KAPSTREAM CAPITAL

The Divine Comedy

'Abandon all hope, ye who enter here'

While today's financial markets have yet to reach the circles of hell described in Dante's Inferno, it's still early in what will likely be a long process of unwinding the excesses of the past. Lust, gluttony, avarice, anger, fraud, treachery – yesterday's European literature, today's European headlines.

As our Greek tragedy moves into year three, the once distant probability of dumping the euro is now closer to reality, despite 240 billion Euro in bailout aid. In response, Greek 10-year yields moved from 18% in March to 30% today. Greek depositors which were abandoning domestic banks at a rate of 80 million Euro per day last week are now moving closer to one billion Euro per day as a default becomes more likely.

Unsurprisingly, the Euro continues to weaken while German bund yields again hit new record lows as markets now look to the contagion impact upon the rest of Europe and the daunting challenges ahead. With over 400 billion Euro in external debt, there will be significant losses for Greek investors. While these losses will primarily be passed to European taxpayers via the European Central Bank and official lending programs, European banks and companies will also face significant losses.

And recent austerity measures only add to the pain. Manufacturing, consumer sentiment and employment data continue to disappoint. Eurozone unemployment is now at 10.9%, its highest level in 14 years. Spain leads the way with 24.1%, followed by Greece at 21.7%. In both countries more than 50% of the eligible workers under age 25 remain unemployed. Spain moved into recession for the second time in two years, the equity market hit a nine-year low and S&P followed with another downgrade (to BBB+) while retaining a negative outlook. And further sovereign downgrades look likely. In 2011, European government debt rose to the highest level since the advent of the Euro, rising to 87.2% of GDP from 85.3% in 2010.

Naturally, frustration surrounding the inability of policymakers to resolve the sins of the past has caused voters to begin replacing their leaders at historic rates. Germany's Merkel and the Christian Democratic Union were heavy losers in the local elections in Germany's largest state, North Rhine Westphalia. We could see a new head of state in Germany by next year. This would mean political leaders in virtually all major European Countries would have lost their jobs or have been thrown out within the past 18 months! We are pessimistic over whether new governments are able to deal with the crisis more effectively than the old.

We believe problems are likely to get even worse before they get better. We grow increasingly concerned over European-wide bank runs as Italian, Spanish and Portugese depositors learn from Greece and could be next to abandon their domestic banks. Policymakers would be forced to guarantee Euro-wide deposits which would put core European countries on the hook for insuring over three trillion Euro in deposits.

And that might not be the end of the story. An even bigger risk would be the financial markets abandoning peripheral sovereign bonds, quickly pushing borrowing costs beyond unsustainable levels. Although not at Greek levels, Italian 10-year yields have moved from a low of 4.8% in March to over 5.8% today, while Spanish yields have moved from a low of 4.8% to 6.4% today.

While politically the tide is turning away from focusing solely on austerity, tough decisions are ahead. Past austerity measures have lacked success. They have managed to: 1) create a substantial drag on current and future growth, 2) lower the standard of living of voters in the periphery and 3) created new opportunities for politicians who oppose austerity.

On balance, we believe voter willingness to continue down the austerity path is weakening. The ramifications are terrible, but almost any path is likely to lead to continued pain. From an investment perspective, we believe there is little to find attractive in Europe except the safety of German bunds.

All is not lost – Purgatory isn't so bad

Like Dante, we believe global markets will survive the depths of hell. While Paradise may be many, many years away, Purgatory, or the ascension from the undergloom, is our base scenario. We base this view upon continuing US recovery and further Asian growth.

While US data has remained mixed, there are bright spots. Consumer sentiment rose to a four-year high, retail sales continue to trend positive, manufacturing is improving and while volatile, the unemployment rate is falling. On the negative side, recent employment data, while positive, was below expectations and first quarter growth came in at 2.2%, slightly below market consensus. The coming election season will bring more uncertainty, although relative to Europe, the risks are smaller. US market direction will continue to be dominated by volatile employment data and to a slightly lesser extent, housing data. But we believe the long-term trend will continue to be positive. The US has turned a corner in that job growth should remain positive, but not stellar. While the Federal Reserve's comments about keeping rates on hold until 2014 should instil confidence in markets, we continue to believe prospects for a third round of quantitative easing are increasing. We expect the Fed to keep rates on hold beyond 2014.

While susceptible to European events, we believe Australian growth will remain strong. In reducing rates by 0.50%, the Reserve Bank of Australia recognised the impact of the higher exchange rate on manufacturing and service exports and the slowing global growth story, particularly in Europe and China. Asian confidence surveys and Purchasing Managers Indices (PMIs) continue to improve, signalling a rebound in domestic activity. While the traditional view has always been that Asia's growth is largely driven by the advanced economies (US, Europe and Japan), the model appears to be breaking down. China is increasingly driving demand for goods produced and Asian countries are progressively holding each other's portfolio assets (bonds and equities) at the expense of the US, Europe and Japan. China's Industrial Production figures rose marginally to 11.9% year over year with momentum showing signs of stabilization. Indian Industrial Production also rebounded on a year over year basis. Industrial production for most of the Asian economies is generally on the uptrend. Thailand is a good example, where since early 2012 growth momentum has been rising significantly, indicating that the country's post-flood recovery is underway.

While we have reduced the portfolio's high cash allocations from the highs of 2011, we remain concerned and will maintain a moderate risk level. However, we intend to maintain positions in US Banks and Asian corporates given their attractive yields. We will continue to maintain our relatively short duration of approximately one year as we feel risk assets still have value. We maintain positions in lower-rated credits as well as Financials, where we are being compensated for the level of spreads we are taking. We are also looking to position for tail risk events in order to insulate the portfolio should the situation in Europe continue to worsen.

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