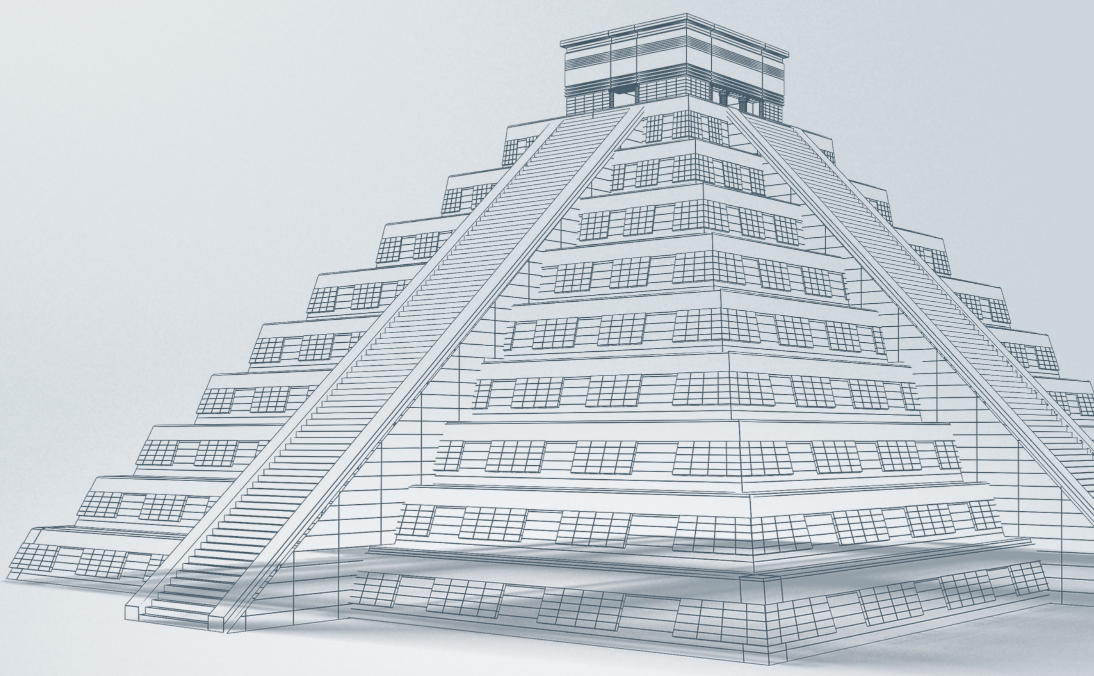
Global Outlook
April 2018

Janus Henderson
INVESTORS

THOUGHTS AND BONDS

Navigating Rising Rates



About Janus Henderson Fundamental Fixed Income

- 30 years of experience emphasizing risk-adjusted returns and capital preservation
- Fundamental, independent research focus
- Quantum Global: proprietary research and risk management system
- Integrated fixed income and equity research effort
- Highly collaborative investment team based in Denver and London
- 69 fixed income professionals as of 12/31/17
- $36.5 billion in assets under management as of 12/31/17

> We are watching closely to see if the incipient signs of inflation have staying power, or if both growth and inflation will taper off to expected levels, allowing the Fed to proceed at its measured pace.

A Word from our Fundamental Fixed Income Team

The shift to tighter monetary policy is upon us after years of quantitative easing that drove down credit premiums, negated term premiums and suppressed volatility. While the U.S. Federal Reserve (Fed) is leading the way, other developed world central banks are joining in, perhaps sooner than many investors expected. In a recent policy statement, the European Central Bank (ECB) dropped its assurance to increase asset purchases in the event the economy deteriorates. The Bank of England (BOE) lifted its growth forecasts, cautioning that rate hikes could come "earlier" and to a "greater extent" than originally expected. And the Bank of Japan (BOJ) is subtly reducing the amount of its bond purchases.

In tandem with the removal of accommodative policy, the U.S. is unleashing fiscal stimulus via tax cuts and budget increases that will require what we view as an ill-timed increase in Treasury supply. Rates seem inevitably set to move higher. Still, we believe inflation will be the ultimate determinant of where things shake out. We are watching closely to see if the incipient signs of inflation have staying power, which could force the Fed into a faster cadence of rate hikes than currently are forecast, or if both growth and inflation will taper off to expected levels, allowing the Fed to proceed at its measured pace.

