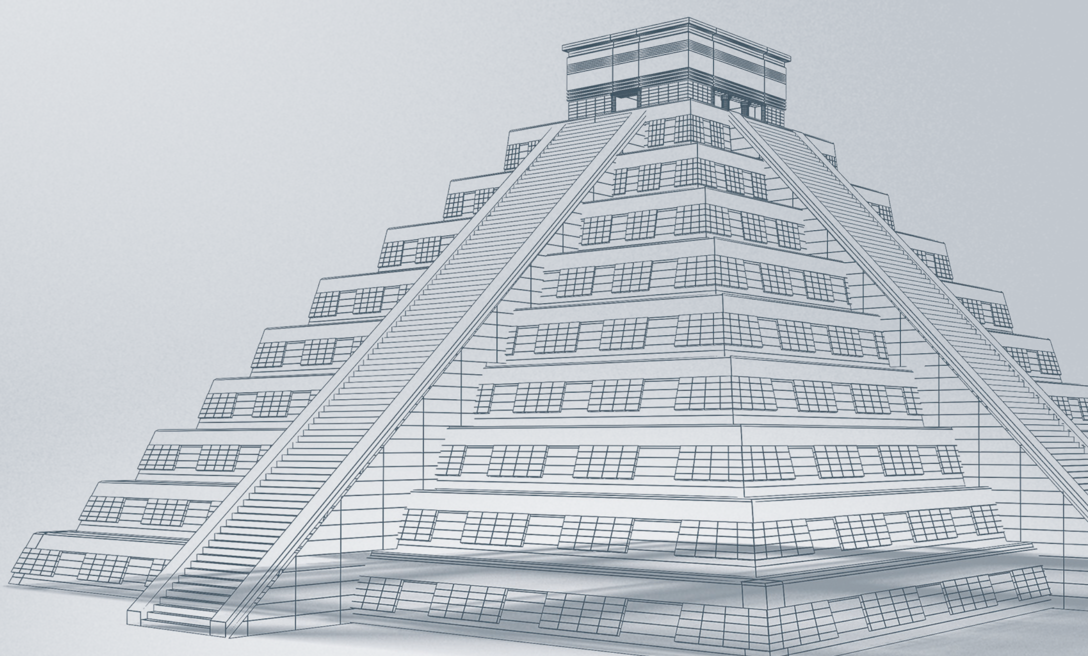
Global Outlook
Autumn 2017

Janus Henderson
INVESTORS

THOUGHTS AND BONDS

Uncharted Territory



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>
> **Chris Diaz, CFA, Head of Global Aggregate**

A Word from our Fundamental Fixed Income Team

Monetary stimulus by developed world central banks has created a market environment in which technicals often supersede fundamentals. Ultra-low interest rates combined with quantitative easing (QE) measures helped to diminish term premiums and greatly reduce credit premiums. These artificial markets have challenged investors in recent years and inspired a reach for yield that has propelled valuations higher and driven volatility lower.

Now, however, the Federal Reserve (Fed) is four hikes into its current tightening cycle and plans to begin normalizing its balance sheet this fall. We're also hearing chatter from the European Central Bank (ECB) and the Bank of England (BOE) suggesting that they too are looking to reverse accommodative policy – albeit for different reasons. This unintentionally coordinated unwind poses a significant risk to bond holders.

And yet, complacency endures. Both risk-asset and risk-free rate volatility remain extremely low as investors seem generally unfazed by the threat of some of the market's largest buyers walking away. While we believe that the central banks will act prudently as they attempt to change course, we are mindful that this is uncharted territory and that the market could be underestimating the impact.

Given the inherent risks in this shift, we are diligently monitoring central bank actions. We are also closely watching for potential progress from the Trump administration on inflation-inducing policy implementation. We believe both have the potential to trigger a repricing in bond markets, should investor sentiment suddenly shift. Additionally, the fact remains that we are in the later stages of the credit cycle. Corporate valuations appear expensive, shareholder-friendly activity continues and many companies are opting to purchase growth – at high prices – through debt-funded mergers and acquisitions.

Perhaps the benign environment of reasonable global growth, decent corporate earnings and cautious central banks persists, and perpetuates a sideways grind in both credit and rates for months, or even years. However, the risks to the downside are too great, in our view. We continue to believe that defensive positioning is warranted. Security avoidance is critical as the end of the credit cycle draws near, and we have increased our emphasis on high-quality business models in traditionally defensive, non-cyclical sectors. While we seek to participate in spread tightening, our primary goal is capital preservation.

