KAPSTREAM CAPITAL

Don't look to get rich in 2009, just stop getting poorer

Happy New Year!

There are many who were ecstatic to put the tumultuous year of 2008 behind them. The speed at which the global economy deteriorated since mid 2008 was remarkable, and now people are faced with arguably the worst economic environment in a generation.

Investors, economists and policymakers dramatically under-estimated how difficult it would be to re-liquefy the financial system and how much damage would be done to banks' balance sheets in the process. Unfortunately, that fed straight through to the real economy creating a vicious economic circle. Double-digit corporate borrowing costs made financing capital expenditure even less attractive than it was before, which in turn added pressure on profits, employment and wage growth, ultimately destroying any semblance of spending and confidence.

Faced with de-leveraging banks, a sharply rising savings rate and lower inflation, central banks slashed interest rates (and will continue to ease policy in 2009), keeping them low for the foreseeable future.

The Fed led the charge taking rates to a target rate of 0 – 0.25%, bringing down the rest of the curve with it (quantitative easing). In fact, three month treasury bills went negative for the first time ever, while investors had to move out to the three year part of the government curve just to get 1%. Investors made it obvious that they were more concerned about the return of their investment as opposed to a return on their investment. At the moment, the only comfort investors have is the prospect of easier fiscal policy, lower mortgage rates (for those that can refinance or buy), and decreasing inflation.

As we commence 2009, most are hoping for some stabilisation, as the effects of the policies and actions put in place in 2008 begin to work their way into the system. The environment has a 'back to basics' feel to it, with institutions and investors moving away from leverage and exotic derivatives, and looking into fundamentally sound assets in which to invest.

There will be a new administration in the White House and more economic stimulus is expected, with the remainder of the TARP likely to be deployed alongside other stimulus packages. The US economy will remain at the forefront of investor concerns, as it is widely expected to be a sluggish period. Other ongoing areas of concern in the US include credit and liquidity conditions, the housing market, commercial real estate and consumer credit.

Kapstream identifies some key themes (and predictions) for 2009:

- **Does Australia follow the US into a recession?** The question of whether Australia falls into a recession is really neither here nor there. The main point is that for most people it will feel like one. Weak global growth is hurting the traded sector, tight financing conditions is impacting the provision of finance across the economy and weak confidence and growing economic uncertainty is dampening spending (ANZ). Additionally, with China showing signs of cracking, we expect this to put further pressure on the Australian economy.
- **Unemployment rates to rise around the world**. We expect to see many regions post double digit unemployment by the end of 2009 as the deep and prolonged global contraction continues. The bulk of the job losses will stem from the US, which lost over 2.5 million jobs in 2008, just shy of the 2.75 million employment decline at the end of World War II.

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- **Confidence in the credit markets is critical for recovery**. Credit conditions are tight and will remain so for some time to come. However, many of the new policies have helped improve short-term funding and lower interbank lending rates. Outside of government intervention, financial markets remain severely constrained. However the hope is that as soon as growth picks up, a healthier re-intermediation process will begin within the financial sector, allowing government involvement to recede. (JPM)
- **Share market valuations are historically cheap**, however the risk is that recovery will be slow. A short term bounce in risk assets is likely (Q1), but it will be short lived. Between the Fed's initiatives throughout 2008 as well as President elect Obama's stimulus plan, the US is throwing everything but the kitchen sink at the economy to get it going again. However, consumers are cutting back on spending, corporations are laying off more employees, and earnings are set to be worse than analyst's projections.
- **Senior debt of 'too big to fail' banks remains an excellent strategy**. Global governments drew a line in the sand with respect to the banking sector, essentially providing a back stop to prevent total chaos and a further melt down in the global economy. The yields on many of these banks are at one in a generation levels, allowing investors to achieve great returns without moving down the credit curve.
- **Longer term credit = the new equity game**. Unlike most other asset classes, credit is priced for a miserable outcome. In 1932, as the Great Depression approached its trough, HY default rates reached 15% and BBB-rated corporate bonds yielded a little over 5% more than US Treasuries. Current spread levels are significantly wider than that already, but the default cycle is still unfolding (RBS). Therefore, investing in high quality, short dated credit will allow investors to capture solid returns in an uncertain environment.