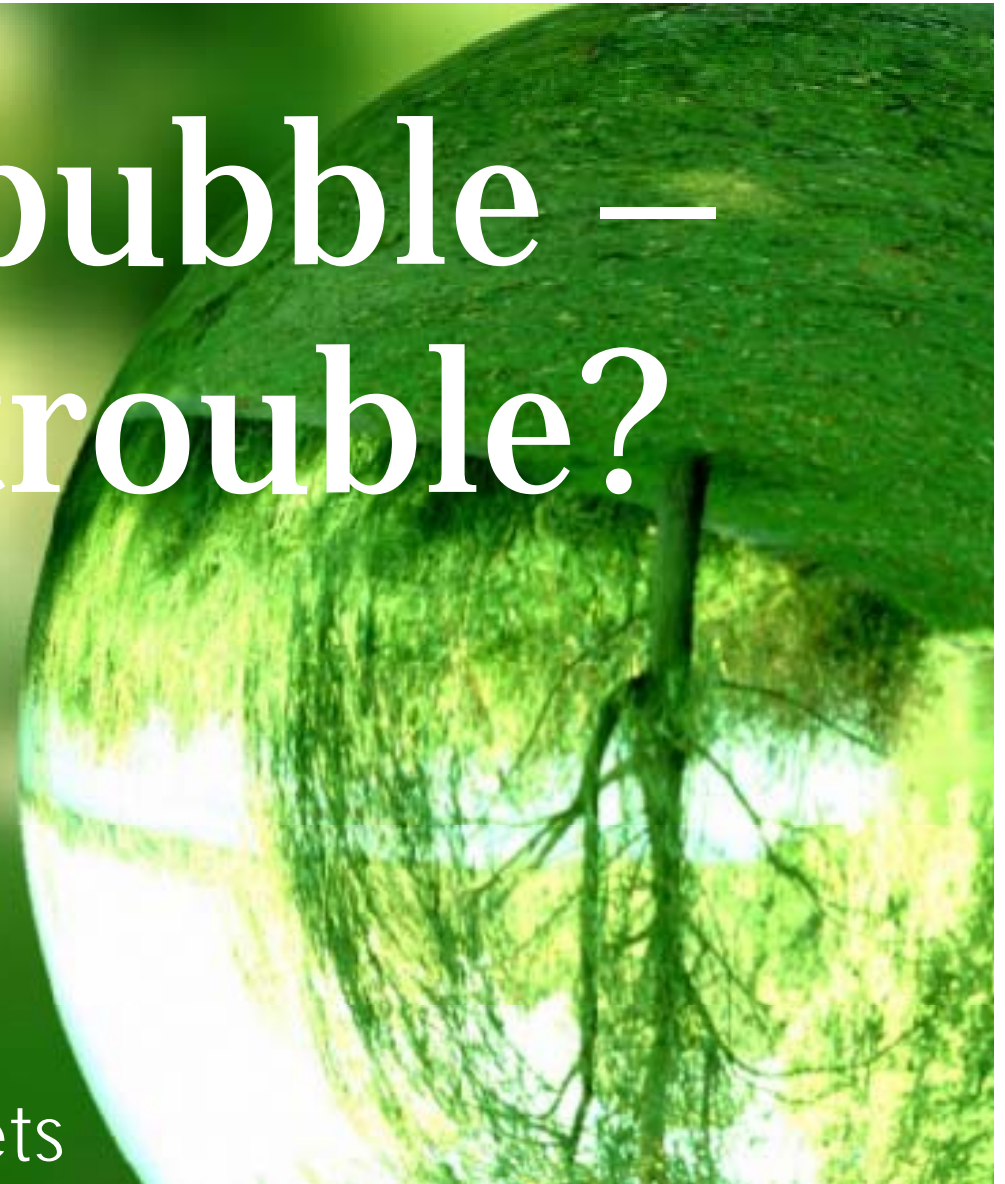


Bubble, bubble – toil and trouble?

