Kapstream
— JANUS HENDERSON —

Quarterly Report

Kapstream Absolute Return Income Fund

December 2018

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception (%) p.a.
Portfolio (gross)[1]	0.16	0.52	2.76	3.58	3.86	5.40
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.23	0.59	2.17	2.13	2.39	3.54
Active return (gross)[2]	-0.08	-0.07	0.59	1.45	1.47	1.86

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 0.16% in December and 2.76% over 2018 (before fees), a modest but at least positive return through an environment in which all major asset classes delivered negative returns. The Fund's coupon income remained the main contributor to returns, however further 'risk-off' market conditions caused our bond holdings to lose some value over the month. Financial market stress, driven by increasing geo-political uncertainties surrounding global trade, a US government shutdown and Brexit dominated markets into the end of the calendar year. Major equity markets posted their worst quarter in seven years, some down double digits over the year.

We retained the Fund's interest rate position near 0.63 years which was positive for December returns as global rates rallied sharply amidst negative risk sentiment. US 10-year Treasury yields ended the year at 2.68%, rallying more than 0.50% from their November highs. However, the continuing sell-off in corporate bonds detracted from Fund returns, offsetting the duration gains. We continue to favour Australian and New Zealand rates given our expectations for their central banks to remain on hold through 2019.

As expected, the US Federal Reserve hiked rates in December, but forward guidance appeared to indicate a smaller series of expected rates hikes over 2019. The ECB also became more cautious, and while it ended its asset purchases in December, it indicated an expectation to keep rates low for a fairly long time. Markets currently anticipate no European rate hikes until at least 2020. Likewise, the RBA has remained on hold at 1.5% since August 2016 with markets predicting little prospect for hikes in 2019.

Portfolio Strategy

2018 was a challenging year, given sell-offs in virtually all financial markets. However, we believe there is good value in short-dated corporate bonds given higher current yields and spreads. Therefore, we will continue to retain a higher level of portfolio risks, believing the sell-off in rates and corporate bond spreads to be largely complete, despite recent market volatility. 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 1.5% for some time, making Australian rates the most attractive, globally. We expect to maintain Australian and New Zealand duration in the 0.50 to 0.80 range. We intend to hedge some of the Fund's long Australian and New Zealand duration position vs. short duration positions in the US to protect against potentially rising US rates although more recent data indicate lower US growth/ inflation prospects.

Outlook

Over the short-run, we expect market stresses to remain elevated as the US government shutdown lasts longer than expected, Brexit progress remains fleeting, and stresses in the European financial sector continue. Investigations of the Trump administration could pose more serious economic damage than expected and severely limit prospects for favourable growth policies.

Our main political concern remains fiscal brinksmanship leading to further government shutdowns (and the requisite back and forth finger-pointing blame) over the debt limit, spending and budget. The potential for repeated government shutdowns over the next two years will keep a cloud over growth prospects. Nonetheless, 2018 payrolls and wage gains reconfirm solid US economic data, consistent with the past few years. Average hourly earnings moving above 3% raises concern over US inflation, however, we believe the trade war and political uncertainty will remain a negative theme and keep a cap on where rates can go. Chairman Powell and Vice Chairman Clarida's more recent comments indicating Fed rates are closer to neutral reconfirm our earlier views of terminal Fed fund rates below 3%. We expect one more rate hike in 2019, closer to current market consensus. A full-blown trade war could reduce US growth by up to 0.5% annually, completely unwinding the benefits of recent tax cuts. A longer term government shutdown and potential for presidential impeachment add further challenges to 2019 US growth.

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 continuing trade war's tax on consumers may limit imports' effects. Payroll gains corroborate the last eight years of stable and steady jobs growth, but inflation risks are limited. We expect unemployment to remain close to the current sub 4% 50-year low. Wage pressures remain a concern, with average hourly earnings above 3% and the ratio of job seekers to number of available jobs moving from 9:1 toward 1:1. Whilst core inflation may slightly increase given increasing wage pressures, it will remain well contained in the 2.0-2.5% range over the next few years.

In global bond markets we continue to favour Australian rates versus the rest of the world, given our expectation for the RBA to remain on hold for all of 2019. 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. 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, 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. Jobs gains remain strong and an unemployment rate at 5.0% reconfirm a solid jobs story. While higher participation rates have kept the unemployment rate in the +/-5.5% range since 2009, we foresee lower unemployment levels and a solid growth outlook. Nonetheless, weaker household consumption and still heavily indebted consumers will offset much of the solid jobs story.

The latest wage data for Q3 2018 shows a seasonally adjusted rise of 2.3% YoY, above the previous quarters 2.1%, and matching expectations. However, dispersion within this number shows wages in the public sector up 2.5% while those in the private sector grew by only 2.1%, re-confirming generally weak wage growth, suggesting core inflation will likely remain at the lower end of the RBA's 2% to 3% target. The latest inflation consumer price data, showing inflation falling from 2.1% to 1.9%, mean inflation may struggle to remain at the bottom of the RBA's target. The underemployment rate at 8.3% 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 with 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, again supporting the theme of the RBA remaining on hold through 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, and wider yield spreads versus comparable US, European and Japanese issuers. Therefore, our portfolios continue to have material exposure to Australia, currently accounting for ~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, and are 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 permanently. We expect 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. Banca Carige, the latest Italian bank struggling with the double whammy of a fraud scandal and a burgeoning bad loan book – and under the control of administrators seeking state-backed guarantees of its bonds in the hope of avoiding a full bailout – is likely the tip of the iceberg. 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 (despite current European rules limiting taxpayer bailouts). This scenario may be many years away. In the interim, we expect a dovish ECB, with little growth and inflation prospects in the Southern European region.

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