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The Six O'Clock Swill

The 'six o'clock swill' was an Australian and New Zealand slang term for the last-minute rush to buy drinks at a hotel bar before it closed. For a large part of the 20th century, most Australian and New Zealand hotels shut their public bars at 6pm. A culture developed of drinking heavily during the time between finishing work at 5pm and the mandatory closing only an hour later.

Six o'clock closing was introduced during the First World War, partly as an attempt to improve public morality and partly as a wartime austerity measure. Before this reform, most hotels and public houses in Australia had closed at 11 or 11:30pm. Support for changing closing times originally came from the temperance movement, which hoped that implementing restrictions on the sale of alcohol would lead eventually to its total prohibition. Although the movement had been active since the 1870s, it had been gaining ground since the turn of the 20th century following the introduction of 6 o'clock retail trade closing, first legislated in Western Australia in 1897.

The argument made by the temperance movement challenged the grounds for "public houses being kept open while bakers' shops were shut", and their agitation was augmented with the outbreak of war in 1914 when it was argued that a "well-ordered, self-disciplined and morally upright home front was a precondition for the successful prosecution of the war."

The Fed

Similar to the Six O'clock Swill, the Federal Reserve Bank of the United States (Fed) has also signalled closing time on cheap money. Remember, it was in December 2008 when the Fed last cut interest rates to nearly zero in the middle of the global financial crisis. It is nearly 7 years to the date that the Fed is now contemplating raising rates.

Why should the Fed lift off?

At Kapstream we believe that the *Fed may start to normalise rates starting Dec 2015* for the following two reasons:

1. ***Economic data continues to improve:***
   - US nominal GDP growth for the past 7 years has averaged 2.75%
   - Unemployment rate has fallen from a peak of nearly 10% to currently at 5.1%
   - US equity markets have risen nearly 219% from their lows in March 2009
   - US Wage inflation during the same period has been contained

Quarter	GDP	Unemp.	S&P	CPI	Fed Funds
Sep-15	3.1	5.1	1920	0	0.25
Jun-15	3.7	5.4	2063	0.1	0.25
Mar-15	3.9	5.5	2067	-0.1	0.25
Dec-14	3.9	5.7	2058	0.8	0.25
Sep-14	4.8	6.0	1972	1.7	0.25
Jun-14	4.5	6.2	1960	2.1	0.25
Mar-14	3.3	6.6	1872	1.5	0.25
Dec-13	4.1	6.9	1848	1.5	0.25
Sep-13	3.1	7.2	1681	1.2	0.25
Jun-13	2.5	7.5	1606	1.8	0.25
Mar-13	2.9	7.7	1569	1.5	0.25
Dec-12	3.2	7.8	1426	1.7	0.25
Sep-12	4.1	8.0	1440	2	0.25
Jun-12	4.3	8.2	1362	1.7	0.25
Mar-12	4.8	8.2	1408	2.7	0.25
Dec-11	3.6	8.6	1257	3	0.25
Sep-11	3.5	9.0	1131	3.9	0.25
Jun-11	3.8	9.0	1320	3.6	0.25
Mar-11	3.8	9.0	1325	2.7	0.25
Dec-10	4.6	9.5	1257	1.5	0.25
Sep-10	4.7	9.4	1141	1.1	0.25
Jun-10	3.8	9.6	1030	1.1	0.25
Mar-10	2.1	9.8	1169	2.3	0.25
Dec-09	0.1	9.9	1115	2.7	0.25
Sep-09	-3.1	9.6	1057	-1.3	0.25
Jun-09	-3.2	9.3	919	-1.4	0.25
Mar-09	-1.9	8.2	797	-0.4	0.25
Dec-08	-0.9	6.8	903	0.1	1.00

2. Paradox of thrift

- Central banks cut interest rates during periods of economic weakness to stimulate growth. It expects corporations and individuals to borrow money (as money is cheap) and use the cheap funding to either invest in future growth or bring forward future consumption. If the citizens react as the central bank expects, consumption and investment should lead to a recovery in economic growth, higher corporate profits, higher share markets (wealth creation) and higher taxable income. Once comfortable that the economy is on a sound footing the central bank can then start to normalise interest rate policy, i.e. raise rates.
- The 'paradox of thrift' argues that the opposite effect can happen as the longer you keep rates lower, people get used to an environment where interest rates are low and start to save more for the future and spend less, as they expect rates to remain low forever. This becomes a vicious circle as more and more savings are needed to fund future retirement income.
- It could be argued that the Japanese economy has been mired in this paradox of thrift for the past 20 years. Even though the Bank of Japan has left rates near zero during this whole period, the Japanese economy has repeatedly been in and out of recession, and the Japanese consumer now saves more than they spend.
- To get its citizens out of this mindset, it is better for the central bank to signal that rates are going to rise soon and therefore change their view on savings, assuring them that they can start to spend – a reverse psychology.

