KANGANEWS AWARDS 2017
WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

Kapstream
—JANUS HENDERSON—

Quarterly Report

Kapstream Absolute Return Income Fund

December 2017

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Portfolio (gross)[1]	0.22	1.04	4.25	3.70	4.28	5.65
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.03	0.48	2.00	2.20	2.50	3.67
Active return (gross)[2]	0.19	0.56	2.25	1.51	1.78	1.98

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 0.22% gross of fees and 0.18% net of Institutional shareclass fees in December. With the 2017 calendar year at a close, pleasingly we exceeded our broad annual return target of delivering investors 2% or more better than cash, while maintaining very low levels of risk. We delivered no negative monthly returns through the whole period. Interest income from the portfolio's bond holdings remained the largest positive contributor to performance over the month, whilst 3.2 years of credit spread duration exposure also aided returns as spreads remained relatively stable. The portfolio's basket of modest currency exposures (notably the short USD vs. SGD, short USD vs. INR, and long NZD vs. CAD) all contributed positively, as did our continued long Australian Itraxx vs. Australian bank CDS position. With bond yields rising in the month, our modest positive Australian interest rate exposure detracted marginally from overall returns.

Portfolio Positioning

Entering December we deliberately positioned the portfolio cautiously which proved sensible in securing a positive final month, as Australian bonds broadly (as measured by the Bloomberg AusBond Composite 0+ Yr Index) fell by over 0.5%. With the Fed raising rates as expected we maintained a modestly negative US duration position (~-0.25yrs), against a modestly long Australian duration position (~+0.5yrs), with overall Fund duration of ~+0.3yrs. Portfolios continue to exhibit a bias to Australian investment grade credit (over sovereign and investment grade credit issued elsewhere) reflecting our positive outlook. We continue to believe that sub-investment grade valuations remain stretched and are maintaining a fully investment grade portfolio. With overall credit spreads continuing to be tight and absolute yields low, we have continually reduced our ‘liquidity bucket’ (comprising cash/deposits/sovereign assets) to the current 5%-6% range to optimise portfolio returns against liquidity. We expect to continue to hold these positions into 2018.

Outlook

Despite signs of improvement globally, we remain cautious given ongoing geopolitical risks and central bank policy settings, changes to which could unsettle the path to recovery. Despite positive reconciliatory developments on the Korean peninsula, tensions remain and the unpredictability of the Norths regime coupled with the brinkmanship of the Trump administration has not disappeared. Adding continued Brexit uncertainty, tensions in the middle East, and the potentially disruptive phenomena of crypto-currencies and we expect 2018 to be a year again where markets face a range of unpredictable factors. That being said, as they did in 2017, we continue to believe that ‘risk assets’ (generally taken to meaning equities) will rally, a view based more on longer term secular changes – innovation in technology, demographics, broad globalisation trends, growth in savings, and the seemingly eternal ‘central bank put’. We expect bond yields to rise – but very slowly – as we think CPI (consumer price inflation) will not be a problem in a globalized world where there is free flow of information, people, goods and services – however the same is also true of wage inflation.

In the US, politics will heat up as the US Congress returns to face the very real risk of a January 19th government shut down. Whilst jobs growth remains mostly 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 labour market. Nonetheless, inflation remains well contained, as wage inflation remains low, driven by weak labour bargaining power.

Following one (25bp) hike in December 2015 and another in 2016, the Fed raised rates three times in 2017, more or less as communicated. Market expectations are for another two to three in 2018 which seems reasonable. The bigger question is where the terminal Fed rate is – somewhere in the 2.5%–3.0% range or higher at ~4.0%? We agree with consensus that the former is more likely, and as such expect just two hikes from the Fed in 2018.

In Australia the growth outlook remains mixed and as a result we continue to expect the RBA to maintain its current low rate position (1.5%) for the foreseeable future. Low wages growth continue to be at the base of our view supporting expectation that growth remains subdued, despite healthy corporate profitability. In the bond market, we expect Australian bond yields to follow global yields higher. Provided there is no sharp sell-off in risk assets we would expect credit spreads and swap spreads to remain well supported. Recent wage data re-confirms weak wage growth at an annualised 2%, near the lowest levels in more than 25 years, suggesting core inflation will likely remain below the RBA's 2% to 3% target. The underemployment rate remains at 8.6%, a near-record high. The 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. While the RBA will tolerate a stronger currency, financial conditions are tightening, limiting the RBA's ability to increase rates. We expect continuing AUD strength leading to further subdued price pressures.

Chinese growth remains key. GDP remaining near 6.5%, in line with targets, remains our base case, and we expect continuation of an agenda supporting the addition of 10 million people/year into the urban labour force as a central economic policy theme whilst financial sector reforms will remain an important yet secondary policy goal.

We continue to hold a positive view on investment grade credit in Australia, largely due to:

- attractive real yields
- healthiness of issuers compared to other developed markets
- wider yield spreads versus comparable US, Euro and Japanese issuers

Therefore, our portfolios continue to have material exposure to Australia, currently above 2/3rds of our holdings. Favoured sectors remain the banking sector due to attractive yields and greater liquidity, and infrastructure such as airports and toll roads which offer attractive yields and solid cashflows, and are typically monopolistic businesses with high regulation and quality underlying collateral, of systemic importance. 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. We believe the ECB will continue to struggle with the effectiveness of its quantitative easing program, currently at EUR30 billion/month in sovereign and corporate bond purchases. Prospects for a greater QE program later in 2018 are increasing despite market expectations for an eventual end to QE. We expect 2018 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.

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. We are particularly concerned over the European banking sector, which had historically done little in raising new capital or writing down bad debts. While the ECB has the capacity to continue to paper over the problem in the shorter-run, balance sheet expansion will be the likely end result, at least before nationalization of weaker performing banks. This scenario may be many years away. In the interim, we expect more QE, with little growth and inflation prospects in the Southern European region.

Elsewhere, 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.

Contact Details

Courtney Chute - Portfolio Analyst, Kapstream Capital | Tel 02 9234 0009 | email: Courtney.Chute@kapstream.com

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