Tell Tail Signs

An asset class outlook based on potential tail gains and losses

February 2017

Upward Inflation Pressures Mitigate but not so with Interest Rates

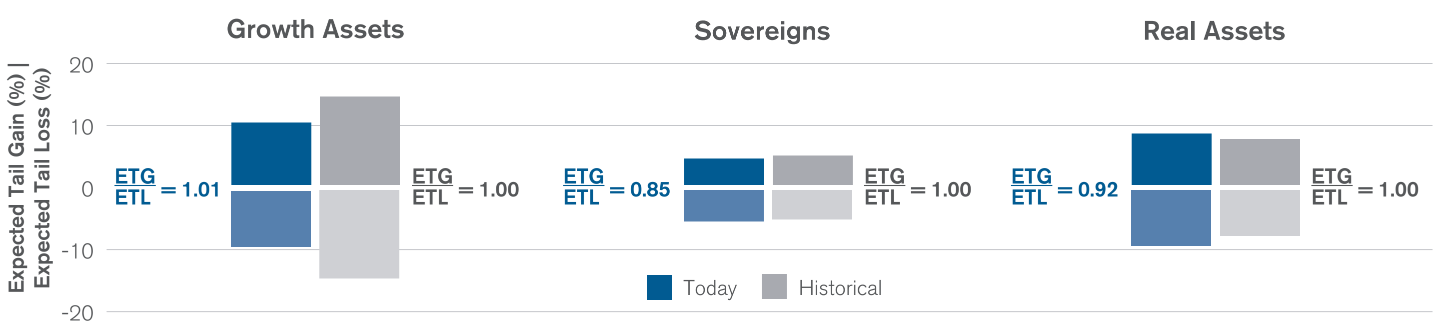
Inflationary pressures have moderated since the start of the year. According to the Janus Asset Allocation team's proprietary tail risk model, equities are expected to offer the most attractive performance going forward, while bonds are expected to offer the least.

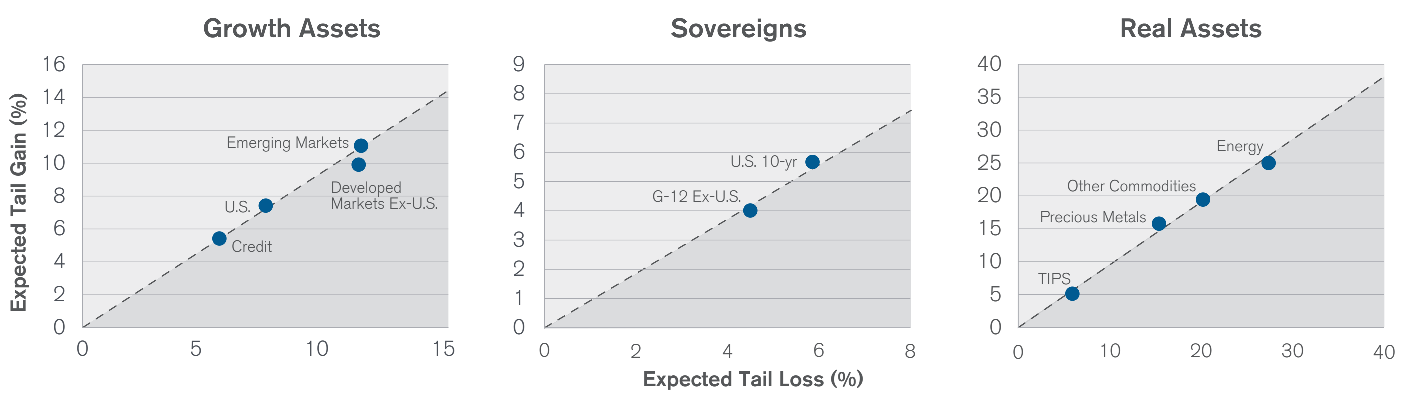
Janus' Asset Allocation team arrives at its monthly outlook using option market prices to infer expected tail gains (ETG) and expected tail losses (ETL) for each asset class. The ratio of these two (ETG/ETL) provides a signal about the risk-adjusted attractiveness of the asset class. We think of that ratio as a "tail-based Sharpe ratio." The tables below summarize the "tail-based Sharpe ratio" of three broad asset class categories.

The recent assault on inflation expectations left the well-watched five-year breakeven just above the Federal Reserve's (Fed) 2% target, leaving the Fed little choice but to closely monitor price pressures. With a watchful Fed, it becomes increasingly difficult for inflation to push sharply higher. Our signals support this case, as seen by January's declining attractiveness of assets that generally do well during inflationary episodes. However, it is important to note that the attractiveness of these assets is still above average, likely indicating that we are not going to see an aggressively hawkish Fed anytime soon.

At the same time, however, our model continues to assign poor attractiveness to duration. If inflation is moderating, yet our signals indicate yields are more likely to rise than fall, then the expected rise in yields will likely be driven by rising real interest rates. Real rates around the globe are still at extremely low levels. In the U.S., 10-year real rates are below 50 bps and in Germany and Japan they are well below zero. While the recent sell-off in rates was driven almost exclusively by a rise in inflation expectations, we see the continued sell-off driven more by rising real rates. The end point is the same, namely higher rates, but how we get there differs – the initial surge was driven by inflation, the later surge will likely be determined by real rates. Our signals tell us that this transition is likely to take place sooner rather than later, as the pickup in growth continues.

Tail-Based Sharpe Ratio (Expected Tail Gain* / Expected Tail Loss*)





*We define ETG and ETL as the 1-in-10 expected best and worst two-month return for an asset class.
Beginning in August 2016, the tail-based Sharpe ratios have been normalized to 1.00 to allow for easier comparison across the three macroeconomic asset categories.

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This brings us to equities. With real rates still very low and inflation moderating at normal levels, the environment is fertile for growth, which our signals support by assigning the brightest outlook to equities.

In addition to our outlook on broad asset classes, Janus' Asset Allocation team uses option market signals to provide insights into specific markets. The following caught our attention:

- **Equities:** U.S. equities are still most attractive. Emerging markets also look attractive, reinforcing the view that President Trump values the importance of free trade and globalization. Peripheral Europe, in particular Italy, offers opportunities, as the potential resurgence of the center-right in Europe (i.e., France), and its pro-growth policies cannot be ignored.
- **Sovereigns:** We see U.S. rates and non-U.S. developed rates, particularly Germany, following a path of convergence. With inflationary pressures mounting in Europe and yield differentials still very wide, we are near a tipping point where European yields need to catch up with U.S. yields.

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