KAPSTREAM
A JANUS CAPITAL Group Company

October 2016

It's a new Don, it's a new day, it's a new life…

Quite how Nina Simone would be feeling today depends upon your perspective. As an entrepreneur? If market response is a barometer, then probably good. But if the current country-wide protests are reflective of the mood, probably somewhat blue.

We will certainly see a much different world over the next few years. To be voted into the highest political office in the largest developed market in the world, with no prior experience of elected public responsibility – and having done more foot-shooting and message u-turning than anyone else in modern electoral campaigning – is a huge rebuff of convention and order. Like many times throughout history, it is a message signifying people have grown weary of the status quo. But as they say, be careful what you wish for, something the Brits are only just beginning to understand. But the results of the recent US election were certainly not unprecedented.

Going to Extremes: Politics after Financial Crisis, 1870 – 2014[1] published by Ludwig-Maximillians University's Center for Economic Studies and the Ifo Institute, which was published in 2015 more than a year before the recent US election, detailed voters' reactions to financial crises over the 144-year period and provided a number of conclusions:

- Financial crises put strains on democracies
- Votes for far right parties strongly increase following crises
- Government majorities shrink
- Fractionalization of parliaments rise with increasing number of parties/views represented
- Government gridlock increases which slows economic progress
- Street protests increase

The key conclusion was that policy uncertainty rises strongly as government majorities shrink and polarization rises and "voters become attracted to the political rhetoric of the extreme right, which often attributes blame to minorities or foreigners."

[1] http://bfi.uchicago.edu/sites/default/files/research/Going_to_Extremes%2C_Politics_After_Financial_Crises.pdf

Today, we are certainly seeing much of the above as globalization and increasing trade hollow out the US (and much of the developed world's) manufacturing sector and force much of the population into lower-paying service sector jobs, creating a two-tiered economy of rich and poor. Policymaker responses of further trade barrier reductions may be the textbook economic prescription for improving growth, but ignores the negative impacts on an ever-growing proportion of the population – the ones that lose from globalization.

Whilst we were as surprised as anyone by the election results, we probably shouldn't have been; history has repeatedly telegraphed these consequences. It is beyond the scope of this update to delve too deeply into better economic solutions to the growing divergence between rich and poor as the result of globalization. Nonetheless, greater access to advanced education and improving skills to remain competitive in a globalized world is certainly a critical aspect. We find it odd that this was mostly ignored in the general election, despite its importance in the democratic primary election.

But it's not for Kapstream to try to solve globalization's problems, we're here to add value to client portfolios.

How do we invest in today's world?

From an investment perspective, there are two key questions we as investors need to contemplate today; firstly, how to deal with the short-to-medium term policy uncertainty and inevitable market volatility, and secondly, just what effect might a Trump administration's policies have on global bond markets?

At Kapstream, there is only one thing we see as a certain outcome: market volatility will remain elevated. For us, that means reducing low risk/return trades such as our interest rate (duration) position. A key principle behind our investment philosophy has always been that making interest-rate calls is not a high information ratio trade. Duration tends to increase portfolio risks, but return expectations from this increased risk would always be relatively low. Nonetheless, over the past few years Kapstream had maintained a small duration position in the 0.50 to 1.25 year range with the view that markets had forecast a set of rate hikes that were unlikely to occur and that inflation was further in the future than markets had anticipated. This position aided portfolio returns over the longer-run.

The challenge for us (as well as all fixed income managers) was in being able to identify when inflation and corresponding rate hikes would come sooner than markets anticipated and thus maintain a short duration position.

Given the increased potential for the new US administration to alter at least some economic policy toward growth and inflation, we no longer have as much conviction in our interest-rate calls. Therefore, we have dramatically reduced our portfolio interest-rate duration, to a current 0.4 years.

We believe duration management is less attractive in an environment characterized by greater uncertainty. Like most financial market participants, we have little clue as to what economic policies the new administration will pass, and much less insight into their impact on financial markets. It is prudent to reduce interest rate risk in this environment.

Current conventional wisdom is that some of Trump's economic plans such as increasing infrastructure spending, cutting business regulation and reducing corporate and personal taxes will soon be enacted and will cause an increase in both growth and inflation. Other plans such as increasing trade barriers and tearing up existing trade treaties appear less likely to be enacted at least with a Republican controlled Congress whose long-held platform has been support for free trade.

Thus far, bond yields have increased by 0.80% over the past few months as volatility dramatically increased. What we have been unable to determine at this point is whether we are at an inflection point for interest rates and inflation. Are we at the end of the secular decline in interest rates? Are interest rates headed dramatically higher and bond prices lower over the longer-run?

At this time we just don't know. We are unsure as to whether many campaign policies can be implemented, such as increasing tariffs and the potential for a resulting trade war, whether the current rise interest-rates risks choking future expansion and whether we end up with the same political gridlock as we've seen over the past 4 years as fractionalization leads to further impasse.

In managing fixed income portfolios, there are better risks to take:

- We expect corporate profitability to remain strong, aided by less regulation and lower taxes. We will continue to hold high-quality, investment-grade issuers. These corporate bonds currently yield approximately 3.3%.
- We expect the US to remain the main engine of global growth providing strong support for the US dollar vs. the rest of the world. We intend to continue to take long US dollar positions vs. a basket of Asian currencies and vs. the Euro.
- We expect US rates will underperform the rest of the world as US recovery continues. We will maintain positions which benefit from narrowing US vs. Australian and New Zealand rates.
- We still see risks in Europe. The European Central Bank will eventually increase the size of its Quantitative Easing programme, particularly as banking risks increase. However, we find little value in Europe given the low and negative yield environment.

It's been a rough ride for bonds over the past few weeks and we expect that ride to remain turbulent in this new world. Nonetheless, we are confident that higher rates combined with stable corporate profitability can still produce a low duration/low volatility bond portfolio which delivers 2%+ over cash rates.