OCTOBER 2015

GLOBAL OUTLOOK

A World Out of Balance

FUNDAMENTAL-INFORMED MACRO VIEWS FROM JANUS FIXED INCOME

Fundamental-Informed Macro Views

Fundamental, independent research has been at the core of the Janus Fixed Income process for over 25 years. While many competitors rely on government statistics to form a top-down view, we focus first on company, issuer and security level fundamentals. We believe this approach differentiates us from our peers and other macroeconomic data providers. Our comprehensive, bottom-up view drives decision making at the macro level, enabling us to make informed sector and risk allocation decisions.

Each quarter we share our global outlook and provide insights on emerging investment opportunities and risks.

ABOUT JANUS FUNDAMENTAL FIXED INCOME

- **Over 25 years of experience focused on risk-adjusted returns and capital preservation**
- **Integrated fixed income and equity research**
- **Quantum Global: proprietary investment research and risk management system**
- **Highly collaborative, non-siloed team based in Denver and London**
- **35 fixed income investment professionals**
- **$34.3 billion in assets under management as of 9/30/2015**

The opinions expressed are those of the authors as of October 2015 and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes.

"…Given the proliferation of downside risks in the market, we remain confident that our defensive posture is aligned with our focus on preserving capital for our clients."

GIBSON SMITH
CIO, FIXED INCOME
& PORTFOLIO MANAGER

A Word from CIO Gibson Smith

For the past several quarters we have articulated the reasoning behind our defensive positioning given building global economic imbalances and stretched valuations. Recall that our portfolio strategy involves moving methodically from opportunistic to neutral to defensive as appropriate across market cycles. We continue to think that being patient and disciplined in these volatile markets will be rewarded. Our focus on generating superior risk-adjusted returns and capital preservation continue to be our guiding tenets.

During the quarter, the market was plagued by bouts of volatility across risk assets, including currencies, spread sectors and equity markets. In our company-informed macro summary that follows, we highlight the Chinese and Brazilian economic slowdowns through the lens of the multinational companies that we research. We are watching the various sources of disinflationary pressures in the global economy very closely, including the strong U.S. dollar and weakness in the energy and commodity markets. While the Federal Reserve garnered a majority of the focus this quarter, we think that the People's Bank of China (PBOC) and other global central banks demand more focus as divergent central bank policies continue to be in play. Any surprise of additional aggressive monetary stimulus, artificially supporting risk assets, could fuel more volatility. In an environment of additional surprise stimulus we may underperform given our defensive positioning. However, given the proliferation of downside risks in the market, we remain confident that our defensive posture is aligned with our focus on preserving capital for our clients. We are also actively reviewing new opportunities created by the volatility and repricing of risk.

Overall, we expect continued heightened volatility and the potential for further repricing of credit risk as we approach 2016. The new issue pipeline remains robust given the current shareholder-friendly environment, as evidenced by debt-financed mergers and acquisitions. There will also be new opportunities created by these financing needs. Caution is warranted.

We appreciate your interest in our fundamental-informed macro view as well as the trust you have placed in us in managing your assets.

Gibson Smith
CIO, Fixed Income & Portfolio Manager

KEY TAKEAWAYS

- The U.S. is proving to be a bright spot for automotive, discretionary and industrial companies, as compared to rapidly cooling emerging markets.
- We continue to be mindful of a rise in shareholder-friendly activities that in some cases are resulting in releveraged balance sheets.

Resilient U.S. Consumers Compensate For Slowing Emerging Markets

Economic strength in the U.S. contrasts with pronounced weakness in key emerging markets. A telling example of the world's uneven economic growth is found in the automobile industry. Monthly sales in the U.S. on an annualized basis have averaged 17.1 million units over the past year, the highest level since early 2006. The story is quite different in China and Brazil.

