Taper tantrum

End of bond purchases?

With the US economy finally appearing to be on more stable long-term footing, in late May US Federal Reserve (the Fed) Chairman Ben Bernanke hinted the Fed was considering reducing the size of its $85 billion/month quantitative easing programme. With this statement, it sent notice that it will not expand its balance sheet into perpetuity and rates cannot stay low forever.

Bond yields rose dramatically since Bernanke's statement, throwing a taper tantrum. US 5-year Treasury rates have risen about 1.0% from 4th quarter 2012 lows of around 0.60%, reaching a current 1.74%. And global bond markets were not immune from the Fed's notice, even in countries where economic growth remains weak and central banks are in easing modes. Australian five-year government bond yields rose 0.82% from its 4th quarter lows of 2.44%, reaching a current 3.26%.

The global growth story appears to be gaining momentum beyond the US. In the 2nd quarter, the Eurozone posted a positive quarterly growth number, putting an end to an 18-month recession. China's slowdown appears to have stabilised, with factory orders rising to a 16-month high amidst stronger exports.

The table below shows rise in five year government bond yields around the world.

Country	Current five-year Gov. Bond yield	Six month change in yield	Six month change in currency vs. USD	Six month change Equity Market
United States	1.74	99	–	5.28%
Canada	2.00	72	–2.50%	
United Kingdom	1.64	80	3.00%	1.40%
France	1.40	47	1.10%	7.41%
Germany	0.90	49	1.10%	6.13%
Italy	3.21	–37	1.10%	3.15%
Spain	3.42	–30	1.10%	8.07%
Portugal	6.15	141	1.10%	8.05%
Japan	0.26	17	–6.10%	19.96%
Australia	3.26	40	–11.10%	3.71%
South Korea	3.21	48	–0.50%	–3.94%
Singapore	1.07	76	–2.50%	–5.71%
Hong Kong	1.34	90	0.00%	–0.64%
Malaysia	3.56	36	–5.4%	5.39%
Thailand	3.76	62	–7.26%	–14.62%
Indonesia	7.74	302	–15.12%	–12.55%
India	9.01	109	–18.99%	–3.61%

With the exception of Italy and Spain where rates have actually fallen (we consider this a credit event, albeit with a delusional market view of an improving situation), Emerging Market countries have taken the brunt of the rate rises. While Emerging Markets were a key recipient of the record liquidity provided by the Fed, they have now seen dramatic capital outflows as investors move back to safe-havens which now have much higher yields. The rise in rates has left many emerging economies vulnerable as their stock markets have fallen and their currencies decimated against the might of the USD. While the outflows have been broad-based, India and Indonesia took the brunt of the rate rises. Government bond yields in these two countries have risen by more than 3% in Indonesia and more than 1% in India. The northern hemisphere summer has ended badly for many market participants. Higher yields have caused higher borrowing costs for governments, home owners as well as corporates around the world.

Is the rate rise in bond markets premature? What level should 10 year treasuries settle around?

We at Kapstream believe that the worst of 2013 bond sell off is behind us. In our view, bond yields will move down as well as up, but we expect a gradual rise in rates with US 10 year treasuries trading in a range of 2.60% to 3.30% over the next 6 months. While not entirely necessary, we expect the Fed to announce some form of gradual tapering starting in September and not to officially raise its key Fed funds rate until sometime in 2015/2016. According to John Briggs (of Royal Bank of Scotland), 'a simple recent example of fair value for 10-year US Treasury rates is if we assume the Fed won't increase the short-term rates until around 2015/2016, then two year notes should yield around 0.50% over the next two years. The steepest the two year/10 year rate differential in the US over the past 20 years has been around 2.80% – So if we add 2.80% to the two year rate around 0.50% – we arrive at a 10 year yield of 3.30%'. We agree with John's analysis. Of course, there are various other factors that make up the 10 year yield which also includes, the Fed funds rate, term premium and future inflation expectations. Future economic data will also have an impact on the level of yields, only time will tell what the impact of higher yields does to the fragile US recovery.

Storm clouds

There are still plenty of risks to global financial markets.

