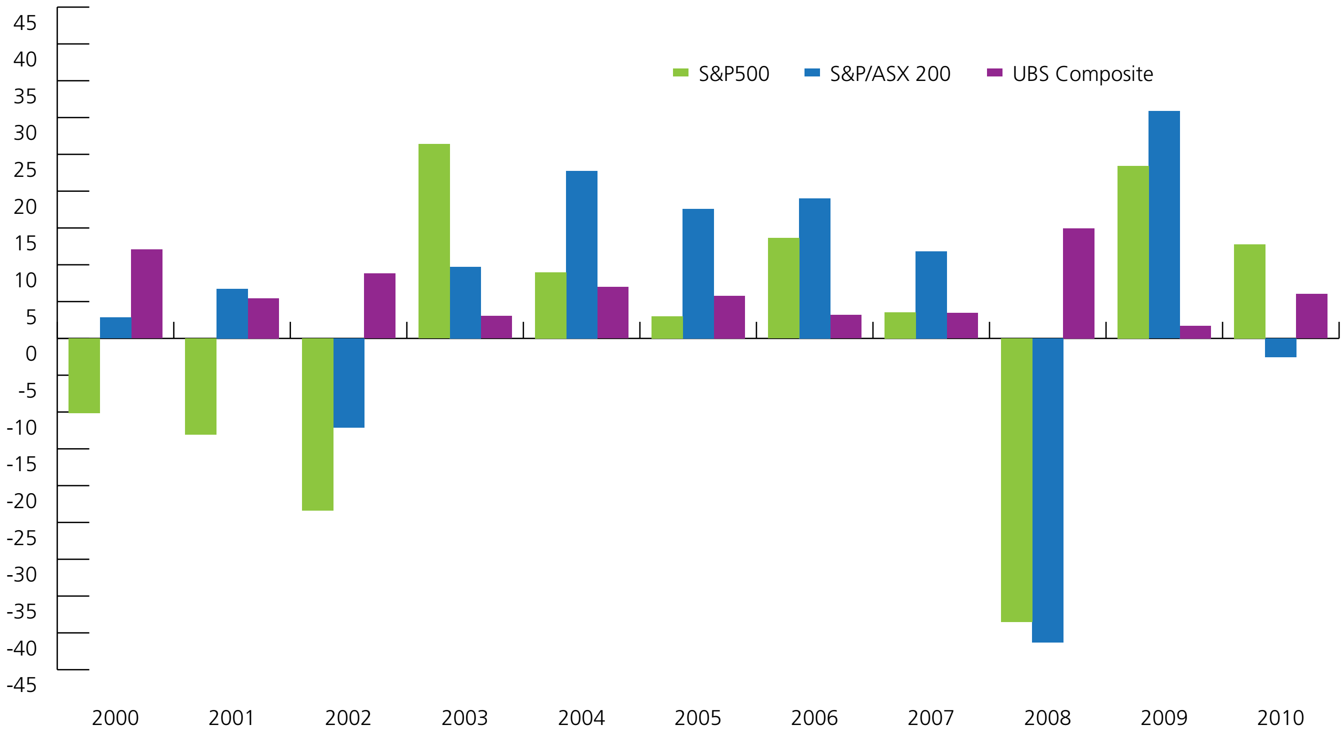
Bonds are beautiful

As the US economy continues to recover from its deep recession, the benefits accruing to Australia and the remainder of Asia are hard to overlook. At Kapstream Capital, we foresee strong Asian export growth over 2011, a continuation of the commodity rally and further currency strength, especially the Australian dollar versus the Euro, as Euroland appears at risk to be the growth laggard.

Bonds have outperformed equities since the beginning of 2000. The chart below shows the annual returns for the S&P 500 (in USD), the ASX 200 (in AUD) and the UBS Composite (in AUD). Over the past 10 years, the US S&P 500 index has returned negative 1.4% annually, while the ASX 200 in AUD$ has returned a partly 3.9% annualised (excluding dividends or reinvestment returns). Meanwhile, from 2000 – 2010 the UBS Australian Composite bond index has returned a lovely annualised return of 6.4%. You beauty!