We've already seen these fears manifest. In February, the calm that had prevailed in markets quickly receded when investors grew concerned that strong U.S. wage growth would force faster-than-expected rate hikes from the Fed. Volatility returned to both rates and risk assets. Looking ahead, we expect that the market will continue to face bouts of heightened volatility amid continued uncertainty around the pace of rate hikes, along with the still unclear implications of tax reform and the administration's trade protectionism.

We intend to use these periods of volatility as opportunities to gain exposure to quality credits. However, we are mindful that we are very late in the credit cycle and shareholder-friendly behavior continues. In this environment, we believe security avoidance is of the utmost importance as we strive to deliver on our core tenets of capital preservation and strong risk-adjusted returns.

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

RATES

Fed Continues to Hike

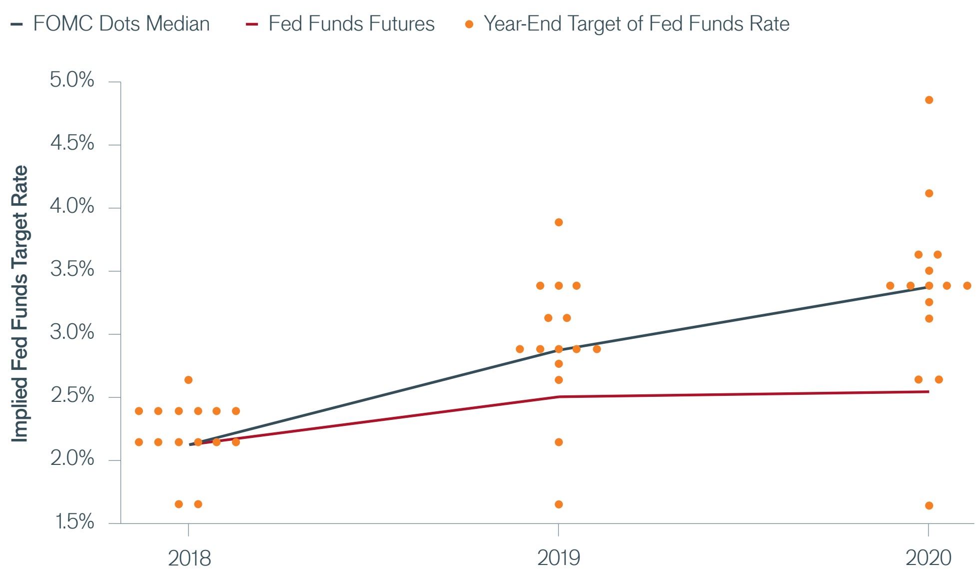
The gradual path of monetary policy normalization, initiated under Janet Yellen, continues under the Fed's new chairman, Jerome Powell. As expected, the Fed raised its benchmark rate at its March meeting by 25 basis points (bps), citing an improving economy and strong job market, bringing the target rate range up to 1.50% to 1.75%.

Going forward, however, the path of Mr. Powell's Fed is becoming less clear as the market starts to be buffeted by crosscurrents. On one hand, economic growth is improving and the job market remains very tight; the Fed even raised its forecast for both metrics during its latest meeting. On the other hand, inflation, while trending higher, does not appear to be breaking out to the upside anytime soon.

As a result, market and Fed forecasts are not in alignment. While the Fed's dot plot indicates a consensus estimate of three total rate hikes in 2018, more Fed officials are now indicating that a total of four hikes may be necessary. They also indicated a potentially more hawkish stance in future years should economic growth continue to run hot, raising the median estimate for the benchmark rate by the end of 2019 to 2.9% and 3.4% by the end of 2020, up from 2.7% and 3.1%, respectively. Market expectations, on the other hand, remain substantially lower: the fed funds futures market indicates that the market is only pricing in 3.5 hikes through 2020.

Exhibit 1: Path for Future Rate Hikes

The market is pricing in fewer rate hikes than the Fed is forecasting



Source: Bloomberg. Data as of 3/27/18

Data shown is for year-end projections.

