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

KANGANEWS AWARDS 2018 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

Kapstream
—JANUS HENDERSON—

Monthly Report

Kapstream Absolute Return Income Fund

October 2019

Performance

	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Portfolio (gross)[2]	0.13	0.48	3.97	3.65	3.74	5.34
RBA Cash Rate	0.07	0.23	1.30	1.43	1.67	3.23
Bloomberg AusBond Bank Bill Index	0.08	0.25	1.65	1.77	1.98	3.50
Active return (gross)[3]	0.06	0.25	2.67	2.21	2.07	2.11

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. Active return is based on RBA Cash Rete

Portfolio Commentary

The fund returned 0.09% in October (after class I unit fees). Coupon income was the largest contributor, but ~1yr duration exposure offset much of this. Spreads tightened, aiding returns. Global markets continued pricing out further policy accommodation; the RBA held at 0.75%, Lowe citing negative rates “extraordinarily unlikely”; US Fed Chair Powell hinted at a pause in easing saying “risks have moved in a positive direction”. Markets increased expectations for a ‘phase 1’ trade deal with China despite prior announcement of additional US tariffs on $125bn of Chinese goods, and China retaliating with new tariffs on $75bn of US goods. Despite this and other uncertainties, equity markets approached new record highs, with indices now up 20%-30% CYTD.

Portfolio Strategy

We retain a higher level of portfolio risk believing, despite recent market volatility, that rates remain low and corporate profits solid. We have maintained a low cash position, given attractive corporate issuance. We believe the RBA likely to hold near 0.75% in the near term and expect to maintain AU and US duration each at ~0.5yr for a total of ~1.0yr, longer than historically given low inflation, global tensions and central banks remaining in easing mode. In ‘alpha’ trades, we observe good relative value and attractive funding costs in select short-dated investment grade repo opportunities, lifting repo exposure to ~6% to enhance returns, purchasing mainly <2yr maturity bonds of high quality issuers in telecoms, banking, property and rental sectors.

Outlook

We still worry that a full-blown trade war could reduce US growth by up to 0.5% annually, unwinding recent tax cut benefits, and causing economic policy gridlock given a split Congress. Material policy progress is unlikely for the next two years and prospects for major infrastructure spending or tax and healthcare policy adjustments limited. Trade policy is also likely to remain unchanged with continuing trade war rhetoric and no near-term resolution. Impeachment proceedings will further hamper progress. While jobs remain solid and wage pressures in the 3% range, we expect core inflation to remain around 2%. Favoured US holdings remain ‘too-big-to-fail’ banks, with bonds supported by a robust regulatory environment; less risk taking and greater capital requirements.

Despite strong rallies, we still like Australian rates. We’d been more dovish than consensus over the path of short-term rates as markets had priced in hikes in 2018, but now price in a hold until 2020. The RBA has not penciled in any further near-term cuts, but will await employment data. We continue to hold a positive view on investment grade credit in Australia, due to attractive real yields, issuer health and wider spreads vs other developed markets. As such, portfolios continue to have material exposure to Australia, currently around 2/3rds, favouring financials due to yields and strong liquidity and infrastructure (e.g. airports, toll roads) offering attractive yields, solid cashflow, and monopolistic structures with high regulation and quality underlying collateral and being of systemic national importance. We remain bullish on Australian banks given conservative business models, strong profitability and implicit government support, though moving out of Big 4 issuers into the second tier – regional banks, credit unions – to pick up yield. We favour Tier 2 given wider yields following increased regulatory capital requirements and expectations for greater supply. While bank lending margins have held up well amidst falling rates, we’ll limit these positions over concern that lower RBA rates will continue to hurt margins. A continuing 2018/19 theme was getting paid for liquidity, and we’ve added to Australian MBS/ABS, upto ~20% of the portfolio, and focused on AAA and AA MBS given attractive yields and little default risks.

In Asia, we like systemically important, highly rated issuers; government-related energy, telecom and banking entities. We remain less positive on Europe, where stresses have increased. We believe it difficult for the ECB to avoid further stimulus, and expect 2019 growth and inflation to underperform expectations amidst structural rigidities in labour and product markets, particularly in the periphery. Low/negative yields already reflect this scenario. It was unsurprising to hear the ECB capitulate on its previous optimistic growth forecasts, and now expect growth in the still unrealistic 1% range. 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 Brexit uncertainty, 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 periphery. While the ECB can 'paper over' the problem in the short-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, having little insight into the political decisions that will ultimately drive economic performance, and scepticism over the leadership's ability to deliver a workable solution; recent developments reinforce our view.

Contact Details

Courtney Chute - Portfolio Analyst, Kapstream Capital | Tel 02 9234 0009 | email: Courtney.Chute@kapstream.com