Darrell Watters
Head of U.S. Fundamental Fixed Income

Chris Diaz, CFA
Head of Global Aggregate

Mayur Saigal
Head of Fundamental Fixed Income Risk

Ryan Myerberg
Portfolio Manager

MARKET VIEWS

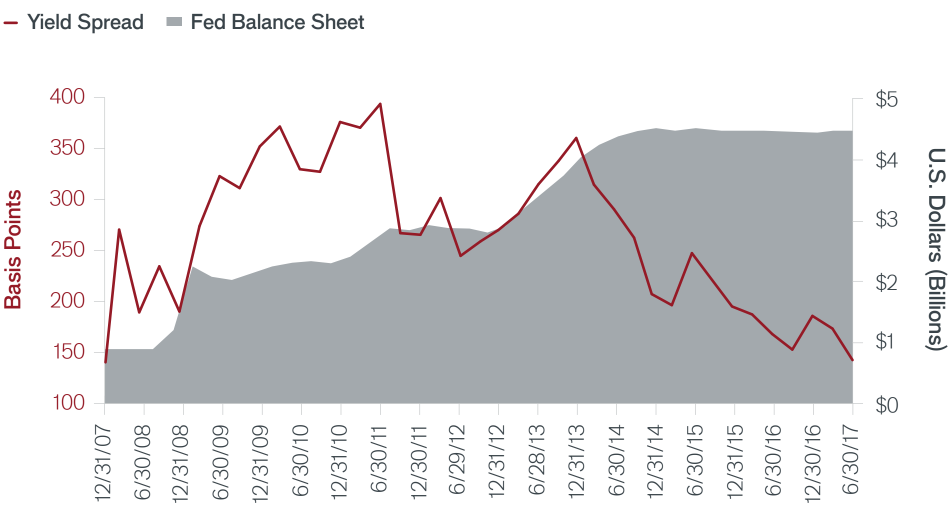
Central Bank-Driven Exuberance

For the past eight years, loose monetary policy by major central banks has pushed bond yields lower, forcing investors to move down in quality and longer in duration to find returns. Market participants have been conditioned to "buy the dip" and seem eager to buy any asset, despite market risks.

To showcase the market's exuberance, Mayur Saigal, Head of Fundamental Fixed Income Risk, points to this year's new issuance. In the sovereign arena, Argentina – a country that defaulted on its debt most recently in 2014 – issued a century bond yielding close to 8%. Demand was three times greater than the deal size. Austria also launched a 100-year issue. At just over 2%, the bonds yield less than a 10-year Treasury note, but substantially more than the German bund. Successful deals were also brought by Greece and Iraq – two countries that recently received bailouts by the International Monetary Fund – and Tajikistan, a country in central Asia.

Term Premiums Driven Lower Amid Quantitative Easing

As the Fed's balance sheet has grown, the yield spread between 2- and 30-year Treasurys has declined.



Source: Bloomberg: Note: Basis Point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%.

Many ailing U.S. corporations have been brought back to life through the cheap cost of financing and investor support, leading to fewer defaults. Market participants have also digested more than $1 trillion in U.S. investment-grade corporate credit issuance year to date through September, and most deals have been oversubscribed.

Risks Remain

Although risk takers have generally been rewarded this year, we do not believe this is the time to engage in aggressive portfolio positioning. In our view, downside risk remains high. The debt ceiling hangs over Congress, a debate that must be settled in early December. On the geopolitical front, the threat of nuclear war with North Korea lingers, as does the potential for a related trade policy misstep by the Trump administration. Despite their complacency, market participants also know that the unwinding of the great monetary experiment is nigh. Investors face all of this as the end of the credit cycle draws near.

For now, markets are on a 24-hour – or less – care streak, notes Chris Diaz, CFA, Head of Global Aggregate. The market doesn't care until it cares. We are discussing on a daily basis what could flip the switch, Mr. Saigal says. When sentiment reverses, we will be ready.

