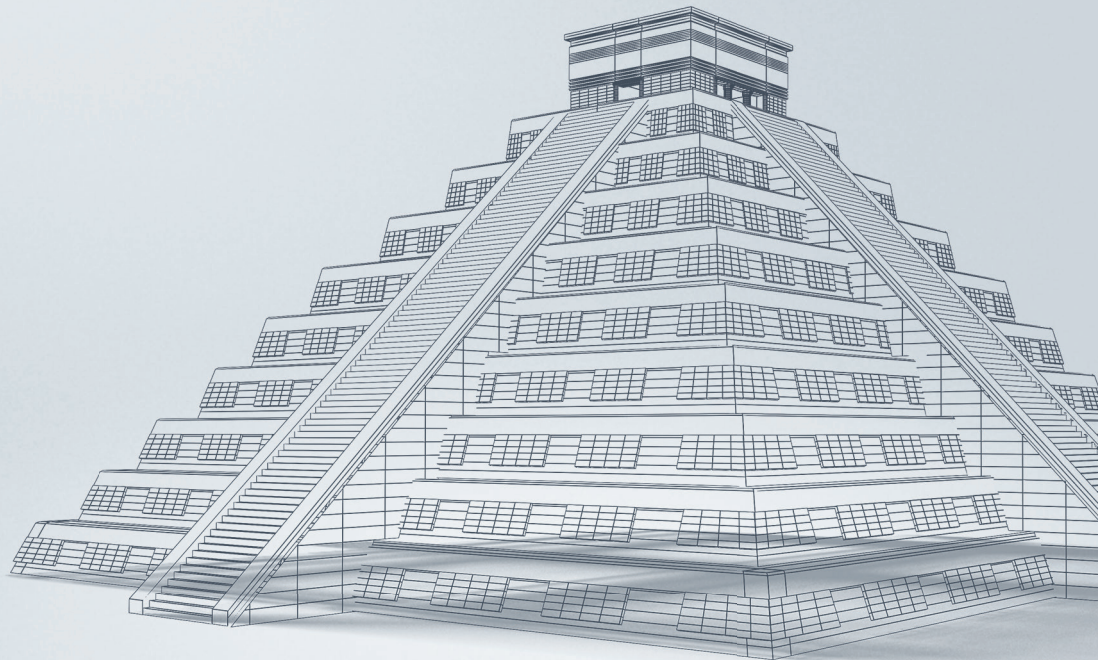


# THOUGHTS AND BONDS

Dealing with Divergence



## About Janus Henderson Fundamental Fixed Income

- 30+ years of experience emphasizing risk-adjusted returns and capital preservation
- Fundamental, independent research focus
- Quantum Global: proprietary research and risk management system
- Integrated fixed income and equity research effort
- Highly collaborative investment team based in Denver and London
- 69 fixed income professionals as of 3/31/18
- \$35.0 billion in assets under management as of 3/31/18

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“ Our current thesis is threefold: the U.S. Treasury curve will continue to flatten, divergence in credit markets will persist with high yield outperforming and credit curves will continue to steepen.”

**Mayur Saigal, Portfolio Manager**

## A Word from our Fundamental Fixed Income Team

As 2017 wound down, bond investors prepared for tighter developed market monetary policy and higher rates. Now, the Federal Reserve (Fed) is delivering, while other major central banks have scaled back hawkish rhetoric. We expect the Treasury curve to move higher and flatter from here and anticipate continued divergence in policy rates between the U.S. and the rest of the developed world. We are, however, mindful of a number of geopolitical risks that could put rate hikes on pause and steer investors toward more defensive assets.

“Buy the dip” served investors in the era of ultra-accommodative monetary policy, but now, as central banks begin to drain liquidity, we believe it’s a thing of the past. Volatility has returned and is here to stay, and we see tail risks on the horizon. In particular, trade policy, the new eurosceptic coalition government in Italy and a significant downturn in global growth could each lead to a sustained risk-off mindset. Amid this environment, we believe investors should be cautious where corporate credit is concerned.

