KAPSTREAM
A JANUS CAPITAL Group Company

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Fixed income = not fixed + no income

The recent plunge in bond prices amidst renewed concern over both the effectiveness and expected duration of further monetary stimulus has led to greater debate over whether the US Federal Reserve (Fed) will hike in 2016, particularly in September.

Some at Kapstream argue that Quantitative Easing (QE) and zero/low rates are the cause of longer-term low growth/inflation and the Fed needs to act now and raise rates soon. They believe that near-zero rates for the long-run lead to 'The Paradox of Thrift' where the prolonged low rate environment causes everyone to *save* more for retirement (to offset the diminutive returns on their savings) and consequently *spend* less. This is the Japan story of the past 25+ years and even unprecedented fiscal and monetary stimulus can't get Japan out of the vicious circle of lower and lower consumer spending.

The solution is to slowly normalise rates to provide income for savers and retirees. This leads to the belief that the Fed is currently behind the curve, but that as they move toward a more normal rate environment investors will get better returns on their investments and thus will save less and spend more. The Fed argues that recent jobs growth and wage inflation is enough justification for them to act to cure this problem. They further state that with continued good telegraphing of the expected future set of rate hikes, the Fed can accomplish its hiking goals with minimal financial turmoil.

On the other side of the argument (while not discounting The Paradox of Thrift) the current reality is if the Fed acts sooner and more often, the US dollar will rally, choking off any manufacturing competitiveness left in the US. That's a political landmine and the Fed isn't in strong shape politically. Add an election where Trump and other politicians are already very critical of the Fed, and they're likely on hold through the election. And when you add the global environment, where Kapstreams views are cautious to fairly negative, it's hard to visualise any material Fed moves.

Nonetheless there is consensus at Kapstream in believing any series of Fed rate hikes will remain muted, and markets will continue to overestimate them. August's 151,000 job gains re-confirm stable and steady jobs growth, albeit with little wage pressure beyond highly skilled jobs. We expect the Fed to tread carefully, given Brexit concerns, European banking volatility, the coming US election and slower Asian growth.

As the Fed remains cautious, we expect other global central banks to increase stimulative activities which will result in further non-USD currency weakness. The world remains in a currency war as policymakers look toward export-led growth amidst consumer weakness and deteriorating domestic demand.

In Europe, we believe the European Central bank (ECB) will continue to struggle with the effectiveness of its QE programme, currently at €80 billion/month in sovereign and corporate bond purchases. Despite recent under-deliverance in terms of the QE message, we expect the size of the ECB's programme to continue to rise over the course of 2016-2017 as European growth and inflation underperform expectations amidst structural rigidities in labour and product markets, particularly in Peripheral regions. There are little alternatives available to European policymakers despite recent rhetoric.

In Japan, the 3 decade bull market in bonds took a recent tumble as Bank of Japan Governor Kuroda noted low long-term yields hurt savers, perhaps forcing them to save more. Diminishing returns from Kuroda's unprecedented package of negative rates combined with bond, exchange-traded fund and Real Estate Investment Trust purchases raised speculation that easy monetary policies cannot be the long-term solution to low growth and inflation. Structural adjustment in labour and product markets, increased fiscal spending and more QE are the textbook solutions to low growth and low inflation, but practical realities show there are no simple solutions to the growth problem.

What should investors do?

Despite low growth, low inflation and easy monetary policy, we find limited bond opportunities given the low/negative yield environment. Whilst higher-yielding investments look optically attractive, greater volatility and probabilities of default warrant extreme caution.

One message Kapstream has delivered to investors over the past few years has been to get used to lower yields and returns, regardless of asset class. In the bond world, gains can still be made with low coupon or negatively yielding bonds – just not (or very little) income.

