of cash/deposits, government and government-related securities, remains above 20% and our second tier of liquidity, consisting of financial sector assets, remains at approximately 40%; we continue to believe higher levels of liquidity are warranted to limit downside losses, should the risk-off market environment continue or deteriorate further, and in order to have 'dry powder' to take advantage of widening bond spread buying opportunities.

Clear parallels exist between those in the music industry who have battled various success-led addictions, necessitating a coerced abstinence through rehabilitation, and risk market participants dizzy with the euphoric effect of protracted QE policy over the past several years. No one said it would be easy once the training wheels were removed, and while we remain in a period of ongoing uncertainty, the title of The Eagles 2005 song about recovery from addiction could not be more appropriate – *One Day at a Time*.