We acknowledge that U.S. corporate fundamentals are strong, tax reform is beneficial and economic growth is decent, all of which can extend the credit cycle, but we are definitely in its later stages. Rates are rising and valuations are rich. Leverage is creeping higher as investment-grade issuers seek to buy growth to combat industry disruption. We expect debt-funded consolidation activity to continue to weigh on valuations. Demand is also tapering, due to a combination of new repatriation policies and higher hedging costs. Investment-grade corporates are struggling in the face of these technical challenges. In contrast, shrinking high-yield supply is supporting valuations, and we anticipate this credit market divergence to continue.

We believe it is prudent to limit credit beta at this point in the cycle, but remain opportunistic. We have shifted our focus to strong risk-adjusted carry opportunities in shorter-dated spread products with minimal interest rate risk. High-yield issuers with fundamental improvement stories could offer attractive return potential. Floating rate securities should also perform well as rates continue to climb. We are monitoring the widening in investment-grade spreads for attractive reentry points. Given the asymmetric risk at this point of the cycle, we believe security avoidance is as important as security selection. This approach aligns with our core tenets of capital preservation and delivering strong risk-adjusted returns.



**Darrell Watters**  
Head of U.S.  
Fundamental  
Fixed Income

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**Chris Diaz, CFA**  
Co-Head of  
Global Bonds

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**Mayur Saigal**  
Portfolio Manager

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**Ryan Myerberg**  
Portfolio Manager

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# RATES

## Fed in the Fast Lane

Jerome Powell's Fed has raised rates twice year to date, lifting the Fed's target rate range to 1.75% to 2%. Recent U.S. economic data support the Fed's actions, with headline inflation creeping above 2% and unemployment at 3.8%. Given their confidence in economic conditions, Fed officials forecast two additional increases this year. We expect that to come to fruition, with more in 2019. However, hikes will likely remain measured in 25 basis point increments, says Portfolio Manager Mayur Saigal, so as not to jar the market.

For years the Fed's desire to raise interest rates was met with skepticism, exhibited in the divergence between the Fed's "dot plot" and market-implied pricing for the forward path of the federal funds rate. The Fed ultimately capitulated to this slower pace of hiking. Now, the Fed is following through on its resolve, says Portfolio Manager Ryan Myerberg, and the market must appreciate, and move to meet, this reality. Currently, however, investors are underestimating the Fed, says Mr. Saigal, which could lead to a dramatic repricing of the 5-year Treasury note. The Fed expects to raise rates six more times by 2020's end, while the futures market is pricing in substantially fewer. The Fed's more hawkish stance suggests it no longer intends to sustain artificial markets, says Mr. Saigal. Fed officials are also keen to have levers to pull in the next economic downturn, he adds. At this juncture, there is little on the horizon to dissuade the Fed from hiking.

### Takeaways

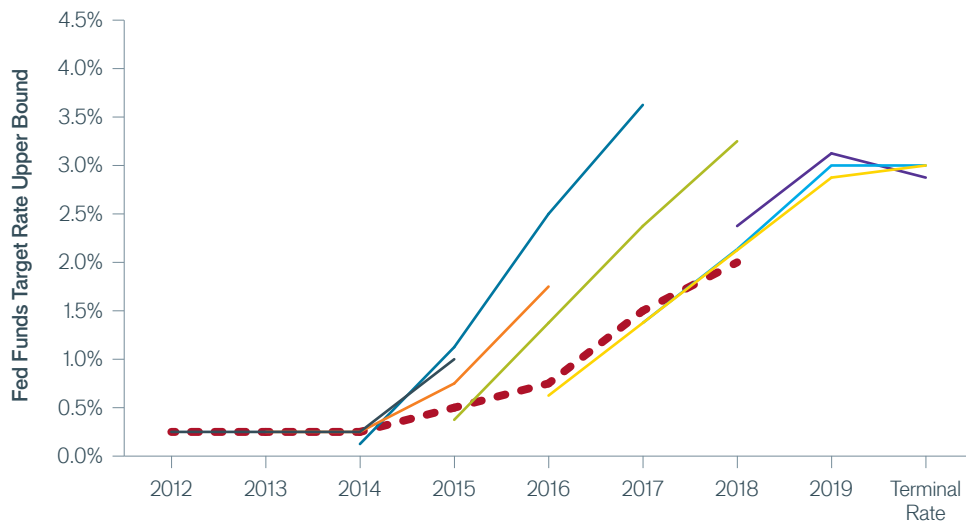
- ▶ Fed rate hikes, in combination with diminished demand for Treasuries and increased supply, should drive U.S. rates higher.
- ▶ The Fed's stable long-term outlook will likely keep longer-dated yields range-bound, leading to a flatter curve.
- ▶ If market expectations catch up to the Fed, the Treasury curve could invert by year-end.

