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KAPSTREAM CAPITAL

An Aussie Bias

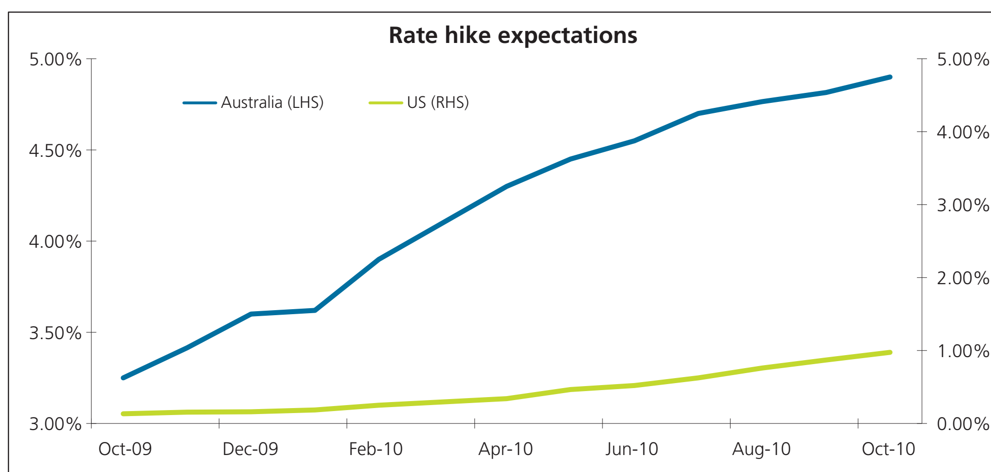
"This time it is different." As Sir John Templeton stated, those are the four most dangerous words for investors. It has been a universal catch phrase used to describe everything from the Global Financial Crisis to every possible sign of recovery over the past six months.

For Australia, the verdict is in. The dynamics of this prosperous nation are different relative to the rest of the developed world. Australia did manage to avoid the brunt of the global recession. In the face of a global crisis, the RBA was aggressive in easing rates and the Government put effective fiscal stimulus measures in place quickly. Australia's proximity to China, its stable banking system, and its natural resources have helped the domestic economy avoid much of the global contraction. Its strong economic and financial position going into the crisis was also critical to Australia's success in emerging relatively unscathed.

Key differences between the Australian and US economies include differences in the banking sector. Despite the liquidity crunch, Australian banks did not need to go to the Government to fund their balance sheets, unlike many of the US banks; nor did they require mergers with other entities to survive. Australian mortgage lending has more stringent underwriting standards (no sub-prime) and better recourse on defaults. No Australian bank failed, stopped dividend payments or had cap-in-hand to the federal government for capital, although the Government did step in to guarantee bank deposits.

Australia entered the crisis with more effective tools in its toolbox. Australia's fiscal situation was in far better shape than the US in the beginning of the crisis and continues to be so. The RBA had plenty of room to lower interest rates and can do even more if necessary in the future, whereas US rates started low and didn't have far to go. Australia's debt-to-GDP and deficit-to-GDP are in much better shape when compared to the U.S. The U.S. Fed's balance sheet has ballooned from $800 billion to $2.0 trillion while Fed Funds rate has dropped from 5.25% to 0.25%. The U.S. fiscal balance has surged from a negative 2% of GDP to 12%!!

The market is now predicting that the RBA will be the first central bank to 'normalise' interest rates. That is, it will be the first G20 country to raise rates in two years and attempt to return rates to their historical averages. This is appropriate given the stronger economic fundamentals here vis-à-vis other developed countries. However, the question is: how much and how fast should rates rise?



As can be seen in the above chart, market expectations are for measured rate rises in the US, and vastly more aggressive increases in Australia. But can the RBA hike rates so aggressively when the rest of the developed world is only pricing in marginal rate hikes over the next year.

Are we there yet in Australia?

On October 6, the RBA tipped its hand by increasing rates by 25 bps, citing resumption of global economic growth. The markets are pricing in additional rate increases before the end of the year. But, has the recovery had time to take root in Australia? Is the RBA being short-sighted in its strategy? What happens if we experience a 'W' or 'L' shaped recovery?

Compared to previous rate hike cycles, an RBA rate hike this year seems premature. The last cut was only five months ago, and we continue to see relatively low GDP growth, low inflation, and low capacity utilisation. Signs of recovery in the housing and job markets are still quite recent. The central bank can afford to wait until the first quarter of 2010 to raise rates, without risking serious consequences to inflation. The rates train is difficult to turn around quickly; the effect of rate changes on the economy takes place with a significant lag. Raising rates too early risks stifling those early signs of recovery and, if we see a second leg down a policy reversal is extremely difficult.

Investment conclusions

- Home country bias in Australia provides attractive returns, even if the RBA were to normalise rates. Resource stocks, banks (equity and debt), and long A$ are very attractive assets.
- The RBA cash rate will head towards 5% by the end of 2010, but markets have already priced this in.
- We continue to prefer senior debt of the Big Four banks. We are cautious on global credits, as interest rates and spreads are extremely narrow.
- Increase exposure to seasoned Aussie RMBS as spreads continue to be attractive.
- Global credit markets have seen substantial normalising and in some instances have already completely normalised. The 'free lunch' in the credit markets is starting to fade. Dynamic beta and alpha in the credit space is more important than ever.
- If credit spreads continue to tighten and absolute yields rise to an opportunistic level, Kapstream will look to switch out of credit, in favour of lower risk assets like semis and government guaranteed debt.
- Over time, look to increase exposure to fixed rate debt in Australia and floating rate debt globally as US and Europe will normalise rates later than Australia.
- Macro economic risks are high, as equity markets have priced in a rosy recovery scenario.
- Kapstream will continue to target absolute returns of 7 – 9% in fixed income space.

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