15 February 2011

facilitating
debate on the
outlook for the markets

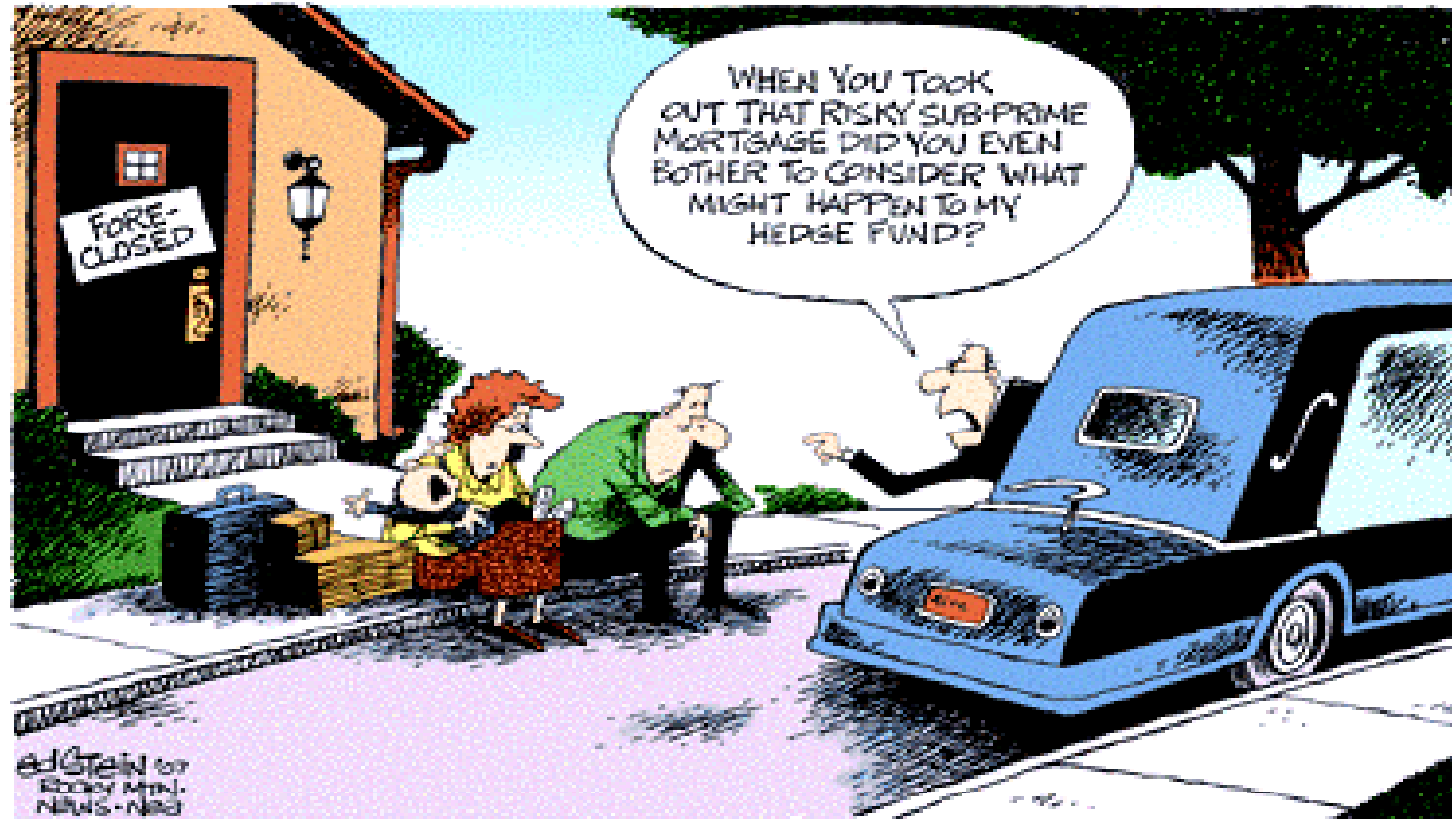




Kumar Palghat

Managing Director
Kapstream Capital

Two sides to every story



2010 – bottom line

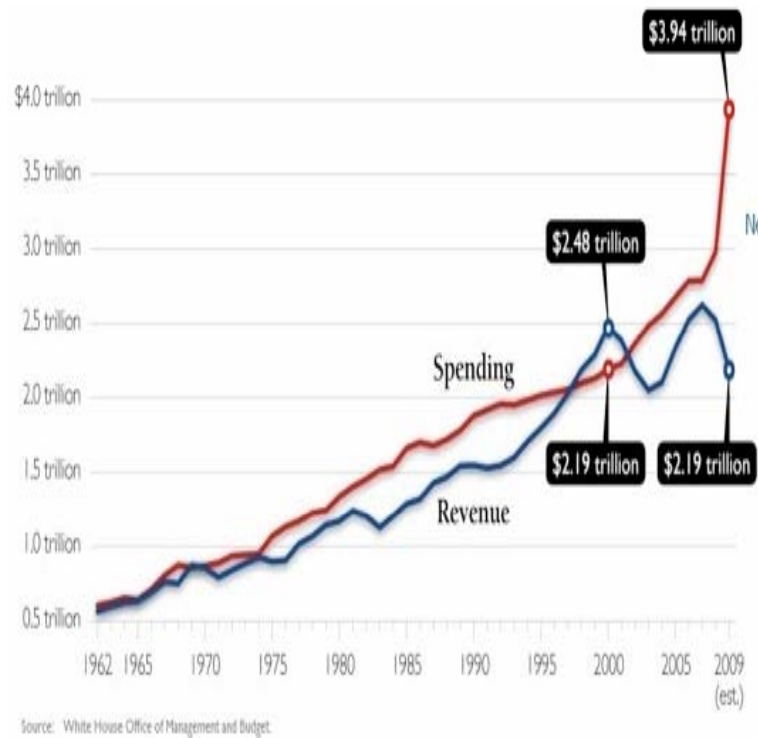
Right

- Rates unchanged
- Stimulus to continue
- High unemployment
- Weak growth
- Asia continues to grow

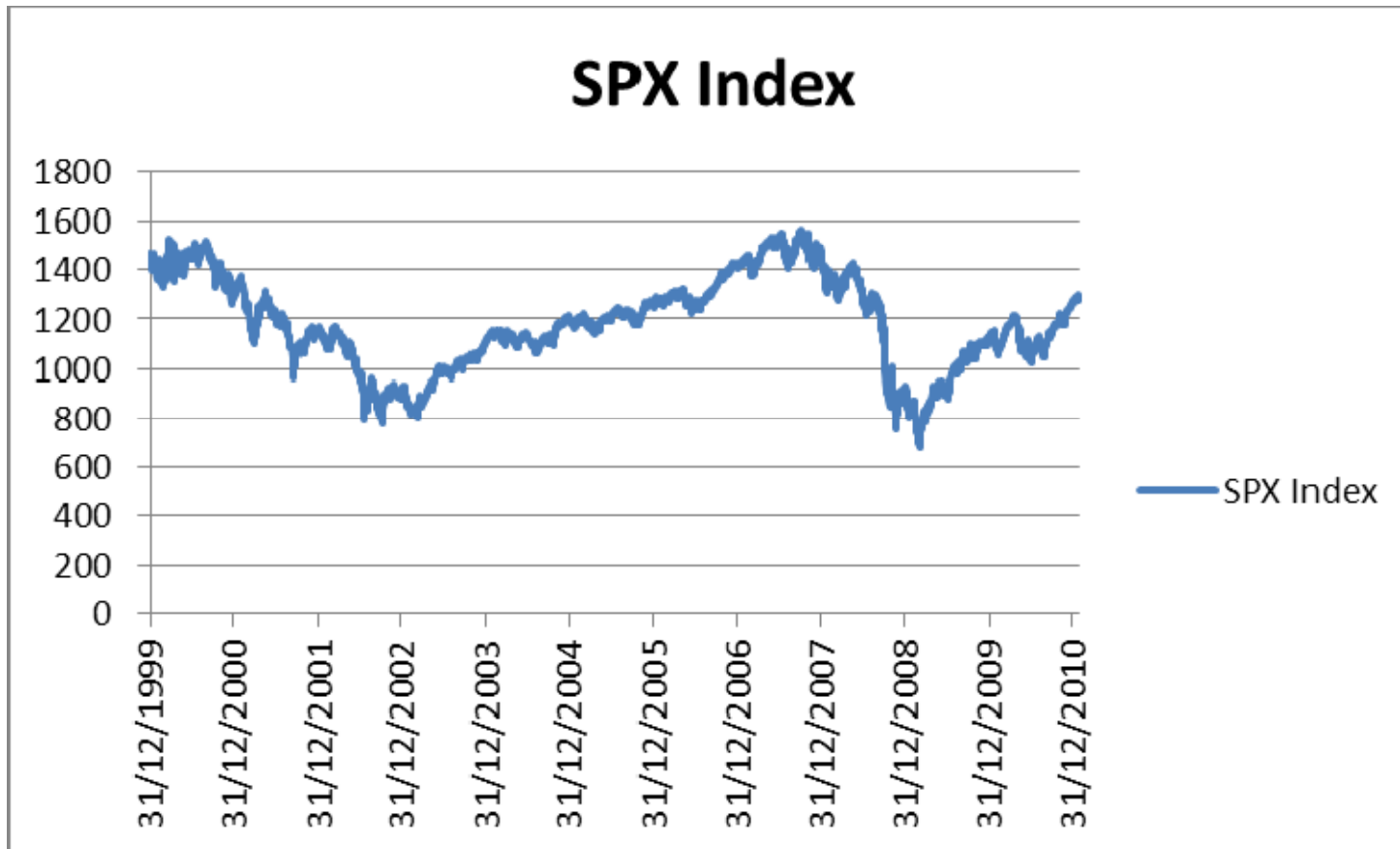
Surprises

- Equities outperform bonds
- European Debt Crisis (gets deeper)
- Aussie equities underperform US

What we thought last year – The solution to the problem



What happened – US summer?