Inflation Expectations Cause Disconnect

Mayur Saigal, Head of Fundamental Fixed Income Risk, cautions that this disconnect could cause a sell-off in the rates market if the Fed sticks to its expectations. Chris Diaz, CFA, Head of Global Aggregate, agrees, and notes that there are likely sufficient inflationary pressures to warrant the Fed's projected pace of rate hikes. Mr. Saigal points to the continued strengthening in the labor market as especially supportive of additional hikes.

Darrell Watters, Head of U.S. Fundamental Fixed Income, however, notes that there are also numerous deflationary forces in today's market. While the labor market has tightened, we have yet to see a sustained increase in wages. Moreover, since the U.S. economy is still largely consumer-driven, continued disruption in the retail space and the digitalization of the global economy could also keep prices in check. Given these headwinds, Mr. Watters expects growth and inflation expectations to taper off by midyear, leading to only one or two more hikes this year.

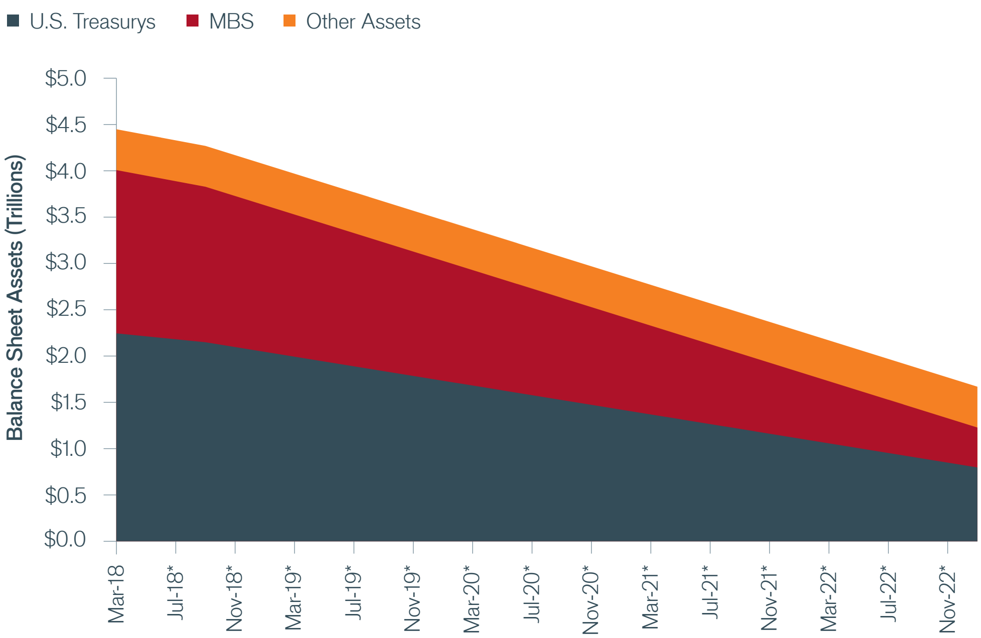
As such, our base case is for the Fed to make a total of three quarter-point hikes in 2018, and for the 10-year Treasury yield to end the year at 3% to 3.5%. We expect the curve to continue to flatten as rate hikes from the Fed move the front end of the curve upward and a bid for yield keeps the long end in check.

Look Out for Curveballs

A few curveballs could change that outlook. One is the impact of what we view as an ill-timed fiscal stimulus in the form of tax cuts and increased government spending. Mr. Diaz notes that we have typically only seen moves like this in a recession, rather than at this point in an economic expansion, when job growth and inflation are trending upward. Moreover, the financing of the stimulus will cause an onslaught of new supply in the Treasury market at the same time that the Fed is stepping back from asset purchases. Ryan Myerberg, Portfolio Manager of the Global Multi-Sector Income strategy, explains that this unfavorable supply-demand dynamic could put upward pressure on Treasury yields, and ultimately may force the Fed to hike faster than is prudent.

Exhibit 2: Reduction of the Fed's Balance Sheet Continues

The Fed is reducing its balance sheet and buying fewer bonds just as Treasury supply is expected to rise



Source: Federal Reserve Bank, Janus Henderson Investors. Data as of 3/28/18

*Estimated. MBS denotes mortgage-backed securities.

