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KAPSTREAM CAPITAL

Back to the 70s – Bell Bottoms, Brady Bunch and Saturday Night Fever

The 70s was a decade of bell bottoms, discotheques, Richard Nixon and a tremendous growth in environmentalism. Let's not forget two oil crises (1973 and 1979), hyper-inflation and record level interest rates. The US economy experienced recession and inflation simultaneously – in one economic word – STAGFLATION!

The average annual inflation rate between 1900 and 1970 in the United States was approximately 2.5%. In the 1970s the average inflation rate rose to 6%, topping 13.3% in 1979. The Prime Rate (borrowing for prime borrowers in the US) reached 21.5% in December 1980. Gasoline was rationed in the US as suppliers shut down exports to the US and tensions rose. Does the situation in the US now look familiar?

By contrast, this past February saw bank bill rates in Australia rise sharply as the market reacted to the rise in the RBA cash rate and also priced in further rate hikes. One year bank bill swap rates rose 80bps to 8.3% in the month of February alone! Economic data continued to be strong and unemployment in Australia hit a 33 year low of 4.1% on February 14.

The happy marriage between world economies is headed to the divorce courts, with the settlement papers being drawn up as we speak. The main bond index (UBS Composite) was down 0.61%, the ASX 200 is down 12% for the first two months of 2008, while the median balanced fund in Australia for the fiscal year 2007 is in negative territory.

Financing rates for banks and corporations are rising. Of the estimated (consensus, for today) $300 billion in losses sustained by financial institutions, we have only seen write-downs of around $160 billion thus far. That leaves another $140 billion in losses to reach consensus. Where does this come from? Does it come from insurance companies, pension funds, and/or asset managers? We are in the fourth day of a five day test. And, as in cricket, there may be no winner declared at the end of the match.

We at Kapstream continue to believe that volatility is here to stay. We have at least another 12 months of pain to come. Daily market movements have become larger, while rumours and headlines drive prices. Markets are driven by fear, panic and sheer gut instinct. If money making and asset allocation was difficult before, it is nigh-on impossible now!

With volatility set to remain, why wouldn't a prudent investor stay on the sideline and keep some powder dry? Australia gives you assets that are relatively safe (AAA and AA rated bonds, if you believe the rating agencies) at 8.5% for the next two years. Knowing what we now know and fearing what is still to come – clipping 8.5% for the next two years will make any Brady Bunch character look like a hero!

With that in mind, Kapstream has continued its conservative approach to investing in this difficult environment. We posted positive returns in February, with our alpha trades delivering once again.

So, dust off those old bell bottoms, turn on the old LP, 'Bad, Bad Leroy Brown' (Jim Croce), turn on the disco lights and wait for the next decade! It's going to seem like the 70s never ended!

Kapstream Capital Pty Ltd ABN 19 122 076 117 Level 15, 255 Pitt Street, Sydney NSW 2000 Phone: +61 2 9994 7000 www.kapstream.com

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