Source: Bloomberg

2010 = European winter?

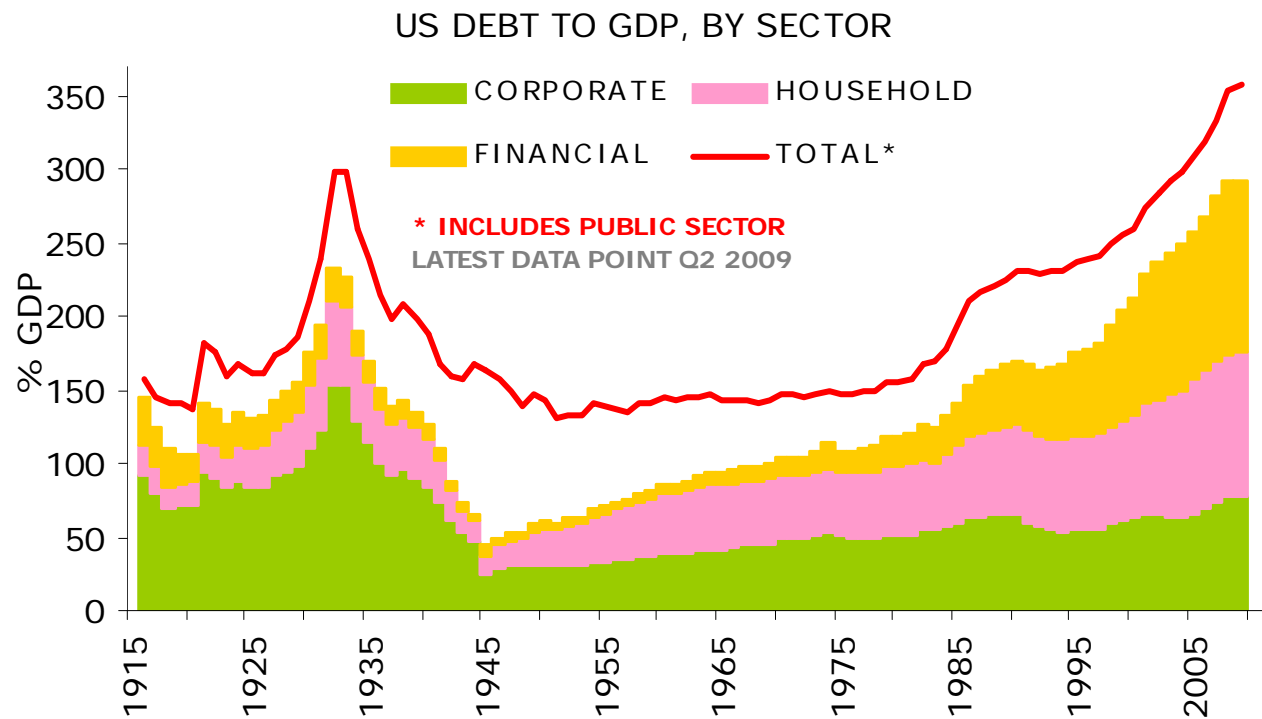
European 10-year bond spreads to bunds

bps

	01-Oct-09	07-May-10	30-Nov-10	26-Jan-11	27-Jan-11
Greece	138	965	919	827	818
Ireland	160	306	669	576	572
Portugal	71	349	430	395	378
Spain	64	164	283	225	227
Italy	96	147	200	161	161
UK	33	103	56	51	49
Netherlands	34	26	27	16	16
Belgium	51	72	133	110	111
France	37	35	48	35	36

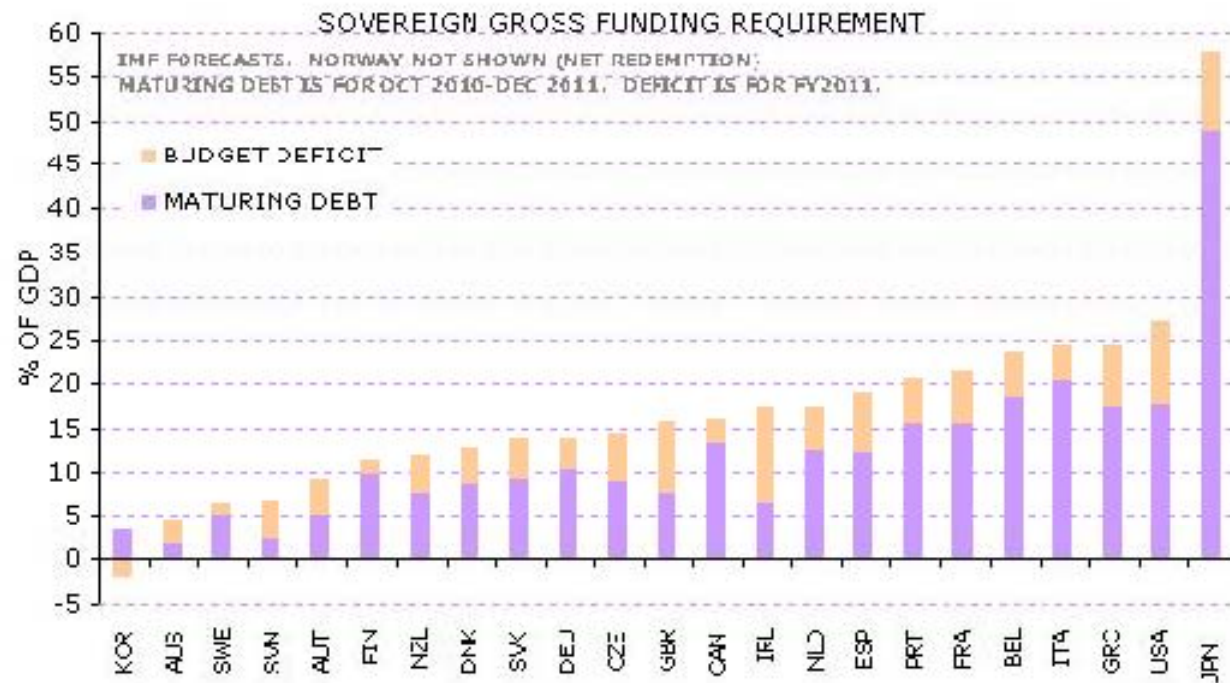
Source: Bloomberg

Debt load capacity = nearly full!



