June 2017

Decayed Decade

Whether the world is a better or worse place today compared to June 2007 is an entirely subjective call, fully dependent on the lens through which one gazes. In the decade since Kapstream's founding, we've seen phenomenal changes, particularly in the technology sector. On par with the euphoria surrounding Kapstream's inception (☺), what has become perhaps an even bigger cultural icon, the iPhone – see how it's not even necessary to reference creator Apple? – priced at USD600 for the first 8GB model, was also launched to the world in June 2007. However, unlike Kapstream, it would take another year for the iPhone to reach Australian shores. Amazon's Kindle e-reader was also launched, and archaic as it sounds remember we were in a pre-Blockchain/Bitcoin/Snapchat/Instagram/Uber/Airbnb/Google Mapped world!

Through other lenses, and hidden from view to most, the Global Financial Crisis was about to begin (which in hindsight probably wasn't the best time to start a funds management business). But by July 2007, the US Dow Jones passed 14,000, a level not to be reached again until 2013, and the ASX passed 6800, a level we still haven't revisited.

US 10-year Treasuries yielded 5.30% as the US Federal Reserve (Fed) had hiked rates 17 times over the prior three years to reach 5.25%. In Australia, 10-year government bonds yielded 6.26%, the Reserve Bank of Australia (RBA) having lifted rates to 6.25%, and subsequently a further 1.00% over the following year in the face of the global slowdown.

Like today, there were big challenges to overcome and opportunities to take advantage of. Limiting credit, high-yield, mortgage and asset-backed securities while focusing on interest-rates, governments and cash were part of a successful strategy back then.

Our strategies have changed with the environment, but we have maintained a few **key investment principles** which have allowed us to navigate the varying economic conditions of the past ten years:

- **The information ratio (risk/return trade-off) of interest-rate decisions is low.** Interest rates are volatile and taking large duration positions will lead to greater portfolio volatility and limited additional returns. In today's world interest-rate calls are even more difficult as markets can move massively with one seemingly random presidential tweet.
- **The information ratio we assign to high-quality short-dated credit is high.** Investment grade default rates have been very low and you get paid to take credit risk in short-dated investment grade credit.
- **Other strategies in the fixed-income toolkit can have varying information ratios over time**. Yield curve calls can be attractive in times where markets price in central bank rate hikes that are unlikely to occur. Country and currency relative value strategies can be appealing when economies are in different stages of the economic cycle.
- **Focus on risk and capital preservation first and returns second.** We think of our portfolios as 'sleep at night' holdings. If we worry about an issuer we tend to sell the name as the marginal additional return is rarely worth the additional risk. Reducing holdings and moving to cash never creates losses.

In today's environment, we still retain a more conservative focus, remaining cautious of growing geopolitical risks including US political turmoil and conflicts in Russia/Ukraine, North Korea, Syria and the South China Sea. This is a world in which we will continue to limit our duration positions to less than 0.50 years in order to control risk.

Nonetheless, we have strong views on currencies and rates. Like US dollar strength, global bond yields will remain a barometer of the markets' faith in Trump's economic plans. We believe these plans will continue to be delayed as internal missteps, controversies, resignations and investigations cause continuing short-run volatility as markets price in rumour and innuendo. Recent rallies in bond yields and US dollar weakness reflect both expectations for further political turmoil, little policy progress and concern that potential US policies, which include increasing trade barriers and ending existing trade treaties, will undermine US economic growth. Market expectations for significant tax policy reform are misplaced as little political agreement will mean a small business/personal tax cut is the most optimistic possible outcome.

The US Fed looks set to remain on hold in 2017

With US political disorder and three consecutive soft Consumer Price Index prints, the Fed is unlikely to hike again in 2017, despite recent dots indicating a third rate hike later this year. We were somewhat surprised by the Fed's hawkish tone, stating that inflation was only running "somewhat" below target and that "conditions are in place for inflation to move up".

April's 174k payrolls and May's 138k payrolls gains corroborate the last 7+ years of stable and steady jobs growth, although the jobs story is undoubtedly slowing. We expect unemployment to remain near the current 4.3%, a 16-year low. Wage pressures remain a concern, with average hourly earnings at 2.5% and the ratio of job seekers to number of available jobs moving from 9:1 toward 1:1. But the US underemployment rate (high skilled workers in low skilled jobs and part-time employees who wish to work full-time) remains at 8.4%. By comparison, the underemployment rate was sub 7% in the early 2000's.

Despite our expectations for the Fed remaining on hold for the remainder of 2017, we expect 'normalization' of the balance sheet to modestly begin. This contributes to our expectations for (again) limited 2018 interest-rate hikes. The Fed's June statement indicates a USD1 trillion taper over the next 3½ years, which would still leave the Fed with a USD3.3 trillion balance sheet. We view this as an optimistic outcome, given Brexit concerns, European banking volatility, slower Asian growth, geopolitical risks and little progress in Trump's economic plans. 'Rolling down the yield curve' as the Fed keeps rates low will remain a central theme in our portfolios.

