KAPSTREAM
A JANUS CAPITAL Group Company

Monthly Report

Kapstream Absolute Return Income Fund

January 2017

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Portfolio (gross)[1]	0.40	0.53	3.75	4.02	5.15	5.79
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.25	0.40	2.19	2.60	2.81	3.84
Active return (gross)[2]	0.15	0.13	1.56	1.41	2.34	1.95

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 Fund returned 0.40% in January. Despite considerable market volatility over the past few months, bond yields stabilized in January. Australian 10-year government yields remained near 2.75% and US 10-year Treasury yields hovered in the 2.45% range.

Australian economic data began the year relatively weak: 3rd quarter GDP fell -0.5%, its first decline in more than 5 years, while inflation fell to an annualised 1.5% inflation over 2016, well below expectations. Inflation has now lagged the RBA's 2-3% target since 2014, the longest such period since the late 1990's. In contrast to expected US Fed policy, markets began to price in larger, albeit still relatively low, probabilities of an eventual RBA rate cut.

In the US, evidence of economic recovery continued. Payrolls increased by a healthy 227,000 in January although the participation rate rose to 62.9% and wage gains only increased an annualized 2.5%, signalling at least some labour market slack.

Elsewhere, global risk assets continued their rally. Emerging market equities were up almost 7% in January, while global equities increased over 3%. The USD fell, as investors took profits from 2016 USD strength.

Outlook

We retained a slightly 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.

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.

More recent economic data leave us neutral to both a Fed March rate hike and 2 more rate hikes priced in 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, 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 continue 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, 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, currently about 60% of our holdings.

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 reduced the fund's "liquidity bucket" of government-related and cash instruments to our 10% target, 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 3.5%.
- 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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