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“I’ll gladly pay you Tuesday for a hamburger today” – it’s good to be Wimpy!

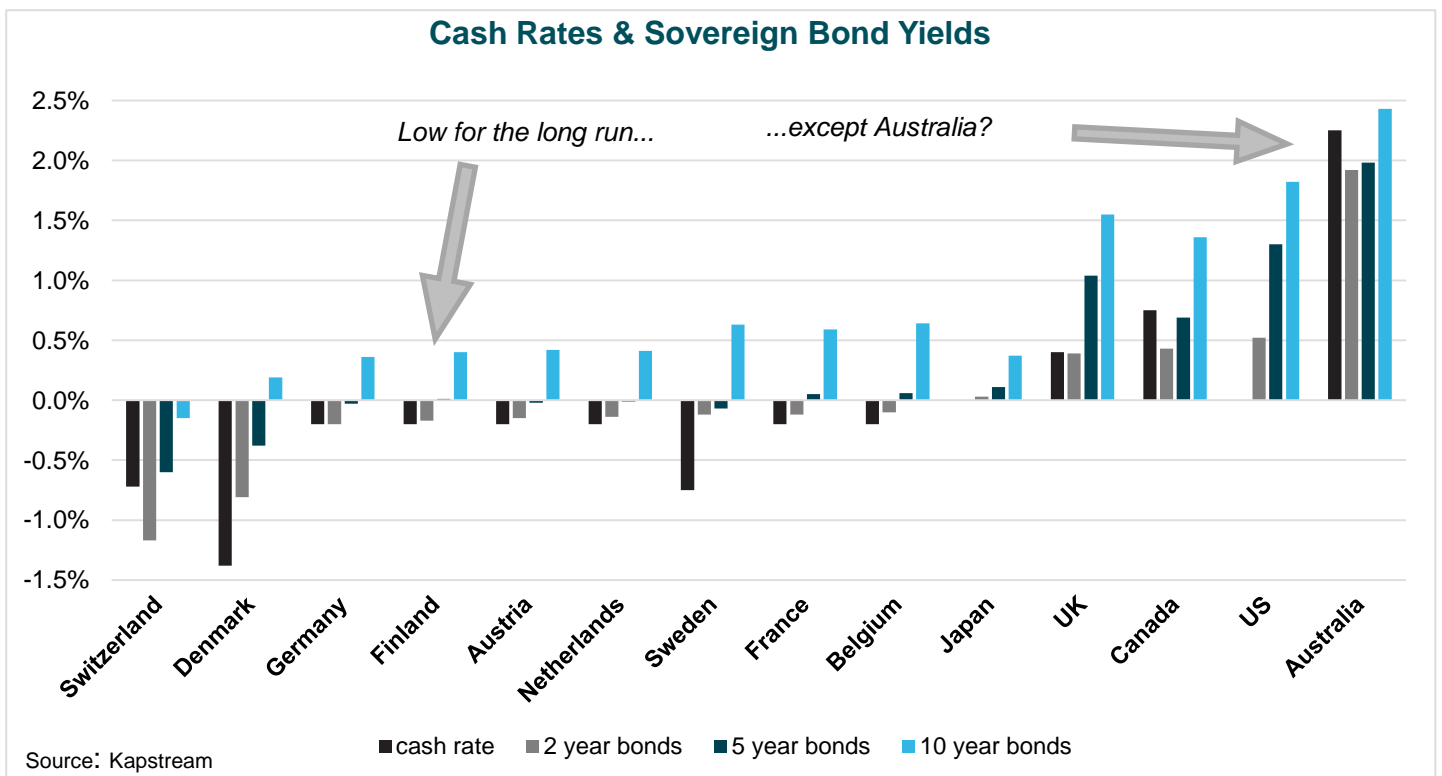
Today, the lucky Swiss can buy a 10-year bond for 117.45 Swiss francs, collect 1.5 Swiss francs each year for 10 years – a total of 15 Swiss francs collected over 10 years – and receive 100 Swiss francs at maturity. You read that right. Swiss investors now have the opportunity to be *guaranteed* to lose 2.45 Swiss francs for every 100 Swiss francs invested in this government bond. This dynamic is now happening in various degrees across global bond markets. And it's not limited to government bond markets. Even some corporate bond yields have turned negative, guaranteeing investors lose money (see Nestle's October 2016 euro-denominated bond which currently yields *minus* 0.04%!).

