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

Kapstream
—JANUS HENDERSON—

Quarterly Report

Kapstream Absolute Return Income Fund

September 2018

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Portfolio (gross)[1]	0.18	0.83	3.29	3.66	4.01	5.48
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.13	0.55	2.05	2.07	2.40	3.57
Active return (gross)[2]	**0.04**	**0.28**	**1.24**	**1.59**	**1.61**	**1.91**

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.

Performance

The Fund returned 0.14% in September and 1.91% calendar year-to-date (after "I" shareclass fees). The Fund's coupon income remains the main contributor to returns, while corporate bonds continued to rally over the month aiding performance. The Fund's small interest rate position of 0.6 years slightly detracted from returns as rates climbed. By month-end, Australian 10-year treasury yields rose from 2.51% to 2.66%, mirroring the move in 10-year US Treasuries, which rose from 2.86% to 3.06%. The Australian/US spread differential of 0.40% reached a level not seen since 1981 which slightly aided returns. We continue to favour Australian and New Zealand rates given our expectations for the central banks to remain on hold through 2018 and 2019.

Portfolio Strategy

After decreasing portfolio risks in the first quarter following greater market volatility, we increased portfolio risks over the 2nd quarter, believing the sell-off in rates and corporate bond spreads was largely complete. We have maintained our low cash position at 5.5%, given attractive corporate issuance. We still believe the RBA is likely to maintain rates at 1.50% for some time, making Australian rates the most attractive, globally. We expect to maintain Australian and New Zealand duration in the 0.50 to 0.70 range. We intend to hedge these modest long duration positions using short duration positions in the US to protect against rising global rates.

Outlook

Despite September US job gains of 134k, well under expectations, a 3.7% unemployment rate and continuing wage gains reconfirm solid US economic data, consistent with the past few months. While average hourly earnings at 2.8% keep us concerned over US inflation, we believe the trade war will remain a negative theme and keep a cap on where rates can go.

A full-blown trade war could reduce US growth by up to 0.50% annually, completely unwinding the benefits of recent tax cuts. As a result of this political uncertainty, we foresee a more limited set of future Fed rate hikes, below market consensus. We expect terminal the Fed Funds rate in the 2.50% to 3.00% range. Despite our view of limited US inflation prospects, we will maintain our interest rate duration in Australia and New Zealand as US rate volatility and prospects for further Fed rate hikes make US interest rate exposures less attractive.

Like US dollar strength, global bond yields will remain a barometer of markets' faith in Trump's economic plans. Whilst we remain negative on the US political situation, jobs growth remains robust and wage gains may eventually reach 3%, which will lead to greater overall inflation expectations. The US is close to full employment as strong payrolls data, less job openings and quit rates point to a strong labour market. Nonetheless, weak labour bargaining power will put a cap on long-term wage gains and core inflation.

Further normalization of the Fed's balance sheet will produce only modest tapering. Sales of Treasuries and MBS, peaking at USD30 billion and USD20 billion, respectively through progressive quarterly caps, indicate a USD1 trillion taper over the next 3½ years, leaving the Fed with a USD3.3 trillion balance sheet. We expect the Fed to tread carefully, given Brexit concerns, a deteriorating Italian fiscal plan, European banking volatility, slower Asian growth and geopolitical risks.

While we foresee eventual rises in service sector inflation, goods inflation will remain well contained, being less linked to decreasing US unemployment. Global spare capacity will continue to make cheap imports a viable alternative to domestic products, although a trade war's tax on consumers may limit imports' effects. Payroll gains corroborate the last 8 years of stable and steady jobs growth, but recent data indicate small inflation risks. We expect unemployment to remain close to the current 3.7%, a 50-year low. Wage pressures will eventually become a concern, with average hourly earnings increasing to 2.9% and the ratio of job seekers to number of available jobs moving from 9:1 toward 1:1. We believe core inflation may increase once wage gains move beyond 3%, and we are moving closer to that level.

In global bond markets we continue to favour Australian rates versus the rest of the world. We expect the Reserve Bank of Australia to remain on hold for all of 2018 and 2019. 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. The latest employment data reconfirm the continuation of last year's strong employment data when 400,000 jobs were added, with 75% of them being full-time. However, employment slack remains with businesses more recently focused on part-time hiring and remaining reluctant to increase wages.

Chinese growth will remain key for Australia and we remain optimistic despite a deceleration in credit provisions and a looming trade war. GDP remaining near 6.5%, in line with targets, remains our base case, despite the trade war rhetoric. 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.

Strong Chinese and Asian growth, inflation reaching 2.2%, employment gains (particularly the recent gains in full-time hiring) and improved terms of trade provide for a solid Australian domestic story. We foresee a continuation of the string of 26 years of recession free growth. However, non-mining investment, an overlevered consumer and a lack of wage growth will cause the RBA to tread carefully. Whilst recent employment gains remain solid, globalization and technology advancements mean wage growth is likely to remain well contained. Averaging 33k/month through 2017, jobs gains remain strong and an unemployment rate at 5.5% reconfirm a solid jobs story. Higher participation rates have kept the unemployment rate in the +/-5.5% range since 2009 and we expect a decrease only gradually in the coming years. Nonetheless, weaker household consumption and still heavily indebted consumers will offset much of solid jobs story.

The latest wage data re-confirm weak wage growth at an annualised 2.1%, near the lowest levels in more than 25 years, suggesting core inflation will likely remain at the lower end of the RBA's 2% to 3% target. The underemployment rate at 8.1% will keep a cap on wage pressures over the near term. RBA Governor Lowe noted that "wage growth of 2.0% and reasonable labour productivity are unlikely to make for 2.5% inflation" (the middle of the RBA's 2 -3% target). Lowe further stated that 3.5% wage growth would likely be required to move inflation toward the middle of the RBA target.

The need for Australia to become more competitive in a global world, technological change and weaker labour bargaining power will likely continue to keep downward pressure on wages. The impact 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 well into 2019.

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 at about 67% 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, rating agency downgrades of 2nd tier banks and 1st tier hybrids, and disclosures in the Royal Banking Commission, we remain bullish on Australian senior bank debt given conservative business models, strong profitability and implicit government support. We have more recently moved out of Big 4 issuers into second tier financials including regional banks and credit unions in order to pick up additional yield.

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.

We remain less supportive of European bond opportunities. In the nearer-term, growth has improved, aided by increased consumer spending and improving employment, but we see little inflationary pressure. Stresses in the Euro region have increased, particularly with the emergence of an Italian coalition government focused on decreasing taxes and increasing spending with little concern over growing deficits. With Italian risks increasing, we believe it will be difficult for the ECB to end QE in the 4th quarter. 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 remain concerned over the European banking sector, which had historically done little in raising new capital or writing down bad debts. Although this has improved somewhat so far this year with bank bad debt sales and continuing capital increases, stresses remain in the Peripherals. 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 QE to continue longer than markets anticipate, with little growth and inflation prospects in the Southern European region.

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