KAPSTREAM CAPITAL

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Storms and Stability

Amongst military leaders, Ho Chi Minh was known for both the determination and patience with which he pursued the goal of Vietnamese independence as he attempted to blend Communism with Nationalism. From his early years, Ho championed freedom for his native country, and grew into a respected leader who played the role of the underdog, ultimately leading a movement to end French colonial rule as well as serving as a formidable opponent to the United States during the Vietnam War.

It was in his role as the underdog where Ho Chi Minh inspired Communists and Nationalists worldwide, persevering for decades when the likelihood of success seemed unlikely. Following a violent clash where Chinese military forces overpowered the Communists, Ho Chi Minh made use of an ancient Chinese proverb, telling his followers “don’t be discouraged by the recent setback”, and “remember that a storm is a good opportunity for the pine and the cypress to show their strength and their stability.”

Whilst being at the opposite end of the economic philosophy spectrum as Ho, we at Kapstream pride ourselves on maintaining a responsible yet flexible approach in the face of difficulties. With key tenets of capital preservation and stable income generation, our main goal is to remain defensively minded, protecting our clients’ investments. The recent volatility in the financial markets has given us cause for concern for a multitude of reasons. On one hand, you have a Federal Reserve which seems eager to abandon the zero interest rate policy (ZIRP) and increase rates for the first time in over nine years combined with corresponding rises in global market yields. On the other hand, you have a global economic environment that continues to show limited-to-no growth, central bank easing biases, and the never ending tragi-comedy that is Greece. With limited directional sentiment, we see yo-yoing back and forth in search of clarity that is becoming more unrealistic each passing day.

Furthermore, decreasing market liquidity continues to be the growing elephant in the (fixed income) room that features in our cold sweat nightmares. Much has been written lately of shriveling dealer inventory, driven by an evermore cautious banking community unwilling (or unable) to be the bulging stockists of years gone by, instead moving to a more purist ‘buyer-meet-seller’ role. We see much theoretic examination of liquidity ‘stress testing’. This is all very interesting (we assume to someone) but the reality is that current liquidity conditions have yet to be truly tested by material levels of forced selling, and we will only learn how poor liquidity will become when the elephant eventually shows itself.

It is these concerns that drive us to grow our ‘liquidity bucket’ (our very own “pine and cypress”), to serve as an anchor of stability and protect against these stormy and volatile times. While we acknowledge the small sacrifice to portfolio yield, investing more heavily in cash and higher quality helps us ensure that the portfolio remains liquid, protecting capital, whilst making good on our stability commitment to clients.

Since mid-April, Australian rate volatility his risen in sympathy with global uncertainty. 10-year Australian sovereign yields moved from a low of 2.25% in mid-April to a mid-June high of 3.15%, with movements as large as 0.20% per day. Globally, eyes remain focused on the timing of US rate hikes versus a still sluggish global economy and prospects for Greek default.

While we believe rate hikes, particularly in the US, are further in the future than markets expect, and that the Federal Reserve is likely to remain on hold for the remainder of 2015, we remain concerned about the extra volatility that too much interest-rate exposure will bring to the portfolios we manage. Wage inflation - in our view the key precursor to general overall inflation and eventual Federal Reserve rate hikes - remains well contained, with average hourly earnings up only 2.3% over the past year. In fact, hourly earnings have increased at less than an annualised 2.5% since the beginning of the current recovery in 2009. Additionally, the Federal Reserve’s preferred measure of inflation, the PCE deflator, is only up an annualised 1.2%, well below the 2% target. While an eventual rate increase will signal a vote of confidence for continuing growth in the US economy, it is important that policy missteps be avoided so as to not impact the global landscape.

From a growth standpoint, Europe remains the biggest threat to progress. Delusion amongst Greek lawmakers continues to astound us. While we increase our pessimism over the political will and ability to avoid default, despite the ECB’s quantitative easing efforts, we believe an eventual Greek default will have little impact on wider European and global markets. While default on an IMF loan seems inevitable, prior experience over the previous 5 years would seem to demonstrate an uncanny ability to kick the can down the road.

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We expect the ECB's expanding balance sheet will provide further temporary support for the remainder of 2015, papering over the deteriorating Greek situation. However, a lack of structural reform in product and labour markets means another Greek default is on the cards, eventually. To a somewhat lesser extent, the lack of structural reform in other peripheral European economies will remain the key hindrance to growth in the region for the foreseeable future as only moderate progress has been made over the past few years. We expect negative core European yields to remain over the next few years, despite recent yield increases. While the US dollar has fallen about 2.5% from its record highs last month, the European slowdown as well as weakening Asian growth will continue to support US dollar strength, especially amidst continuing easy global monetary policy and quantitative easing. We remain bullish on the US dollar, despite our belief that Federal Reserve rate hikes might be further away than markets anticipate, with inflation well contained. We believe a more cautious approach/position for our long US dollar beliefs is warranted over the coming months.

In Australia, we expect the Reserve Bank to hold rates at 2.0%, particularly given a surprisingly strong domestic economy in the form of stronger employment, growth and inflation. In the longer-run, the transition from mining investment to manufacturing/export sectors will take time and require an even lower Australian dollar. We foresee terminal rates at 2.0% with the RBA maintaining low rates as limited wage growth stems inflationary pressures which will provide continuing support for the housing market.

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