Source: Morgan Stanley

Sovereign crisis?



Source: Morgan Stanley

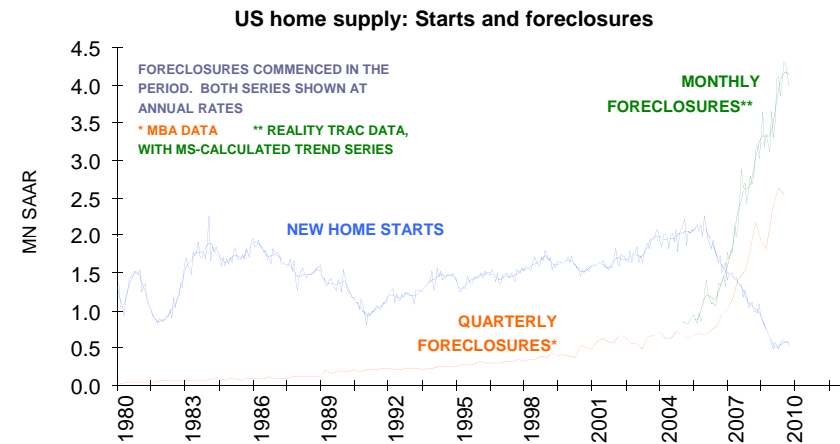
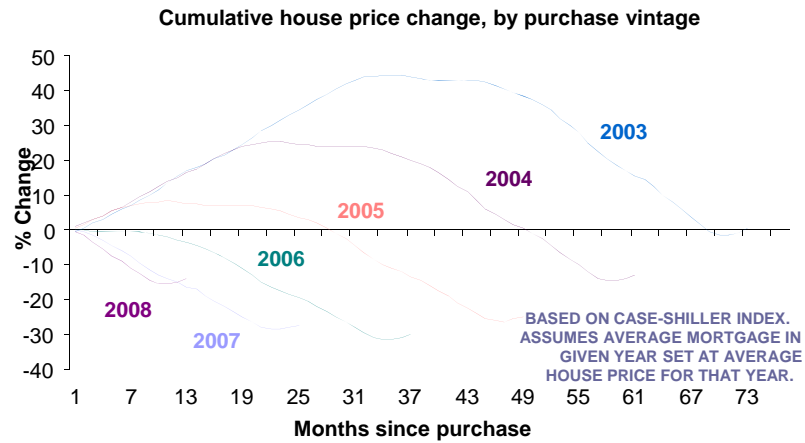
Rates – steady as she goes

- Low interest rates
- Leverage
- Housing boom
 - Sub prime
 - Poor lending and underwriting standards
- Financial engineering (CDOs/CLOs)
- **Caused** financial systems to collapse
- Brought economies to their knees ~ governments stepped in to bail out

