KAPSTREAM CAPITAL

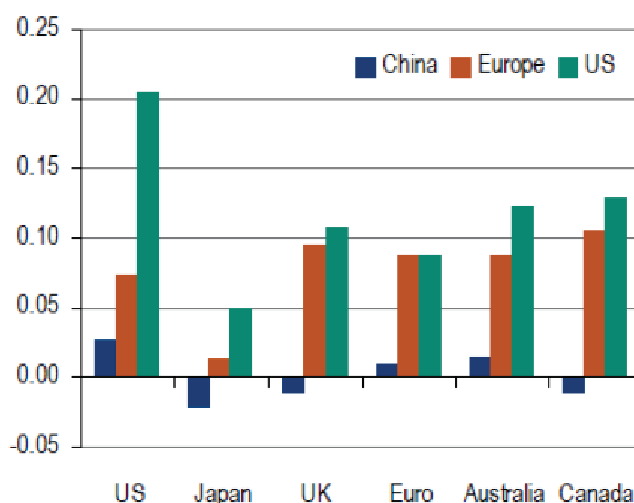
# Staring out over the cliff

The combination of high unemployment, spare capacity, benign inflation and continued quantitative easing means that monetary policy will stay 'easy' for the foreseeable future, through 2013 and beyond. As a result, we expect short-term bond yields in developed markets (US, Germany, Japan, UK, and Australia) to remain at historically low levels. However, 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,
- European sovereign tail risk gets priced out,
- 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. As Asian growth continues to remain relatively strong, we believe that the Reserve Bank of Australia (RBA) will not deliver the scope of rate cuts priced into markets (terminal cash rate of 2.5%). While the RBA may continue with another rate cut in early 2013, a rosier global picture should keep movements by the RBA to a minimum over 2013. We expect similar outcomes in Asia ex-Japan where markets have been slowly pricing out rate cuts as the growth and political situations in the US, Europe and China look more favourable. Post the Global Financial Crisis, Asia led the charge in terms of normalising interest rates (the RBA was the first to hike) and we believe this will continue, as Asian Central Bankers will move towards curbing inflation as global growth improves.

As expected, movements in global rates are largely correlated to developments in the US, Europe and China. As the graph below shows, interest rates are most sensitive to shocks (both positive and negative) in the US.




Source: BofA Merrill Lynch Global Research.

We firmly believe that once the political barriers in the US are cleared, the focus will be placed on the global recovery. The fiscal cliff has dominated headlines since the election, muting what has been a respectable turnaround story for China and Asia. Key demand variables across Asia have begun to improve on both a year on year and momentum basis. This has started with China and is now shaping up in other Asian countries. In China, the purchasing managers index (PMI) improved in November registering 50.6, the second consecutive reading above the expansionary threshold of 50. As the easing measures continue to filter through the Chinese economy, we expect GDP growth to rebound to 8% in 2013. While the Fiscal Cliff has the potential to counteract any positive growth story, the eventual resolution will likely give a boost to risk assets. While it would be shameful for politicians to drive the US over a cliff into an avoidable recession due to meaningless political ideology, politicians

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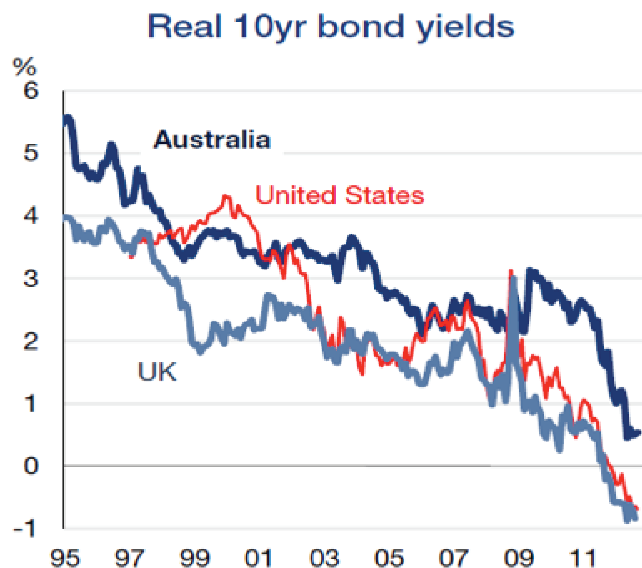
behaving rationally remain an anomaly. Therefore, we expect some short-term volatility in global rates as the political game of chicken continues well into early 2013.

A short-term or complete resolution around the fiscal cliff would likely result in risk assets (credit, high yield, and equities) performing well in 2013. Longer-term interest rates (globally) will likely suffer due in part to a renewed focus on the recovery as well as worries around ever expanding Central Bank balance sheets. We believe maintaining large duration positions has more downside than in 2012 as rate rises look more likely in 2013. Negative US real yields are unsustainable and we expect to see small, positive real yields by the end of 2013. We see better value in Australia, the only developed market with positive real yields.




We expect to see continuing market volatility over 2013, as the positive stories including:

- A continuing slow US economic recovery,
- Short-term containment of the Euro crisis,
- positive Asian growth,

which will contrast against the negative stories of:

- continuing fundamental Euro structural problems,
- US political gridlock including short-term fiscal cliff risks,
- the need for fiscal austerity in developed markets leading to lower growth prospects.

With the above in mind, we expect global interest rates to rise marginally over the course of 2013, but still trade within a narrow range. We believe there is still more room for corporate spread compression, although not to the extent experienced in 2012. We expect to position our portfolios to benefit from relatively stable, but slightly rising interest rates, while still maintaining conservative corporate risk positions.

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