Bonds have outperformed equities since 2000
Annual returns 31 December 2000 to 31 December 2010



Source: Bloomberg

The US recovery or lack thereof will continue to drive global bond and equity returns in 2011. Despite December's bond sell-off, over the course of 2010 US 10 and 30-year Treasury yields fell by 0.50% and 0.25% respectively as the Federal Reserve kept interest rates near zero and pumped in more money into the US economy. However at 3.3% and 4.4%, US 10 and 30-year year bond yields are now almost 1.0% higher than their October lows. Reflecting the strong Asian growth story, Australian 10-year bond yields have risen by 0.65% from their 2010 lows, as the Reserve Banks raised interest rates by 1.0% and expectations for further hikes through 2011 are being priced by the market.

The driving theme for global financial markets in 2011 will be whether the multitude of government programs in the US enacted in 2008 through 2010 have been enough to jump start US business investment and consumer demand. Recent tailwinds to the economic growth story include the passage of favourable business and consumer tax cuts and the Fed's continuation of massive quantitative easing, while headwinds include housing market stagnation and the inability to meaningfully stimulate job growth (albeit 2010 saw the creation of one million new jobs).

As we begin 2011, the positive economic data appears to dominate the headwinds as equity markets rally and bond yields rise. Additionally, investor re-allocations out of bonds and into equities is likely to be another continuing theme, putting further pressure on bonds. US bond yields in the 2% to 3.5% range are hardly exciting, particularly in a positive global growth/rising inflation world. The S&P in the US returned 15.06%, while global and domestic bonds in Australia returned around 6%. The 'new normal' as a few market participants have coined, is not here yet.

Early themes, tailwinds and headwinds

Early themes in 2011 include an improving US economy (jobs and economic data), a continued strength in the Asian economies, including Australia, while the dark spot remains Europe, particularly countries in the periphery that have yet to go through painful restructuring.

Central banks will continue to keep interest rates at historical lows. In the US the Fed will continue its buying of assets. Governments, through fiscal policy measures will also support pro-growth policies in most economies. This leads to easy money available for investment and speculation. Rising standards of living in the developing world, increases demand for goods and services, thereby aggregate demand.

The risks to the tail winds are monetary stimulation and the longer-term fiscal imbalances (local, state, federal and non-US), that eventually leads to higher marginal taxes and belt tightening. In addition to this, a stubbornly high unemployment rate, policy mistakes by central banks and geo-political tensions among nations can easily threaten to derail any economic recovery.

However, being bond managers, we still see opportunity

1. Australian bond yields in the 6% to 8% range remain more attractive than US bond yields and thus compare more favourably to equities. In fact, Australian bonds outperformed equities over 2010 as bonds returned +6.0% (as measured by the UBS Composite Index) while equities returned -2.5% (before dividends, as measured by the ASX200 Composite Index). Thus we remain focused on attractive yielding Australian bonds, particularly short-dated bonds with little interest rate sensitivity.

2. We are positioned to benefit from the US economic recovery and the resulting positive knock-on effect to Asia. We favour corporate credit in Asia and the US, particularly senior debt in the banking sector which should benefit from further economic recovery, improving capital ratios and a steeper yield curve (in the US). This rosier outlook for financials and strengthening balance sheets should allow banks to restart their lending to corporations with sound business plans. This will in turn allow risk-taking behaviour to return to markets, propping up equity, property and high yield markets. This would argue for a higher than normal allocation to financials and lower rated debt markets.

3. We believe many headwinds remain in the global marketplace: look for US Congressional deadlock (with the first major test being the raising of the budget cap versus a government shutdown and potential debt default), further crisis in US mortgages and the foreclosure process, and continuing questions over European Union stability and European Economic and Monetary Union break-up potential. These concerns warrant some downside protection in the form of interest rate (duration) exposure, albeit small exposures, which we will continue to take in the US and Euroland.

4. Interest rate (duration) exposures should not dominate bond portfolios, in fact they should remain a very small part of one's bond portfolio's risk. Our portfolio risks will continue to be region specific, centred around credit and currency exposures, where we believe consistent positive absolute returns can be extracted. Investment-grade Australian corporates and US banks hedged back to the Aussie dollar currently yield in the 7+% range. On the currency front, we favour Asia and other commodity-based currencies such as the Canadian dollar and Norwegian krone, while avoiding the Euro and Yen. We expect to deliver 7% to 9% returns over the course of 2011, despite a return to more normal global growth and inflation prospects.

We wish you all a happy and prosperous 2011!