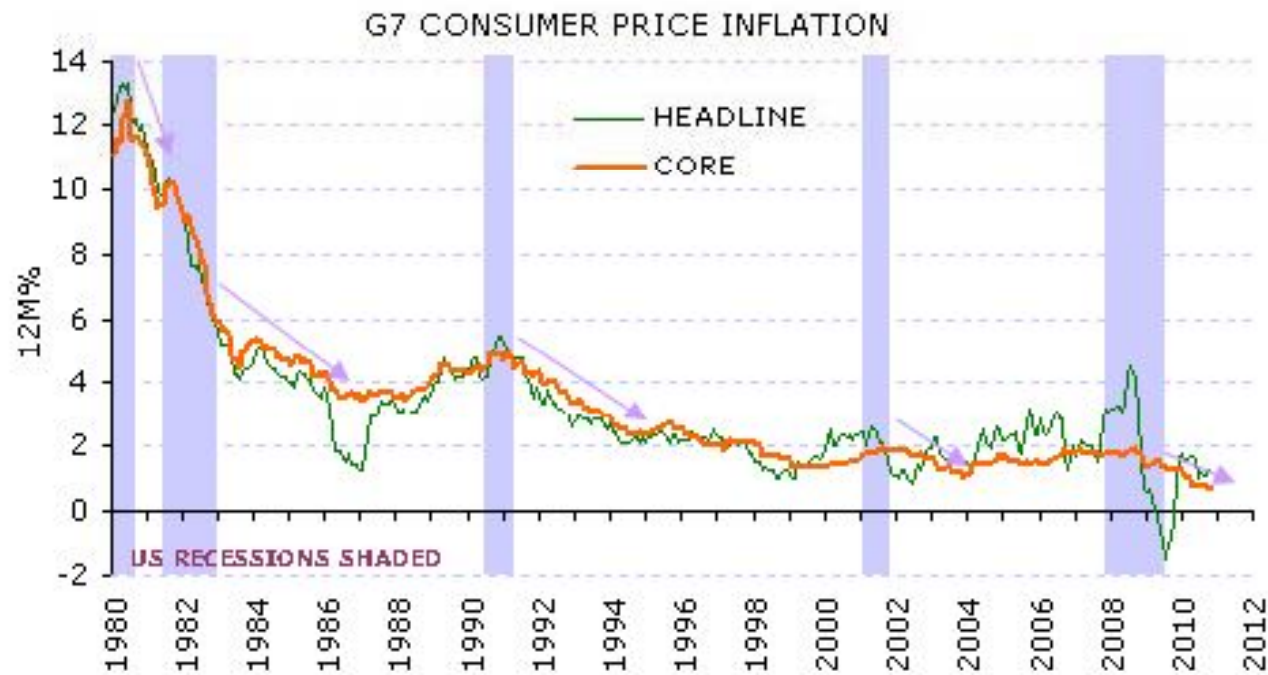


Source: Bloomberg

Housing – Under water everywhere... literally

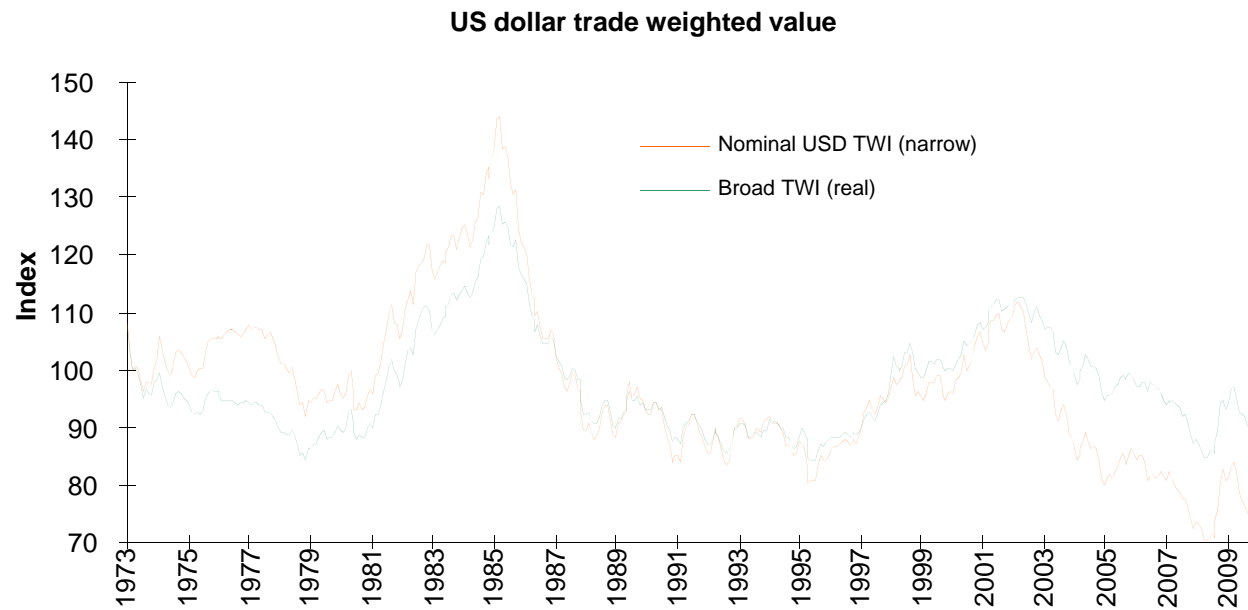


Reflate? = problem solved



Source: JP Morgan

Depreciate = problem solved



Source: JP Morgan/Bloomberg

The aftermath ~ US job losses

- US unemployment rate has risen from 4.6% to 9.6%, and is likely to remain over 8% for a long time

	US unemployment												
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average
2000	4	4.1	4	3.8	4	4	4	4.1	3.9	3.9	3.9	3.9	4
2001	4.2	4.2	4.3	4.4	4.3	4.5	4.6	4.9	5	5.3	5.5	5.7	4.7
2002	5.7	5.7	5.7	5.9	5.8	5.8	5.8	5.7	5.7	5.7	5.9	6	5.8
2003	5.8	5.9	5.9	6	6.1	6.3	6.2	6.1	6.1	6	5.8	5.7	6
2004	5.7	5.6	5.8	5.6	5.6	5.6	5.5	5.4	5.4	5.5	5.4	5.4	5.5
2005	5.3	5.4	5.2	5.2	5.1	5	5	4.9	5	5	5	4.9	5.1
2006	4.7	4.8	4.7	4.7	4.6	4.6	4.7	4.7	4.5	4.4	4.5	4.4	4.6
2007	4.6	4.5	4.4	4.5	4.4	4.6	4.7	4.6	4.7	4.7	4.7	5	4.6
2008	5	4.8	5.1	4.9	5.4	5.6	5.8	6.1	6.2	6.6	6.8	7.3	5.8
2009	7.8	8.2	8.6	8.9	9.4	9.5	9.5	9.7	9.8	10.1	9.9	9.9	9.3
2010	9.7	9.7	9.7	9.8	9.6	9.5	9.5	9.6	9.6	9.7	9.8	9.4	9.6

- US needs over 15 million jobs over the next 5 years to get back to pre-recession levels

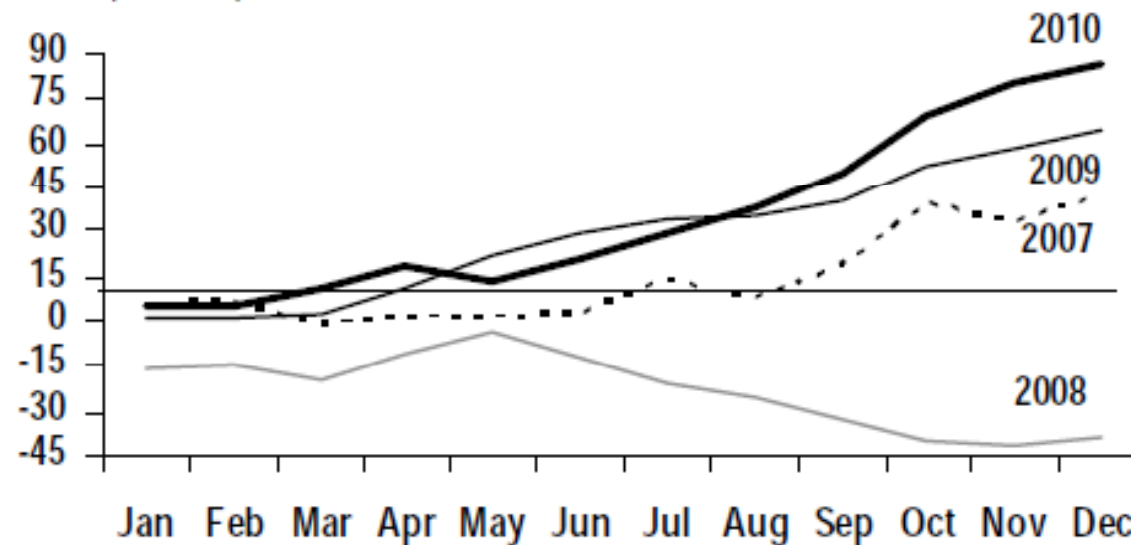
	US jobs													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average	Sum
2000	249	121	472	286	225	-46	163	3	122	-11	231	138	163	1953
2001	-16	61	-30	-281	-44	-128	-125	-160	-244	-325	-292	-178	-147	-1762
2002	-132	-147	-24	-86	-7	45	-97	-16	-55	126	8	-156	-45	-540
2003	83	-158	-212	-49	-6	-2	25	-42	103	203	18	124	7	87
2004	150	43	338	250	310	81	47	121	160	351	64	132	171	2047
2005	136	240	142	360	169	246	369	195	63	84	334	158	208	2496
2006	262	326	304	174	31	69	232	141	100	43	201	177	172	2060
2007	194	104	239	92	149	55	-20	-71	52	86	128	70	90	1078
2008	-10	-50	-33	-149	-231	-193	-210	-334	-458	-554	-728	-673	-302	-3623
2009	-779	-726	-753	-528	-387	-515	-346	-212	-225	-224	64	-109	-395	-4740
2010	14	39	208	313	432	-175	-66	-1	-24	210	71	103	94	1124