Despite solid growth in SUVs and its premium Cadillac brand, **General Motors'** (GM) sales in China have notably weakened. Similarly, **Ford Motor Company** has stated it has seen a slowdown in its Asia-Pacific business, with commercial vehicle sales falling at a faster rate than passenger cars. This company-level data is consistent with a slowdown in Chinese industrial production.

Both Ford and GM have expressed consternation over previously high-flying Latin American markets. GM has cut its workforce in Brazil and cited the country's plummeting currency, the real, as a drag on earnings. For its part, Ford has seen a pronounced drop is sales in Brazil. Perhaps of greater concern is that the weakness is spreading to other parts of the region.

In its most recent earnings report, GM named the U.S. as its main source of sales growth, with truck sales doing particularly well. Often considered a barometer of the construction industry, it is our view that robust truck sales represent a resilient and relatively confident U.S. consumer.

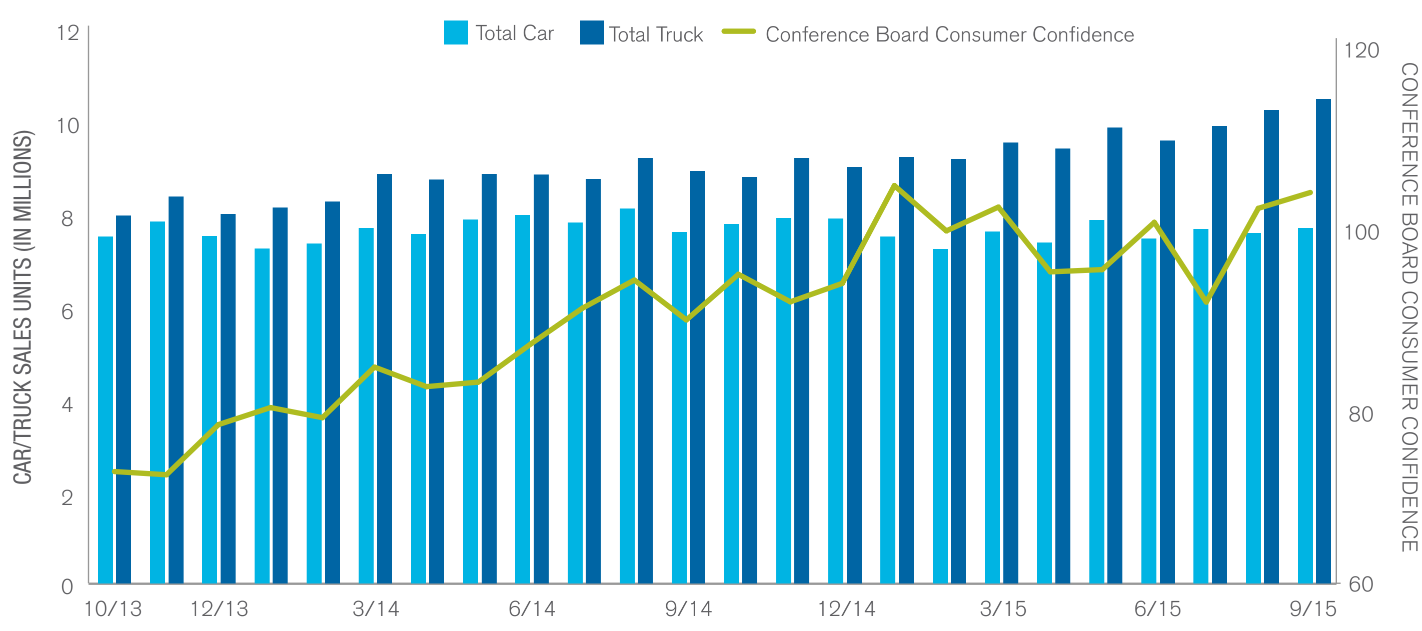
Sectors sensitive to the global business cycle had historically touted their non-U.S. growth opportunities. We have seen recent weakness, however, from the non-U.S. segments of select industrials and the hardware subsector of technology. Given the fact that the latter is seen as a leading indicator, disappointing revenue growth within hardware could foreshadow a broader slowdown in business investment. Connector company **Molex**, for example, has recently spoken of tepid overseas demand and foreign currency headwinds.

