KAPSTREAM CAPITAL

December 2014

2015: Sunshine? Moonlight? Good Times? Blame it on the QE.

As we look forward to 2015, the Kapstream crystal ball suggests some potential distinctive changes in the markets as equities continue their defiant march higher – though perhaps with the occasional hint of stalling – and global central bankers wrestle with growth accelerating in the US while it deteriorates elsewhere. The effects of unconventional monetary policy (or the lack thereof in the US) will be front and centre and likely to dictate returns. That said, we feel compelled to take one last look in the rear view mirror and evaluate our predictions of 2014. As published in our January 2014 newsletter, we made a series of broad based forecasts, some right, some wrong, and some still in limbo…

Risk assets will continue their ascent and markets will deliver solid returns in 2014: HIT

Roughly 70% of the global equity indices were in the black over the course of the year despite heightened volatility, geopolitical issues and the unwinding of QE in the US.

The selloff in bonds will continue albeit at a more gradual pace: MISS

Our biggest miss of the year, we certainly would want to take a mulligan on this prediction. It seemed all too obvious at the end of 2013 that yields would track higher following the "taper tantrum" and eventual unwinding of QE. We still believe that the US Federal Reserve (Fed) is borrowing at teaser rates but misjudged the effect of the deterioration of the global economy and the ongoing deflationary pressures from low wages and lower energy prices. Despite improving growth and the unwinding of QE, the US 10 year bond rallied 0.80%. Similarly in Australia, growth was sluggish, leading to bonds outperforming stocks as the Reserve Bank of Australia (RBA) adopted an easing bias towards the back end of 2014.

Growth will continue to recover in the US led by consumer confidence, housing and jobs, where the unemployment rate will hit 6%: HIT

It was full steam ahead for the US economy as most key indicators pointed to a gradual recovery. Job growth continued throughout the year with payrolls averaging over 200,000 per month. This allowed for a steady decline in the unemployment rate to 5.8%.

The likelihood of a hard landing or debt spiral in China dissipates: HIT

Equity markets in China soared (43%) despite a noticeable growth deceleration over the course of the year. The slowdown in China saw demand for commodities fall, yet policy makers were swift to introduce measures to reduce the likelihood of a hard landing.

The market prices in a monetary policy exit/the USD will strengthen: HIT (mostly…)

As the Fed unwound QE, the market quickly started pricing in future rate hikes. But contrary to what many believed, rates stayed anchored aside from a handful of brief sell-offs which was met with buying. The US Dollar was the biggest beneficiary to the monetary policy exit, rallying significantly versus all major currencies over the year.

Rate hikes remain years away: Jury still out

Following the unwinding of QE, communication from the Fed was mixed as to when the first rate hike would come. Although we still do not have a clear cut answer, the market is pricing in hikes for mid/late 2015.

The European Central Bank (ECB) will pay lip service to easy money and QE: HIT (but watch this space…)

The Japanese joined the QE party and signs are pointing to the ECB introducing policy measures. As usual, the ECB is taking their sweet old time for a full blown QE program, preferring instead to initiate an ABS purchase program, cutting rates to zero and maintaining an LTRO program.

The RBA will be on hold while the AUD will be lower: HIT

While there was some risk of an RBA cut in 2014, the concern of the overheating housing market kept cash rates on hold. Helping the situation was the depreciation of the AUD which fell 8%, largely attributed to the strengthening of the US Dollar.

How will 2015 be different?

With concerns of growth, fears of deflation facing most of the world, and the collapse of oil weighing on markets, we make the following predictions for 2015…

- The Fed will not hike rates in 2015.
- Bonds will not return to normal, nor will they rally aggressively. (i.e. be range bound).
- The USD will outperform all major currencies.
- Oil will not drop below $35 per barrel.
- Stocks and/or bonds will struggle to return double digits.
- The spread between US 10Y bonds and Aussie 10Y bonds will go to zero.
- The RBA will reluctantly cut rates unless the AUD drops below 75 cents.

While growth in the US is improving, many factors are weighing on the economy which will not only keep the Fed on hold for 2015, but also keep rates in check. Global deflationary risks, combined with low wages and the collapse in oil will give the ever optimistic Fed time to let the dust settle. The real test for interest rates will begin when the Fed's preferred inflation measure, core PCE, gets closer to 2%. For the foreseeable future we expect slow improvement in economic data, and despite an improving consumer, private sector deleveraging will continue and put pressure on recovery in the near term. Inflation will remain under control, below the Fed's 2% target given the enduring slack in the labor market in the form of lower paid and temporary jobs. This will allow the Fed to remain on hold for longer than anticipated. As a result we expect the shape of the US yield curve (and global curves for that matter) to be flatter, with US Treasuries trading in a 1.75% to 2.75% range for the foreseeable future. Lastly, US bond yields are considerably higher than those of most other developed countries, making the debt and currency more attractive. In the developed countries where yields are higher than the US, we expect a continued convergence – most notably in Australia as the economy slows.

Such a backdrop provides widespread flexibility for the Fed, since lower oil prices bring inflationary pressures, while a stronger dollar indirectly tightens monetary conditions. While lower commodity prices result in a cost savings to the general population, a stronger dollar makes US goods more expensive abroad, likely slowing the growth of US exports which will put pressure on the trade deficit. Furthermore, a higher US dollar could present difficulties for emerging market countries in the form of capital outflows and higher debt burdens.

In Australia, we continue to believe that the RBA will be on hold for much of 2015 (we foresee a 15% chance of a cut), despite nearly 50 basis points of rate cuts that have been priced into the market in the last two months. While the housing market has cooled off to some degree, the labor market remains a key hurdle due in large part to cost cutting measures and the lack of non-mining domestic growth. We expect growth to hover around the 3% level assisted in part to further falls in the AUD. In many ways the depreciation of the currency over the past six months is doing much of the RBA's heavy lifting, with analysis showing that a 5% depreciation translates into roughly a 25 basis point cut.

In conclusion, while we arguably enjoyed more economic 'sunshine' through 2014 than most were forecasting – though it clearly depended on where you were as to whether you were reaching for sunscreen or an umbrella – evidence suggests that in the main it was less genuinely 'good times' and rather more a QE-engineered outcome. With an ECB QE program highly probable in 2015 perhaps Europe will enjoy a similar time *au soleil*. Conversely, the withdrawal of direct Fed stimulus will certainly test the true robustness of economic recovery in the US.

Kapstream Capital Pty Limited (AFSL 308870) is the investment manager of the Kapstream Absolute Return Income Fund ARSN 124 152 790 (Fund). Fidante Partners Limited (ABN 94 002 835 592 AFSL 234668) is the responsible entity and issuer of interests in the Fund. The information has been provided by Kapstream and is for use by wholesale clients only and no other persons. The information is general information only and is not financial product advice. It has been prepared without taking your objectives, financial situation and needs. Because of that, you should, before acting on any such information, consider its appropriateness, having regard to your objectives, financial situation and needs and seek independent financial advice. You should obtain a copy of the Product Disclosure Statement (PDS) relating to the Fund and consider the PDS prior making a decision with respect to the Fund. The PDS can be obtained from your financial adviser, by calling Investor Services on 13 51 53, or on www.fidante.com.au. Stated performance of the Fund is since inception 31 May 2007 to the stated month, and assumes reinvestment of distributions and is after management fees and before any taxes at the unitholder level.