Cheap money = new bubble

EM capital flows

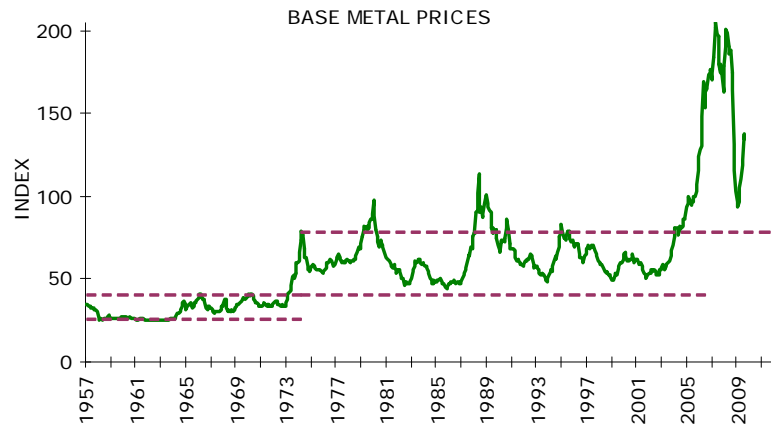
EM net equity inflows

USD, billions; Cumulative to date



Source: JP Morgan

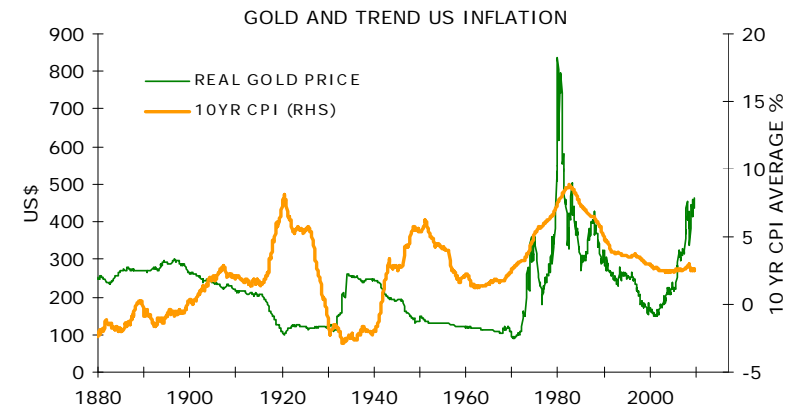
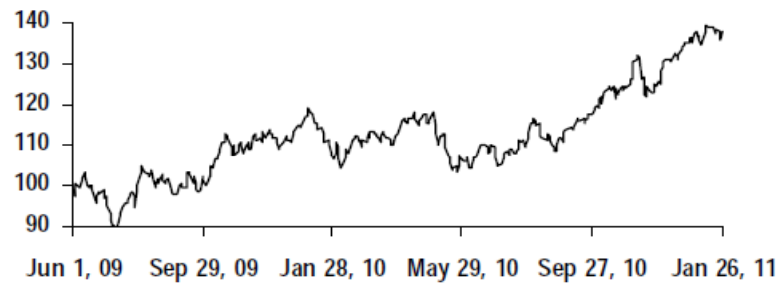
Cheap money = new bubbles



Commodity prices

JPMorgan commodity price index

Jun 1, 2009 = 100



Source: JP Morgan

Cheap money = China in a bubble?

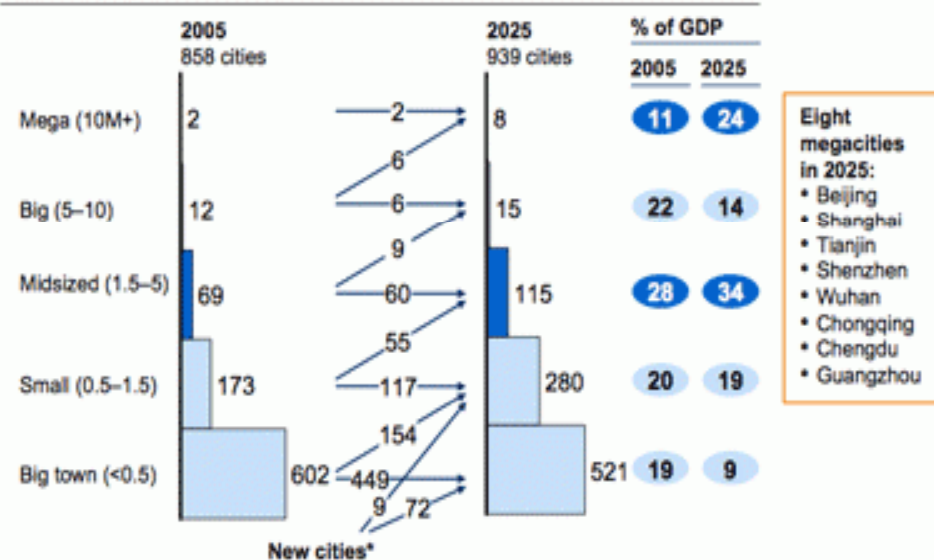
By 2025, China will build ten New York sized cities