### Exhibit 1: Fed Target Rate Projections and Actual Rate Path

In the past, Fed officials undershot their anticipated path for interest rate hikes. Now, the Fed is following through, and the market must appreciate this reality.

#### Meeting Date

— Dec-12 — Dec-13 — Dec-14 — Dec-15 — Dec-16 — Dec-17 — Jun-18 — Actual



Source: Bloomberg

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With each hike, hedging costs increase for foreign buyers in the U.S. fixed income market and deplete return potential, says Mr. Saigal. Simultaneously, Treasury issuance this year is expected to more than double to compensate for unfinanced corporate tax cuts and other fiscal stimulus. Given the confluence of these events, we believe that the Treasury curve will continue to move higher. However, while the Fed upwardly revised its short-term economic projections, it did not lift its long-term expectations for the terminal rate or economic growth. This stable long-term view leads us to anticipate a higher but flatter curve, says Darrell Watters, Head of U.S. Fundamental Fixed Income. With long-term rates range-bound, Chris Diaz, Co-Head of Global Bonds, is concerned that the yield curve will invert, particularly if the market aligns itself with Fed expectations.

## Political Predicaments

As the Fed and other central banks begin to remove liquidity, we believe the “buy the dip” mentality, so prominent in the era of synchronized central bank accommodation, is a thing of the past. Volatility has resurfaced, says Mr. Saigal, and it is here to stay. We are particularly mindful of two potential tail risks that could incite a more durable risk-off mindset and impact the Fed's ability to raise rates.

The first is trade policy. We are concerned that President Trump's plans to impose tariffs on Chinese imports could escalate into an all-out trade war, says Mr. Diaz. A trade war would weigh heavily on global growth and could force the Fed to break its tightening stride. We would also expect such developments to shatter investor confidence and drive market participants to defensive assets.

Italian politics are also on our radar. The newly formed government between the anti-establishment Five Star Movement and the right-wing League could be on a collision course, says Mr. Saigal. The populist government largely blames the European Union and fiscal austerity for Italy's post-crisis struggles, and has expressed a desire to push back on eurozone fiscal agreements and to unwind previously enacted domestic reforms. Looser fiscal policy in a country with debt to GDP hovering just above 130% would be detrimental not only to Italian spreads versus core Europe, but to the entire periphery, says Mr. Myerberg, as the market still packages Spain and Portugal together with Italy in times of stress. More concerning, says Mr. Saigal, is the contagion risk to global markets should the new government decide to exit the eurozone.

## Mind the Gap

Political landmines aside, developed world rates may move modestly higher in sympathy with the U.S., but we ultimately expect to see a significant divergence in policy rates. European Central Bank (ECB) actions, for example, are setting the stage for a continued gap between U.S. and core European rates. The ECB's intent to end quantitative easing (QE) sounds hawkish; however, it is largely a result of the limited number of securities left available for purchase, says Mr. Diaz. It is also important to keep in mind that reinvested coupons and proceeds from maturing bonds can be used by the ECB to dampen volatility. The market may be underappreciating that policy tool, says Mr. Myerberg. Further, the central bank's decision to hold the overnight rate steady through summer 2019 is undeniably dovish. We therefore expect core European rates to steepen.

## Takeaways

- ▶ While the Fed establishes a more hawkish stance, other major central banks remain accommodative, which will perpetuate the divergence in policy rates.
- ▶ In core Europe, longer-dated rates should rise in sympathy with the U.S. and as QE ends. The front end should remain pinned by the ECB's decision to hold rates steady well into 2019.
- ▶ Geopolitical risks, including trade wars and Italy's new eurosceptic government, pose threats to rising rates.

