Kapstream
— JANUS HENDERSON —
Quarterly Report

Kapstream Absolute Return Income Fund

June 2017

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Portfolio (gross)[1]	0.21	0.83	3.80	3.82	4.88	5.74
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	-0.01	0.48	1.88	2.45	2.65	3.76
Active return (gross)[2]	0.21	0.35	1.93	1.37	2.23	1.97

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

The Fund returned 0.21% in June and 2.23% year-to-date. Australian 10-year bond yields rose 0.20% over the month, reaching 2.60% while US 10-year Treasuries rose 0.10%, reaching 2.30%. Likewise, German 10-year bund yields rose 0.20% to reach 0.46% amidst central bank confidence and comments regarding ending QE and easy monetary policy.

The US payrolls story remained solid, with an additional 222k jobs created in June. The average monthly gain over 2017 now stands at 180k/month, demonstrating continuing solid employment growth. Nonetheless, fragile credit growth, low inflation and weak productivity continue to create headwinds for US economic growth. The political story, including new Russia links to Trump's family, Congress again failing on US healthcare reform and no progress on tax reform will also continue to hamper growth. The Fed's preferred measure of inflation, PCE, again came in weaker than expected at 1.4%, remaining well below the 2% target.

Outlook

We retained 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.

Like US dollar strength, global bond yields will remain a barometer of the markets' faith in Trump's economic plans. Over the remainder of 2017, we believe those 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. Bond yields have moved toward to the higher end of a trading range. Whilst jobs growth remains robust, wage increases and inflation remain well contained. Further political turmoil, little policy progress and concern those potential US policies, which include increasing trade barriers and ending existing trade treaties, will undermine US economic growth will continue to weigh on bond yields.

Considering US political disorder and 3 consecutive soft CPI prints, the Fed is unlikely to hike again in 2017, despite recent jobs growth and dots indicating another rate hike later this year. We have been 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, May and June's payroll gains corroborate the last 7+ years of stable and steady jobs growth, although this story is so far non-inflationary. We expect unemployment to remain close to the current 4.4%, a near decade low. Wage pressures will eventually become 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 not in 2017. We believe core inflation will remain contained until wage gains move beyond 3%, a level not seen since 2009. Normalization of the Fed's balance sheet is expected begin later this year, but we expect only modest reinvestment tapering which would also reduce prospects for a larger set of rate hikes in 2018. The June statement, indicating initial monthly caps of $6 billion and $4 billion for Treasuries and MBS, respectively, peaking at $30 billion and $20 billion through progressive quarterly caps, indicate a $1 trillion taper over the next 3-1/2 years leaving the Fed with a $3.3 trillion balance sheet. Nonetheless, we expect the Fed to tread carefully, given Brexit concerns, European banking volatility, slower Asian growth, geopolitical risks and little progress in Trump's economic plans.

In global bond markets we continue to favour Australian rates versus the rest of the world. Like the US Fed, we expect the Reserve Bank of Australia 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 will 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. Whilst recent employment gains remain solid, increasing part-time employment at the expense of full-time, globalization, and technology advancements mean wage growth is likely to remain well contained. May's 42k jobs gains and an unemployment rate at 5.8% reconfirm a solid, firm jobs story. However, the latest wage data also 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 underemployment rate remains at 8.8%, the second highest reading on record. A need for Australia to become more competitive in a global world, technological change and weaker labour bargaining power will likely continues to keep downward pressure on wages. The impacts of macro-prudential policy changes have yet to filter through the economy, but we believe inflation risks will remain to the downside, keeping the RBA on hold.

The differential between Australian vs. US 10-year government yields spreads rose to 0.30% over the month, rising from a 20-year low (Australian 10-year government bonds yielded 2.60% vs. 2.30% for 10-year US Treasuries). The fund has long been positioned for 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, currently 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 businesses, high regulation and quality underlying collateral.

Whilst Australian banks came under further pressure with the revelation of a new bank tax and rating agency downgrades of 2nd tier banks and 1st tier hybrids, we remain bullish on Australian senior bank debt given conservative business models, strong profitability and implicit government support.

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 pressures. We believe the ECB will continue to struggle with the effectiveness of its quantitative easing programme, currently at €60 billion/month in sovereign and corporate bond purchases. Prospects for a greater QE programme later in 2017 or 2018 are increasing. We expect 2017 European growth and inflation to continue underperform expectations amidst structural rigidities in labour and product markets, particularly in Peripheral regions. Low/negative bond yields already reflect this scenario.

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.

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 fund'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 3.1%.
- 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.

Contact Details

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