Six new megacities will emerge by 2025

TRENDLINE FORECASTS

Distribution by city size

Millions of people, number of cities



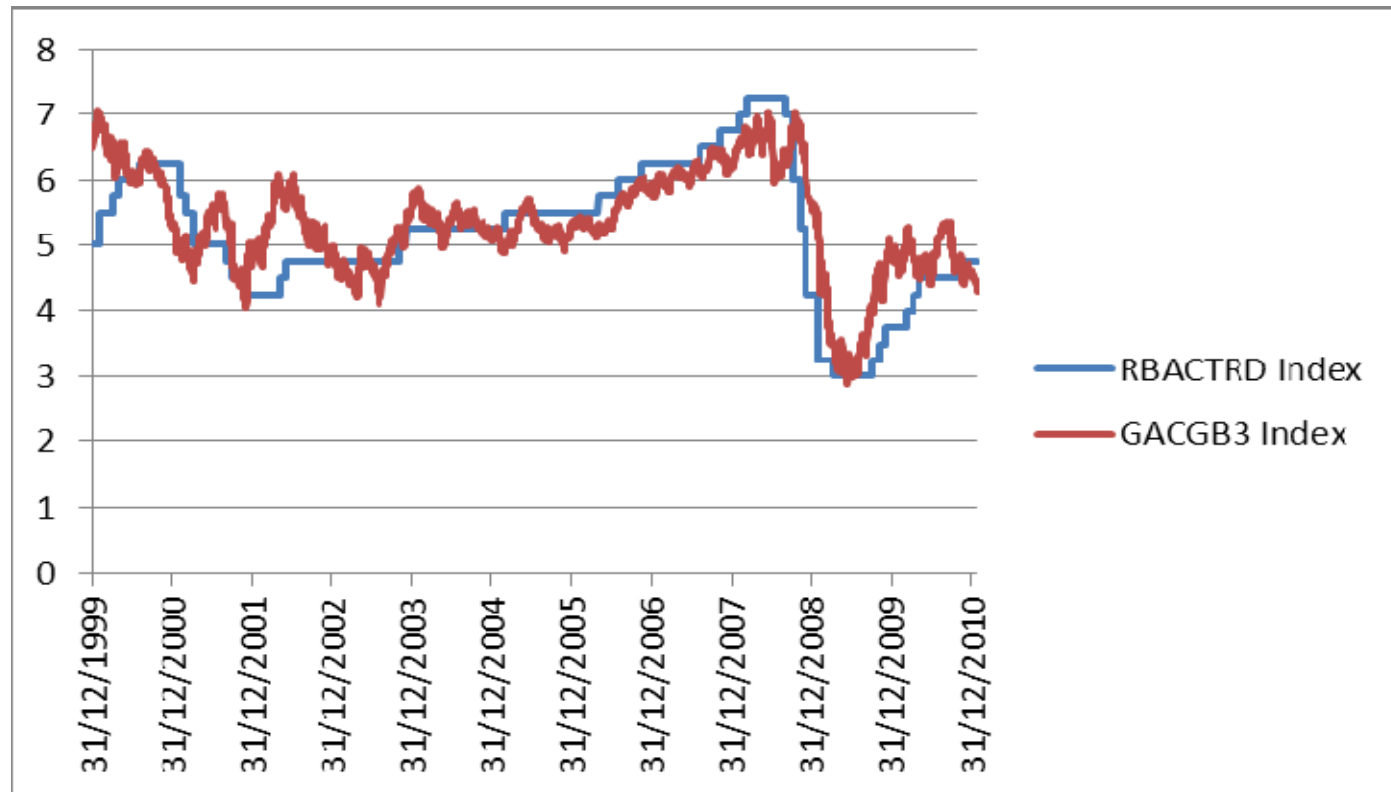
* From the MGI model, the number of new cities between 2000 and 2005 was nine, accounting for about half a percent of total urban population.

Source: McKinsey Global Institute China All City Model; McKinsey Global Institute analysis

'By 2025, 40 billion square meters of floor space will be built – in five million buildings. 50,000 of these buildings could be skyscrapers – the equivalent of ten New York Cities.'

McKinsey, Preparing for China's urban billion

Impact of the GFC on Australia



Source: Bloomberg

Impact of the GFC on Australia

- The Australia unemployment rate has held steady:

	Australian unemployment												
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average
2000	6.5	6.4	6.6	6.5	6.4	6.2	6.1	6.1	6	6	6.3	6.3	6.3
2001	6.2	6.6	6.5	6.8	6.8	6.9	6.9	6.9	6.8	7.1	6.9	6.8	6.8
2002	7	6.6	6.4	6.3	6.3	6.5	6.2	6.4	6.3	6.1	6.2	6.2	6.4
2003	6.1	6	6.1	6	6.1	6.1	6.1	5.8	5.8	5.8	5.7	5.7	5.9
2004	5.5	5.7	5.4	5.5	5.3	5.5	5.5	5.5	5.4	5.1	5.2	5.1	5.4
2005	5.1	5.1	5.2	5.1	5.1	5	5	4.9	5	5.1	5	5.1	5.1
2006	5.2	5.1	4.9	4.9	4.8	4.8	4.7	4.7	4.7	4.5	4.6	4.6	4.8
2007	4.6	4.6	4.4	4.3	4.3	4.3	4.3	4.3	4.2	4.4	4.5	4.3	4.4
2008	4.2	4	4.1	4.2	4.3	4.2	4.2	4.1	4.3	4.4	4.5	4.6	4.3
2009	5	5.4	5.7	5.4	5.8	5.8	5.7	5.8	5.7	5.7	5.6	5.6	5.6
2010	5.3	5.3	5.4	5.4	5.2	5.1	5.3	5.1	5.1	5.4	5.2	5	5.2

- Australia has created jobs every year in the last decade!