1. **Quantitative easing (QE) and tapering** – Impact on markets around the world as liquidity gets unwound. Will other central banks follow the Fed's lead in managing expectations on future rate raises or unwind of liquidity. What guidance will we receive from the European Central Bank (ECB) and the Bank of England? What should we expect from them in the future?
2. **Federal Reserve leadership transition** – Federal Reserve Chairman Ben Bernanke has announced that he will be leaving the Fed when his term ends in January. The battle for the next chairmanship seems to be between Larry Summers and current vice chairman Janet Yellen. Aside from questions of the size of the eventual QE tapering, both of the candidates will face the bigger issue of an eventual unwind of a likely $4 trillion balance sheet. It is also likely that three or four of the current Fed governors could be leaving (Bernanke, Duke, Raskin and Yellen) in the near future. This turnover comes at an unfortunate time for the Fed as it moves towards an exit.
3. **Change in governments** – Elections in Germany and Australia could see a change in incumbent governments. A change in Germany will have ramifications on fiscal policy and support for Peripheral Europe, perhaps putting more pressure on the ECB. And much of peripheral Europe has gone through elections where voters tire of austerity as policymakers attempt to transition economies to a more competitive global landscape. Similarly in Australia the government and the central bank are dealing with the challenges of transitioning a commodity-driven economy (while

Asia is slowing) to a more broad-based manufacturing/ export recovery. The Reserve Bank of Australia (RBA) has already driven cash rates to record lows and is looking for a weaker A$ to kick start a fragile recovery.

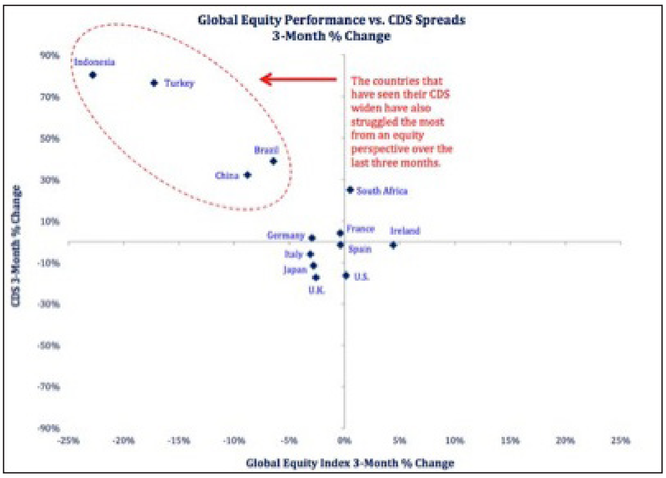
4. **Emerging market dislocation** – Emerging economies have faced difficult circumstances since the announcement of QE tapering by the Fed. India and Indonesia with twin deficits (budget and current account) have taken the brunt of sell off both in bond yields, equity markets and depreciating currencies. This rapid exit from market participants will cause a major headache to both the governments who are forced to rein in spending and the Central Banks who have to figure out ways to defend their currencies and the destruction of wealth. Emerging economies are in a tough spot. They are damned if you do, and damned if you don't. There are few options left in dealing with the current crisis

   a. **Hike rates** – slower growth – loss of confidence – further selling

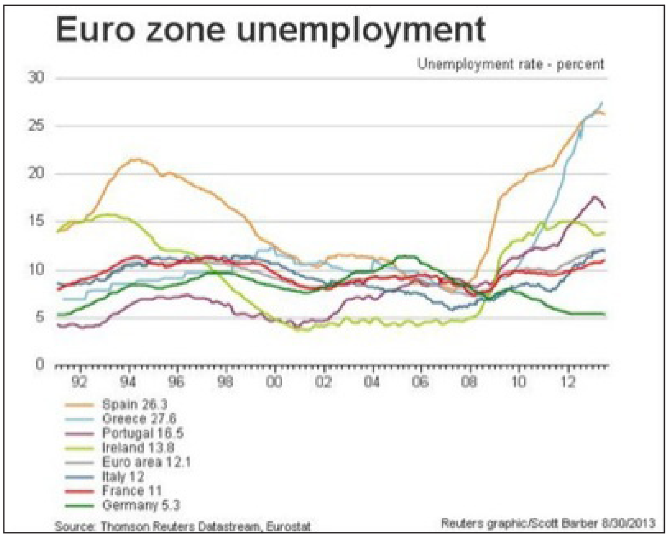
   b. **Defend FX** – Reserves depleted – loss of confidence – further selling

   c. **Do nothing** – Currency falls – loss of confidence – further selling

   d. **Tighten fiscal policy** – lose upcoming elections – recession – further selling



5. **High unemployment** – A lack of structural reform means much of Europe is faced with high unemployment rates and a lack of job creation, which has led to political unrest. Unemployment in Spain and Portugal are nearly 25% while the youth unemployment is nearly 50%. Idle citizens have plenty of time on their hands to cause unrest. While there are signs of a slow recovery in Europe, it is nearly not fast enough to lower the unemployment rates. The race between growth and politics shows up in the lagging indicator of unemployment.



