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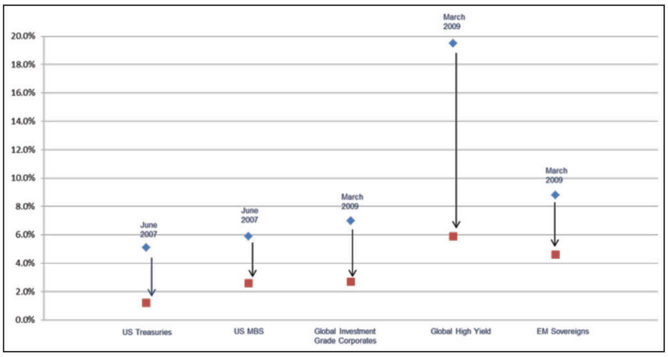
The End of Dirty Beta

Active bond managers have had a good run post GFC, it's been hard not to produce 'alpha,' so long as the term is defined as performance over a benchmark. Global central banks have buoyed sovereign bonds and risk assets with unprecedented policy accommodation. According to Michael Hartnett at Bank of America, 'In the past 6 years, central banks around the world have cut interest rates 515 times. They have increased global liquidity by $12 trillion'.

As a result, bond yields have moved toward record lows. Today, about 50% of sovereign bonds currently trade below 1%. The stunning collapse in interest rates across debt markets has led to increased risk taking in search of more attractive yields. As a result, investors have managed to get strong performance from both their bond and equity allocations. All risk markets have rallied from their lows in 2008, post the collapse of Lehman brothers. There are reports that point to US consumers having recovered their losses post GFC with the run up in equity and housing markets.



Japan joins the quantitative easing party

Japanese Prime Minister Abe and Bank of Japan head, Kuroda, boldly announced plans to target Japanese inflation at 2% in April 2013. Mr Abe promised a growth strategy to kick start the ailing Japanese economy. This strategy included improving health care, industry deregulation, private business support and replacing aging infrastructure including waterworks and highways. Kuroda simultaneously promised to double Japan's monetary base over the next two years and expand its balance sheet to stimulate an otherwise stagnant economy.

And financial markets responded. Since last November, the Japanese yen has fallen nearly 30%, the Nikkei has risen 83.5% from its lows and Japanese bond yields began to rise.

Over the past few years investors and managers that were able to correctly identify these central bank actions were able to buy risk assets at crisis levels and deliver unprecedented returns. Today, most bond managers have delivered significant outperformance versus their benchmarks due to these falling yields and narrowing credit spreads. Most will claim that multiple, diverse sources of added value delivered this bond 'alpha.' However, we refer to gains obtained solely by falling yields and narrowing corporate bond spreads as 'Dirty Beta'. Dirty beta has the handprints of aggressive central bankers from around the world, who have used tax payer funds to bail out the economic system. How long this will be sustainable in the future depends on the transition from dirty money/dirty beta into real economic growth. But this transition will likely be volatile.

Market risk increases as Bernanke floats a balloon

On 22 May, Bernanke suggested that the Federal Reserve was contemplating a tapering of its asset purchases – an eventual unwinding of its quantitative program that has been in effect over the past few years. In remarks to the

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US Congress, Bernanke said that the Fed 'will gradually reduce the flow of purchases,' depending on the strength of economic data and inflation levels. 'We are looking at whether or not we have seen real and sustainable progress in the labour market outlook,' he said.

'If we see continued improvement then in the next few meetings we could take a step down in the pace of purchases.' We are not aiming towards a complete wind down, but looking to see how the economy evolves,' Mr Bernanke said.