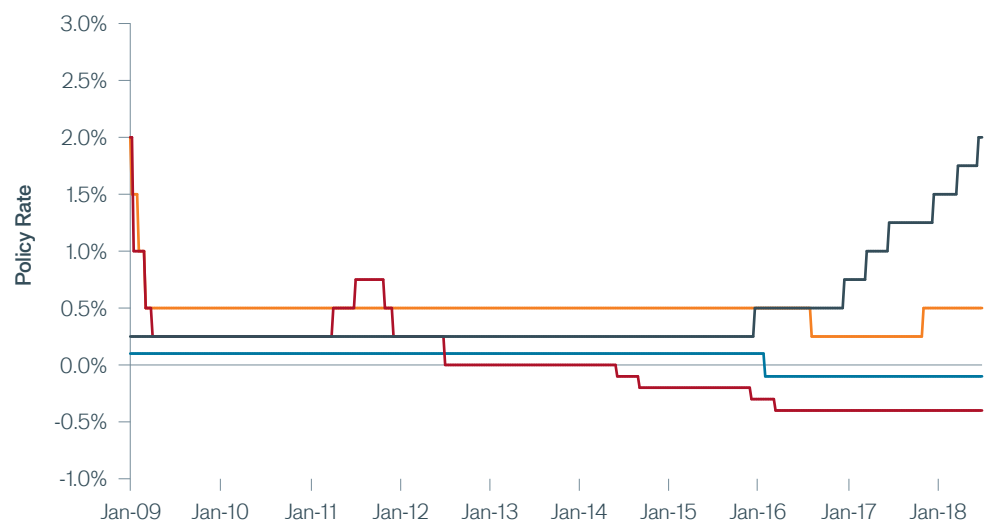
In the UK, we believe the Bank of England (BOE) should hold rates steady, as the economy is slowing and both wages and inflation have recently turned over. Additionally, Brexit looms, and even a soft Brexit would present challenges for the economy. Now is the time for the BOE to be stimulative, says Mr. Myerberg. However, hawkish sentiment from the BOE, along with Brexit uncertainty, makes UK assets unattractive, in our view.

In Japan, inflation remains well below the Bank of Japan's (BOJ) 2% target, and continued easing, to the extent possible, is likely. Similar to the ECB, however, the BOJ faces constraints on the amount of assets available for purchase. Further, recent scandals have impacted the popularity of Prime Minister Shinzo Abe. While not our base case, we are monitoring threats to Abe's ability to maintain power, and whether someone less committed to ultra-accommodative policy could assume leadership of his Liberal Democratic Party.

## Exhibit 2: Global Policy Rates

As the Fed hikes and other major central banks remain accommodative, we expect a continued divergence in policy rates.

— U.S. — Core Europe — UK — Japan



Source: Bloomberg. As of 6/29/18

## Seeking Relative Value

Given that core European rates are pinned, we are finding attractive opportunities elsewhere on the continent. Countries that have tightened their fiscal belts and increased their competitive nature, such as Spain and Portugal, stand to benefit from economic momentum as well as rating upgrades. In such countries, we expect the risk premium over core European rates to eventually compress, Mr. Myerberg explains.

Central banks positioning to hike ahead of the ECB could create compelling currency opportunities. A handful of smaller European economies where growth is strong and inflationary pressures are emerging may need to consider upwardly revising rate paths, says Mr. Diaz. In particular, we are watching economic growth in Scandinavia and tight labor markets in Eastern Europe. ■

# CORPORATE CREDIT

## Consolidation Continues

Corporate earnings continue to be constructive, with S&P 500® earnings growth up 23.94% last quarter versus first quarter 2017. Strong fundamentals are, however, one of the only bright spots for corporate credit, in our view.

