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

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Kapstream
—JANUS HENDERSON—

Monthly Report

Kapstream Absolute Return Income Fund

January 2019

Performance	Month (%)	3 Months (%)	1 Year (%)	3 Years (%) p.a.	5 Years (%) p.a.	Since Inception (%) p.a.
Portfolio (gross)[1]	0.36	0.54	2.70	3.57	3.81	5.39
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.22	0.59	2.19	2.10	2.39	3.53
Active return (gross)[2]	0.14	-0.05	0.50	1.46	1.42	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 0.36% in January (before fees), with coupon income remaining the main contributor to returns. The Fund's corporate holdings also contributed positively, while the defensive focus on lower volatility Australian-dollar denominated securities – which protected the Fund through a large part of 2018 – somewhat underperformed the overall corporate market rally in the month. Long positions in Australian and New Zealand short-term rates also aided returns.

A return to 'risk-on' was the dominant January theme as US equities had their best start in 30 years (following the stock market's worst December in more than 80 years) with the S&P up almost 8% as the earnings season began with strong data. US jobs data remained strong while global data was more mixed; Chinese manufacturing data weakened while European growth disappointed and Italy approached recession.

The Federal Reserve continued a move toward a more dovish stance and markets completely removed expectations for a rate hike in 2019. Similarly, the Reserve Bank of Australia ('RBA') indicated a more neutral stance between prospects for future a rate hike vs. cut and the markets priced in a 100% probability for a cut over the next year.

Portfolio Strategy

We will continue to retain a higher level of portfolio risks, believing the sell-off in rates and corporate bond spreads is 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, although market expectations have moved toward this view over the month. We expect to maintain Australian and New Zealand duration in the 0.5yr to 0.7yr range. We removed the Fund's short US dollar interest-rate position amidst growing geo-political and economic risks and expectations that growth will underperform current expectations. We expect to maintain a larger interest rate position overall in the 0.8yr to 1.0yr range as a hedge against our corporate holdings. We still favour Australian and New Zealand rates given our expectations for the central banks to maintain low rates through 2019 and beyond, but US rates are also becoming more attractive despite their recent rallies.

Outlook

US January payrolls and wage gains reconfirm solid US economic data, consistent with the past few years, albeit 300,000+ jobs growth will not become the market norm. Average hourly earnings growth reaching 3.2% heightens our concerns 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. A full-blown trade war could reduce US growth by up to 0.5% annually, completely unwinding the benefits of recent tax cuts.

Given a split Congress, major policy changes are unlikely for the next two years and prospects for major infrastructure spending or tax and healthcare policy adjustments will be limited. The relaxing of regulatory reform will continue as the Democrat-held House has limited authority in this area. Trade policy is also likely to remain unchanged with continuing trade war rhetoric, albeit with likely court challenges to the President's authority to act. House investigations of the Trump administration are likely to materialize and while impeachment proceedings are becoming more likely, there is no chance Democrats will gain the necessary voting for success.

Our main political concern following the US elections is fiscal spending brinksmanship leading to further government shutdowns (and the requisite back and forth finger-pointing blame) over the debt limit, spending, wall and budget. The potential for repeated government shutdowns over the next two years will keep a cloud over growth prospects.

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 eight years of stable and steady jobs growth, but inflation risks are limited. We expect unemployment to move beyond its near 50-year low, to the mid 3% level by year-end. Wage pressures are becoming a concern, with average hourly earnings increasing to 3.2% 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% to 2.5% range over the next few years.

In global bond markets we continue to favour Australian rates versus the rest of the world. We expect the RBA to remain on hold for 2019 and beyond. We are somewhat surprised by market expectations for a 0.25% cut as early as February 2020, but still remain biased for a longer-term cut. 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. 270,000 jobs added in 2018 reconfirm the continuation of 2017's strong employment data when 400,000 jobs were added. 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 ten 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%, 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. Whilst still strong, jobs growth slowed in 2018 and weaker household consumption and still heavily indebted consumers will keep the RBA on the sidelines.

We continue to hold a positive view on investment grade credit in Australia, largely due to attractive real yields, the 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 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. 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 avoid further stimulus. 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 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 reappear, with little growth and inflation prospects in the Southern European region.

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