In its most recent earnings call, industrial conglomerate **United Technologies** highlighted how the slowdown in China has impacted its Otis elevator division. The weak construction market has resulted in new orders declining by 10% during the second quarter of this year. Conversely, Otis' new orders in the U.S. rose by 10% over the same period.

Slower growth abroad, coupled with earnings headwinds due to a resilient U.S. dollar, leads us to favor domestic companies at this juncture. The confidence that is emboldening consumers to purchase cars is also coaxing them to dine out with greater frequency. **Landry's**, a restaurant operator whose portfolio of brands include its eponymous seafood restaurant, Morton's The Steakhouse, and McCormick & Schmick's, reports that a strengthening consumer is driving improved same-store sales. The company also has the confidence to invest over $100 million in capital expenditure, while at the same time, expecting to generate sufficient free cash flow to pay down debt. Another restaurant group, **P.F. Chang's China Bistro**, is looking to capitalize on consumers' improving appetite by opening more of its flagship restaurants, its Pei Wei Asian Diner brand, and True Food Kitchen, a brand in which it has a majority stake.

From a credit cycle perspective, the health care sector has experienced a massive wave of debt-financed consolidation. Within the past year, **CVS Health** has acquired the pharmacy operations of Target and Omnicare, a pharmacy services provider. The company has also increased both its dividend and share buyback amounts by 25% over the previous quarter. Still, management expects its recent acquisitions to be sufficiently accretive to enable it to return its leverage ratio to a level below 3x in a reasonable amount of time.

U.S. Light Truck Sales and Consumer Confidence Rising



Source: Bloomberg, The Conference Board. As of 9/30/15.

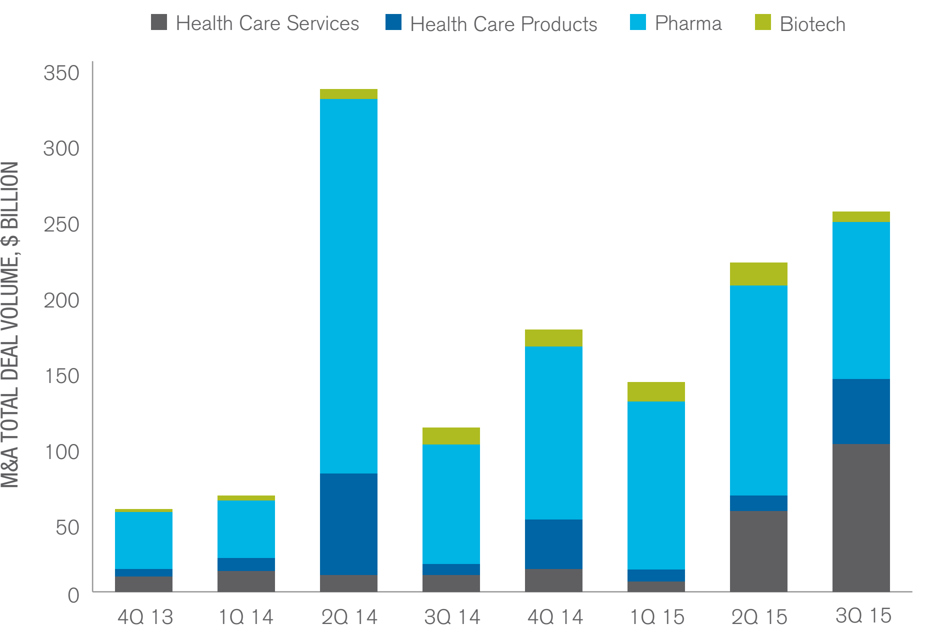
Resilient U.S. Consumers Compensate For Slowing Emerging Markets