Future Guidance

There is a strong chance that the Fed will raise its target Fed Funds rate on Dec 16/17, however raising rates from 25 basis points will not have a meaningful effect on overall borrowing costs for the US consumer or corporation. We have been forewarned many times in various speeches from Fed governors that a rate rise is imminent. So this initial action itself should not come as a surprise. The interest rate futures market currently attaches a 70% probability to a December Fed Funds rate rise.

The critical action post that first rate rise (if we get one) will be the press release/forward guidance from the Fed as to the path of future rate rises. We believe that the Fed will be 'dovish' in its future rate rise expectations, given the lack of inflation, geopolitical issues, China slowdown, and weakness in European economies, and that any future rate rises will be small and far between.

We believe that the neutral Fed Funds rate once the Fed starts to normalise rates is somewhere between 1.5% and 2.0%. We expect the Fed to raise rates 0.25% a quarter, so getting to 1% through 2016 and 2% through 2017. Of course the eventual neutral level of the Fed funds rate will be dependent on various economic outcomes between now and then and the uncertainty of geopolitical risks, as well as equity market reaction, will have to be factored in to this guidance.

What we know today

- Volatility will increase - it appears certain that financial markets will face a lot more volatility in the future than in the past
- Rates are set to rise in the US
- The US dollar should be stronger vs. most other major currencies as the Fed raises rates, and Europe and Japan particularly continue to ease monetary policy

What we don't know today

- How risk assets will react to rate rises
- How bond markets will price future rate rises
- How emerging markets asset prices will react (equities, currencies and bonds)

All in all it will be a tricky road ahead.

Managing bond portfolios in a rising rate environment

Now that we assume that the Fed will start to raise rates, how does one manage a bond portfolio?

- Interest rate risk is the biggest risk – rising rates causes direct capital losses for fixed rate bonds – so reducing duration and owning floating rate assets seems prudent.
- The 'teaser rates' of the past 5 years that through QE bond buying programs artificially lowered the cost of borrowing for most governments should end, evident in negative yields (yes, you get paid less in the future) both in Europe and in Japan.
- Default risk in owning investment grade corporate bonds continues to be low and the return premia remains attractive. Again, floating rate assets should be sought over fixed rate assets, until the rate rise cycle is complete
- Investment grade corporate bonds only deteriorate suddenly in ratings and quality for two reasons – leverage (e.g. Lehman) or fraud (VW). Otherwise deterioration is gradual and allows the investor to exit. By avoiding the one or two that do deteriorate suddenly you still get paid to own investment grade assets.

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- Spending some premium on insurance against rising rates is prudent given the uncertainty around predicting changes and the pace of change accurately. The use of options to hedge against global interest rate markets is critical.

Kapstream Portfolios

Given the *near* certainty of the Fed commencing lift off in December but the *un*certainty of future rate rises:

- We prefer to keep our duration very low at 0.8 years;
- We prefer floating rate assets to fixed rate assets;
- Our 'liquidity bucket' (cash, deposits, sovereign, semi-government) remains at ~20% of our portfolio, and we consider it prudent to sacrifice some return to protect capital;
- We continue to own investment grade corporate bonds instead of sovereign bonds;
- We use derivatives to hedge the inherent risks that arise from our physical holdings;
- We also use derivatives to buy options in anticipation of future rate rises – specifically in the US;
- We prefer to be long the US dollar.

The current running yield of our flagship Kapstream Absolute Return Income Fund is 3.63%. We believe that if you hold the assets to maturity you get paid the return. We are cognizant of short term mark-to-market volatility and prefer capital preservation to return-seeking in the short term in a rising rate environment.

The Fed is nearing its own 'Six O'Clock Swill'

We think its approaching six o'clock in the financial markets. The Fed is now warning us that the free/cheap money 'bar' is about to close for financial markets, although of course there still remains a chance that the Fed decide to 'extend hours'. Incidentally it was not until 1954 when a NSW referendum narrowly passed allowing the extension of closing hours to 10pm. Perhaps surprisingly given Melbourne's reputation today for fine bars and restaurants, the more temperance-leaning Victorians of the period had to wait another dozen years until in 1966 drinking hours there were extended.