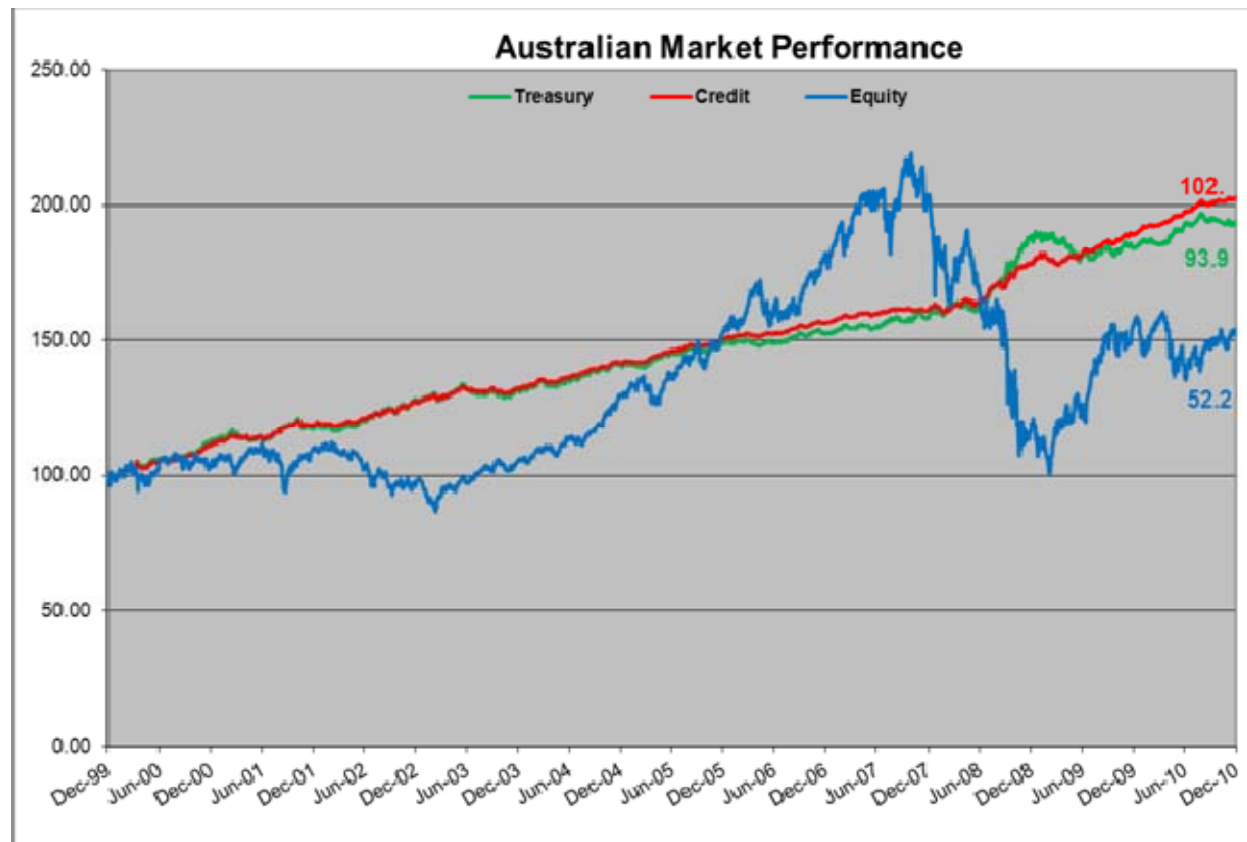
	Australian Jobs													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average	Sum
2000	-18	41	24	36	12	17	82	10	-13	-5	-40	30	15	176
2001	-1	-15	7	55	-9	-3	12	29	-24	21	20	0	8	93
2002	17	47	11	-2	12	28	4	50	0	9	63	38	23	276
2003	43	31	-44	8	15	-24	-4	51	10	25	12	20	12	141
2004	-7	14	38	18	18	-3	14	-10	63	53	24	24	20	245
2005	51	34	45	47	-12	40	18	40	-13	0	34	-4	23	281
2006	4	32	44	12	37	34	48	19	47	-27	29	59	28	339
2007	10	15	34	33	42	13	18	32	34	-1	50	24	25	303
2008	37	34	23	47	-27	42	16	19	-5	23	-18	3	16	193
2009	-1	6	-18	34	-7	-25	40	-21	38	20	29	40	11	135
2010	62	-9	26	30	17	41	28	30	47	34	55	2	30	364

Source: Bloomberg

Outlook – US equities, ‘the lost decade’



Outlook – Aussie assets, ‘the sweet spot’



Source: Bloomberg

Conclusion – Crystal ball!

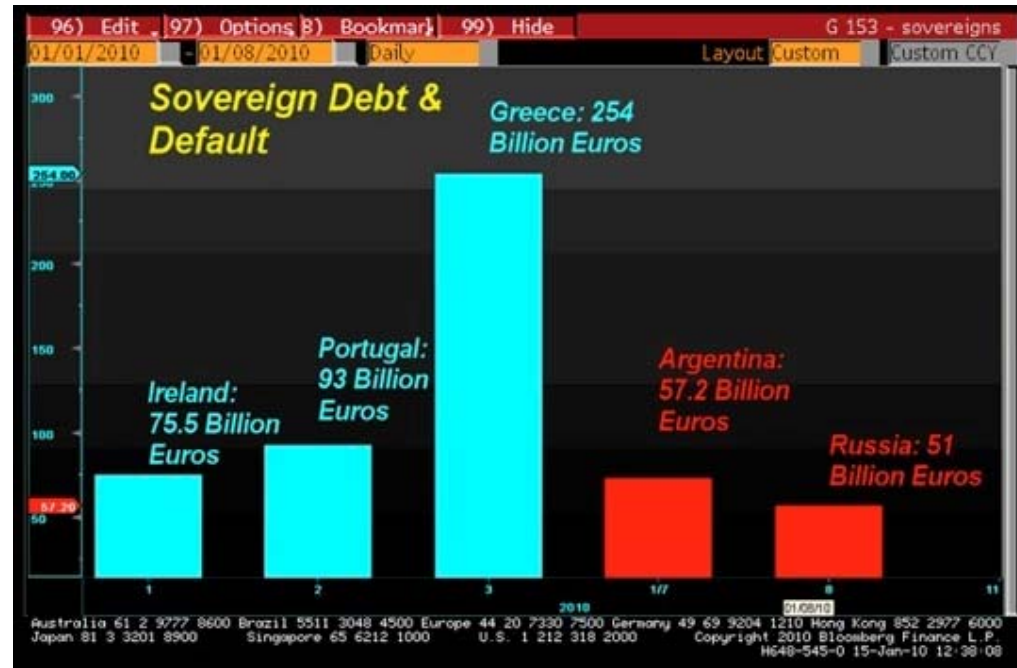
- US recovery looks to be gaining traction
- European debt problem should find a solution
- Global geo-political risks impacts, oil prices, unemployment and regime changes
- Asian economies to continue to surge (bubble formation)

Investment implications

- Adding long-dated sovereign bond exposures actually adds to risk to balanced portfolios
- Avoid sovereign exposure and reduce duration (maturity) of bond portfolios
- Prefer floating rate assets to fixed rate assets
- Long debt of Asian corporates
- DO NOT SHORT THE US\$
- Strong growth in Asia, US recovering while Europe is the laggard

Key risks

- **The US cannot afford (i.e. can't fund debt with debt):**
 - a drop in GDP
 - a fall in equity markets
 - a rise in interest rates
- **European Economies in a mess:**
 - Greece, Spain, Italy, Portugal and Ireland all in trouble
 - They have to cut spending and increase taxes ~ when economic growth is on shaky ground!
- **RBA – a little too trigger happy:**
 - domestic economy is good shape
 - global backdrop remains tricky



Source: Bloomberg

Bubble, bubble – toil and trouble?

15 February 2011

facilitating
debate on the
outlook for the markets