This statement by the FED caused increased volatility in all risk markets for the month of May. 10-year Treasury yields rose by 0.50% and equity markets promptly fell 4.75% from their peak. With markets gyrating between risk-on and risk-off, investors are struggling to find the right balance. Historical asset class correlations have broken down as investors began to cut losses on all assets. If you were bearish on the equity markets in the short term, bonds had historically provided a reasonable hedge. But this is no longer the case, as bonds have been selling off when stocks sell off. Why? Because the FED is now less likely to buy bond supply with the greater probabilities for sustainable growth, and the huge increase in money supply means that inflation expectations are being moved forward. Investors are now asking themselves why they should hold bonds in this environment. And if the FED is no longer supporting the economy with additional liquidity, why own stocks? So both bonds and stocks have begun to fall. Clearly, this was not the market reaction the Federal Reserve was looking for when it floated the tapering of a quantitative-easing balloon.

In Japan, as markets more recently question the potential long-term success of such large-scale stimulus, markets have fallen from their new peak. The equity market has fallen 20% from its top, the JPY has strengthened 4.5% from its lows and bond yields have again dropped.

We believe the transition process – the hand-off from central bank-led liquidity to real economic growth – will prove extremely volatile. As the US Federal Reserve floats balloons signalling a tapering of quantitative easing, the prospects for the bursting of risk asset bubbles will increase, hence the recent market volatility. In the near future, investors will better understand which managers are adding alpha, and which ones were supported by a reliance on central bank led dirty beta.

Upcoming themes

1. **The Federal Reserve and QE** – The biggest question facing financial markets is when the Federal Reserve starts tapering the purchase of assets. In our view the Fed will begin this process until it is confident that the US economy has recovered from the depths of the crisis of 2008. Unemployment is slowly falling, but an increasing employment participation rate and jobs growth in the 180k to 200k/month range mean tapering is likely a few years away. The first tapering trial balloon was floated to test the market reaction to removal of quantitative easing. If markets begin trading as if QE will be around forever, it will become impossible to remove without triggering massive volatility and crashes. So the Fed will remain patient.
2. **US Fiscal Risk** – Markets may not be sufficiently accounting for Main Street's total resentment of Wall Street. This has driven grassroots responses like Occupy Wall Street, but has also helped drive anti-banking legislation (like Dodd-Frank). Because of current anti-financial sentiment, American legislators were seen as rubberstamping just about any anti-bank bill, without adequately thinking through the consequences. For instance, the Brown-Vitter Terminating Bailouts for Taxpayer Fairness (TBTF, of course) Act sailed through the Senate, but the terms of the act (for instance, forcing banks to hold reserves against derivatives) was seen as capable of significantly clamping down on the size of markets, and the velocity of flows within them. This could trickle through the economy, causing capital flight out of the United States, fuelling a larger slowdown.

