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

September 2019

Performance

	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Portfolio (gross)[2]	-0.01	0.82	4.19	3.63	3.76	5.37
50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index	0.04	0.42	2.63	2.15	2.36	3.49
Active return (gross)[3]	-0.06	0.40	1.56	1.48	1.41	1.88

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 -0.05% in September (after class I unit fees). Coupon income remained the largest contributor, but our ~1yr rate duration offset these gains. Corporate bond spreads tightened somewhat, aiding returns whilst positions intended to protect against Italian bank defaults detracted. The RBA and the Federal Reserve cut rates, as expected. Brexit clarity remains uncertain, while Hong Kong entered its 17th week of protests with resolution elusive. US/China trade negotiations remained a failure amid continuing Chinese manufacturing retraction. In the US, Ukraine/impeachment talk continued to drive market volatility. The US S&P still eeked out a positive return, but bond yields rose despite geopolitical risks and little prospect for inflation.

Portfolio Strategy

We retain a higher level of portfolio risk believing, despite recent market volatility, that rates will remain low and corporate profitability solid. We have maintained a low cash position at ~2%, given attractive corporate issuance. Despite market sentiment for further RBA cuts, we still believe the RBA is likely to maintain rates near 0.75% for some time, although they will cut in 2020. We expect to maintain Australian and US duration each in the 0.50 to 0.80 year range for a total of ~1.25yrs; longer than historically given our views of little inflation, continuing global tensions and central banks continuing to ease.

Outlook

While US jobs growth has slowed, 150k/mth gains are likely. Trade war and political gridlock could reduce growth by 0.5%. We expect unemployment to move beyond its near 50yr low to mid 3%. Wage pressures are becoming a concern, with average hourly earnings rising by 3%+ and the ratio of job seekers to available jobs moving from 9:1 to 1:1. Whilst core inflation may rise, it will remain around 2%.

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

We continue to view Australian investment grade credit positively; attractive real yields, issuer health, and wider yield spreads compared to elsewhere. Portfolios reflect this, with domestic 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 the 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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