6. **Geopolitical risks** – Looming war in Syria and unrest in much of the Middle East has caused oil prices to spike. This has led to higher inflation in countries that are dependent on imported oil for energy consumption.

7. **China credit bubble?** – The shift over the summer on China was notable – as fears of a hard landing shifted to fears over a looming banking crisis. The credit crisis that started in June abated somewhat and 'fine tuning' remains the policy preferred with growth coming back in July and August according to PMI and other reports. The issue is higher US rates and the squeeze on debt rollover.

8. **US sequester/debt ceiling** – According to the Wall street Journal, 'The collision of the $1 trillion in budget cuts known as sequestration and the breakdown of the normal budgeting process is creating headaches not just for Washington but also for a vast web of offices dependent on federal financing. US Congress hasn't agreed on a budget in five years, leaving much uncertainty for financial markets. Earlier this year, the House and the Senate passed spending bills for the 2014 fiscal year, which begins on Oct. 1, that were about $100 billion apart and never settled. As lawmakers return to Washington after a long summer break, Congress is expected to pass another stopgap bill, known as a continuing resolution, financing the government for a few more months, but it is unclear whether such funding will stay at current levels or shrink. And if the Republicans, who control the House, and the Democrats, who hold sway in the Senate, fail to come to a deal before October, many parts of the federal government could shut down.'

Portfolio outlook and strategy

By June, the increasing volatility resulting from market questions over the timing and pace of tapering of quantitative easing caused us to re-evaluate the portfolio's risk levels. At that time we decided to reduce portfolio risks given our view of increased market volatility going forward. In reducing portfolio risk, we: 1) steadily reduced portfolio interest-rate duration from about 1.2 years to 0.70 years, currently, 2) reduced our corporate holdings – we sold some of our higher volatility issuers, particularly Asian names, and 3) we raised cash – the portfolio currently holds about 21% cash, up from about 11% in late May.

While we foresee much volatility in the coming months, we believe credit markets will continue delivering solid returns. As the political barriers to US growth appear to weaken, the focus will be placed on the global recovery which looks to be taking shape. Over the near-term (next 6 months), we expect short-term bond rates in developed markets (US, Germany, Japan, UK, and Australia) to remain low but with a bias toward rising yields as the probability of tapering quantitative easing gains momentum. 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
- The market begins to price in a monetary policy 'exit'
- Real yields normalise from alarmingly low levels

While US tapering may begin in September, we remain on the more dovish side; the Fed could wait until 2014, given the predominance of temporary and low-paying jobs in the employment gains and the lack of both inflation and significant consumer credit growth. If the Fed does begin tapering, we believe it will be on the smaller side, a reduction of something less than $10 to $15 billion/month. Rate hikes remain years away, in our view. We don't believe taking large interest-rate positions are warranted in this environment as the information ratio is low and interest-rate volatility will remain high.

We believe there is a cap in bond yields as global deflationary risks still remain, particularly in Europe, despite being out of the news over recent months. The ECB may continue to play lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues, but they will eventually reach their limit. Despite recent (temporary) success in Greece, Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term. The rationale the ECB has used to continue supporting Peripheral countries, i.e., promises of fiscal austerity, is quickly deteriorating. We foresee significant European financial shocks over the course of the next 12 months, leading to more volatility for global markets.

In Australia, the RBA should continue reducing rates closer to year-end, despite the currency doing much of the RBA's work. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD.

Australian domestic data will remain muted, unemployment at 5.7%, its highest level since 2009, will eventually move even higher. Other recent weak data including declines in building approvals, consumer confidence and business conditions point to weaker conditions ahead. While the declining Australian dollar is welcomed by the RBA, they will continue to signal that the current interest rate easing cycle is unlikely to have reached its conclusion. With 2.25% in cuts over the past two years, we continue to forecast further RBA cuts in expectation of sluggish growth as mining investment fades.

While we expect considerable volatility in the coming months, we believe credit markets will continue delivering solid returns. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals still look attractive, the technical surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. We favour corporate assets to sovereign assets (specifically in Australia and Asia); with a preference for floating rate assets, as in rising rate environment, fixed assets will lose more value. We will continue to favour the financial sector as low interest rate environments should continue to support the banking sector.

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