Kapstream
— JANUS HENDERSON —

Monthly Report

# Kapstream Absolute Return Income Fund

## August 2019

| Performance | Month (%) | 3 Months (%) | 1 year (%) | 3 years (%) p.a. | 5 years (%) p.a. | Since Inception[1] (%) p.a. |
|---|---|---|---|---|---|---|
| Portfolio (gross)[2] | 0.36 | 1.21 | 4.38 | 3.72 | 3.83 | 5.41 |
| 50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index | 0.17 | 0.62 | 2.72 | 2.16 | 2.38 | 3.51 |
| **Active return (gross)[3]** | 0.20 | 0.59 | 1.66 | 1.56 | 1.45 | 1.90 |

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 Commentary

The Fund returned 0.36% before fees and 0.33% after class I unit fees in August. Coupon income and interest-rate duration were the largest contributors. Currency positions slightly detracted, as did spread widening and positions intended to protect against Italian bank defaults. The RBA left rates unchanged as expected but markets still anticipate a further 0.50% reduction by year end. Argentina edged nearer default, extending capital controls as the currency fell 30%. Clarity surrounding UK Brexit remained elusive despite Parliament rejecting a no deal exit. Hong Kong entered week 13 of protests despite eliminating the extradition law proposal. US/China trade negotiations remain far from settlement.

### 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 solid. We have maintained our low cash position at about 4%, given attractive corporate issuance. Despite market sentiment for further RBA cuts, we still believe the RBA is likely to maintain rates near 1% for some time, although they will cut in 2020. We expect to maintain total portfolio duration of 1.25 years, longer than historically given our views of low inflation prospects, continuing global tensions, and global central banks remaining in easing mode.

### Outlook

While US jobs growth has slowed, 180k/mth gains remain likely. Trade war and political gridlock could reduce US growth by 0.5%. We expect unemployment to move beyond its near 50 year low, to mid 3% levels. Wage pressures are becoming a concern, with average hourly earnings up 3.3% and the ratio of job seekers to available jobs moving from 9:1 to 1:1. While core inflation may rise, it will remain around 2%.

We continue to favour Australian rates. Markets price in two RBA cuts over the next year. Australia's property downturn continues and tougher lending standards will keep house prices tight. Employment remains relatively robust; 270k jobs added in 2018 reconfirms continuation of 2017's strength (+400k). Asian growth, employment gains and improved terms of trade support a solid domestic story. However, non-mining investment, overlevered consumers, housing stress and limited wage growth will cause the RBA to tread carefully.

We view Australian investment grade credit positively; attractive real yields, issuer health, and wider yield spreads compared to elsewhere. Portfolios reflect this, with Australian issuers accounting for ~2/3rds of holdings. Favoured sectors remain financials (attractive yields and liquidity), and infrastructure e.g. airports and toll roads (attractive yields, solid cashflow, monopolistic attributes, strong regulation, quality underlying collateral). While banks came under pressure with the revelation of a new bank tax, rating downgrades of tier 2 banks and tier 1 hybrids, and Royal Banking Commission disclosures, we remain bullish on Australian senior bank debt given conservative models, strong profitability and implicit government support. Exposure is balanced between Big 4 issuers and regional banks and credit unions (for their additional yield).

Elsewhere, we like systemically important, highly rated Asian issuers, and US 'too-big-to-fail' banks supported by an increasingly robust regulatory environment.

Not so Europe where stresses have increased; another new Italian government likely to continue focusing on lower taxes/higher spending, unconcerned with growing deficits. With those risks increasing, how can the ECB avoid further stimulus? We expect 2019 growth and inflation to underperform expectations particularly in peripheral regions. Low/negative bond yields already reflect this. The ECB capitulated on its previous optimistic growth forecasts, now telegraphing a still unrealistic 1% level.

Bond opportunities are limited given low/negative yields and risks associated with higher-yielding assets. We continue to avoid Europe given Brexit uncertainty and limited corporate profitability, and concern over European banks; although somewhat improved with bank bad debt sales and capital increases, peripheral stresses remain. While the ECB may paper over the problem in the shorter-run, balance sheet expansion is likely, at least before weaker bank nationalization. While sometime away, we expect QE to reappear, with little growth and inflation prospects in Southern Europe. The UK has mostly been avoided since the 2016 Brexit vote; recent developments reinforce our low confidence in a workable Brexit solution anytime soon.

## Contact Details

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