

# Celebrate a 'paper anniversary'

Kapstream Capital officially celebrated its first year of trading on June 1, 2008. Oh, what a year it has been for this baby's first year of life!

From an investment perspective we have had our share of ups and downs. Where shall we start? Getting lucky or smart in starting on June 1, 2007, as the credit crisis was about to explode. Was it bailing out of most of our US investment bank exposure in July 2007 before the worst hit, or protecting our client's capital in stressful times. Let history be the judge...

Highlights for the year

- Our fund returned a positive **6.02%** outperforming the UBS Composite (All Maturities) which returned 3.63% but underperforming the RBA cash rate, which averaged 6.75%. Note that in this period, local equities (S&P/ASX 200) fell 10.4% (excluding dividends).
- **Assets under management** grew from AUD\$100 million (courtesy of Challenger Financial Services Group) to **AUD\$340million** as at 1 June 2008.
- Our fund has been rated by at three asset consultants with one in the final stages of evaluation.
- The Kapstream client list grew from one to five (all institutional clients)
- The original staff of three (Nick, Kumar and Kathy) quickly grew to five (with the additions of Madhu Gayer and Stephen Mackie). Unfortunately, Stephen left the firm after a short stint of nine months, lured away by more lucrative and safer playing fields offered by Citibank. We are very close to finalising a replacement.
- We continue to offer our only product in Australia, the Kapstream Absolute Return Income Fund.

Low point

- The physical assets we own have been written down on a mark-to-market basis by 100bps. In retrospect, I wish we had been 100% in cash!! But at least we held 50% of our money in cash.

Now on to markets and the month of May 08

## Inflation: Here, there, and everywhere

As much as Central bankers try to fight it, inflation is everywhere. Taken as a whole, the average world inflation rate has risen to 5.5%, its highest level since the late 1990s. The primary driver of the rise in inflation has been the rise in food and oil prices, caused by:

1. A structural shift in the demographic composition of the world: as emerging economies evolve, many people who were once producers of goods are now transitioning to consumers of goods. As this evolution continues, the consumption of food, energy, and other finite commodities will continue to rise. This is most apparent in the BRIC economies of Brazil, Russia, India and China.
2. In the shorter term, as many experts have stated, the level of inflation is significantly higher than what is being reported (especially in the US). If the US used the same methodology for calculating inflation that they used in 1983 and 1998, inflation would be a staggering 11% and 7% respectively.

More importantly, this structural shift has been reinforced by some of the loosest monetary policy on record since the 1970s. It would appear *prima facie*, that the main culprit (the US Federal Reserve) is sowing the seeds of a new hyper-inflationary era.

What does this mean? The world is (still) a risky place. For many years we have all reaped the benefits of cheap money (excessively low rates for an extended period of time) and disinflation (courtesy of Asia/globalisation). In the US, the economy is still reeling from one of the worst financial crises ever. Consumer confidence is at an all time low, while the housing market continues to worsen. Even with the stimulus package commencing later this quarter, we believe that rather than spending that extra cash, the average American will most likely use it to pay their increased utilities and grocery bills.

Market focus however has shifted from the credit/liquidity crisis to fighting inflation; the US market is now pricing in rate hikes as early as September and December of 2008 in order to combat the threat of inflation. What people do not realise is that raising interest rates in this environment would be extremely difficult. As John Mauldin wrote in a recent column, 'it is not clear that inflation would respond to rising rates without a severe slowdown and an even worse recession. Oil is a function of supply and demand (not interest rates), spurred on by speculation. Food price increases are due more to government policy (as in ethanol and subsidies) and increased demand for higher-quality foods, especially protein, from developing nations.'

If the Fed tightens in the face of low growth and vulnerable markets in order to avert price pressures, it will be reminiscent of the Volcker era (1979-87), and stand in direct contrast to the Greenspan (and now Bernanke) paradigm (1987-current). Yet if the Fed does nothing, there could be renewed parallels with the inflation era of the 1970s (Burns/Miller).

Needless to say, this environment is likely to be extremely bearish for bonds, especially in the US. History shows that a neutral interest rate is roughly some 2% above inflation, which translates to nearly a 6% yield, nearly 2% higher than where US 10 year government bonds traded at May month end. If inflation continues to creep higher and the Fed takes a tight monetary stance, not only will the potential upside for yields become downright scary, but also, returns in US government debt will suffer significantly. Between the end of 1965 and the end of 1981, an investment in US treasuries lost 46.5% in real terms, including reinvested interest. Thus, owning fixed rate bonds at low yields during inflationary periods is a disastrous investment policy.

By contrast, Australia offers a much rosier picture with respect to fixed income. The RBA has a tightening bias, but is most likely near the end of its hiking campaign. Australian bonds are attractive both on an absolute scale and relative to other fixed income markets. Inflation is still a concern; however, with cash rates at 7.25%, investors can slowly begin scaling into longer duration fixed assets, and benefit from locking in high yields for many years to come.

Let us hope for all our futures and our superannuation that we do not have to revisit the 1970s! Hang on to that cold hard cash – it will become very useful... onwards to year two and the opportunities for Kapstream and our clients.