



Tell Tail Signs

The Forces That Took Hold in December are Still in the Driver's Seat...

January 2017

Inflation risk still points to the upside, according to the Janus Asset Allocation team's proprietary tail risk model. We see demand pickup carrying prices to more normal levels, which is healthy for equities and other growth-sensitive assets, to the detriment of bonds.

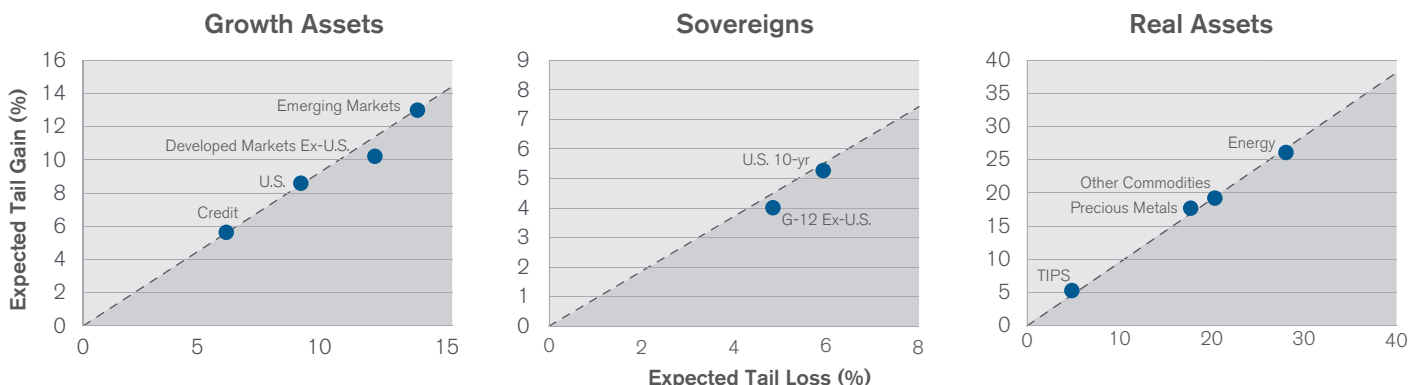
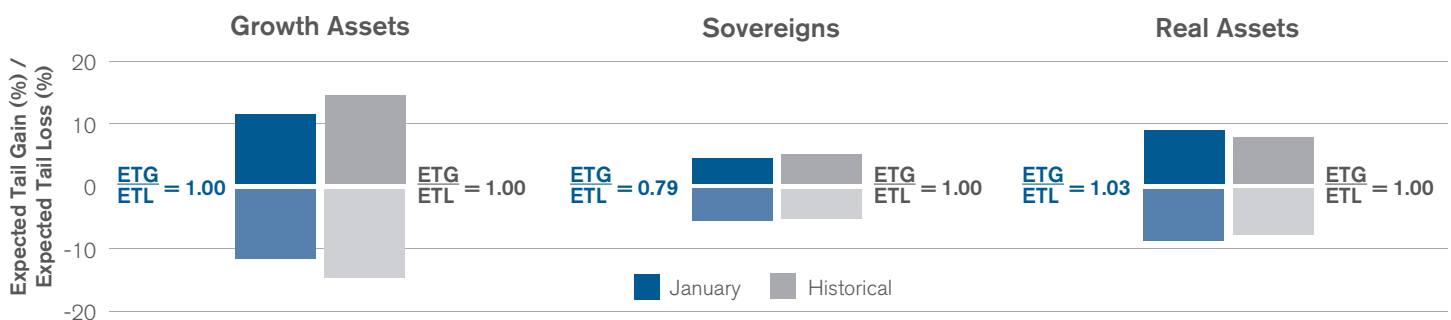
Janus' Asset Allocation team arrives at its monthly outlook using option market prices to infer expected tail gains (ETG) and expected tail losses (ETL) for each asset class. The ratio of these two (ETG/ETL) provides a signal about the risk-adjusted attractiveness of the asset class. We think of that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

The safe has become the unsafe

Global sovereigns (i.e., what we characterize as capital preservation assets) continue to offer the lowest expected tail-based Sharpe ratio and, therefore, represent the least attractive asset class to hold, while real assets (i.e., inflation-sensitive assets) continue to offer the highest ratio. With inflation risk still rising, the recent increase in global interest rates is likely to continue. A valid concern for many investors is whether growth is a realistic expectation in a rising interest rate environment. Our view continues to be that growth will not be stifled by rising interest rates.

We see both developed (especially in the U.S.) and some emerging market equities as attractive. As mentioned last month, financial conditions remain very accommodative with negative 10-year real rates in Europe and Japan, and U.S. real rates still under 50 basis points. These low real costs of capital, combined with President-elect Trump's proposed fiscal spending, lower tax and deregulation plans, create a stimulative environment. Option market pricing reflects this picture.

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



*We define ETG and ETL as the 1-in-10 expected best and worst 2-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.

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:** Despite Mr. Trump's protectionist rhetoric, emerging markets continue to look attractive. Additionally, peripheral Europe and France offer better upside versus downside compared to Germany. The resurgence of center right governments in the European Union (EU) could unleash a rally in risk assets similar to what we saw following Mr. Trump's victory in the U.S.
- **Commodities:** Overall, forces are still in play that will support commodities – infrastructure building, inflation, and an environment for improved demand. We see the agriculture complex offering the greatest attractiveness, but a dim outlook for oil and precious metals.
- **Sovereigns:** While our signals point to further increases in global interest rates, from a relative perspective, U.S. bonds offer better reward-to-risk than European or Japanese bonds. However, we still see bonds representing the riskiest asset class – “the safe has become the unsafe.”

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