CONTINUED

An analogous story can be found in the telecommunications sector. In September, **Frontier Communications** issued $6.6 billion in high-yield notes to help pay for its recent acquisition of wireline assets from Verizon Communications. The deal, rather than being interpreted as deleterious to bondholders, can be viewed as a sign of confidence on behalf of both the company and fixed income investors in the stability of the broadband industry and the improving prospects of the U.S. economy. It is imperative that each transaction or bond issuance be judged on their business merits and the ability to meet obligations. Otherwise, investors may be exposing themselves inordinately to the risks inherent in a market characterized by record-setting new issuance and increasing leverage.

Health Care Sector Merger & Acquisition Activity

Industry consolidation, as with other shareholder-friendly activities. is often financed with bond issuance.



Source: Bloomberg. As of 9/30/15.

Diverging Growth Trajectories, Diverging Monetary Policy

UNITED STATES

The U.S. economy continues to set the pace among its developed market peers. Auto sales are only one facet of what is evolving into broad-based growth. Housing data is improving in many markets and, given stricter lending standards, this is likely durable growth rather than the unsustainable aberrations experienced in the run up to the housing crisis. Our analysts recently attended a homebuilding conference and reported that the sector's growth outlook remains bullish due, in part, to a strong consumer and the expectation that we are in the midst of an elongated housing recovery cycle.

More broadly, second quarter gross domestic product (GDP) growth was strong, and perhaps just as important, final sales to domestic purchasers – a bellwether for domestic demand eliminating the effects of exports and inventory buildup – has finally broken out of its post-crisis rut.

At 5.1%, the unemployment rate is within the Federal Reserve's (Fed) range of full employment. Furthermore, the underemployment rate has fallen considerably in the past two years. Naysayers may point to the lowest labor force participation rate since the late 1970s, but it is difficult to be certain how much of that is owed to demographic shifts and how much to workers leaving the workplace in discouragement. We remain mindful of the pace of wage gains, as most assuredly does a Fed especially attuned to the labor market. An interest rate hike occurring when wage growth is unable to break out would essentially act as a pay cut to consumers.

Low inflation remains another complicating factor for the central bank. As both materials prices and wage growth remain tepid, disinflation becomes a risk. Any diminishment in upward pricing pressure would result in de facto monetary tightening as it would raise real interest rates.

We continue to be positioned for what we see as an eventual divergence of monetary policy, with the U.S. ultimately being the first advanced economy to tighten. The Fed's acknowledgment of global considerations when choosing not to raise rates in September, however, clouds the timing of such a move, with the initial hike plausibly expected in 2016. Whenever the move occurs, we anticipate seeing upward pressure on the short end of U.S. Treasury yield curve, as those tenors are the most sensitive to rate increases. Consequently, we would also expect to see a stronger dollar. That development merits watching as it could further limit inflationary pressure and hinder foreign earnings of U.S. multinationals. However, we expect any movement on the long end of the curve to be contained.

KEY TAKEAWAYS

- Although the unemployment rate meets the Fed's conditions for a rate hike, inflation and global growth concerns cloud the timing of an initial move.
- Europe's economy has strengthened recently, but we are watching how lower energy prices affect the ECB's push to stoke inflation and the effect slowing global growth has on the region's export-based industries.
- The transition to a consumer-led economy in China continues to be bumpy and the fortunes of commodities exporters still face headwinds.