Takeaways

- While the Fed is forecasting three total rate hikes this year, with more to come, the market is pricing in only 3.5 hikes through 2020.
- This disconnect, along with the effects of an ill-timed fiscal stimulus or a potential trade war, could impact the rates market.
- Higher U.S. rates should help push global rates upward, and we expect other developed market central banks to step away from their overly-accommodative policies.

A potential trade war could also impact the rates market. Mr. Watters explains that such a trade dispute may hinder growth in the U.S. by raising prices and weakening the dollar. Given the diminished role of the U.S. in global trade, we do not expect that it would weigh materially on global growth. However, this uncertainty leads us to expect range-bound Treasury yields, with the 10-year yield likely capped at 3% in the near term.

Global Rates Set to Move Higher

Higher U.S. rates should help push global rates upward, and we expect that other developed market central banks will also have to step away from their overly accommodative policies. The ECB is reckoning with strong growth but low inflation. Given this dynamic, we continue to expect that the central bank will end its asset purchases by the end of the year and could initiate hikes by mid-2019. Further, at its March meeting, the ECB removed from its statement a specific reference to the possibility of increasing the size and duration of its asset-purchasing program if the economic situation were to deteriorate. The unanimous decision further supports our expectations that they intend to continue moving toward normalizing monetary policy.

The BOE also held policy steady at a recent meeting, although officials commented that they may be forced to tighten faster than expected as inflation is rising above its 2% target. However, Mr. Myerberg notes that officials still want greater clarity over Britain's post-Brexit future as they consider the economic outlook.

In Japan, Mr. Diaz explains that incipient inflationary pressures could help boost rates. The seasonally adjusted unemployment rate in the country was reported at 2.5% in February, up slightly from January's 2.4%, its lowest level in 25 years. This could help foster an environment for wage pressure, despite the country's aging population. We continue to believe investors should consider the possibility of the BOJ readjusting its yield curve control to higher bounds, especially given its recent move to step back its bond-buying program. ■

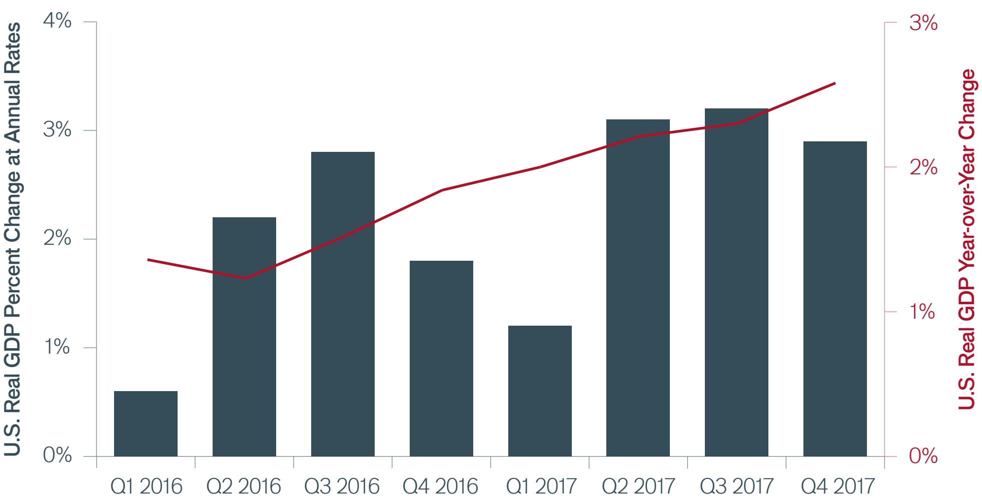
Supportive Fundamentals

We continue to expect a positive return environment for corporate credit in 2018. However, with the Fed raising interest rates and buying fewer bonds, returns are likely to be lower than in recent years. Further, we expect carry to be the primary driver of returns rather than spread tightening, Mr. Saigal says. Late in the business cycle, with valuations remaining rich, Mr. Watters argues that balancing alpha-generating opportunities with capital preservation will be critical. We continue to believe a diversified portfolio and emphasis on security avoidance can help maintain such a balance.

