Kapstream
— JANUS HENDERSON —

Quarterly Report

Kapstream Absolute Return Income Fund

June 2021

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Fund Return (before fees and sell spread)	0.04	0.31	2.32	2.60	3.00	4.89
Fund Return (after fees, before sell spread)[1]	0.00	0.20	1.90	2.14	2.55	4.54
Fund Return (after fees and sell spread)[2]	0.00	0.20	2.02	2.11	2.54	4.54
RBA Cash Rate	0.01	0.02	0.15	0.77	1.06	2.88
Active return[3] (before fees and sell spread)	0.03	0.29	2.17	1.83	1.94	2.01
Active return[3] (after fees and sell spread)[2]	-0.01	0.18	1.87	1.34	1.47	1.66
Bloomberg AusBond Banks Bill Index	0.00	0.01	0.06	0.96	1.29	3.12

Past performance is no guarantee of future results. After fee returns are 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) For a continuing investor the actual return experienced based on the NAV performance of the Fund, after accounting for management fees. 2) The return experienced by a redeeming investor, based on the exit price performance of the Fund which accounts for the end of period sell spread of 0.07% and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate).
Source: Fidante Partners Limited, 30 June 2021.

Performance & Market Commentary

The fund was essentially flat in June returning 0%, and modestly positive over the June quarter returning +0.20% (both after I class unit fees), though has performed well over one year despite a volatile environment. At a higher level, while coupon income remained a positive contributor throughout, interest rate exposure of ~0.75 years' at the end of June, having been systematically reduced over the calendar year-to-date period, was an offset to this as rates remain elevated. Australian yield curve positioning, long 10-year rates vs 3- and 5-year rates added value as the yield curve flattened. Corporate positions continued to aid returns as corporate bond spreads narrowed. Default risks in high-quality corporate bonds remain small although current pricing more accurately reflects this decreased risk. Our currency positions, long US dollar against the CAD, GBP, JPY and Euro, aided returns as the US dollar strengthened.

The Australian yield curve flattened over the month as 10-year Australian government bond yields fell from 1.71% to 1.53% while 5-year government bond yields remained flat at 0.82%, and 3-year yields rose from 0.27% to 0.41%.

The RBA balanced improving economic conditions including unemployment falling to 5.1% – effectively recovering all jobs lost during the pandemic – versus declining sentiment following new Sydney lockdowns and growth of the delta variant of COVID-19. In more recent statements, the RBA cast wider scenarios for the future cash rate, acknowledging improving conditions and forecasting the eventual reining in of quantitative easing and yield curve control. Although still unlikely prior to 2024, markets now forecast small prospects for rate hikes by the end of 2022.

Outlook & Portfolio Strategy

We remain optimistic on global recovery, perhaps seeing global GDP return to pre COVID-19 levels by Q4 2021. We expect greater levels of vaccination opening businesses sooner and permeating to additional pockets of global economies. However, as demonstrated in Sydney, the effects of the pandemic will remain with us throughout 2021 and 2022, as the Australian border remains closed through the first quarter of 2022 at least. Although we expect a temporary spike in inflation, persistently high inflation is not a story for 2021, given it will take many years to reach full employment globally. Whilst Australian unemployment returned to pre-pandemic levels, the eventual return of foreign workers will keep a lid on wage inflation and overall inflation in the longer-run, keeping a cap on overall interest rates.

It will take many years for US jobs to fully recover the more than 20 million lost over the crisis, and we expect the Federal Reserve to continue its bond purchases and keep rates at zero for the intermediate term.

As telegraphed for some time, we have maintained low cash levels given penalty rates. Strong consumer balance sheets, fiscal expansion and expectations for strong employment data (once the vaccine begins wider distribution) add to our more optimistic outlook. The ability for Democrats in the US to pass budget legislation including greater COVID-19 relief programs mean both fiscal and monetary stimulus will be running on all cylinders in the short run. Whilst we believe bond yields have risen beyond our medium-term expectations, we'll maintain slightly shorter interest-rate duration in the 0.75 year range as volatility remain high.

Low short-term rates are a given for the next 12-18 months. We're not believers in the consensus view for a steeper yield curve as massive deficits fuel record Treasury bond issuance. Lessons from Japan and Europe demonstrate longer-term deflation risks combined with central bank purchases override supply concerns. Nonetheless 2-7 year bonds remain attractive given their yield advantages over cash rates and prospects for 'roll-down' gains or yields falling as these bonds move closer toward maturity.

Bond market liquidity continues to improve toward pre COVID-19 levels. We remain biased toward shorter dated (<7yr) issues, and with a continued avoidance of more volatile or higher beta sectors (such as commodity, energy, gaming, tourism and autos) as well as the worst affected regions. We maintain only a modest exposure to China (and only in USD-denominated quasi-sovereign issuers), and otherwise nothing in emerging markets. Our portfolio can be simply split across three major 'buckets'; financials (~45%), corporates (~30%), and mortgage-backed (~15%) with the residual in governments and cash. Geographically, we have maintained a roughly 2/3rds to 1/3rd split between Australian and international issuers (the latter divided between the US and developed Asia). Again, we have no greater concern with default risk across any portfolios we manage as we did before the turmoil in markets began. For the coming period our main goal will remain protecting the portfolio from a sell-off in risk assets and corporate bond spreads.

Contact Details

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

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