Kapstream
— JANUS HENDERSON —
Monthly Report

Kapstream Absolute Return Income Fund

July 2017

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Portfolio (gross)[1]	0.38	1.01	3.73	3.82	4.79	5.73
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.20	0.45	1.84	2.45	2.64	3.75
Active return (gross)[2]	0.17	0.55	1.89	1.37	2.16	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 0.38% in July and 2.61% year-to-date. Bond yields were roughly flat over the month. Global yields initially moved higher following continuing hawkish central bank rhetoric, but fell back toward late June levels as markets dampened belief in large sets of central bank rate hikes. Equity markets reached new highs, buoyed by a strong start to earnings season and reduced market volatility. 73% of US corporates reported above consensus earnings, the highest percentage in almost 10 years. The US dollar declined versus most global currencies, falling 2.6% against its trading basket.

The Fed and RBA left rates unchanged. In the US, second quarter GDP came in at a strong annualised 2.6%, but inflation data remained weak. RBA minutes revealed expectations for an eventual 3.5% neutral rate, well above the current 1.5% rate. Markets interpreted this statement as a signal for higher rates, initially causing bond yields to rise. Subsequent comments by the Governor and Deputy Governor downplayed the relevance of the statement, causing Australian bond yields to return to lower levels.

The A$ rallied toward 0.80/US dollar amidst stronger commodity prices and more positive Chinese data. Iron ore rallied 13% over the final 2 weeks of the month and coking coal up 10%. Oil ended the month slightly above $50/barrel, driven by falling inventory and a weaker US dollar.

On the political front, more failure on US policy dominated news over the month. In addition to US Congress' failure to overhaul healthcare, a 7-year effort which has yielded zero results, President Trump fired his chief of staff, communications director and spokesperson. Korea tested a missile capable of reaching the US mainland and Russia expelled 755 US embassy staff in retaliation for US sanctions.

Outlook

We retained a conservative focus, remaining cautious of growing geopolitical risks including US political turmoil, conflicts in Russia, North Korea, Syria and the South China Sea. We increased portfolio duration to 0.60 years, up from 0.45 years last month, as we believe bond yields are closer to the top of their trading range given little inflation expectations. We will look to add duration as opportunities permit.

Controversy surrounding the healthcare/immigration/tax reform debate and the latest addition/purge in the revolving show circus that has become the White House inner-circle are the smaller of our political concerns. But the growing potential for US Congress to fail to raise the US debt ceiling, creating a government shutdown and prospects for US Treasury default, remain our biggest political/economic concern.

2 of the 3 branches of government are currently broken. The Republican led Congress currently views the debt ceiling as a secondary issue, messaging their continuing focus on a healthcare overhaul bill, expanding upon the vast progress they've made over the past 7 years. A Republican House minority stated they would force a Treasury default and government shutdown unless their demands that Obamacare was repealed and funding for building the wall across the Mexican border were met. This faction shut down the government for 16 days in 2013 over a similar set of hostage demands, all of which failed. As expected, Congress declined to extend their current session to deal with the debt ceiling, as having another 1-1/2 month vacation was deemed too important to the welfare of the country.

We have little confidence in Treasury secretary Mnuchin's stature and ability to push Congress into raising the debt ceiling. And with a career epitomized by defaulting on investors, it's hard for us to foresee President Trump having anything positive to add to situation other than finding a way to blame Hillary Clinton and Obama for the upcoming chaos.

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 expect those plans will continue to be delayed as internal missteps, controversies, resignations and investigations cause continuing short-run volatility as markets price in rumor and innuendo. Whilst jobs growth remains robust, wage increases and inflation remain well contained. The US may be close to full employment as strong payrolls data, less job openings and quit rates point to a strong labor market. Nonetheless, inflation remains well contained, as wage inflation remains low, driven by weak labor bargaining power.

Further political turmoil, little policy progress and concern that 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 a succession of 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 had been surprised by the Fed's hawkish tone in the 2nd quarter, 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 tapering 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 labor markets will remain key factors in future growth and inflation expectations and we expect the RBA will await further data before acting.

Chinese growth will remain key for Australia and we remain bullish despite a deceleration in credit provisions. GDP remaining near 7%, in line with targets, remains our base case and should continue through to the 19th Party Congress later in the year.

Strong Chinese and 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. 240k jobs gains over the past 3 quarters and an unemployment rate at 5.6% 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 labor bargaining power will likely continue 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. While the RBA will tolerate a stronger currency, financial conditions are tightening and limiting the RBA's ability to eventually increase rates.

The differential between Australian vs. US 10-year government yields spreads rose to 0.40% over the month, rising from a 20-year low of 0.15% near the end of June. 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 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.

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 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 underperform expectations amidst structural rigidities in labor 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.

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 3.0%.
- We expect the US to remain the main engine of global growth providing support for the US dollar vs. the rest of the world.
- 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 program, particularly as banking risks increase. However, we find little value in Europe given the low and negative yield environment.

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