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RATES

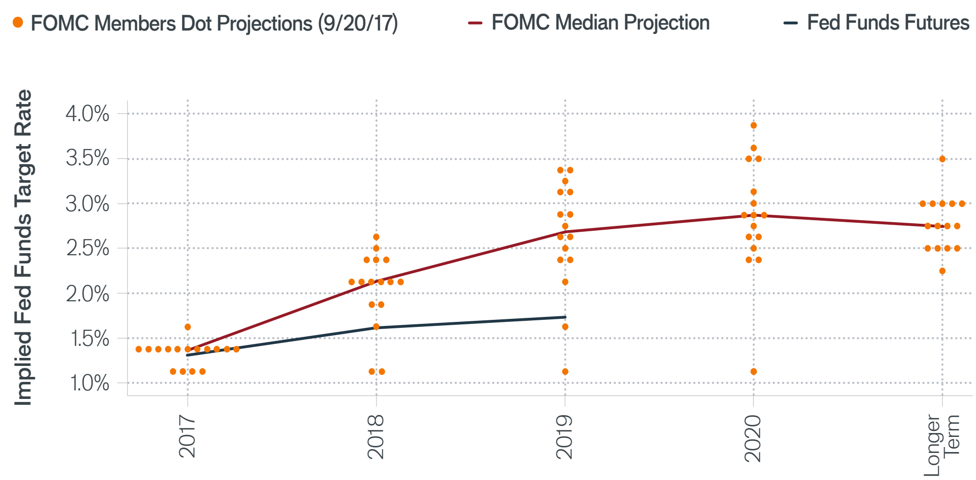
Underestimating the Fed

Inflation generally remains elusive, the Trump reflation trade has faded and the Fed has struck a dovish tone for much of 2017. Production efficiencies, driven by technological innovations and globalization, are helping to keep a lid on wage pressures and suppress inflation. In our view, these structural changes can persist and the lack of inflation will sustain a lower-for-longer environment. We are, however, concerned that the market has gone too far in underestimating the Fed's notion to raise interest rates, says Darrell Watters, Head of U.S. Fundamental Fixed Income. Particularly if inflationary pressures pick up from currently expected levels.

The market anticipates two to three more interest rate hikes through 2019. The Federal Open Market Committee's (FOMC) dot plot survey suggests the Fed could tighten approximately six more times in the same period. While the neutral rate (roughly 4% to 5% historically) may be lower going forward, it is unlikely to be stuck at 1.25%, says Mr. Diaz. The Fed will hike as gross domestic product (GDP) growth and inflation allow in order to create a cushion in the event the economy rolls over, says Mr. Watters. The tightening cycle will remain gradual to protect the consumer – the largest engine of the economy – but we expect the number of forthcoming rate increases to fall between market and Fed expectations.

Fed and Market Disagree on Future Rate Hikes

Market participants may be underestimating the Fed's notion to raise interest rates. Particularly if inflationary pressures pick up from currently expected levels.



Source: Bloomberg. As of 9/22/17

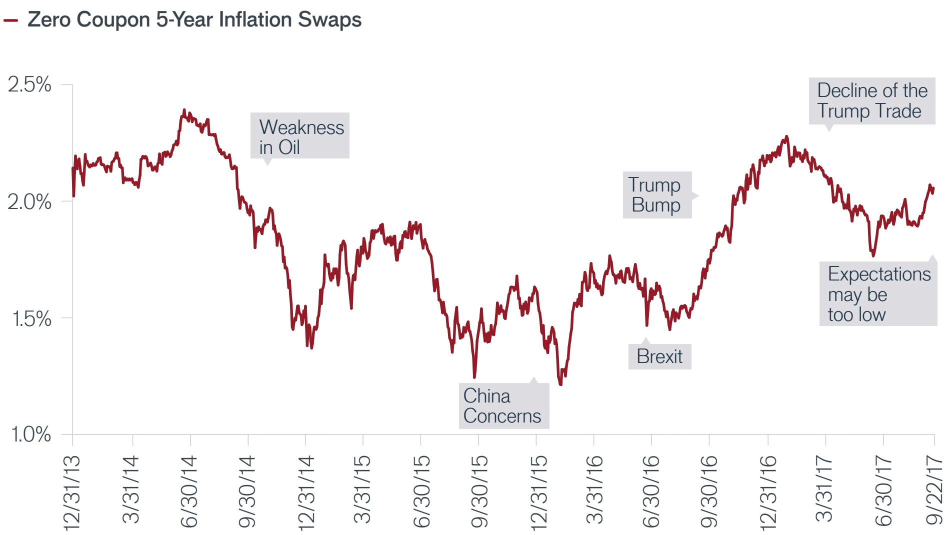
The Fed's tightening cycle will remain gradual, but we expect the number of forthcoming interest rate increases to fall between market and Fed expectations.

