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Conscious Uncoupling

Gwyneth Paltrow and Chris Martin famously described their deliberate parting of ways using the above phrase, attracting almost universal ridicule from the media, who are not known for their sensitivity in dealing with high profile separations.

Global markets appear to be struggling to come to terms with their own set of 'relationship breakdowns' (although with far less consciousness than our Hollywood couple). News searches for words containing 'economic dislocation' and 'financial dislocation' throw back an alarming number of articles, particularly over the last few months. Financial markets appear to react in more and more erratic and volatile ways following release of economic information and policymaker statements.

An early March speech by an IMF spokesman cited "adverse feedback loops between the real economy and markets", and given the delicacy of global economic recovery, "where risk of economic derailment has grown". It appears that economic and financial relationships are falling apart more often than Hollywood relationships.

We appear to have reached the limit of our understanding of the long-term effects of continuing low and negative rates on global growth, employment, inflation and interest rates. With the RBA's recent cut, the 650th globally since the global financial crisis, central banks have largely failed to solicit the desired (growth) response. Are further marginal cuts still effective, or will they cause further reductions in growth?

There is little market consensus. Many participants believe rates should remain low in order to continue to force savers into taking risks in order to get returns. Keep your money in the bank, get zero or negative returns. Keep your money in government bonds, get zero or negative returns. Other participants believe rates need to rise in order to stop people from being forced to save even more for retirement, given lower expected future investment income with reduced rates.

In 1936, Keynes' General Theory popularised *The Paradox of Thrift*; that is when people save more, they spend less, which results in a drop in consumption, spiralling into lower growth and employment and ultimately causing economies to fall deeper into recession. *The Paradox of Thrift* concept had largely fallen from mainstream economic dialogue until its re-emergence as an explanation for Japan's long-term on/off recessionary environment of the last 20+ years. Lower rates had actually caused savers to save more for retirement resulting in a chronic downward spiral, leading to perpetually low growth and inflation.

However, *The Paradox of Thrift* concept originated well before Keynes; proverbs 11:24 states "There is that scattereth, and yet increaseth; and there is that withholdeth more than is meet, but it tendeth to poverty." or in better English: savings may hurt an economy.

Kapstream has historically expressed scepticism over the effectiveness of lower rates in stimulating growth. It forces more saving and is mainly beneficial to people who already own risky financial assets – mostly rich people who have a lower marginal propensity to consume increasing wealth. Rather than printing money to purchase financial assets, a more effective policy would be to print money to build things – roads, railways, bridges. Put more people to work with a higher marginal propensity to spend.

Globally, political will to increase fiscal spending is low which has lead monetary policy to become the only choice across much of the world. We remain supportive of the Australian government's fiscal plans, which we believe will be more effective than further reductions in the RBA's discount rate. The complementary fiscal and monetary stimulus announced in the new budget will aid the domestic economy in limiting the downside effects of deteriorating global growth. We remain sceptical of arguments centred around credit rating cuts due to deteriorating fiscal balances having a negative long-term impact on the economy. At 19% debt/GDP, Australia retains amongst the lowest levels of outstanding debt in the developed world. A belief that debt costs will rise with a lower rating (for both the government and corporates) is not connected to any recent economic reality. And it would be hard to argue that the skills required to build the unprecedented mining/commodity infrastructure of the past decades aren't compatible with building roads, railways, and bridges.

On the monetary side, we expect further RBA cuts later in the year, but dependent upon how well the global economy holds up in the coming months and how resilient the AUD remains. The Australian unemployment story has held up remarkably well, reaching a 2½ year low in March, and is forecast to fall from 5.7% to 5.5% over the next year.

So what? What does this mean for portfolios?

The 'what to do' in the face of this ongoing uncertainty and volatility continues to challenge both global policymakers and investment professionals. Recent volatility, increasing regulatory pressure and lower market liquidity has created both challenges and opportunities.

At Kapstream, we focus on high-quality, low volatility, short-dated bonds. And corporate bond yield advantages over cash rates continue to grow in this uncertain environment. Today, we find investment grade bonds that have considerably higher yield advantages versus what has existed over the past few years. Has the probability of default worsened? No. Do we feel it any less likely that these borrowers will be able to pay the interest on their bonds? No. We feel you get paid better than ever to take the default risk in corporate bonds today.

The trick is to assemble a portfolio that provides attractive returns over cash whilst at the same time maintaining capital preservation and lower prospects for downside losses.

Over the past year we had maintained a historically more conservative portfolio – cash and government-related securities were increased to 20% to 25% while duration exposure was retained near a long-term average 0.75 years. More recently we increased the fund's overall duration ahead of the RBA's announcement, reaching about 1 year duration, given our view of lower Australian inflation over the longer-run leading to an eventual series of RBA rate cuts. We expect to continue to reduce the fund's 'liquidity bucket' of government-related and cash instruments from a current 16% position toward 10% over the coming months as attractive corporate issuance opportunities continue to emerge.

Financial dislocation and greater market volatility appear to becoming the norm. It's becoming much harder to understand the impact of continued policy leverage on financial markets. While we believe further rate cuts will likely have less impact and be harder to assess than those made before, we intend to continue to focus on what we can analyse with a greater degree of certainty – business fundamentals, credit quality, market liquidity, and default risk.