July 2008

On the brink of that recession we HAD to have?

Central bankers in America and Europe are stuck between a rock and a hard place. Leave rates too low for too long and you run the risk of stoking global inflation. Tighten monetary policy too soon, you run the risk of the world economy grinding down into a series of recessions. What's a central banker to do?

Take the ECB for example – interest rates were raised by 25bps in the middle of crisis to combat inflation, now the market expects them to cut rates. This is not only because the European economy has slowed significantly, but also because the Euro (versus the USD) is at a record level, which is hurting exports. The ECB is walking a very tight rope.

The Australian de-coupling (Australia vs. US and the rest of the world) theory came crashing down during the last week of July. National Australia Bank wrote down A$900million of AAA rated CDOs and there are widespread rumours that there is another A$4.5billion of write downs still to go. Now the question is, are there other institutions with the same problem as NAB? In financial markets terms, Australia has never de-coupled from the United States. So far, only a few Australian banks have revealed assets that were directly/indirectly exposed to the US sub-prime market. Are superannuation funds and pension funds, as well as insurance companies next? If everyone marked their books to fair market value, surely there have to be more NAB-like write downs to come!

In the past, when the U.S. economy has weakened, the rest of the world usually followed quickly, and inflation eased as demand for oil and commodities fell. This time it is different. Two years after the U.S. housing market went bust, and at the first anniversary of the start of the credit crisis, the slowdown is starting to spread worldwide. Kapstream's view continues to be that the economic recovery will be slow in coming. The Fed cannot wave a magic wand to make the problems go away. The only wand at their disposal is monetary policy, and while it is effective, it can only do so much. The US government has employed its magic wand—fiscal policy—and the effects will only mean higher borrowing costs in the future.

July also saw Terry McCrann's article suggesting that the RBA (who was once the lone ranger of Central Banks with the sole focus of fighting inflation) may have done a bit too much to hurt the Australian consumer. Following the article, the market did a 180 degree turn, from pricing in further rate rises a month ago, to expecting 85 bps of easing by the RBA over the course of the next 12 months. In New Zealand the markets expect at least another 150bps of easing! How quickly sentiment can change.

A few thoughts on the Aussie interest rate policy:

1. In March, the RBA was worried about inflation and decided to raise rates
2. By August the RBA was looking through any high inflation…why?
3. If the RBA starts to cut interest rates despite inflationary indicators, why the sudden reversal in policy? Granted there will have been 6 months between the last rate hike and any potential rate cut.
4. Shouldn't the Central Bankers have more of a long-term focus, rather than tinkering with rates too much, too often? Why not leave rates alone and let things work themselves out?
5. Are Central Bankers worldwide too reactionary? Is this not contributing to recent market volatility?

Only history can judge whether the RBA has done the right thing or not. This will be determined by how deep a recession (if any at all) Australia might face during this global credit/housing crisis, and where inflation goes.

Market Recap – July

- Bank bill rates fell 14 bps during the month.
- Three year note yields fell 50 bps and 10 year note yields fell 25 bps as the Australian economy showed signs of cracking.
- The A$ reached a record (25 year mid month high) of 0.9850 during the month, before falling back towards 0.93 cents versus the greenback.
- Employment was solid at 29,800 jobs and May retail sales increased by +0.7%. These were quickly forgotten as June Building approvals and June retail sales printed -0.7% and -1.0% respectively. Rounding out the bad news was the huge write down from NAB and worse than expected profit warnings from most major banks.
- Several prominent CEOs have recently retired. (Qantas, Macquarie, NAB).
- The RBA left rates on hold.
- The UBS composite bond index produced a solid 1.78% return for the month, while the ASX 200 fell 4.5% excluding dividends during the month.
- Kapstream Absolute Return fund was up 99 bps for the month.

Inaugural Kapstream Poker for Charity

- Kapstream hosted a charity poker night on 24th July in Sydney
- The proceeds from the evening, A$16,500, were donated to Bear Cottage in Manly.
- Bear Cottage is the first children's hospice in NSW. It is a place where children with terminal illnesses and their families can stay from time to time and receive rest and medical care in a home-like environment. In addition to providing respite and end of life care, Bear Cottage runs a number of other programs aimed to support the entire family. Families do not pay for any Bear Cottage services and all operating expenses are raised entirely through community donations.
- Kapstream is hoping to make this an annual event for a very worthy cause!

Kanangra Capital – Strategic Alliance

- Kapstream Capital has entered into a strategic alliance with Kanangra Ratings Advisory Service. Kanangra is the new company formed by respected credit specialist, Dr. David Howell. Dr. Howell will be assisting Kapstream on an advisory basis in its evaluation of opportunities in credit across all sectors and markets.
- David Howell has spent the past six years with Moody's Investors Service as a Vice President and Senior Analyst specializing in corporates and infrastructure. With an impressive educational foundation in the sciences (geology), and strong career background in project finance (NAB, NatWest, Westpac) Dr Howell brings with him a wealth of experience. His knowledge spans the globe and crosses a variety of sectors, especially mining and infrastructure.
- Kapstream is delighted to have the opportunity to work with Dr. Howell, and looks forward to a long association with Kanangra.

Market Outlook

- We are bullish on interest rates and bond markets in Australia over the next 12 to 18 months.
- The RBA will be cutting rates, probably down to 6.25% by end-2009
- We are bearish on US government debt, and US interest rates in general (higher inflation, Fed reversing policy, Treasury supply, budget deficit and eventual normalisation of interest rates)
- We think the Australian economy cannot decouple from the U.S. even though commodities act as a buffer.
- Storms are forming over Asian economies as both India and China combat high inflation and housing bubbles. Both have started aggressively raising interest rates.
- Market volatility will continue to be high as the market and central bankers grapple with low rates and high inflation versus economic slowdowns
- Given the uncertain environment, Kapstream cannot stress enough that locking in quasi-safe assets (AAA and AA debt) with yields of 8.0 – to 8.5% over the next 2 years continues to be a prudent investment.