KAPSTREAM
A JANUS CAPITAL Group Company

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Known knowns, known unknowns, and unknown unknowns….

Donald Rumsfeld was widely credited in 2002 for bringing this concept to the public eye through his response to the US Department of Defense on the topic of 'WMD':

"…there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones."

However, this means of situational categorisation has been used by security and intelligence professionals for decades, and stems from the development of a mid-1950's technique referred to as the 'Johari window', the work of two pre-eminent American psychologists, Joseph Luft and Harrington Ingham, the original creators of the idea of 'unknown unknowns'.

It could be said that our world today – and financial markets as a subset – has faced and is facing an unprecedented number of 'unknown unknowns'. Cast your minds back only to the surprise Trump election victory to find a fitting example to a popular 'unknown unknown' definition – *"…situations so out of this world that they never occur to you…".*

It therefore becomes vital in investing to be very clear about what we know, what we don't know and most importantly what we will likely miss.

The shadow of Q4 2016

Trump's surprise victory and the uncertainty surrounding his growth policies resulted in highly volatile fixed income markets in the 4th quarter of 2016.

While we reduced risks ahead of the election due to the unknowns, we believed cutting risk even more - particularly interest rate risk – was prudent given our inability to understand what could next happen on the political stage, much less the impact of such events on interest rates and bond prices.

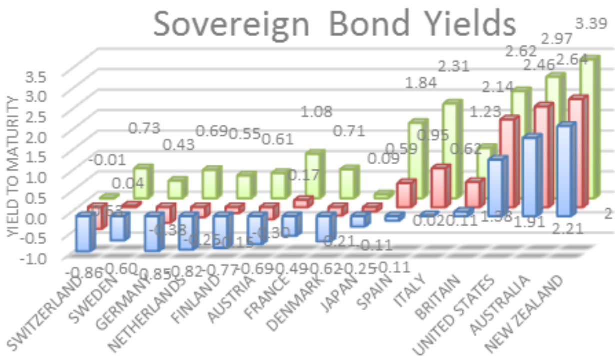
And clearly, financial markets had a difficult time coming to terms with election results, the initial market response was a "risk-off" rally in bond yields before a reversal in sentiment and euphoria over Trump's victory which saw bond yields rise. Australian 10-year bond yields, now approaching 3%, have risen more than 1% since the beginning of the 4th quarter of 2016. Despite little domestic inflationary pressures, it appears to us that Australian bond markets are being driven by outside events which have proved difficult to predict and even more difficult to forecast for the future.

Today, our portfolios continue to be driven by what we don't know, what we know and what we'll likely miss. As we don't know what President Trump's economic policies will be, we find it difficult to forecast interest rate movements in the US, much less Australia or the rest of the world. But there are still things we know.

What do we know and think about the world today

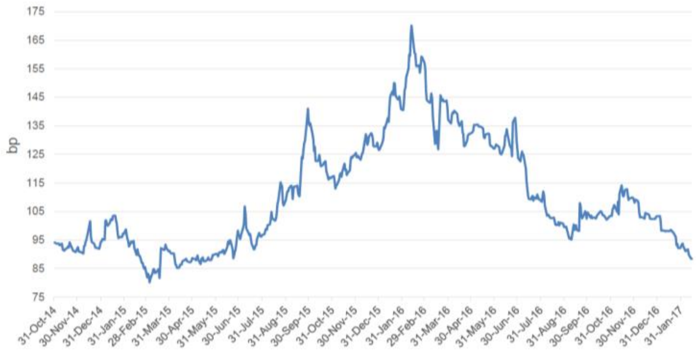
1) US, Australian and New Zealand bond markets offer positive real yields, in contrast to much of the rest of the developed world (see Chart 1), making these markets the most attractive.
2) Government bond markets are too expensive relative to high-grade corporate bonds, where you still get paid to take default risk; investment grade yields in Australia are offering ~90bps more than government bond yields (shown in Chart 2), reinforcing our belief that you still get paid to take the default risk inherent in corporate bonds.

Chart 1: Government Bond Yields



Source: Bloomberg

Chart 2: Australian iTraxx 5-year



Source: Australian iTraxx (comprises 25 equally-weighted investment grade entities).

3) Despite our views of which markets offer the best value, bond markets will inevitably be driven largely by Trump and US markets. While we prefer Australian rates to the rest of the world, they won't be influenced by Australian fundamentals and growth, and will rather be driven by the US, at least in the short run and uncertainty will remain over the course of 2017.