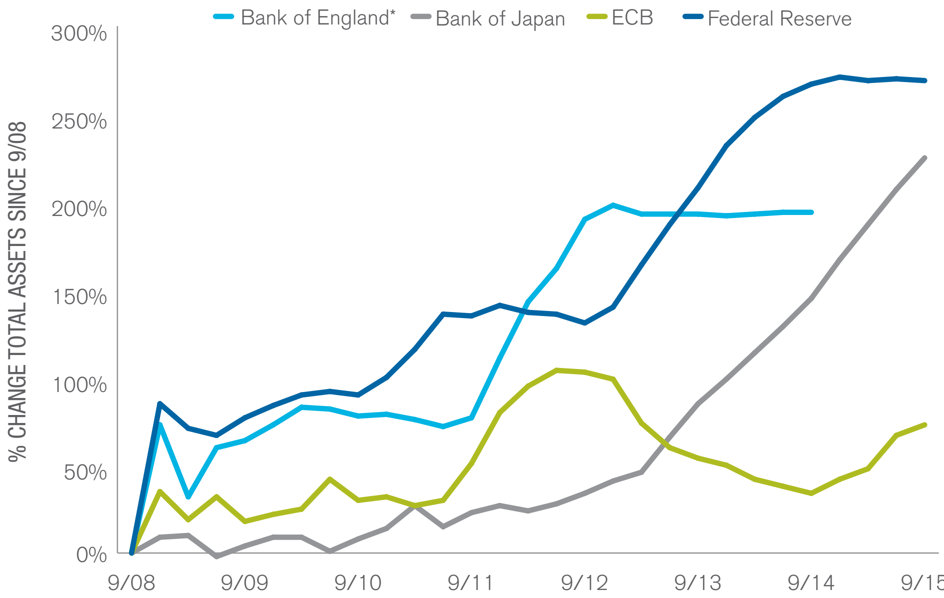
DEVELOPED MARKETS

While the Bank of England (BOE) is presumed to be second in line behind the Fed in raising interest rates, much of the developed world remains firmly in the accommodative camp. Over half the world's economy falls under the auspices of loose or accommodative monetary policy. Similar to the situation in the U.S., largely absent inflationary pressure in the UK may delay the BOE's initial hike. Still, the UK pound should have winds at its back as the timing of the BOE move becomes clearer.

Within the eurozone, the Fed's delay in raising rates was met with comments from the European Central Bank (ECB) that it may extend its quantitative easing (QE) program. Over six months into the ECB's program, core inflation has moved off its lows, although headline data remains vulnerable due to weak energy prices.

Central Bank Balance Sheet Growth

While the U.S. and UK have stabilized balance sheets, Japan and the eurozone continue to purchase assets.



**Bank of England stopped reporting weekly asset levels in September 2014.*
Source: Bloomberg. As of 9/30/15.

Purchasing manager indices are maintaining an upward trajectory and retail sales data hint at a strengthening consumer. This latter fact is further illustrated by strong new car registration data in southern Europe. We continue to monitor the pace of reforms in peripheral countries. Ireland has provided a template, which Spain and Portugal are attempting to emulate, with Italy also making efforts to push through market-friendly structural reforms. We are mindful, however, of the impact slowing global growth may have on Europe's substantial export sector. Exports, aided in part by a weaker euro, have been a source of strength as the continent emerges from its debt crisis. A recessionary Russia, which is hamstrung by weak energy prices and sanctions, is a specific cause of concern as the country is a significant destination for European autos, capital goods and luxury products.

