

# Aftershocks

With the Global Financial Crisis fading to the back of our minds, the question pushed to the forefront is what kind of recovery we are going to have, and what the investment implications will be. The collapse of Lehman Brothers (and what seemed like the financial system) was over a year and a half ago, yet a series of aftershocks have jolted investors, reminding people that the road to stability will not be smooth.

A muddle-through period for the next five or more years seems likely. Investors should expect more aftershocks as the economy attempts to achieve some sort of footing and resume growth. The markets are currently grappling with excessive government debt (US/Europe/UK) versus signs of economic growth fuelled by government stimulus. From 2000 – 2009, the annualised US economic growth was less than 2%. For the reasons outlined below, Kapstream believes that over the next five or more years developed nations will face growth constraints, whereas emerging market nations, particularly in Asia, will lead the growth campaign.

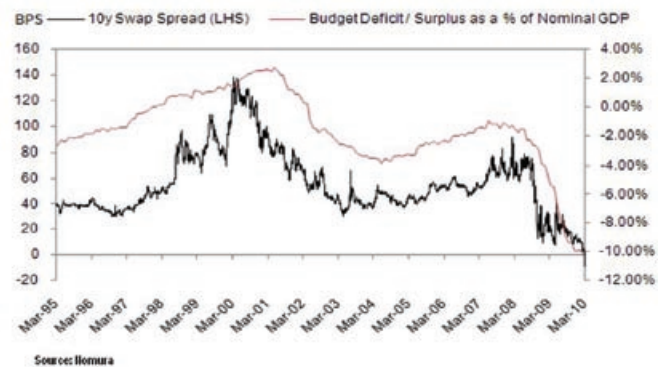
## The amount of borrowing is unsustainable

While consumers and corporations have ceased leveraging and repaired their balance sheets, governments have stepped in to fill the void. As an example, United States swap spreads are now negative for the first time ever (Chart 1). The swap spread is the difference between the swap rate (intra bank borrowing rate) and government bonds. The swap rate represents AA rated credits, whereas government debt reflects the credit of the US government. While the negative swap spread can be attributable to the rising demand of higher yielding assets, much of the decline in spreads reflects a shift in investor focus away from the troubles of

financial institutions to the ability of sovereigns to finance their rising fiscal deficits.

### Chart 1 – Declining spreads a sign of investor focus changing

10-year swap spreads versus budget deficit/surplus as a % of GDP

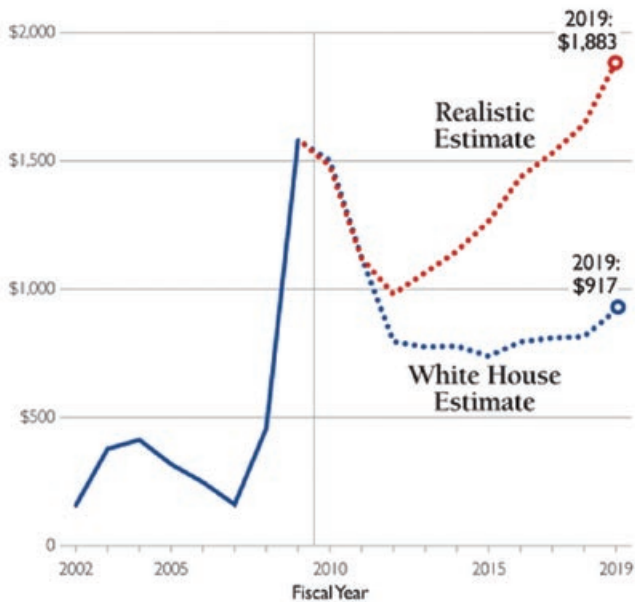


The US government is now borrowing funds at a higher rate than that at which most major banks fund. As a result, investors have shunned government debt, forcing yields higher. Rates will continue to rise, particularly in government bonds, unless sovereign nations make a concerted effort to clean up their fiscal situation. This is difficult to achieve, as governments have to reduce spending and increase taxes at a time when unemployment rates are hovering around 10% in the Western World.

As Chart 2 displays, a realistic estimate for the US budget deficit in nine years' time is \$2 trillion, as opposed to the White House estimate of just under \$1 trillion. The US faces two choices: either initiate fiscal austerity measures via spending cuts or tax increases, or continue on the current path and face an outcome similar to Greece or Japan.

**Chart 2 – Obama budget agenda would bring annual budget deficits to nearly \$2 trillion**

Budget deficit, in billions of dollars



Source: Heritage Foundation calculations based on data from the Congressional Budget Office and U.S. Office of Management and Budget.

**Investment implications**

The next five plus years will be a very difficult investment environment. The predicted recovery will be slow and full of aftershocks. In the US:

- The Baby Boomers have started to retire and will demand income to pay for their retirement lifestyles. Many states face the daunting task of pension reform. In California alone, the unfunded pension debt is more than \$500 billion, nearly eight times greater than officially reported. To put that number in perspective, it is nearly seven times the size of the all the outstanding state general obligation bonds in California.
- While employment looks to be on the mend, unemployment rates will remain at elevated levels for an extended period of time. The most recent non-farm payroll in the US turned positive for the first time in over two years, however employment needs to expand at an of average 125,000 jobs a month just to keep up with population growth.

- Over the next few years, a nasty set of tax increases are on the horizon, not only to help reduce the deficit but also to pay for the health care reform that was recently passed.

Over the last decade (2000 – 2009) the annualised return of the S&P was –2% (excluding dividends). Given the problems the world is facing, it is very likely that investors could get a similar outcome in returns over the next ten years.

Kapstream believes if investors are going to own equities or debt, the focus should be on certain emerging markets or those developed countries that have sound monetary and fiscal policy. These countries have decoupled from developed markets, and will outperform in the coming years.

Australia is in a unique position, with both sound fiscal and monetary policy measures in place. The unemployment rate peaked at 5.8% during the Global Financial Crisis, far lower than most economist and government predictions. With demand for commodities from Asian economies and signs of economic recovery in the US and Europe, the Reserve Bank of Australia (RBA) has started removing some of the stimulus provided during the crisis. The RBA has raised rates at five of the last seven meetings and, barring unforeseen economic derailments, is expected to take short-term rates to 5% by the end of the year.

Australian assets (equity/debt) continue to provide very attractive returns especially compared to the US and Europe, where central banks and governments are yet to start the process of removing stimulus.

For those investors at or nearing retirement, a fixed income portfolio that protects principal in a rising interest rate environment should be the primary choice.

In the end, investors need to lower return expectations as mid single digit returns will be the norm in coming years.