Two Fed rate hikes priced in for 2017

In keeping with expectations over the last six or seven years, markets are pricing in an almost certain probability of a further Fed rate hike this year – following the first in March – with strong potential for one or even two more. Whilst the Fed (and markets) have consistently got it wrong when predicting hikes in the past, we are more supportive of expectations in the current environment, and as a result have cut the portfolio's duration back toward zero. Over the last three to four years the average portfolio duration was in the 0.75-1.25 year range, with the view that markets were pricing in unlikely rate hikes and we could capitalise by moving up the yield curve to take advantage of the higher yields.

Why we think the Fed will hike rates this year

We find it extremely difficult to predict Fed actions over 2017 as Trump's conflicting statements mean we don't really know exactly what his economic plan is, much less what the impact is going to be on growth, inflation, and ultimately bond prices. Here's what we think we know, and what the market thinks it knows, at least as of today:

1. **Tax reform** plans to cut corporate tax rates from 35% to 15% (we expect it will end up around 20% once through Congress) will be positive for corporate profitability and jobs growth; personal tax cuts are also planned (the top marginal tax rate will move from 39.6% to 33.0% and couples earning less than US$50,000 combined will pay zero tax); however there are few details on how revenue losses from tax cuts will be offset.

2. **Infrastructure reform** plans to revitalise roads, bridges and airports; Trump has promised to spend at least double whatever Hillary Clinton had planned – this is at most US$1tn over the next 10 years, or US$100 billion per year; not a large impact but it will add some jobs and be positive for infrastructure companies.

3. **Regulatory reform** plans to cut 'red tape' include repealing parts of the Dodd-Frank Wall Street Reform and Consumer Protection Act (we've already seen a positive impact of this on the banks) and cutting two existing regulations for every new regulation passed; we know regulatory reform is coming, and it appears the markets are already taking that as very positive for corporate profitability.

4. **Trade reform** is where we see a big negative impact; cutting the Trans-Pacific Partnership and the North American Free Trade Agreement, labelling China a currency manipulator, and raising tariffs somewhere between 20% and 45% in China and Mexico has all the makings of a trade war, and is likely to be very bad for the global economy.

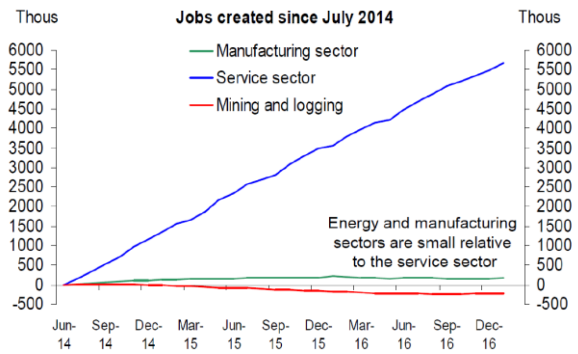
Can Trump do what he says?

It's not surprising to see US manufacturing jobs shifting to China and Mexico – they're low cost producers. Talk of building a wall, increasing tariffs and bringing those manufacturing jobs back to the US hit home with much of middle America, but given the differentials in labour costs, it's highly unlikely Trump will actually succeed here.

What's really happening in the US is globalization. The movement of manufacturing jobs abroad has left those without a higher education with fewer job prospects, resulting in a lack of good jobs growth.

As Chart 3 shows, the jobs growth is coming from the service sector. This has been a long-term trend – many good, high paying jobs continue to be lost, and new jobs tended to be barbelled between a few high paying service sector jobs and many lower paying service sector jobs, particularly in retail, healthcare and food.

Chart 3: Jobs created since July 2014



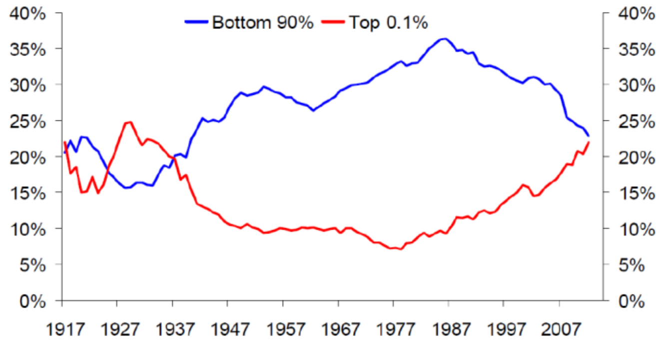
Source: Deutsche Bank, February 2017

Positively, the unemployment rate is down to 4.7%, likely the level where inflation starts coming back in to the US economy. However, it's important to also consider the *under*employment rate (U6), which includes the unemployed (U3) plus 'marginally attached' (those who aren't working nor looking for work but would be available for a job) plus part time employees who want a full-time job. The spread between U6 and U3 is declining, and that's very good for the US economy, but there is still almost 10% of the eligible population counted in U6 unemployment.

