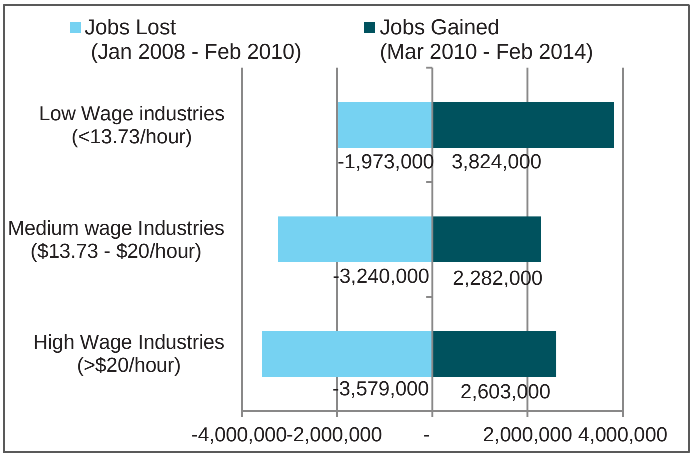
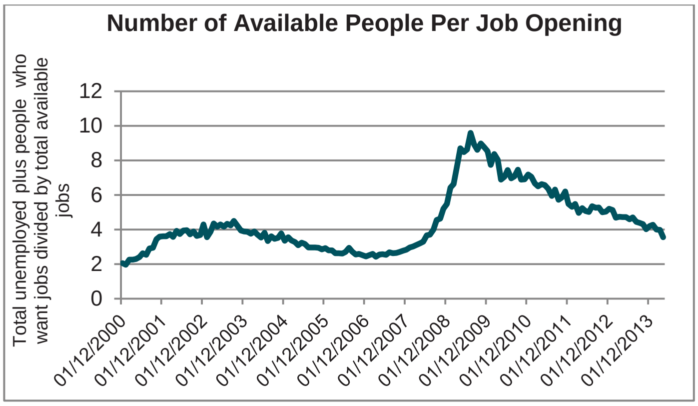
May 2014

The new… whatever

The addition of 217,000 new US jobs in May means that almost 8.8 million new jobs have been created since the start of 2010, offsetting the 8.7 million jobs lost over 2008-2009. Job creation has so far come with low inflation; annualised CPI is at 2.0%, core inflation is at 1.8% and the US Federal Reserve (Fed's) preferred PCE measure is at 1.6%. And to Kapstream, it looks like low/stable inflation will remain for longer than markets anticipate. Although jobs are returning at a modest pace, we see little wage pressure as much of the job gains are in lower paying industries such as food service and retail trade.



But this is only part of the story. Other measures of wage pressure are showing signs of increasing, including unit labour costs and average hourly earnings. A measure we follow, the number of available people per job opening, has fallen from about 10 during the GFC, to a current 3.6.



While there are still many jobs available, the ratio of people looking for work[1] to available jobs is decreasing, which in the longer-run will eventually lead to wage inflation. In fact, over the past few weeks, markets have put increasing probability on the Fed increasing rates by this time next year, with that probability now more than 50%. We at Kapstream are more sanguine over inflationary pressures, mindful of the risks that threaten a sustained global recovery, such as global unrest in Thailand, the Ukraine and Middle East, the moderate pace of global jobs growth, and evidenced by new and continuing quantitative easing programmes in Europe, Japan and Asia.

Nonetheless, pundits continue warning of higher inflation and higher rates, a story we've been hearing since 2008! Eventually, they'll be right and inflation will pick up, but for today, the underlying weakness in the global employment story will continue to put a

[1] Defined as total unemployed plus civilians not in the labour force but who currently want a job by the Bureau of Labour Statistics

cap on both inflation and bond yields, in our view.

On the other end of the spectrum, many pundits are calling for lower global growth over the longer-term. We've heard it called:

- "new normal" = disappointing equity returns, stagnant corporate profits, high unemployment, lower living standards and nominal growth in the 2% range, or
- "new neutral" = new normal + 1%, or
- "new destination" = who knows, or
- "secular stagnation" = probably something very bad.

In the midst of all of these prophecies, global stock markets continue their advance toward new records. The US S&P approaches 2000, the Dow Jones nears 17,000 and the ASX moves back toward 5,500. Other risk markets have fared well too; investment grade corporate bonds have returned 5.8% and high yield bonds have returned 4.8%.

While we remain surprised over the magnitude of the current 2014 bond market rally, we continue to believe the combination of deflationary forces and further central bank support will provide a cap on global bond yields in the near term. We don't have a fancy name for the current environment, other than calling it a moderate growth, low inflation world.

We are maintaining a 0.75 year interest-rate duration exposure in our portfolios, focused in 2 to 5-year maturities in Australia and the US, given our expectation for central banks to remain on hold much longer than markets currently anticipate. Nonetheless, we foresee a continuing moderate recovery in the global economy over the next 12 months.
In the US, we expect continuing slow improvement in economic data (with payroll increases averaging about 200k/month over the next year) and remain biased toward an eventual rise in global long-term bond yields as:

- Growth continues to recover in the US (housing, jobs, and consumer confidence);
- The likelihood of a hard landing or debt spiral in China dissipates;
- The market prices in a monetary policy 'exit';
- Real yields normalise from alarmingly low levels.