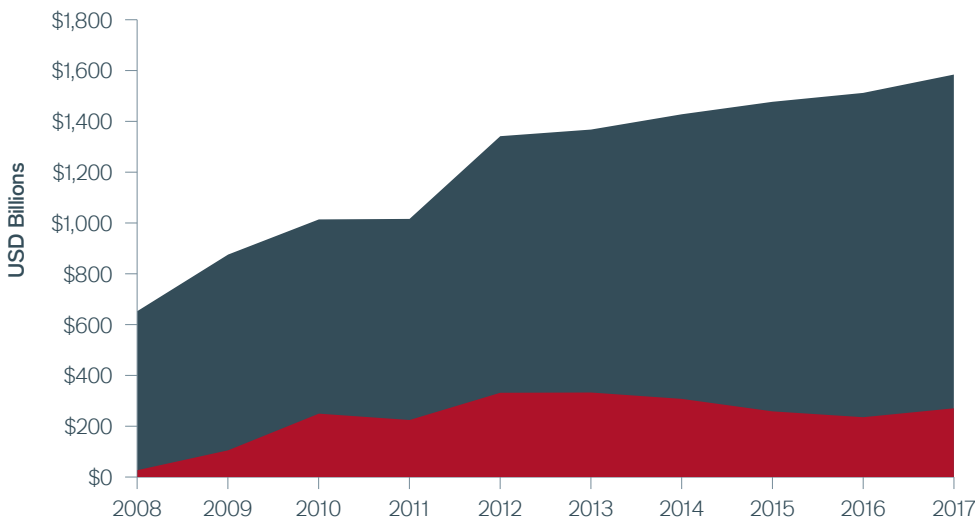
Given the recent clarity of tax reform, companies appear keen to undertake capital expenditures and consolidation activity. We are concerned with elevated merger and acquisition (M&A) activity being financed with debt. The recent approval of AT&T's acquisition of Time Warner creates precedent for vertical mergers, says Mr. Watters, which is likely to encourage even more consolidation activity. A number of investment-grade companies, particularly in the BBB-rated space, are seeking to buy growth, says Mr. Saigal, and many of them are willing to overpay for it. In some cases, investment-grade balance sheets are taking on high-yield like leverage. Investment-grade valuations remain rich, but have sold off in recent months. We expect debt funded M&A to continue to weigh on valuations.

In contrast to the last few years, spreads on new investment-grade issuance are generally wider than existing bonds and are negatively impacting the secondary market. This is partly because robust supply is hitting at a time when demand is shrinking. As a result of the tax overhaul, U.S. companies that invested profits of offshore subsidiaries in high-grade bonds can instead repatriate those profits at a reduced rate. Further, hedging costs increase as rates rise, making U.S. securities less attractive to foreign buyers. We anticipate these technicals will remain in play, further challenging investment-grade corporate credit.

### Exhibit 3: Corporate Credit Issuance

While investment-grade issuance has steadily climbed, high-yield issuance declined in three of the last four years, and 1Q18 issuance was down 30% versus 1Q17.

■ Investment Grade ■ High Yield



Source: SIFMA, Thomson Reuters Datastream

#### Takeaways

- ▶ First quarter earnings beat analyst expectations, and strength in corporate fundamentals is likely to continue through year-end.
- ▶ However, M&A activity, stretched valuations and rising rates warrant a cautious outlook on investment-grade corporate credit.
- ▶ A shrinking supply technical is favorable for high yield.

## Takeaways

- ▶ We continue to believe that spread tightening will be modest and that carry will be the primary source of returns this year.
- ▶ Risk is skewed to the downside at this point in the cycle, making security selection – and avoidance – a critical aspect of portfolio management.
- ▶ In a rising rate environment, shorter-dated spread products and floating rate securities offer attractive risk-adjusted opportunities with minimal interest rate risk.

## Divergence in the Credit Markets

Despite the recent sell-off in investment grade, we've seen high-yield corporate credit fare generally well, and we believe this can continue, says Mr. Saigal. The asset class is shrinking, creating a technical tailwind. Balance sheet behavior in the sector has largely improved, leading to a higher-quality ratings mix in the high-yield index. Additionally, those high-yield entities that are raising capital are often issuing leveraged loans instead of fixed-rate bonds (or some combination thereof). Thus, high-yield bond issuance is on the decline. Combined with investors' reach for yield, this factor is supportive of continued spread tightening.

