



# Staying Ahead of the Curve

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## What to Tell Your Clients:

Consider diversifying rate risk by investing in fixed income markets abroad, but selectivity is key.

- ▶ Fixed income exposure is important for capital preservation long term across varying interest rate cycles.
- ▶ Index-oriented core fixed income funds are vulnerable when U.S. rates are rising. Diversifying yield curve exposure *before* a prolonged rise in U.S. rates may temper downside risk.
- ▶ Select European sovereigns and corporates are favorable compared to Treasuries.
- ▶ Be careful about trading rate risk for macroeconomic risk. A selective, bottom-up investment approach can help identify and navigate risks.

Investors could soon face an environment of rising U.S. interest rates and heightened rate volatility. Already, the Federal Reserve has begun setting the stage by tapering its quantitative easing program. Once rates start to rise, it's difficult for a fixed income portfolio to make up lost ground if it's not already positioned for higher rates. We think it's crucial for investors to diversify their yield curve exposure by investing abroad. Chris Diaz, Co-Portfolio Manager of the Janus Global Bond Fund, explains why he favors European sovereigns and corporate bonds, with the goal not to replace interest rate risk with geopolitical or macroeconomic risks.

## Many index-oriented U.S. core bond funds are vulnerable to rising rates

Investors are increasingly concerned about how they can protect their portfolios in an environment of rising U.S. interest rates. There is good reason for concern as many investors own core fixed income funds, which are typically indexed to the Barclays U.S. Aggregate Bond Index. The index has a heavy allocation to Treasuries, specifically those with longer duration, which heightens the index's rate sensitivity.

Core fixed income funds can be a key portfolio component long term. However, the Federal Reserve's steps to exit its loose monetary policy are a strong reminder that it's important to diversify one's fixed income exposure, particularly yield curve exposure.

## Diversify U.S. rate risk by investing in bond markets abroad

Low-hanging fruit is hard to come by in the global fixed income market, so we must be selective about where we seek yield curve diversification. Highly accommodative monetary policies around the world helped spark a multiyear bond rally (bond prices rise as their rates fall). That has left sovereign rates of developed economies at historic lows and valuations in the fixed income market generally rich.

But, the euro zone with its tepid growth is still early in its monetary cycle. The region's rates structure is led by Germany, the zone's largest economy. German rates could remain historically low amid aggressive monetary stimulus by the European Central Bank (ECB). Moreover, the ECB has created somewhat of an investing tailwind by making an explicit commitment to doing whatever it can to support the euro zone's recovery. It's possible that when Treasury rates rise, European sovereign rates could rise in sympathy, but if they do, we believe they won't rise as much and will still stay relatively low. Given our euro-zone rate outlook, we generally favor European sovereigns over Treasuries. Moreover, sovereign rates of select "peripheral" euro-zone countries, like Spain and Ireland, may have more room to fall. Their economies are becoming more competitive amid gradual structural reform, which is good for their sovereigns.

We've also looked beyond the euro zone to economies like Sweden, as the broader continent remains in the earlier stages of its economic and monetary cycles. Sweden's central bank may still ease monetary policy further, making its sovereigns attractive, in our view. Still, Europe, with its varying success with structural reforms, requires selectivity and constant vigilance. The ECB's commitment to backstop the euro zone's recovery only offsets the investing risks of peripheral economies to a degree. For example, Italy slipped back into recession in the second quarter. Meanwhile, under a worst case scenario, Russia's conflict with Ukraine could disrupt energy supplies to Europe and derail its economic recovery.

## About the Manager:

**Chris Diaz, CFA**, since joining Janus in 2011, has been the firm's Head of Global Rates and Co-Portfolio Manager of the Janus Global Bond Fund.

## Janus Global Bond Fund: Portfolio Snapshot

- ▶ Seeks risk-adjusted returns and capital preservation with a flexible approach to global fixed income investing, with the ability to deviate significantly from the index on a sector, country, currency and duration basis.
- ▶ Bottom-up, fundamentally driven corporate and sovereign research drives portfolio and individual security selection.

## Corporate bonds also offer yield curve diversification

European sovereigns are just one way to diversify U.S. interest rate risk. We also favor corporate bonds that are priced off the German yield curve. Corporate Europe has yet to catch up to the U.S. in its deleveraging and restructuring. European corporate bonds have priced in prospects for improvement to an extent, so both investment-grade and high-yield spreads have tightened considerably there.

But, within the financial sector in particular there are turnarounds, which are now bearing fruit. We believe debt lower in the capital structure of these firms is attractive as deleveraging remains a top priority ahead of the European stress tests later this fall. Meanwhile, we favor select names in Europe's automotive industry as they could continue to register improvement in the euro zone's economy. We would add that even in a rising rate environment, we believe U.S. corporate bonds offer attractive risk-adjusted returns on a selective basis given corporate growth prospects and ongoing balance sheet improvement for many firms.

## Selectivity is key as global macroeconomic risks remain

Our goal is to not replace U.S. interest rate risk with other risks of foreign countries. For example, we don't think Japanese government bonds with their near-zero yields compensate for the risks of Japan's experimental fiscal measures. Our bottom-up, fundamental approach and flexibility allows us to go where we see value, and avoid areas that we think are risky. We believe that what we don't own can be just as beneficial as what we do.

This maxim applies to emerging markets (EM). Some of these markets have become dependent on the liquidity generated by easy monetary policy, and their bonds have proven to be subject to considerable losses amid changes to the Federal Reserve's stimulus. Investors need to recognize the downside risk that the geopolitical and/or macroeconomic issues may create in certain EM countries.

In the end, we believe using yield curves abroad can be an effective way of spreading out interest rate risk as investors face a rising rate environment in the U.S., but selectivity is critical.



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**Mutual fund investing involves market risk. Investing involves risk, including the possible loss of principal and fluctuation of value.**

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Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility and differing financial and information reporting standards, all of which are magnified in emerging markets. Sovereign debt securities are subject to the additional risk that, under some political, diplomatic, social or economic circumstances, some developing countries that issue lower quality debt securities may be unable or unwilling to make principal or interest payments as they come due.

High-yield/high-risk bonds, also known as "junk" bonds, involve a greater risk of default and price volatility than U.S. Government and other high quality bonds, and can experience sudden and sharp price swings which will affect net asset value.

Barclays U.S. Aggregate Bond Index is made up of the Barclays U.S. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least \$100 million.

Investment products offered are: 

NOT FDIC-INSURED	MAY LOSE VALUE	NO BANK GUARANTEE
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