Kapstream
—JANUS HENDERSON—

Monthly Report

Kapstream Absolute Return Income Fund

June 2019

Performance

	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Portfolio (gross)[2]	0.37	1.28	4.20	3.81	3.82	5.42
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.25	0.77	2.76	2.19	2.41	3.53
Active return (gross)[3]	0.13	0.51	1.44	1.62	1.41	1.89

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.

Performance

The Fund returned 0.37% in June, and 2.81% calendar year-to-date, before fees (respectively 0.34% and 2.59% after class I unit fees). Coupon income remained the main contributor to returns, and long interest-rate positions in Australia and the US also aided returns as bond yields continued to fall amidst expectations for a future series of global central bank rate cuts.

Geopolitical risks and the resulting prospects for lower growth have caused financial markets to dramatically reverse course over the year-to-date period. Equity and bond markets have reached new highs as markets reassess the future path of short-term rates. In the US, market expectations have moved from 4+ expected US rate hikes last year, to 4+ expected rate cuts this year. In Australia, markets went from 1 expected rate hike in 2019 last year to a current competition over who can forecast the most rate cuts over 2019-2020.

Portfolio Strategy

We continue to retain a higher level of portfolio risks believing, despite recent market volatility, that rates will remain low and corporate profitability will remain strong. We have maintained our low cash position at less than 5%, given attractive corporate issuance. With market expectations of a further RBA cut in 2019 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 for some time. We had removed the portfolio's short US duration position in January amidst growing geo-political 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 as the Fed nears the end of its rate hiking cycle.

Outlook

As we stated last month, February's US 20,000 payroll gain was an anomaly and 200,000/month gains in coming months, consistent with the past few years, are likely. However, we still worry that a full-blown trade war and political gridlock could reduce US growth by up to 0.5% annually, completely unwinding the benefits of recent tax cuts. Given a split Congress, significant policy changes are unlikely for the next two years and prospects for major infrastructure spending or tax and healthcare policy adjustments will be limited. Relaxation of regulatory reform will likely 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 little political incentive for a solution, leading to a long, drawn-out saga with no near-term resolution. Immigration, health care and further tax reform are also off the table over the next two years.

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 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 elevate given increasing wage pressures, it will remain well contained in the 2.0% 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 had been more dovish than market consensus in terms of the future path of short-term rates, but with markets now pricing in one more RBA rate cut over 2019 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 will remain key for Australia and we remain optimistic despite a deceleration in credit provisions and a looming trade war. Chinese GDP remaining 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 which 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. 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.

We have mainly avoided UK positions since the 2016 Brexit vote, believing we had little insight into the political decisions that will ultimately drive economic performance. We had been skeptical over the leadership's ability to deliver a workable Brexit solution and recent developments reinforce our view.

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