It's hard to be a saver in today's world, but it's certainly good to be a borrower. In Denmark, as the central bank reduces deposit rates deeper into negative territory in order to maintain the kroner's currency peg to the euro, its biggest banks are considering offering negative mortgage rates – yes, *paying* borrowers to take out loans! The banks can afford it with depositors now paying the banks to hold their money – currently about 1.38% per year!

Borrowers, including bond issuers, have become like Wimpy – fat and happy. Euroland, Switzerland and Denmark are in the headlines today, but much of the developed world isn't far behind:

Number of countries with <i>negative</i> cash rates	13
Number of countries with <i>negative</i> 2 year bond yields	9
Number of countries with <i>negative</i> 5 year bond yields	6
Number of countries with <1% 10 year bond yields	10

With a lack of domestic demand from weak consumers, **global central banks have reduced borrowing rates to encourage borrowers to borrow and penalize savers for saving.** Lower rates also have the benefit of weakening the currency, allowing manufacturers to export at more competitive prices. As increasing exports cannibalize other countries' manufacturing sectors, more global central banks are forced into the same game. Not surprisingly, we've seen more than 150 central bank rate cuts over the past 7 years.



With the US Federal Reserve telegraphing its intent to begin hiking rates in 2015 while most of the rest of the world continues in the opposite direction, it is not surprising that virtually every global currency has now substantially weakened versus the USD over the past year. Last week, the Reserve Bank of Australia (RBA) cited the weakness of the currency as part of its rationale for its latest cut, *“The Australian dollar has declined noticeably against a rising US dollar over recent months, though less so against a basket of currencies. A lower exchange rate is likely to be needed to achieve balanced growth in the economy.”*

Effectively, the RBA has now joined the currency war. While it's likely they'll cut again (as there was little point in just one cut), they can afford to wait for longer than markets expect given a surprisingly strong domestic economy across employment, growth and inflation. In the longer-run, the transition from mining investment to manufacturing and export sectors will take time and require an even lower Australian dollar. While continuing falls in the Australian dollar 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 lower rates as limited wage growth will stem inflationary pressures and allow continuing support for the housing market.

Elsewhere, the Danish central bank cut its main deposit rate deeper into negative territory, the Swiss abandoned its Euro peg, China cut interest rates for the first time in two years and reduced reserve requirements, Japan pledged over US\$700 billion in quantitative easing and the European Central Bank pledged €60 billion per month in asset purchases. The message is clear - easy money is here for the long-run.

What does this mean for bond investors?

If the theme of low global central bank rates and more liquidity continues, investors will remain compelled to hold risk assets, which should remain well supported. We foresee a continuing currency war as global central banks position for export growth amidst deteriorating domestic environments. The US will remain the only developed market not playing the currency game as prior structural and banking reforms promote greater growth prospects – the USD should continue its rally.

In today's environment, bond investors have two choices: 1) accept lower and lower yields and returns, or 2) take more risks.

The high yield, emerging market, bank loan and structured credit bond sectors continue to enjoy healthy inflows as investors grow more disturbed over lower high-quality bond yields. At Kapstream, we are focused on the higher-quality segments of the bond market, and believe that any weakening in the credit fundamentals of higher risk sectors will be obscured by lower and lower central bank rates. Some companies with weak or dubious business models may flourish when borrowing rates are low, but eventually normalized rates will mean higher defaults for weaker companies. But maybe not in the foreseeable future as low central bank rates are here to stay.

We continue to favour higher-quality, 'sleep-at-night' positions for our portfolios. Most of our funds are managed with risk control as the number one priority. Although we believe investors may benefit from taking greater risks in fixed income portfolios over the intermediate term, greater risk taking would break the agreement Kapstream has made with our investors. Therefore, we strongly prefer companies with robust and visible cashflow, underlying collateral, monopoly positions and solid ownership structures. While we foresee a 4½ to 5% return range in the future, with short-term Australian rates at 2.25%, we believe that is a good trade-off. Invest with Wimpy today, at least he'll pay you back on Tuesday. Bluto's track record foretells of an eventual punch to the mouth instead of a return of your capital.

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