EMERGING MARKETS

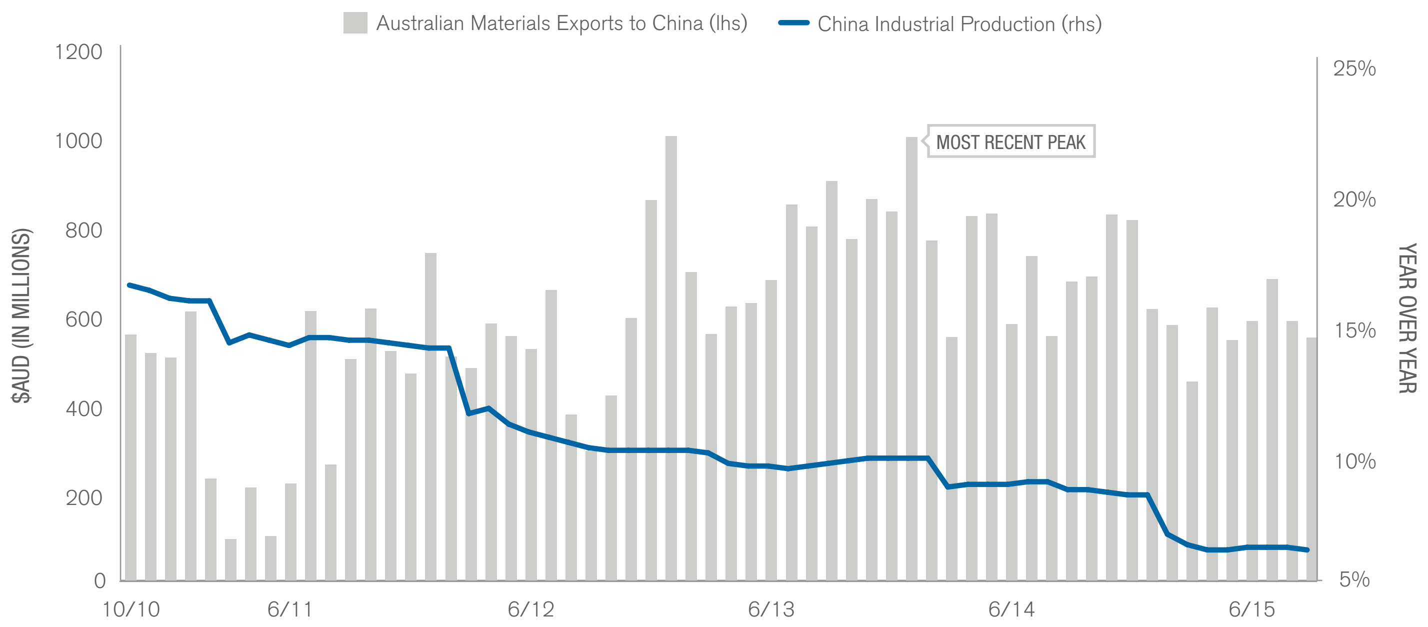
China's bear market and cooling economy dominated markets over the past quarter. Economic disruption in the world's second largest economy is directly transmitted via trade linkages to its Asian neighbors. Commodities exporters that have ridden the wave of voracious Chinese demand for materials and energy products must also adjust to a more subdued environment. Energy producers such as Russia, Venezuela and Brazil that had already faced headwinds due to buoyant supply are now dealing with stress from the demand side. This, in turn, is putting government accounts under pressure as current crude prices are well below the levels upon which national budgets are based.

We have limited exposure to emerging markets, with the notable exceptions of Mexico and India, two countries that we believe exhibit sound fundamentals. We see a possible end to the BRIC theme, as the conglomeration of Brazil, Russia, India and China has been known. Brazil, in particular, is harnessed by weak productivity and internal political strife, in addition to weakening demand for its natural resource exports.

Exacerbating these challenges are risks present in financial markets. Yields on Brazilian bonds may appear attractive as the government attempts to stave off inflation and capital flight, but downward pressure on currencies, such as what has been recorded this year, can wipe out any potential returns. And unlike during past periods when emerging market debt came under pressure, a greater amount of issuance is denominated in local currencies. This has the effect of transferring much of the risk to bondholders, who are more vulnerable to issuers devaluing away their debts. From this perspective, the recent spike in spreads on emerging market benchmarks and global high-yield bonds comes as little surprise, and validate our defensive positioning.