Solid outlook for Australia despite a lack of wage growth

In global bond markets we continue to favour Australian rates versus the rest of the world. Like the US, we expect the RBA to remain on hold for the remainder of 2017. Housing and labour markets will remain key factors in future growth and inflation expectations and we expect the RBA to await further data before acting. Stronger global growth, core inflation reaching 1.8%, employment gains and improved terms of trade provide for a solid domestic story. However, non-mining investment and a lack of wage growth will cause the RBA to tread carefully. Recent employment gains remain solid, with 42k, 46k and 53k jobs gains in each of the last three months. However, globalization and technology advancements mean wage growth is likely to remain contained. The latest wage data confirm weak wage growth at an annualised 1.9%, the lowest level in more than 25 years, suggesting core inflation will likely remain below the RBA's 2% to 3% target.

The Australian underemployment rate remains at 8.8%, the second highest reading on record. A need for Australia to become more competitive in a global world facing continued technological change and weaker labour bargaining power will likely sustain downward pressure on wages. The impact of macro-prudential policy changes has yet to filter through the economy, but we believe inflation risks will remain to the downside, keeping the RBA on hold into 2018.

The differential between Australian and US 10-year government yield spreads remain tight at 0.20%, approaching a 20-year low (Australian 10-year government bonds yielded 2.35% vs. 2.15% for 10-year US Treasuries). Our portfolio has long been positioned for this spread tightening as we believed Australian yields would eventually move below US yields over the longer-run. More recent data, including confirmation of Australia's AAA rating, an expected smaller government borrowing program and little inflationary pressures re-confirm our beliefs of a continued contraction in this spread.

We continue to hold a positive view on investment grade credit in Australia, largely due to attractive real yields and healthiness of issuers compared to other developed markets. Our portfolios continue to have material exposure to Australia, accounting for 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, solid cashflows, systemic importance, monopolistic structures, with high regulation and quality underlying collateral. While Australian banks came under further pressure recently with the revelation of a new bank tax and rating agency downgrades, we remain bullish on Australian bank debt given conservative business models, strong profitability and implicit government support. We also favour top tranche Australian Residential Mortgage Backed Securities given their wide spreads and high AAA/AA rating.

In other regions of the world, 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.

Europe remains a key concern

We remain less supportive of European bond opportunities. In the nearer-term, political risks have decreased following the French elections and near-term growth has improved, aided by increased consumer spending and improving employment, but we see little inflationary pressure. We believe the European Central Bank (ECB) will continue to struggle with the effectiveness of its quantitative easing (QE) program, currently at €60 billion/month in sovereign and corporate bond purchases. Prospects for a greater QE program later in 2017 or 2018 are increasing. We expect 2017 European growth and inflation to continue to underperform expectations amidst structural rigidities in labour and product markets, particularly in peripheral regions. Low/negative bond yields already reflect this scenario. Questions over solvency in the European banking sector, further Greek bailout drama and political discord will remain key European themes over the next year.

Kapstream
—JANUS HENDERSON—

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, limited corporate profitability, political discord and banking soundness.

Portfolio positioning

We have maintained the portfolio's 'liquidity bucket' of government-related and cash instruments at 10%, near our long-run average, taking advantage of attractive corporate issuance opportunities as they arise.

In managing fixed income portfolios, key themes include:

- **Strong corporate profitability sustains**, aided by less regulation and lower taxes. We will continue to hold high-quality, investment-grade issuers, currently yielding approximately 3.0%.
- **The US will remain the main engine of global growth** despite political gridlock, 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 the Euro.
- **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.
- **European risks remain**. The European Central Bank will eventually increase the size of its Quantitative Easing program, particularly as banking risks increase. However, we find little value in Europe given the low and negative yield environment.

Lessons from a decayed decade…

On balance, it would be hard to refute that on the technological front we have progressed, and perhaps even to some extent on the financial too – if you accept valuable lessons in transparency and prudence learned through the post-GFC recovery. However, at what cost? In ongoing central bank market intervention (through QE programs) are we not simply delaying a necessary decay before pure market dynamics are permitted to find their own new equilibrium? And on the technology front the 2009 film *Surrogates*, starring Bruce Willis, portrayed an almost-within-touch near-future existence where people have expanded their use of technology to the extent their lives are lead almost completely within their own virtual sphere, depriving them of the basics of natural, human relational existence. Not so far away from many millennial lives today…

If there is one lesson as investors that we can learn from the past decade of what's been – and remains – an environment punctuated with uncertainty, it is to stick to investing based on information and research that can be substantiated, and in a period where returns from most major asset categories remain muted, to spend an equal or greater amount of time assessing (and protecting against) the risks, which in today's world are many and if left unchecked can all too easily gnaw quickly at the precious positive absolute returns available. Elements of our world may well continue to decay around us, however Kapstream enters the next decade confident that our approach to investing has more than proved its resilience against all that the last has thrown at us!