3. **Japan** – It can be argued that the only reason that JGB rates aren't higher is because the Bank of Japan is currently wavering in its commitment to a massive quantitative easing program. At some point the BOJ will double down on its commitment. It could also be argued that the only reason the BoJ is even buying bonds is to provide a reasonable exit price (and sufficient exit liquidity) for Japanese pension funds heavily invested in JGBs. There was some argument over whether the spike in JGB yields was due to current exits of pension funds (pulling down on prices despite BOJ actions) or whether the BOJ was not doing enough, and we haven't begun to see the exits yet. The dispute seemed to end on the latter stance, with the note that we may see rapid changes if and when pension funds start divesting their debt. However, it can be noted that the JGB market continues to be 'the Widow maker,' despite massive shifts in Japan in recent years (tectonic and political) – as such, it should be regarded with a strong degree of caution.
4. **Australia** – The Australian economy is stuck between a rock and a hard place as it faces a difficult transition from growth led by resource investment. Resource investment has peaked and by 2015 construction work on the 7 largest LNG projects will wind down. While this may be followed by an increase in LNG exports which should help the federal budget, much of the income will flow to overseas shareholders. Nonetheless, the sudden drop in commodity prices and slowdown in Chinese economic growth has caught both the RBA and the government off-guard. The revenue projections on the Federal Government's budget have been grossly missed. The transition from a once in a generation benefit from a commodity boom to more of a broader economic recovery is proving challenging for the RBA. The RBA has cut interest rates to 40-year historical lows. The currency has fallen nearly 15% from its peak, which should start helping the export sector and make Australian products more competitive in global markets.
5. **Inflation** – Much of global central bank action was seen as an attempt to shift inflation expectations, and it was described as a significant failure that inflation continues to be so low in many developed countries. Part of this was attributed to the reduced bargaining power of workers—since the supply of labour far outstrips the demand, wages have been held relatively constant, and part was attributed to low velocity of money (we are not seeing the same transactional vigour as we saw before the crisis). A distinction can be made between 3.5% real growth with negligible inflation (3.8% nominal growth, for instance, with 0.3% inflation) versus 3.5% with hefty inflation (example: 8% nominal growth). In the latter example, the perceived nominal growth gives the impression of an economy growing at breakneck speed, and prompts more transactions (and the desire to earn return exceeding inflation also prompts these transactions). The FED can be criticized for focusing on maintaining low inflation levels, when higher inflation may have positive effects. On the other hand the spectre of the disinflationary forces leading to the dreaded debt deflation cycle, in which asset price drops fuel distress selling which, in turn, fuels more price drops.
6. **Volatility** – Break down of correlations – Recent market movements post the announcement of the BOJ and the comments made by Ben Bernanke have left investors confused. The traditional measures of hedging portfolios between equities and bonds have broken down. Volatility is on the rise and the option of keeping ones investment in cash has become very expensive.

Portfolio implications

As the political barriers to US growth appear to weaken, the focus going forward will be placed on the global recovery, which looks to be taking shape. However, we will maintain our long-duration bias to protect against downside risks to the global economy, particularly in Peripheral Europe. We believe the recent market volatility has moved bond yields toward the top of our rate expectations over the short-term, but we will maintain a modest 1 to 1.5 year duration position. As conservative stance remains warranted as we expect market volatility will continue amidst changing optimism over the pace of US growth and prospects for the tapering of quantitative easing.

Over the near term (next 6 months), we expect short-term bond rates in developed markets (US, Germany, Japan, UK, and Australia) will remain at relatively low levels as quantitative easing continues. We forecast a measured but steady rise in long-term bond yields (10 year maturities and beyond) over the course of 2013 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.

In Australia the growth picture remains stronger than other developed nations. The positive carry and roll down in Australian yields will marginally offset yield increases, however that 'carry' benefit has eroded over the past year. We also believe that the RBA will not deliver the scope of rate cuts priced into the market (terminal cash rate of less than 2.5%).

The ECB will continue to play lip service to easy money and quantitative easing, despite growing fundamental structural issues. Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term. While we remain cautiously optimistic for risk assets, we foresee continued volatility as increasing prospects for sweeping political change and the unwinding much of the recent fiscal progress will continue to drag on global markets.

- With increased volatility and uncertainty in the markets, Kapstream has started to take some risk off the table to protect our investor's capital. Our cash holding has increased to 15% from nearly 5%.
- We continue to prefer corporate bonds over sovereign assets, even though we recognise that there will be some short-term market-to-market losses on the assets we hold. We do not expect further contraction in corporate spreads from current levels, but believe that the carry makes it an attractive allocation.
- We prefer Australian/Asian and US corporate names with allocation to the financial sectors in the region. Low interest rate environments should continue to support the financial sector. We prefer lower rated debt of the financials in Australia given the profitability of the big 4 banks.
- We prefer floating rate assets to fixed rate assets – as we believe in an inflationary world, fixed assets will lose value.
- We expect central banks around the world to continue to be accommodative at least over the next 12 months.
- It has been never more important for clients to start thinking of target/absolute returns for the risks in the markets. We believe that allocating to standard benchmarks will end in tears in the future!
- We also believe the next 12 months will be a very challenging environment for all our investors!