KAPSTREAM
A JANUS CAPITAL Group Company

Monthly Report

Kapstream Absolute Return Income Fund

February 2017

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Portfolio (gross)[1]	0.54	1.08	4.37	4.01	5.09	5.80
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.15	0.51	2.11	2.57	2.78	3.82
Active return (gross)[2]	0.38	0.57	2.26	1.44	2.31	1.98

1. Gross returns exclude impact of ongoing management fees. No allowance is made for tax.
2. Numbers may not add due to rounding
3. Benchmark performance includes the RBA Cash Rate until 31 January 2014.

Portfolio Commentary

Your portfolio returned 0.54% in February. Equity markets continued their post-Trump election rally in February, reaching new highs across many exchanges. Positive US economic data continued in February, including better earnings reports, steady payroll gains, 1.9% annualized 4th quarter GDP and inflation reaching 2.5%.

Although still volatile, 10-year US Treasury yields ended the month where they began, at 2.45%, while 10-year Australian government bonds remained near 2.80%. Shorter dated bond yields rose, pricing in greater probabilities for a March Fed rate hike, which is currently near 95%. Bond markets remained relatively subdued compared to equity markets, awaiting key details of Trump economic policies, acknowledging the difficulty in gaining support from the republican base on policies such as import tariffs and health care changes.

Elsewhere, support for Marine Le Pen in the upcoming French elections grew, although her probability for a win is still low. French debt slid on the Le Pen news. Headline euro inflation reached 1.8% in January, the highest in almost 4 years, although core inflation remained below 1%.

Australian 4th quarter GDP reached a quarterly 1.1% after falling 0.5% in the 3rd quarter, amidst renewed strength in coal and iron ore. 4th quarter's 2.4% annualized growth implies the economy is moving toward the RBA's 2017 3% forecast. Unemployment remained at 5.7% with part time job gains accounting for all job gains in recent periods. Since 2016, 185,000 part-time jobs were added while a net 80,000 full-time jobs were lost. A recent OECD report highlighted risks in the Australian property sector. While the RBA is unlikely to reduce rates in the near-term, they signaled they would be taking a closer look at bank mortgage lending standards.

Outlook

We retained a more conservative focus, as we believe Trump administration policies to be business/market positive in the short-run at potentially the expense of economic stability over the longer-run, mainly due to prospects for decreasing regulation. In a market characterized by greater volatility we expect to continue to minimise low risk/return trades such as our interest rate (duration) position. Given our expectations for much economic policy being geared toward more growth and inflation, we will maintain very small duration positions, which is currently 0.25 years.

As policy focus moves away from immigration toward economic platforms, we remain concerned that increasing trade barriers and ending existing trade treaties will both raise inflation and lower US economic growth. We believe the Trump economic package will be revealed much later in 2017 which will cause continuing short-run volatility as markets price in rumor and innuendo.

More recent economic data lead us to believe in both a Fed March rate hike and 2 more rate hikes over 2017. January's 227,000 job gains re-confirm stable and steady jobs growth. Wage pressures remain a concern, with average hourly earnings at 2.5%. Nonetheless, we expect the Fed to tread carefully, given Brexit concerns, European banking volatility, French elections and slower Asian growth.

We believe the ECB will continue to struggle with the effectiveness of its quantitative easing programme, currently at €80 billion/month in sovereign and corporate bond purchases. We expect the size of the ECB's programme to rise over the course of 2017 as European growth and inflation underperform expectations amidst structural rigidities in labour and product markets, particularly in Peripheral regions. Despite low growth, low inflation and easy monetary policy, we have found bond opportunities limited given low/negative yields and too great risks associated with higher-yielding investments. We expect to continue to avoid Europe, given uncertainty surrounding the Brexit campaign and French elections, low yields and limited corporate profitability, particularly with the uncertainty surrounding Brexit.

We continue to hold a positive view on investment grade credit in Australia, largely due to attractive real yields and robustness of issuers compared to other developed markets. Our portfolios continue to have material exposure to Australia.

Favoured holdings remain

1) the banking sector due to attractive yields and greater liquidity
2) infrastructure-type assets such as airports and toll roads which offer attractive yields, systemic importance, monopolistic businesses, high regulation and quality underlying collateral.

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 have maintained the portfolio's "liquidity bucket" of government-related and cash instruments at our target, back to our long-run average, taking advantage of attractive corporate issuance opportunities.

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.

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