Kapstream
—JANUS HENDERSON—

Monthly Report

Kapstream Absolute Return Income Fund

February 2019

Performance	Month (%)	3 Months (%)	1 Year (%)	3 Years (%) p.a.	5 Years (%) p.a.	Since Inception[1] (%) p.a.
Portfolio (gross)[2]	0.44	0.97	2.81	3.75	3.78	5.40
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.26	0.71	2.29	2.12	2.39	3.53
Active return (gross)[3]	0.18	0.25	0.51	1.63	1.39	1.86

1. Fund inception 31 May 2007
2. Gross returns exclude impact of ongoing management fees. No allowance is made for tax.
3. Numbers may not add due to rounding
4. Benchmark performance includes the RBA Cash Rate until 31 January 2014.

Portfolio Commentary

The Fund returned 0.44% before fees (and 0.41% after I share class fees) in February. The Fund's coupon income remained the main contributor to returns, while the Fund's corporate holdings also contributed positively as spreads continued to rally. Long positions in Australian, US and New Zealand rates also aided returns although interest rates were generally rangebound.

Global data was mixed, but generally more muted than prior months. US jobs data remained strong but Chinese manufacturing again weakened. In Australia, private sector credit growth slowed to its lowest pace in more than 30 years, leading to greater probabilities of an eventual Reserve Bank (RBA) cut. 2018 growth fell to 2.3%, well below the RBA's optimistic 2.8% forecast and second-half 2018 growth falling to 1.0%. US equity markets rallied further with the S&P up 11% YTD, its best start since 1987. Talk of a China trade deal, uncertainty over Brexit negotiations and Trump/Kim Jong Un peace negotiations weighed on markets over the month.

The US Federal Reserve (Fed) and RBA continue to telegraph a more neutral stance between prospects for future rate hikes vs. cuts, although markets still price in small probabilities of a cut in both markets over the course of 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 less than 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 and are now even pricing in a 2019 cut. We expect to maintain Australian and New Zealand duration in the 0.5 to 0.7 year range and US duration in the 0.5 year range for a total portfolio duration of more than 1 year, our longest duration position in many years. We had removed the Fund's short US duration position amidst growing geopolitical and economic risks and expectations that growth will underperform current expectations. We still favour Australian and New Zealand rates given our expectations for their central banks to maintain low rates through 2019 and beyond, but US rates are also becoming more attractive despite recent rallies.

Outlook

February's 20,000 payroll gain is not as weak as the number suggests and is more likely payback from prior months' outsized gains. We expect 200,000/month gains in coming months, consistent with the past few years but moderating jobs gains are likely as growth cools. We also worry that 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 continuing 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. 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 increases rising 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 2.0%-2.5% over the next few years.

In global bond markets we continue to favour Australian rates versus the rest of the world. We had been more dovish than market consensus in terms of the future path of short-term rates, but markets now price in one RBA rate cut over 2019 and we are becoming more neutral to that view. 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. Australia's property downturn continues to deepen, but the employment story remains relatively robust. 270,000 jobs were added in 2018 and reconfirm the continuation of 2017's strong employment data when 400,000 jobs were added. Tougher lending standards as regulators crack down on risky lending, while long-term positive, will keep house prices under pressure over 2019.

Chinese growth continues to be key for Australia and we remain optimistic despite a deceleration in credit provisions and a looming trade war. Chinese GDP at near 6.25%, 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.

Solid 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 27 years of recession free growth. However, non-mining investment, an overlevered consumer, housing market stress and a lack of wage growth will cause the RBA to tread carefully.

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 at about two-thirds 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 2019 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. It was not surprising to hear the ECB capitulated on its previous optimistic growth forecasts and now expect growth in the still unrealistically hopeful 1% region.

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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