Positive total return will be difficult to come by this year, and we believe the ability to out-carry, or earn more income than the index, will be crucial. To that end, high yield remains attractive. However, valuations are still rich, cautions Mr. Watters, and it's best to avoid companies facing even potential challenges. Credit in general is overvalued, rates are going higher, and we're nearing the end of the credit cycle, says Mr. Diaz. Within high yield, it's prudent to invest in securities higher on the quality spectrum, he adds, positioning to mitigate potential downside, should we experience a broader risk-off move.

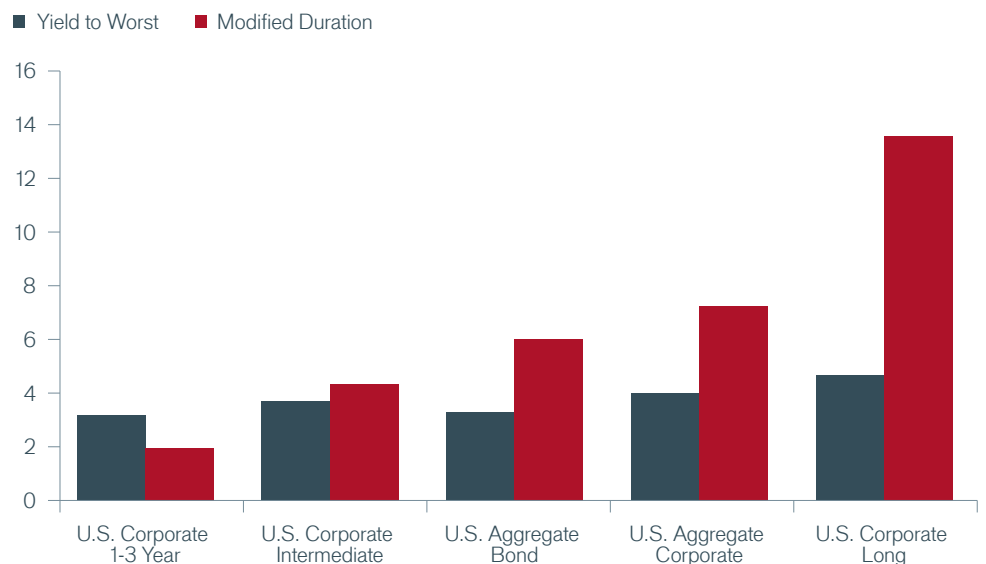
## Front-End Opportunities

While we are incrementally positive on the economy, rising rates and the potential for bouts of heightened volatility lead us to believe investors should be cautious where corporate credit is concerned. At this juncture, we do not believe that investors are being compensated enough to extend duration in corporate credit. As such, we have shifted our focus to front-end spread products. It is important to actively manage duration, says Mr. Watters, and we are honing in on spread products maturing in five years or less in issuers that we believe have the ability and willingness to pay down debt. These securities enable investors to lock in yield and get paid off in the near term while avoiding the interest rate risk associated with longer-dated credit.

Shorter-dated floating rate securities should also perform well in a rising rate environment. As rates move higher on the margin, instruments with base rates that adjust as the fed funds rate increases offer attractive risk-adjusted carry opportunities, says Mr. Saigal. We find bank loans, which are more defensive securities due to their senior position in the capital structure, particularly compelling.

### Exhibit 4: Shorter-Dated Bonds Exhibit More Favorable Risk Profiles

Amid rich valuations, credit risk is skewed to the downside, and we do not believe investors are being sufficiently compensated to extend duration in corporate credit.



Source: Bloomberg, Bloomberg Barclays Indices. As of 6/29/18



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## A Bond Picker's Market

While it is prudent to limit credit beta at this point in the cycle, says Mr. Myerberg, we continue to rely on our analysts to identify opportunities in companies with fundamental improvement stories. These issuers have the potential to generate outperformance as they progress through an upgrade cycle, even when risk is skewed to the downside. It's a bond picker's market, Mr. Watters says. The ability to identify companies with sound business models, consistent free cash flow and potential catalysts for ratings upgrades will be key to navigating the latter half of the year, he adds. ■



# Road Map

## Portfolio Positioning

- The Fed's more hawkish stance suggests that U.S. rates will climb from here, although its stable long-term outlook will likely keep longer-dated rates range-bound. We expect a higher but flatter yield curve. However, we are mindful that geopolitical events could put rising rates on pause, and we intend to maintain duration modestly below that of the benchmark.
- Corporate earnings trends remain strong. Yet we are mindful of elevated M&A activity and related corporate issuance, along with stretched valuations and rising rates. We are cautious on corporate credit but intend to remain opportunistic. At this point of the cycle, security avoidance is as important as security selection.