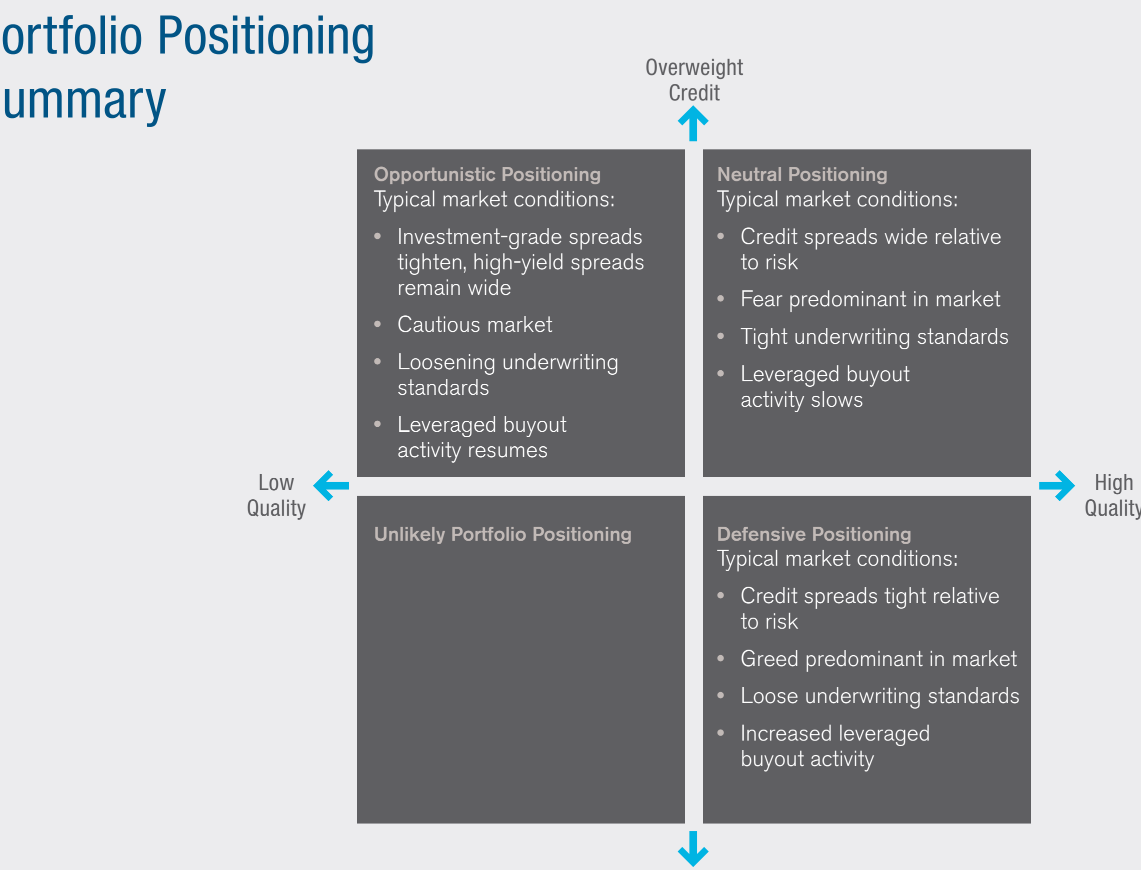
Australian Thermal Coal, Coking Coal and Iron Ore Exports to China

Commodities exporters suffering as Chinese industrial production wanes.



Source: Bloomberg. As of 9/30/15.

Portfolio Positioning Summary



Defensively Positioned

Portfolio Positioning: Defensive

- Our defensive stance was validated by the widening spreads recorded by investment-grade and high-yield corporate credits over the third quarter. Our credit allocation is near the low end of its historical range. We continue to be mindful of the risks posed by a potentially peaking credit cycle, characterized by an increase in shareholder-friendly activity, including share buybacks and merger and acquisition activity, often financed by releveraged balance sheets. Consequently, we favor higher-quality issuers whose management teams have exhibited a commitment to balance sheet discipline and generating stable cash flows supported by fundamentally sound businesses.

