Kapstream
—JANUS HENDERSON—
Quarterly Report

Kapstream Absolute Return Income Fund

December 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)	0.12	0.48	4.15	3.72	3.60	5.30
Fund Return (Net of fees)	0.08	0.36	3.69	3.28	3.17	4.96
RBA Cash Rate	0.07	0.19	1.17	1.39	1.61	3.20
Active return (Gross of fees)[1]	**0.05**	**0.29**	**2.98**	**2.33**	**1.99**	**2.10**
Bloomberg AusBond Banks Bill Index	0.12	0.48	4.15	3.72	3.60	5.30

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 0.12% in December and 4.15% over 2019 (after I class unit fees), coupon income consistently the largest contributor. Corporate bond spreads tightened over the month and year as central banks continued to telegraph lower rates, forcing investors into riskier assets, aiding returns. Overall duration of 1yr was also a large contributor over the year as global rates fell.

It was hard to find many negatives in 2019 financial markets. Following the Fed's interest rate policy u-turn at the start of the year, most risk assets rallied. In the US, the S&P was up 28% and the Barclays bond index 15%. Likewise, Australian markets rallied to an impressive but smaller degree, with the ASX up 23% and bond markets up more than 7%. Commodity markets also saw impressive gains, with oil up 36%, gold up 19% and even coffee up 29%. As markets returned to 'risk on' mode, M&A activity increased, capital markets saw record issuances and we saw the world's largest IPO, Saudi Aramco, which also raised USD12bn in its debut global bond sale.

But not everything was positive. UK star manager Neil Woodford imploded, putting a spotlight on liquidity risks. Argentinian risks were again revived following the victory of a leftist president, causing government bonds to fall more than 40%. The Argentinian peso also fell 20% vs. the USD. Fragility in financial markets was exposed when repo markets, historically a financial backwater, saw unexpected volatility, forcing the US Fed to temporarily inject hundreds of billions of dollars to stem the crisis. WeWork's IPO became the highest profile flop in history, forcing the scrapping of plans due to concerns over leadership, not helped by touting the smoking of pot on the corporate jet, amongst other indiscretions.

The Fed ended 2018 by hiking rates for the 4th time in 12 months and signaled that further hikes were likely. By January 2019, the Fed announced a 180 degree turn, telegraphing potential rate cuts, and eventually cutting rates 3 times over the year. Global bond yields approached record lows and by mid-year a record $18 trillion in debt was trading at negative yields (currently 'only' about $11tn of global debt is trading at negative yields).

Trade war rhetoric increased following an initial Trump tweet complaining about ECB stimulus. Threats of tariffs moved beyond Europe and China, all the way to Brazil and Argentina who Trump also complained were manipulating their currencies. The Chinese renminbi fell to 7, its weakest level since the 2008 crisis. We ended 2019 with hopes for a Phase 1 China trade deal which would miraculously solve the world's major economic headwind, and prayers that geo-political risks in US impeachment, Iran war and Hong Kong protests would end better than the current state of the House of Windsor.

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. Both governments will eventually spend, although Australia will be slower to announce spending plans given political pressure on the Liberal majority to deliver a fiscal surplus through May 2020. Australian bushfires may lead the government to spend quicker than initially expected, aiding 2020 growth. Central banks are near the end of their cutting cycles although we can't envision an environment where rates move higher despite solid jobs data out of the US. We will 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, given attractive corporate issuance. We believe the RBA is likely to maintain rates near 0.75% for some time, though cutting in 2020 toward 0.25%, the bottom of their range. We expect to maintain Australian and US duration each in the 0.5-0.8 year range, making a total portfolio duration of 1.0-1.5 years, a longer duration position than we have historically taken given our views of little inflation prospects, continuing global tensions and global central banks remaining in easing mode.

Global rates will continue to be led by US markets. We remain confused by market reactions to random Trump trade war tweets. We are general believers in lower US rates as the trade war will remain unresolved in 2020, despite Phase 1 rhetoric. However, we view the trade war as a political rather than economic game and don't place a high conviction/information ratio on lower rates/longer duration. Given still low volatility priced into bond markets we favour remaining long duration while being long put options on bonds, in case our central scenario of lower rates is wrong.

Outlook

We foresee sub-trend growth in most developed economies. In Australia we expect 2.0-2.5% growth levels, prolonging the sub-trend status of the past several years, despite eventual increases in government spending. Whilst the job growth story will remain attractive, wage growth will continue to struggle, capping overall inflation. The Reserve Bank will continue to cut rates, but has already telegraphed a 0.25% terminal level, which will be reached by year-end.

We like Australian rates, and don't believe the RBA has penciled in any further near-term cuts, but will await data indicating weaker employment. 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 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 the US we still worry that a full-blown trade war could reduce growth by up to 0.5% annually, completely unwinding the benefits of recent tax cuts. We see economic policy gridlock given a split Congress. Material 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 drawn-out saga with no near-term resolution. Impeachment proceedings will further hamper progress. Nonetheless it will be virtually impossible for Trump to be convicted in the US Senate. While the jobs story remains solid and wage pressures remain in the 3% range, we expect core inflation to be well contained in the 2% range 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.

In Asia, we like systemically important, highly rated issuers such as 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 2020 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 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 has the capacity to continue papering 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 years away. In the interim, we expect QE to reappear, with little growth and inflation prospects in southern Europe.

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