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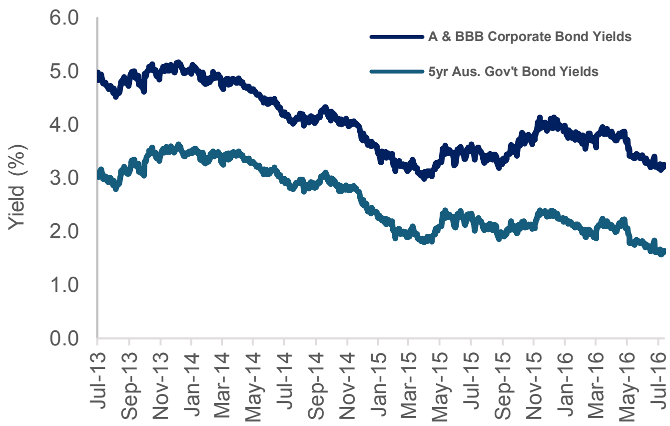
The old conventional asset allocation logic that says 'equities for growth, bonds for income' no longer seems to hold. Bonds with no-or-negative yields may be bought with the hope that a 'greater fool' exists to buy them from you at a higher price than the one you paid, delivering you a capital gain (does that sound a bit like equities?). In much of the bond world a gain only comes if you assume future bond issuance is at yields *worse* than those today, making the assets you already own (relatively) more valuable.

Fortunately for bond investors, Australia remains one of the developed world's rapidly dwindling pockets where bonds still offer some positive yield. We actively avoid the headline-dominating no-or-negative yielding sectors in much of the globe, focusing on fertile ground closer to home.

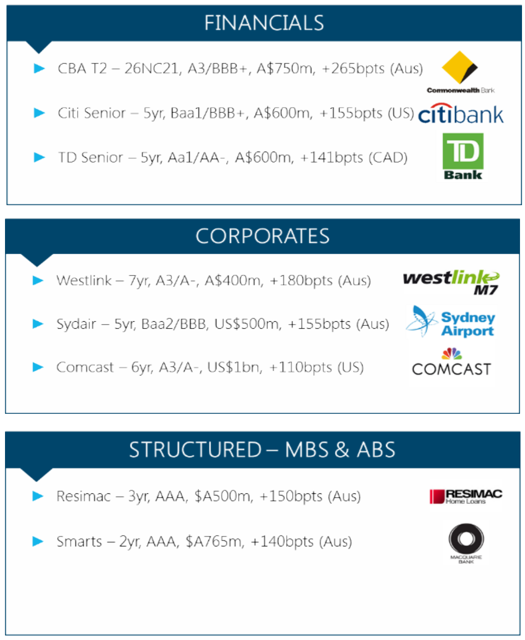


Source: Bloomberg

Our portfolios continue to have material exposure to Australia, currently about 60% of our holdings. Favoured holdings remain 1) the banking sector due to attractive yields and greater liquidity, and 2) infrastructure-type assets such as airports and toll roads which offer attractive yields, systemic importance, monopolistic businesses, high regulation and quality underlying collateral.

Short-term noise in rates markets notwithstanding, we remain near the top end of our interest-rate duration range at 0.85 years as we believe global interest rates will remain well contained amidst slower growth and inflation and continuing central bank liquidity. Globally, we like systemically important, highly rated Asian issuers such as government-related energy, telecom and banking entities and the US 'too-big-to-fail' banks, whose bonds should be supported by an increasingly robust regulatory environment focused on less risk taking and greater capital requirements.

We expect to continue to reduce the fund's 'liquidity bucket' of government-related and cash instruments from a now current 13% position toward 10% over the coming months as attractive corporate issuance opportunities continue to emerge. Examples of some recent purchases include:



For those able to seek them out, attractive investment grade returns where you still get paid to take the default and term risk are indeed alive and kicking…

In the 111 months Kapstream has been operating the average monthly return of its flagship fund is 0.48%. Plus the fund has only delivered a negative monthly return on six occasions, i.e. positive monthly returns 95% of the time. Admittedly the average monthly return of the AusBond Composite Bond index over the same period is marginally more at 0.56%, though bear in mind that's through a strong bond bull market of perpetually falling rates. However the index has also suffered 32 negative monthly returns over that period, so has delivered positive monthly returns only 71% of the time. And in the current and forecast environment of lower absolute yields – where the monthly coupon income 'cushion' is far flatter than in the past – it does not seem unreasonable to assume that conventional indices are likely to deliver negative monthly returns more frequently going forward. Step forward strategies that are more flexible and biased toward positive absolute returns, and that move dynamically to adjust to changing risks.

Kapstream. Doing its best to return the 'fixed' and 'income' to fixed income.

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