Treasury

- While slightly lowering our Treasury allocation in relation to the benchmark, we have increased its contribution to portfolio duration. We believe it necessary to actively manage duration and yield curve positioning due to the potential for continued volatility. In such markets, our core tenet of capital preservation guides us. Our Treasury positioning, which is concentrated on the short end, also provides us with ample liquidity. Should markets become illiquid, we aim to be providers of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations. We continue to use our longer-dated Treasurys for overall portfolio "insurance." We are closely monitoring the economy for signs of when the Fed may initially raise interest rates. Such a development would be specifically felt on the short end of the curve as those securities are most sensitive to rate hikes.

Securitized

- Although we have slightly increased our allocation to Agency MBS, we remain markedly below the benchmark. We approach MBS as portfolio ballast, emphasizing cash-flow certainty by focusing on specified pools of securities with high coupons and prepayment-resistant characteristics. The continued ambiguity on the timing of interest rate hikes poses a challenge in gauging prepayment risk. We are also monitoring the Fed's reinvestment into MBS as its existing holdings mature. Buttressing the asset class is our low expectation for meaningful new supply.
- We continue to be constructive on CMBS, focusing on securities that offer competitive yields with potentially less volatility than high-yield corporates. We are finding better relative value in single-asset, single borrower vs. conduit (i.e., multi-loan) deals. Within ABS, we are finding opportunities in whole business securitizations including franchise revenue-backed securities.

Corporate Credit

- We have been concerned for several quarters about historically narrow spreads in investment-grade and high-yield credits. Rather than seeing the recent widening, especially among high-yield securities, as the possible return to more fundamentally sound valuations, we view it as a potential harbinger for future market dislocations. With global growth slowing, companies are seeking to boost earnings growth by undertaking shareholder-friendly initiatives. This is the hallmark of the latter stages of a credit cycle. The bulging new issuance pipeline continues to concern us as well. Consequently, we are focused on capital preservation in part by concentrating our positions in higher-quality companies.
- Market illiquidity is among our chief worries and is a central driver behind our defensive positioning. By keeping our allocation to corporates near the low end of its historical range, we aim to avoid the securities most at risk to market dislocations. Instead, by utilizing our short-term Treasurys as a source of liquidity, we want to position ourselves as buyers of mispriced assets during liquidity events.

Developed and Emerging Market Sovereign Credit

- We maintain exposure to the sovereign debt of the peripheral European countries that have shown a commitment to structural reform. Spain and Portugal have followed Ireland's lead in implementing market-friendly, pro-growth initiatives. This past summer's standoff over another Greek bailout highlighted the risks of failing to address elevated levels of public debt and an uncompetitive labor market.
- Our minimal exposure to emerging markets proved astute, given the summer's pronounced sell-off of these regions' securities. Still, we are closely monitoring the second-round effects that slowing growth will have on commodities exporters and countries with significant trade relationships with China, among others. Commodities exporters that rely upon tax receipts to meet budgetary obligations appear especially vulnerable to weak energy prices.

Yield Curve / Duration*

- Earlier in the summer, we considered better-than-expected growth as a risk to our yield curve and duration positioning. While that may still be the case in the U.S., the coalescence around lower global growth expectations merits consideration when adjusting our portfolios. While unemployment data are within the range that the Fed stated would justify a rate hike, the inclusion of soft global growth as yet another factor to consider only adds to our belief that, in the current environment, we must take an active approach to yield curve positioning in order to sufficiently adjust to a number of potential scenarios. We have increased the duration contribution of our Treasurys allocation, but still maintain a level below that of the benchmark. We seek to maintain sufficient dry powder by holding liquid, short-term Treasurys, but also expect that the Fed likely won't move on interest rates until 2016. At the same time, we have further lowered the duration contribution of our credit allocation, expressing our view that markets remain extremely volatile.

** Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to interest rates, all else being equal.*

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Investing involves market risk. Investment return and value will fluctuate, and it is possible to lose money by investing.

There is no assurance that the investment process will consistently lead to successful investing.

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, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

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