Strong corporate and macroeconomic fundamentals continue to be supportive of corporate credit, and therefore we do not expect spreads to materially widen in the near term. During the first quarter, companies reported strong earnings growth and rising free cash flows in the wake of tax reform. Further, the outlook for U.S. gross domestic product (GDP) continues to improve. We anticipate that these trends will persist in the near term and expect that they should be supportive of spreads.

Exhibit 3: U.S. GDP Continues to Strengthen

Given an improving U.S. economy, we do not expect corporate credit spreads to materially widen in the near term



Source: Thomson Reuters Datastream. Data as of 3/28/18

Assuming policymakers do not surprise investors with faster-than-expected rate hikes, corporate credit should provide incremental return opportunities in the months ahead. While rising rates certainly can pressure credit spreads, we expect that if central banks focus on tapering without causing a market tantrum, range-bound rates and low volatility should continue to drive investors' reach for yield and demand for "riskier" asset classes, including corporate credit.

Takeaways

- We do not expect spreads to materially widen in the near term given strong corporate fundamentals and solid GDP growth.
- We are closely monitoring whether credit spreads have sufficient yield to absorb new issuance and higher rates.
- In balancing our constructive fundamental outlook with current credit market valuations, we seek to capitalize on spread movements that create the potential for attractive total returns.

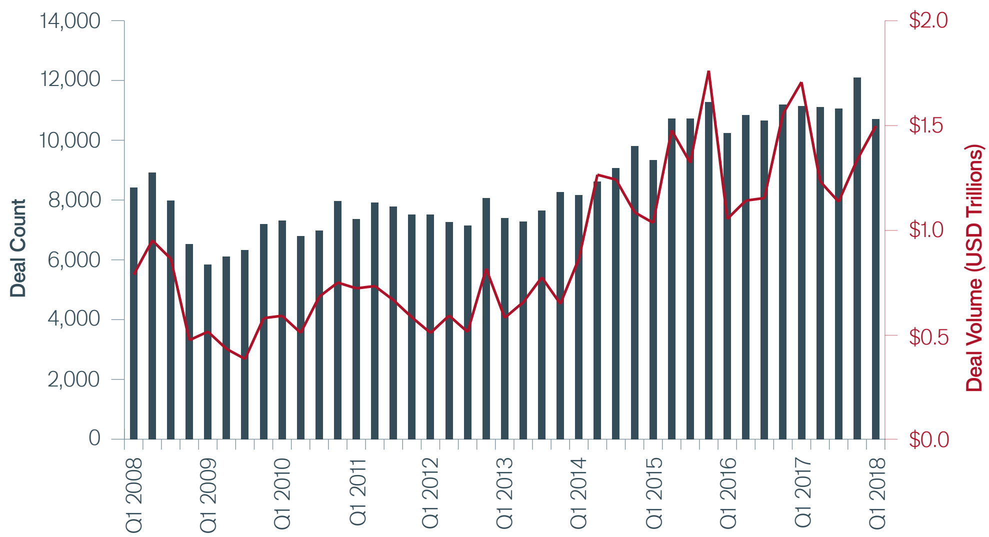
Potential Headwinds

However, we continue to monitor whether corporate valuations can absorb rising rates. Rising rates can pressure spreads, but the speed of the hikes is of the utmost importance, as that is what determines whether the hike can be absorbed by credit spreads. The handoff from monetary stimulus to fiscal stimulus could influence this pace, especially so late in the business cycle. If the injection of fiscal stimulus causes the economy to overheat, the Fed may be forced to raise rates faster than expected, which could cause investors to rush for the exits.

Corporate leverage also remains a key concern. Tax reform has given more companies the confidence and wherewithal to pursue mergers and acquisitions (M&A). Also, with the Fed clearly signaling that it will continue to hike rates, management teams are acting now so they can finance their M&A activity while interest rates are still low, Mr. Watters explains. This push has led many firms to pay significant premiums for acquisition targets and resulted in higher leverage and a flurry of new debt issuance. As Mr. Saigal notes, companies are trying to buy growth. Should that growth falter, we're concerned credit spreads could widen.