Mr. Watters notes that the Fed will have opportunities to hike as inflation creeps above the Fed's 2% target. August's year-on-year headline inflation increase of 1.9% is progressing toward that goal. One or two more strong inflation prints will set the stage for an additional rate hike in coming months, most likely in December or early 2018. Modestly higher gas prices along with recovering crude oil prices, continued improvement in the labor picture and a weaker dollar are all tailwinds for a higher fed funds rate. While the inflation pickup is unlikely to be sustainable, these pops could jolt the bond market. Mr. Saigal cautions that the passage of fiscal policy by the Trump administration could also cause a shock. With low productivity and the economy near full employment, any drastic bump in GDP will bolster inflation. Tax reform could be the catalyst that finally offsets inflation's structural challenges and pushes wage growth higher, he says.

In the months ahead, we believe that rates can stay rich, particularly with U.S. Treasury yields more attractive than their safe-haven peers. However, they may be too rich with both balance sheet contraction and additional interest rate hikes on the horizon, says Mr. Diaz. We anticipate Treasury yields will remain range-bound, but will bump up against the higher end of that range, Mr. Watters says. In our view, the 5-year note faces the most risk due to its close ties to Fed policy. The yield on the 10-year note could reach 2.5%.

Inflation Expectations

We believe inflationary pressures could pick up from currently expected levels, although prolonged higher inflation is unlikely.



Source: Bloomberg

Three's a Crowd

Portfolio Manager Ryan Myerberg points out that while the Fed's decision to unwind its balance sheet is self-inflicted, the ECB is in a more precarious position. Europe's central bank is running out of bonds to buy within its parameters and will soon be forced to taper its purchases. The strengthening euro and its deflationary effect have put another wrench in the ECB's plans, Mr. Myerberg says. Eurozone economic data is strong – despite the lack of inflation – but the central bank will need to proceed with caution to avoid putting additional upward pressure on the euro.

The BOE is the third central bank to announce its intent to reverse accommodative monetary policy. However, it too is in a challenging situation. The decline in the pound has brought on inflationary concerns, which in turn has prompted the bank to prep markets for a rise in interest rates. Economic conditions are uncertain at best as Brexit looms, says Mr. Myerberg, so the BOE will need to tread carefully to avoid derailing Britain's fragile economy.

With three developed-world central banks signaling their intent to remove stimulus, we believe it is prudent to limit interest rate risk in these regions. One bank reversing course would have had minimal impact, says Mr. Saigal, but three shifting simultaneously is more concerning. The pace of tightening may be gradual, and that of tapering glacial, but markets moved to new heights amid eight years of accommodative monetary policy. As Mr. Diaz notes, the thought that its reversal will not be disruptive to markets seems far too complacent.

CORPORATE CREDIT

Late-Cycle Symptoms

The global reach for yield bodes well for corporate credit, due to its relative attractiveness versus other fixed income sectors. Additionally, the U.S. economy is strengthening – albeit slowly – while China is stabilizing and global growth is moving in the right direction. Second-quarter earnings were solid and the weaker dollar should support a positive earnings trend. Further, fundamentals are generally decent and companies are adequately covering their interest expense.

While these factors should help to keep credit range-bound, we see few catalysts, outside of tax reform, to drive spreads significantly tighter. Valuations appear expensive. Spreads on corporate credit are hovering near their tightest levels of the cycle. Leverage remains high, and corporate behavior is symptomatic of the credit cycle's later innings, with companies tapping the debt market for dividends, stock buybacks and merger and acquisition (M&A) activity.

M&A activity is one of our primary concerns. Forward clarity on earnings may be obscured, but funding is inexpensive and investors are eager, making it easy for companies to lever-up to buy growth, says Mr. Diaz. Evaluating fundamentals and management intentions is crucial in this environment. Due to the asymmetric profile of bonds, it is important to avoid these entities until after consolidation efforts are underway and a company has expressed a willingness to engage in responsible balance sheet management, adds Mr. Saigal.

We are also closely watching the value of the dollar as a potential threat to inflation, rates and corporate credit, says Mr. Watters. We've seen fairly consistent inflation in service sectors, but price increases have been flat in goods sectors as companies source cheaper components from overseas. A declining dollar will make those components more costly – a price increase that will either negatively impact retailers or be passed on to consumers.

Uncomfortably Tight Valuations

While Europe is not as late cycle as the U.S., we are seeing similarities across the two regions. The crowding-out effect of the ECB's QE program has led to stretched valuations and dampened volatility, says Mr. Myerberg. The economic backdrop presents a benign environment for credit, and fundamentals are decent. However, valuations are uncomfortably tight, in our view.