Overall it's a better story for the US jobs markets, but it's still a barbelled market – you're either working in a low paying service sector job, or you have a high paying job.

The problem here is the uneven distribution of wealth this creates. As Chart 4 shows, the top 0.1% richest people in the US have the same household wealth as the bottom 90%. The risk of backlash is something the markets haven't yet priced in and will become a growing risk in the coming years.

Chart 4: Share of US household wealth by income level



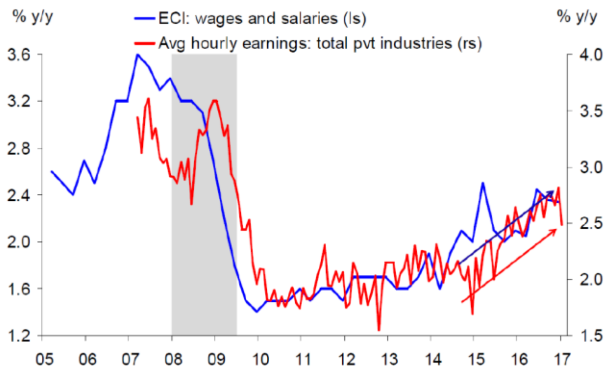
Source: Saez and Zucman, QJE May 2016, DB Global Markets Research.Note: date estimated by Berkeley Professors Seaz and Zucman using capitalised income tax returns.

So with the unemployment rate at 4.7%, in theory the Fed should already be on their hiking path…

…what's holding the Fed back?

Average hourly earnings increases (%y/y) are currently up around 2.5% (the red line in Chart 4). Markets have historically expected the Fed to hike rates when it reached that 2.5% level, but they've been wrong on that account for the last six to seven years. Nonetheless, over the last few months, the number has neared 3%, increasing our conviction in further Fed rate hikes.

Chart 5: Wage increases in the US



Source: BLS, DB Global Markets Research

It may be a temporary story, but as we near 3%, wage inflation starts leading to second round CPI inflation, and the Fed will likely continue on its hiking path.

What about the rest of the world?

We don't see any other central banks raising rates this year. In fact, we expect the opposite, and quantitative easing and continuing liquidity is going to be the story for the rest of the world.

In Europe, we believe the markets are missing two European risks for 2017, 1) countries like France and Italy edging to leave the Euro, putting further pressure on the region, and 2) banking solvency.

We've always viewed France to be closer to a peripheral market rather than a low-risk German-type issuer, given rigidities in labour and productions similar to peripheral markets. However, financial markets allowed French and German yields to trade within a narrow spread. It can be argued that many sovereign investors, including from Japan, continued to support the French sovereign given its AA sovereign rating, thus ignoring credit fundamentals. More recently, French 10-year bonds have risen and now yield about 0.76% more than equivalent German bunds in 10 year maturities - a record level, now more accurately reflecting the risks facing markets if France bows out of the Euro.

The second risk is the banking sector in Europe. The failure to raise capital following the GFC or recognise bad debt on balance sheets has taken its toll and we view much of the sector as insolvent, should loan books be marked to market. While Italian banks are our biggest worry, the potential failure of Deutsche Bank in the 4th quarter of 2016 brought the issue to the forefront more recently.

The combination of weak fundamentals and low European yields mean we find little to no value in European bond markets.

Australia, on the other hand, remains our favourite market. While growth and inflation have picked up slightly in recent months, and employment remains stable (albeit part-time jobs growth offsetting full-time job losses), growth and inflation will remain below target. Given minimal wage gains, similar to much of the developed world, we remain neutral to the current market pricing of a 70% probability of unchanged rates in 2017.

However, Australian bond yields remain higher than US and other bond yields, leading us to continue to favour the region. We expect to continue to see a convergence of Australian yields with the rest of the world. This is a trade we've maintained in the portfolio for some time, and will continue going forward.

Portfolio positioning

- We remain focused on liquidity – the portfolio's **liquidity bucket is around 10**% (comprised of cash, semi-government and agency type paper)
- Overall **duration is flat/zero years;** despite our favourable views of Australian bond markets, US Fed moves will continue to dominate global rates.
- The current **yield of the portfolio is 3.4%,** 0.80% more than a few months ago, with roughly the same positions, meaning we have a larger tailwind to our portfolio given expectations for the RBA to remain on hold.
- **Average credit quality remains A+.**

That's where we stand today and our view is: collect the coupon income, hold as much floating rate paper as you can, and don't take a lot of interest rate risks because you just don't know what policies Trump is going to be able to enact. Do not allow yourself to be exposed to the known unknowns, and even less so to the unknown unknowns!