

Opportunities in the eye of the storm

Let's face it. It is not pretty in the financial markets. Many were hoping that once the calendar ticked over to the New Year, we could rid ourselves of the perils of 2008 and start fresh. Not only have many of the issues facing markets/economies continued to 2009, but also, the New Year has brought on an onslaught of new challenges, with threats of nationalisation, increased sovereign risk and global ZIRP (zero interest rate policy). In light of all this negativity, there is an elusive silver lining as investors can take advantage of some fantastic opportunities.

The stress in the financial markets has intensified in 2009. Equity and bond markets continue to exhibit signs of large volatility. The pace of sell off in equity markets has continued, with the Dow Jones falling 21% in January and February (after having fallen 43% in 2008), while the ASX is down another 15%, year to date. Similarly, government bond markets sold off in January and February, as massive issuance is affecting the yield premium demanded by investors to hold government debt.

Further contributing to the crisis is a substantial increase in sovereign default risk. Governments around the globe have been forced to take equity stakes (quasi nationalisation) in various financial organisations to stop the haemorrhaging of the banking sector. In addition to providing capital and bail out packages to financial institutions, governments have turned on the issuance taps of both government and government guaranteed debt.

Central Bankers are doing their part, by cutting interest rates to historical lows and embarking on quantitative easing. The Reserve Bank of Australia cut 100bps in February and has now lopped off a whopping 4% in the last 6 months lowering borrowing rates from 7.25% to 3.25%. This was in response to continued deterioration in domestic and global economic conditions since December (remember they did not meet in January).

The macroeconomic data in the past three months has broadly surprised on the downside with, for instance, 4Q08 real US GDP being revised to a 6.2% annualised contraction from an initial estimate of -3.8%. The data for 1Q09 shows little respite, with pressure on industrial output, home prices and unemployment, which is causing consumer confidence to deteriorate further. While the fiscal stimulus bill in the US and programs to address the mortgage market are significant, investors must realise that fixing the problems will take time.

Ideally, there are a **few things we would like to see before we are convinced** that the end of the crisis is near:

- A **strategy for recapitalising the banking sector**. Thus far Treasury Secretary Tim Geithner has been light on plans and high on uncertainty.
- While the US Government's step in quasi nationalising Citibank somewhat addressed some concerns, we wonder **where you draw the line?** People argue that the US should do what Sweden did 20 years ago. Yet, in Sweden, there were only a handful of banks, whereas the US has well over 8,000. A complicated project nonetheless. Furthermore, which banks qualify for nationalisation, and which banks would be left for dead?
- A plan for addressing the issues in Western and Eastern Europe. While **the probability of a break up in the EMU is low, the threat is there**. Moreover, Western Europe must address the issues of bank solvency, balance of payments stress in Eastern Europe and rebalancing global savings/consumption patterns.

- A move by Central Banks to implement programs to **purchase corporate bonds, securitised assets and even equities**. Some countries have begun this process and we feel that it will have a much more pronounced effect compared to traditional quantitative easing.
- In Australia, there are signs that the stimulus is starting to work. Better than expected December Retail sales (+3.8%) and housing finance (+6.4%) gave hope that substantial monetary and fiscal stimulus was taking effect. The RBA left rates unchanged at 3.25% in March and now **the market is anticipating that less rate cuts** will be required in the future.

Against such a backdrop of volatility, increased defaults and mark to market risk, there are pockets of **SIMPLE OPPORTUNITIES for investors** in fixed income.

Kapstream's central view is that **central banks around the world are in no rush to hike interest rates**. Our analysis reveals that once a cutting cycle is completed, central banks are on hold for an extended period of time (12 – 18 months). Additionally, we do not expect the volatility in the market to subside any time soon. Therefore:

1. **A portfolio of government, government guaranteed paper, and senior debt of the big four Australian banks** is not only a **safe investment**, but also will generate BBSW + 150 bps.
2. Investments in **high quality, short dated floating rate corporate bonds** (senior in capital structure) are once in a generational opportunity. There is **no need to move down the capital structure**, when investors can achieve equity like return from debt instruments.
3. **Reducing duration in global bond portfolios seems prudent**. Interest rates will rise at some point in the future due to concerns of excess government supply and/or increasing expectations of future inflation.
4. Employing **managers (regardless of asset class) that are nimble and flexible** in their investment approach. It is important to protect capital in periods of crisis and produce returns in normal environments.