A Time for Defense

A continued sideways grind in credit is likely, says Mr. Watters. However, downside risks are plentiful – from politics to central banks to the late stages of the credit cycle. In our view, maintaining a defensive stance is still the appropriate course of action. Our analysts are seeking opportunities in higher quality credit, companies with less cyclicality and issuers with limited volatility of cash flows. We are emphasizing shorter- to intermediate-dated issues, in which we believe we have a better view into the company's ability to pay down debt. Our goal is to participate in spread tightening, but our priority is to provide capital preservation and strong risk-adjusted returns for our clients.

> We see few catalysts to drive spreads significantly tighter, but numerous threats to the downside. Now is the time to get defensive.

Roadmap to Fundamental Fixed Income Investing

Portfolio Positioning

- With downside risk stemming from multiple sources, including geopolitics, central banks and late-cycle behavior, we are emphasizing defensive companies that exhibit solid fundamentals and sustainable free-cash-flow generation.
- U.S. growth is likely to remain subdued, but we could see modest pops in inflation due to recovering crude oil prices, continued improvement in the labor picture and a weaker dollar. Upward pressure on Treasury yields is likely; however, we expect them to remain generally range-bound. We will actively manage yield curve positioning with a focus on shorter- and intermediate-dated corporate credit balanced by longer-dated Treasury exposure.

U.S. Corporate Credit

- We are opportunistically adding to credit, including high yield. However, we are focused on non-cyclical, defensive issuers as we seek to participate in spread tightening while keeping capital preservation at the forefront.
- Across the quality spectrum, our focus remains on shorter- and intermediate-dated issuers with ample liquidity, strong free-cash-flow generation potential and management teams committed to a sound balance sheet.
- We expect bank loans – which benefit from a senior position in the capital structure and can offer protection against rising rates – to offer stable and attractive risk-adjusted opportunities in the months ahead.

Yield Curve/Duration

- The divergence between Fed and market expectations regarding future interest rate hikes could drive rate volatility in the months ahead. We expect the yield curve to be generally range-bound; but Treasury yields are likely to bump up against the higher end of their respective ranges. The 5-year note faces the most risk due to its close ties to Fed policy.
- We use long-end Treasurys to hedge our underweight in long credit, as well as to adjust our overall portfolio duration. Short-duration Treasurys act as a source of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations.
- 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 intend to maintain an active approach to duration and yield curve positioning with a focus on capital preservation.

Securitized

- The Fed will begin shrinking its balance sheet in October by curtailing the amount of proceeds it reinvests, subject to a set of rising caps. This will impact the Fed's activity in the mortgage market. However, we expect the unwind to be painstakingly slow, and impact on mortgage-backed securities (MBS) to be limited.
- 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 our CMBS and ABS allocations, 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 seek to avoid those 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 maintain a constructive view on European corporate credit; however, we remain mindful of the upward pressure QE measures have had on valuations.
- As the ECB contemplates tapering, volatility in sovereign yields is likely. However, asset purchases should continue to anchor short-term yields, while a stronger economic outlook could push long-term yields higher. We intend to remain underweight core European duration.
- Due to the unknowns surrounding Brexit, and the BOE's desire to raise interest rates, we intend to remain underweight sterling, gilts and corporate credit.
- We are actively seeking investment opportunities in countries where we expect the central bank to hold or reduce interest rates in the coming months, including Australia and New Zealand.

Emerging Markets

- Our outlook is cautiously positive. Low volatility, the upward trajectory in global growth and the underperforming dollar are supportive of emerging markets. In this environment, the real rate differentials between emerging and developed markets are compelling.
- We are emphasizing exposure in countries with limited ties to commodity prices, and seeking opportunities in countries with minimal expected political volatility.
- We continue to evaluate whether easing inflationary pressures in certain economies could lead to interest rate cuts, thereby creating attractive risk-adjusted duration opportunities.

About Janus Henderson Fundamental Fixed Income

- 30 years of experience emphasizing risk-adjusted returns and capital preservation
- Fundamental, independent research focus
- Integrated fixed income and equity research effort
- Quantum Global: proprietary research and risk management system
- Highly collaborative investment team based in Denver and London
- 69 fixed income professionals as of 9/30/17
- $35.6 billion in assets under management as of 6/30/17

For more information, please visit **janushenderson.com.**

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