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

January 2020

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Fund Return (Gross of fees)	0.66	1.02	4.47	3.81	3.61	5.32
Fund Return (Net of fees)	0.63	0.90	4.00	3.37	3.18	4.98
RBA Cash Rate	0.06	0.19	1.11	1.37	1.58	3.18
Active return (Gross of fees)[1]	0.60	0.83	3.36	2.44	2.04	2.14
Bloomberg AusBond Bank Bill Index	0.08	0.24	1.40	1.70	1.88	3.45

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 0.66% in January (after I class unit fees). Coupon income remained a large contributor, while Australian corporate bond spreads tightened, aiding returns. Whilst US corporate bond spreads widened over the month, a continuing bias to Australian corporate bonds more than offset US underperformance. Overall portfolio duration of 1.25yrs was also a large contributor as global rates fell in response to concern over the spread of the coronavirus. Despite this, risk assets remained steady. In Australia, the ASX was up ~5% whilst US equity markets were slightly down. Commodity markets were volatile, with oil down 15%, but 'risk-off' assets such as gold rose 4% and bitcoin 30%.

Portfolio Strategy

We remain concerned that coronavirus data underreports the severity. We will maintain our long duration positions even with ugly global bond yields. Australian and New Zealand central banks have indicated that government fiscal spending must take up the reins with monetary policy having limited further impact. Both governments will eventually spend, Australia slower given political pressure on the Liberal majority to deliver a fiscal surplus through May 2020. Central banks are near the end of cutting cycles, although we can't envision rates moving higher over the next few years despite solid jobs data.

We foresee sub-trend growth in most developed economies; in Australia 2.0-2.5%, prolonging the sub-trend status of the past few years. Whilst the job growth story remains attractive, wage growth will struggle, capping overall inflation. The RBA will continue to cut rates, but have indicated a 0.25% terminal level, likely reached by year-end.

Global rates will continue to be led by the US. We remain confused by market reactions to random Trump trade war tweets. We're general believers in lower US rates as the trade war will remain unresolved, despite the Phase 1 deal. However, we view the trade war as a political game rather than economic story and don't place a high conviction/information ratio on lower rates/longer duration. Given still low volatility priced into bond markets we'll remain long duration while being long put options on bonds, should our central scenario of lower rates be wrong.

We will continue to retain a higher level of other portfolio risks believing, despite recent volatility, that rates remain low and corporate profitability solid. We have maintained low cash, given attractive issuance. We believe the RBA is likely to maintain rates near 0.75% for some time, though cutting later in 2020 toward 0.25%, the bottom of their range. We expect to maintain Australian and US duration in the 0.5-0.8yr range for each market, making a total portfolio duration of 1.0-1.5yrs, longer than historically given our views of little inflation, continuing global tensions and global central banks remaining in easing mode.

Outlook

In the US a full-blown trade war could reduce US growth by up to 0.5% annually, unwinding the benefits of recent tax cuts. We see economic policy gridlock given split Congress. Policy progress is unlikely until the November elections 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, albeit with little political incentive for a solution, leading to a long, drawn-out saga with no near-term resolution. While the jobs story remains solid with wage pressures in the 3% range, we expect core inflation to stay contained around 2% over the next few years as worker bargaining power remains weak, providing a cap on wage gains. Favoured US holdings are dominated by 'too-big-to-fail' banks, whose bonds are supported by an increasingly robust regulatory environment focused on less risk taking and greater capital requirements.

We like Australian rates, and 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, Euro and Japanese issuers. Therefore, portfolios continue to have material Australian exposure, currently ~2/3rds of total holdings. Favoured sectors remain financials due to attractive yields and greater liquidity, and infrastructure such as airports and toll roads which offer attractive yields, solid cashflows, and typically monopolistic structures with high regulation and quality underlying collateral, and retain systemic importance. We remain bullish on Australian banks 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, to pick up additional yield. We also favour tier 2 given wider yields following increased regulatory capital requirements and expectations for greater new supply. While bank lending margins have held up in a falling rate environment, we'll limit these positions over concern that lower RBA rates will hurt margins. A continuing theme will be getting paid for liquidity. We've added to MBS/ABS, currently about 20% of the portfolio, focusing on AAA/AA given attractive yields and little default risk.
In Asia, we like systemically important, highly rated issuers such as government-related energy, telecom and banking entities. It appears the coronavirus will have a negative impact over Q1 and Q2, which is what markets currently price in. We remain concerned of a deeper impact in terms of both infection and longevity. A more cautious approach remains warranted.

We remain less supportive of European bonds. Stresses in the Euro region have increased. We believe it difficult for the ECB to avoid further stimulus. We expect 2020 growth and inflation 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 capitulate on previous optimistic growth forecasts, now expecting 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 with higher-yielding investments. We expect to continue to avoid Europe, given uncertainty surrounding Brexit, 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 improved somewhat, stresses remain in the peripherals. While the ECB has the capacity to paper over the problem in the short-term, balance sheet expansion will be likely, at least before nationalization of weaker performers. This scenario may be 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. We had been skeptical over the leadership's ability to deliver a workable Brexit solution, despite the 31 January withdrawal. The real work in terms of agreements is yet to begin.

Contact Details

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