## U.S. Corporate Credit

- Corporate valuations are stretched and the credit cycle is long in the tooth. We expect substantial M&A activity and commensurate new issuance, while increased hedging costs for international buyers as the Fed raises rates may weigh on demand. Investment-grade spreads will continue to seep wider, in our view, and we are monitoring for attractive reentry points.
- While we are mindful of rich valuations in high yield, the asset class continues to be supported by a waning supply technical. We are opportunistically seeking fundamental improvement stories and issuers that we expect to outperform, regardless of the broader market environment, as they progress through the upgrade cycle.
- The credit curve has flattened and compensation for owning longer-dated securities is generally insufficient. We have shifted our focus to the front end, which we believe offers more attractive risk-adjusted carry opportunities with less interest rate risk than longer duration credit.
- We remain bullish on bank loans. Their shorter-dated nature and floating base rate are attractive given the rising rate environment. They also benefit from a senior position in the capital structure.

## Yield Curve/Duration

- Barring a major risk-off event, the Fed will proceed with two more rate hikes in 2018. With each hike, higher hedging costs make U.S. Treasury securities less attractive to international buyers. This – in combination with an increase in Treasury issuance to fund fiscal stimulus – should drive yields higher still.
- However, the Fed's stable long-term outlook should keep longer-dated rates range-bound and lead to a flatter curve.
- The return of volatility and the threat of geopolitical risks could incite a risk-off mindset. Therefore, we intend to maintain duration close to that of the benchmark, but will continue in our tactical approach to yield curve positioning with a focus on capital preservation.
- Our corporate credit duration remains skewed to the front end and belly of the curve in issuers in which we believe we have a clearer insight on fundamentals and their ability to pay down debt. We use long-end Treasuries to balance our corporate exposure. Short-duration Treasuries act as a source of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations.

## Securitized

- Fed balance sheet normalization is underway, and banks and international buyers have scaled back purchases of mortgage-backed securities (MBS). This has led to a modest widening in MBS spreads. We are actively analyzing relative value opportunities, particularly versus investment-grade corporate credit.
- We utilize MBS as ballast for our core portfolios, to act as a diversifier when volatility rises. We emphasize securities with higher expected certainty of cash flows and seek to optimize carry per unit of convexity.
- Within commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS), we seek to identify opportunities with favorable optionality, liquidity and upgrade potential. We invest only when we hold a constructive fundamental view on the underlying assets. Our analysts aim to avoid securities highly correlated to rate volatility while taking advantage of shorter-dated, more credit-intensive securities where risk is more likely to be mispriced.

## Developed Markets

- We expect core European rates to steepen. An end to ECB QE will likely push the long end higher, while the front end should remain pinned by the ECB's decision to hold rates steady through summer 2019.
- We seek duration opportunities in countries that have tightened their fiscal belts and increased their competitive nature, such as Spain and Portugal. Risk premiums over core European rates should compress as these countries benefit from both economic momentum and upgrade momentum from the ratings agencies.
- Growth and inflation in smaller European economies could result in select central banks hiking ahead of the ECB, which may create compelling currency trades.
- Due to the unknowns surrounding Brexit, and a general lack of clarity from the BOE, we believe sterling, gilts and UK corporate credit are generally unattractive.
- As inflation continues to disappoint in Japan, we do not anticipate any near-term change in BOJ policy. We are, however, closely monitoring scandals that could affect a change in government.

## Emerging Markets

- We find the asset class to be generally unattractive given higher U.S. rates, the potential for contagion from idiosyncratic issuer risk, and the asymmetric risk profile of the asset class should markets encounter a major risk-off event – such as a trade war or slowdown in global growth.
- However, we continue to like relative value currency trades in smaller European countries where central banks are positioning to hike ahead of the ECB.
- We are opportunistically investing in issuers poised to benefit from increased demand for commodities that are domiciled in countries with improving economic and political backdrops.

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