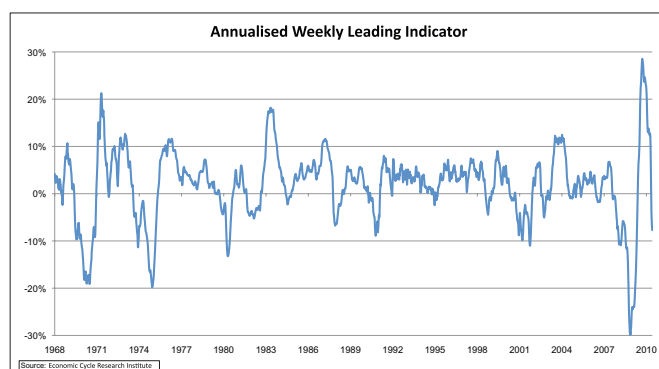


Double dip or double up?

The doomsayers have sent the bulls running for the hills. The double dip theory has hit the mainstream as bearish sentiment dominates the media. Just in the last ten days of June, stocks plunged nearly 8%, housing data deteriorated further, and US government bonds rallied dramatically. As at month end, US ten year bonds closed at 2.93%, the lowest level in over a year. Similarly, US two year bonds closed the month at an astounding 0.60%, the lowest yield ever.

Downside risks to growth have increased due to the growing concern around sovereign risk, the effect of austerity measures, and funding stress for many European banks. But adding fuel to the fire has been the financial markets focus on the US growth outlook, particularly consumer spending, employment and housing. The Economic Cycle Research Institute's (ECRI) proxy for growth, the Weekly Leading Indicator (WLI) dropped to -7.7% on an annualised basis, its lowest level since May 2009. According to research, a recession has never failed to materialize following a -10% reading.



Market fatigue seems to have set in. While cutting rates to zero combined with quantitative and fiscal easing created a short term resolution, the market looks to be poised for another setback unless additional stimulus is added. European economies are implementing austerity

measures however it is expected to destroy growth in the process. A case in point is Ireland. The once prosperous nation is facing an uphill battle with no sign of a turnaround in sight. Unemployment is over 13%, while the Irish economy remains in a recession after shrinking over 7% last year. These self-imposed austerity measures paint a grim picture of what other European nations will likely encounter. Even many US states are facing headwinds as forty-six of the fifty states are likely to have budget shortfalls of more than \$112 billion combined for the fiscal year ending next June. California is in the worst shape with over 12% unemployment and a budget gap of \$19 billion, more than Greece, Portugal, Ireland, Hungary and Romania combined.

No question that the current environment is unique with the economy facing subdued growth and minimal inflation. But should investors be surprised that the market cooled down following the surge in risk assets? After rallying over 80% from the March 2009 lows, stocks have sold off roughly 15% since April. The global economy has come a long way but it remains weak, so a soft patch while in this recovery stage should be expected.

Barring a major catalyst (sovereign default, another large drop in US housing, etc), the likelihood of a double dip is low. That said, the risks are higher than at any time since the recovery began. If the economy continues to deteriorate, expectations are that policymakers will be forced to take the necessary steps to calm the markets. While monetary and fiscal ammunition is low compared to where it was prior to the crisis, further stimulus measures could be implemented in the form of quantitative easing, continued aid to state and local governments, or an extension of unemployment benefits and tax cuts.

In Australia, the RBA voted to keep rates on hold at 4.50% despite inflation edging higher, a resilient housing

market, and strong job growth. The market began pricing in rate cuts as a result of the impending global slowdown however we feel that is unlikely for two reasons: (1) It would be difficult to see RBA Governor Glenn Stevens reversing his hawkish stance and (2) the global backdrop is not expected to lead to downward revisions to Australian growth. The Australian economy remains on sound footing with growth around trend and higher terms of trade. While yields have rallied following the recent turmoil in markets, Australia remains as a great place for investors to achieve high yields for low levels of risk.

Investment implications

The past crisis has taught investors to place a greater focus on maintaining high levels of liquidity. At Kapstream, the past two months has been dedicated to preserving our client's money and minimising mark to market risk during this time of heightened volatility. This has involved increasing our cash holdings, reducing our risk offshore, and increasing the overall quality of our portfolios.

Unless the economic circumstances worsen significantly from here, we feel that the upside in owning G7 government debt is limited. The rally over the past three months has been driven by fear as bond yields now fully reflect a slowdown in economic growth over the next year. As mentioned earlier, the US two year bond closed the month at 0.60%, even below the lows following the collapse of Lehman Brothers. Similar to what happened during the crisis, market psychology is currently driven by the adage: Return of capital is more important than return on capital.

While you are virtually guaranteed to get your money back when investing in government debt, it is not a risk free asset. As depicted in the chart below from GMO, long-term bond investors face an uphill battle when buying government debt at such low levels. Valuation becomes essential.

