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The markets always need a blessing or two!

With the Pope visiting Sydney this week, we are sure that there are plenty of investors hoping he enacts some sort of divine intervention into their superannuation accounts. Returns at the end of the fiscal year (June 30th) were less than stellar which brought upon an enormous amount of anxiety to fund managers, pension funds and superannuation funds. Of note, Australian equities recorded their worst performance since 25 years, i.e. 1982!!!

Bond markets recovered some of their earlier losses as Central Bank rhetoric turned from economic growth to becoming inflation fighters.

A quick recap of the year brings things to better light.

- **July – Sep 07** – Two US hedge funds backed by Bear Sterns collapsed, as did Basis Capital in Australia. The credit crunch rocked RAMS home loans, while in the UK, Northern Rock struggled and the US started slashing interest rates.
- **Oct – Dec 07** – The Dow, SPX, and ASX all posted record highs (go figure!), the RBA lifted cash rates to 6.75%, and Centro Properties needed to refinance a significant amount of (Centro shares plunge 76%).
- **Jan – Mar 08** – Share markets wobbled, as problems arose within Allco and Tricom, ANZ and CBA revealed higher bad debt problems, the RBA raised rates again to 7% and then to 7.25%, while oil moved past $100 a barrel. The Fed lent $200billion in short-term debt and bailed out Bear Stearns. Opes Prime and ABC Learning have significant issues.
- **Apr – Jun 08** – Equities rallied in April, Westpac bids for St. George, the AUD$ hit a new high of 96.5 US cents, oil jumps $10 in one day to reach a record $145 a barrel. The share markets have their worst financial year since 1982.

By year end, the global share markets show material cracks with the China equity market, Nikkei, ASX, and Dow all down 28%, 25%, 16%, and 15% respectively. Meanwhile, the UBS composite bond index posted a return of 4.4% for the year.

So what now?

Here we are in mid July:

- The credit crisis is back on the cards
- Investment grade credit and Australian ITRAXX (which measures credit spreads in Australia) have started to widen
- Risk taking is evaporating
- Equity markets are on knife's edge
- The US dollar is weaker against major currencies
- Gold is still around $950/ounce and oil is well north of $140 a barrel.

The markets are starting to anticipate no moves from the Fed and an unwinding the rate hikes that were priced in earlier this year. The ECB raised rates in July by 25bps and Mr. Tough Trichet, called it one and done. It's sort of moving into a boxing ring, taking one big punch and apologizing to your opponent. If you are going to fight (inflation), you may as well give it all you got and go for the kill. So what's the next move by the ECB?

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A recent article (They say – 'Never Bet against the US Consumer', we say – 'Never say Never') by Tom Fitzpatrick and Shyam Devani of CitiFX summed the current situation and compared it to history as well:

1980 – 1982

- The price of oil spikes from $14 in 1978 to $35 (133%) on the back of the Iranian revolution and the Iran-Iraq war
- Housing collapses, the Dow falls 25% between 1981 and 1982, and unemployment reaches 10.8% by December 1982
- The Fed cuts interest rates from 20% to 8.5%, which starts a 25 year consumption binge.

1991

- The price of oil spikes from $15 to $41 (173%) as Iraq invades Kuwait
- Housing falls from 1984 – 1989 and then collapses again from 1989 – 91. Unemployment rises from 5% to 7.8% between 1989 – 1992
- The Fed cuts interest rates from 9.75% to 3%, and the Dow rallies 45% between 1989 – 1991.

2001

- Oil spikes again from $10 to $37 (270%) between 1998 – 2000
- Equities fall as the dot.com boom busts, while unemployment rises from 3.8% to 6.3% between 2000 – 2003
- The Fed cuts again from 6.5% to a low of 1% by 2003.

LONG LIVE THE CONSUMPTION AND CREDIT BINGE!!

Today

- Oil has spiked from $50 to $144 (180%) in 2007 – 2008
- The Dow sits 20% off its 2007 peak and is now below the peak in 2000
- Housing has collapsed after a 15 year bull market, credit markets have suffered significantly, and sub-prime losses are at $400 billion and counting
- Credit spreads have widened despite the Fed lowering rates by 325 basis points from 5.25% to 2%
- Unemployment has risen from 4.5% to 5.5% from December 2006 to July 2007 (In May 2008, we witnessed the biggest monthly rise in unemployment in 26 years)
- The budget deficit in the US is nearing record levels.

In a nutshell, the credit crisis is back, equities are hitting new lows, oil continues to break record levels and economic growth around the world is generally weak. Kapstream strongly believes that investors are getting paid around 9% to sit on the sidelines and watch the drama unfold. It's not a bad option considering that in the US, investors only earn 2% for sitting on the sidelines.

When will we stop being so bearish on the equity markets?

We will change our bearish tune on equity markets once liquidity returns to the front end of higher quality credit markets. Unfortunately we are not there yet. We understand that high yield and emerging market spreads widen in times of crisis (this has happened before). But when short term AA and A rated companies are having a tough time financing and spreads in this high quality are trading like they were in the 1930's then we will remain firmly planted on the sidelines, owning high quality bonds earning yields in excess of 9% for our investors.