However, rate rises may still be years away as low global inflation and moderate jobs growth create a cap on bond yields. We believe bonds are fairly priced in today's environment and expect rates near today's levels over the coming months. Additionally, central bank 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. 10-year US Treasury yields in the 2½ to 3% range and Australian Commonwealth government yields in the 3½ to 4% range appear fairly priced, balancing moderate growth and minimal inflation risks versus the imminent end of Federal Reserve support for the Treasury market amidst a more stable jobs environment.

While US growth is improving, the pace will remain fairly muted and well below the 3.4% average pace for the period following WWII through 2007. Despite an improving consumer, private sector deleveraging will continue and put pressure on the recovery in 2014, and business spending will only improve marginally. Nonetheless, the private sector will continue with moderate gains over 2014. We expect modest acceleration in personal and business spending as housing and equity markets continue to support wealth, despite eventual increases in mortgage rates which will slow the housing recovery. Despite occasional hiccups, employment gains will continue in the 200,000/month range, which could bring the unemployment rate down toward the 6% range by year-end 2014. The US has now regained the 8.6 million lost jobs over the 2008 – 2009 period. We foresee continuing jobs gains in the coming months. However, inflation will remain under control, still below the Fed's 2% target given the enduring slack in the labour market in the form of lower paid and temporary jobs.

Globally, other global deflationary risks still remain, particularly in Europe. The European Central Bank (ECB) will continue to play lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues. The ECB will eventually reach their limit, but we believe they have ample political support to continue current policies through the remainder of 2014. European quantitative easing may take longer than currently expected, but we eventually expect the announcement of a €1 trillion programme mainly focused on sovereign debt closer to year end. However, the rationale the ECB has used to continue supporting peripheral countries, i.e., promises of fiscal austerity, has deteriorated over the past 12 months. Despite marginal improvements, peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term, but we view this as a 2015 and beyond problem, given the ECB's continuing support.

In Australia, the Reserve Bank of Australia (RBA) will remain on hold although the currency isn't doing as much of the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower Australian dollar. The economy is still functioning at below trend in terms of jobs and sentiment. Potentially tighter fiscal policy may also drag on the growth story. We forecast annual 2014 growth around 2.7%, well below the 4.5% long-term average of the past 25 years. While the 15% fall in the Australian dollar (from last year's highs) will continue to aid the non-mining and export sectors, these sectors are unlikely to fill the gap created by the fall in mining investment. The RBA will maintain low rates as limited wage growth will stem inflationary pressures and allow continuing support for the housing market.

While equity markets continue to approach new record highs, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures which will put more pressure on the labour market and non-mining domestic growth. The downward pressure on wages has kept disposable income levels extremely low. While we foresee further Australian dollar weakness, the currency is more likely to be driven more by US Fed action and US economic data rather than by anything in Australia. We expect US QE3 will conclude toward the 4th quarter of 2014 and provide some further relief for the Australian dollar, although it's hard to see a dramatic fall, particularly as the interest-rate differential between the US and Australia will continue to support financial flows into Australia. With moderately attractive real yields, we like Australian interest-rates relative to the US and the rest of the developed world. We expect US dollar weakness to continue its reversal in 2014 as the ending of the Fed's quantitative easing programme, combined with stabilising growth, supports the US dollar over the remainder of the year.

Markets will continue to worry about China, but as the 2013 headline stories of the risks of a Chinese hard-landing dissipate, the 2014 story will centre over the growth of Chinese local debt and risks in the ’shadow banking‘ sector, another red herring in our view. This burgeoning debt of Chinese municipal localities, used to finance infrastructure projects, is unlikely to bring about a major debt crisis in 2014. This growing debt may represent China’s largest economic problem, however, material defaults are unlikely and ultimately the central government will allow more tax revenues to flow to localities to pay construction debts. While a recent report showed this debt alarmingly increasing over the past 2½ years, reaching $3 trillion, China’s overall total debt at 56% of GDP still compares favourably to most developed countries. We expect Chinese growth will remain in the 7½% range over 2014, allowing China to continue to support the global growth story. Reforms will continue, and we expect eventual liberalisation of deposits rates combined with necessary deposit insurance, although this may take considerable time.

While Asian fundamentals appear fairly solid in both the corporate and sovereign world, a rising rate environment will prove challenging for inflows, similar to the 2nd half of 2013. From a fundamental perspective, sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world, particularly Europe. We will remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e. those with deteriorating budgets, current accounts and reserves. India will remain a top Asian story as weaker fundamentals will provide a challenge to maintaining its investment-grade rating. We will continue to favour investment grade corporates in lower-beta (less volatile) countries such as Korea, China, Hong Kong and Singapore. We expect to hold 10% to 15% of the portfolio in this region over the course of 2014.

Summary

Overall, the theme of extremely low global central bank rates and more liquidity will continue in 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the equity and risk market gains of 2013 amidst a steady but moderate growth environment. While we expect continued volatility in the coming months, we believe risk markets will continue delivering solid returns, particularly investment-grade credit, which we expect will also have lower volatility. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals remain attractive, the technicals 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 floating rate assets will outperform in a secular environment of increasing rates. We particularly like short-maturity, defensive securities (less than 5-year maturities, high-rated global banks, conglomerates and quasi-sovereigns) which are both held in more solid hands and less sensitive to moves in interest-rates. We have again implemented small positions in Spanish and Italian sovereign bonds with expectations for further ECB liquidity, providing both support for peripheral economies and a back-stop against major yield rises.