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

November 2019

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Fund Return (Gross of fees)	0.23	0.35	4.19	3.73	3.69	5.33
Fund Return (Net of fees)	0.20	0.24	3.74	3.30	3.26	4.99
RBA Cash Rate	0.06	0.21	1.23	1.41	1.64	3.22
Active return (Gross of fees)[1]	**0.17**	**0.14**	**2.96**	**2.32**	**2.05**	**2.11**
Bloomberg AusBond Banks Bill Index	0.08	0.25	1.58	1.75	1.95	3.49

Past performance is no guarantee of future results. Net of fee returns inclusive of 0.41% annualised total expenses for class I units. Fund inception date 31 May 2007. No allowance is made for tax. Numbers may not add due to rounding.
[1] Active return of the Fund compared to Benchmark (RBA Cash Rate).

Portfolio Commentary

The Fund returned 0.20% in November (after class I unit fees), coupon income remaining the largest contributor. Corporate bond spreads tightened, aiding returns, while overall duration of 1yr was relatively neutral.

Uncertainty over a 'phase 1' China trade deal dominated as prospects for further tariffs on $125bn of Chinese goods and new China tariffs on $75bn of US goods approach a mid-December deadline. Nonetheless, markets price out further policy easing; the RBA held at 0.75%, Governor Lowe stating negative rates "extraordinarily unlikely", and US Fed Chair Powell hinted at a pause, "risks have moved in a positive direction since the last meeting". UK Brexit solutions remained elusive, HK protests continued and Trump impeachment talks progressed. But equity markets again approached new record highs.

Portfolio Strategy

Global bond yields are ugly, but less so in the US, here and NZ, with the latter two central banks stating that monetary policy has limited further positive impact. Trade war Trump tweets continue to confuse. An unresolved trade war will keep US rates low, but it's a political rather than economic game. Given low volatility priced into bonds we favour staying long duration while also having long put options, should our lower rates view be wrong. We expect to maintain Aus and US duration each at 0.5-0.8yr, a total of 1.0-1.5yrs. We've maintained low cash, given attractive issuance, believing the RBA maintains at 0.75% awhile, before cutting in 2020. At ~9% of the portfolio, we still favour select investment grade repo, buying mainly <2yr maturity bonds in telecoms, banking, property and rental sectors.

Outlook

In the US we still worry that the trade war could reduce annual growth by ~0.5%, unwinding tax cut benefits, and causing economic policy gridlock. Material policy progress is unlikely for the next two years and prospects for major infrastructure spending or policy adjustments limited. Trade policy is also likely paralyzed with continuing trade war rhetoric and no near-term resolution. Impeachment proceedings will further hamper progress. While jobs remain solid and wage pressure around 3%, we expect core inflation to stick around 2%. Favoured holdings remain 'too-big-to-fail' banks, with bonds supported by a robust regulatory environment; less risk taking, greater capital requirements.

Despite strong rallies, we still like Australian rates. We'd been more dovish than consensus over the future path of short-term rates as markets had priced in hikes in 2018, but now price in a hold until 2020. The RBA hasn't penciled in any further near-term cuts. Governor Lowe has cited a terminal rate of 0.25% suggesting this the lower bound due to RBA bank deposits earning the cash rate less 0.25%.

We still favour Australian investment grade credit due to attractive real yields, issuer health vs other developed markets, and wider yield spreads vs comparable US, Euro and Japanese issuers; portfolios continue to have material Australian exposure, 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, quality underlying collateral and 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; we've added to Australian MBS/ABS, upto ~20% of the portfolio, focused on AAA/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, with increased stresses. 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, bond opportunities are limited given low/negative yields and risks associated with higher-yielding investments. We continue to avoid Europe, given Brexit uncertainty, low yields and limited corporate profitability. We remain concerned over European banks, 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. In the interim, we expect QE to reappear, with little growth and inflation prospects in southern Europe.

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

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