Exhibit 4: Global M&A Activity Remains Elevated

The rush to finance M&A while rates are still low is flooding the market with new debt issuance, a potential headwind for investment-grade credits



Source: Bloomberg. Q1 2018 data as of 3/28/18

This dynamic is especially concerning within investment-grade credit. While we think the high-yield market has sufficiently large yield to absorb new issuance and higher rates, not as much cushion currently exists within investment grade. If M&A and debt issuance increases from here, these credits could be especially vulnerable.

Defensive but Opportunistic

As we balance our constructive fundamental outlook with current credit market valuations, we remain opportunistic, seeking to identify and capitalize on spread movements that create the potential for attractive total returns. Our analysts are evaluating disruptive trends in their respective industries and digging into company fundamentals, attempting to identify which issuers are prepared to adapt to new trends and which may not survive. While we seek to avoid the downside risk surrounding M&A activity, we believe entities committed to deleveraging post-transaction can offer strong, risk-adjusted opportunities, Mr. Saigal says.

Industries that have been out of favor with the market but still offer sound fundamentals also offer potential for spread tightening, Mr. Watters says. He points to utilities and master limited partnerships (MLPs) that own and manage energy pipelines as prime examples. Both have underperformed as rising rates and low energy prices, respectively, have weighed on these industries. However, these credits now trade at significant discounts to Treasurys, and many companies have focused on paying down debt to improve their balance sheets. Further, demand for electricity and natural gas continues to rise, which should help support these companies' earnings power.

An emphasis on traditionally defensive sectors and issuers with higher-quality business models, steady free cash flow and management teams committed to sound balance sheets should offer steady carry and minimize downside risk. Our focus remains on short- and intermediate-dated securities in which we believe we have clearer insight into the issuer's ability to pay down debt. Within high yield, we continue to seek out "crossover" issuers that may be candidates for ratings upgrades. These are issuers with positive earnings outlooks and management teams ready to delever, Mr. Watters explains. ■

Road Map

Portfolio Positioning

- Corporate fundamentals remain strong; however, we are mindful of late-cycle behavior, stretched valuations and the return of volatility. We intend to minimize systematic risk while maintaining our opportunistic approach in corporate credit.
- Inflation data will have the most significant impact on rates in the months ahead. We expect modestly higher rates as the Fed tightens, and will actively manage yield curve positioning with a focus on capital preservation.

U.S. Corporate Credit

- Steady global growth, strong corporate earnings and corporate tax reform are all favorable for corporate credit. However, given late-cycle behavior, stretched valuations, an active Fed and the return of volatility, we believe risk is skewed to the downside.
- We intend to minimize systematic risk while seeking to identify strong idiosyncratic stories of balance sheet improvement with the ability to perform well, despite the performance of the broader credit market. Security avoidance remains critical.
- We expect bank loans – which benefit from a senior position in the capital structure and can provide protection against rising rates – to offer stable and attractive risk-adjusted opportunities in the months ahead.

Yield Curve/Duration

- We expect modestly higher rates, commensurate with Fed activity and an increase in Treasury supply. As the front end of the yield curve rises with Fed expectations, we expect the long end of the curve to exhibit more stability. Skepticism over U.S. economic growth and a continued demand for yield should help keep long-term yields in check and lead to a flatter curve.
- Three interest rate increases are feasible, but the direction inflation takes from here will ultimately drive the number of hikes in 2018. We are mindful of the potential for policy error – whether the Fed gets behind the inflation curve, or moves too quickly ahead of it.
- We intend to maintain our underweight allocation to Treasury securities and duration modestly below that of the benchmark. However, we will continue in our tactical approach to yield curve positioning with a focus on capital preservation.
- 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 use long-end Treasurys to balance our corporate exposure. Short-duration Treasurys act as a source of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations.

Securitized

- We expect volatility in mortgage-backed securities (MBS) to increase in tandem with rate volatility. As the Fed normalizes its balance sheet and many asset manager allocations appear full, we are also questioning “who will be the marginal buyer?” We maintain our underweight allocation.
- MBS is utilized as ballast for our core portfolios, to act as a diversifier when corporate credit volatility rises. We emphasize securities with higher expected certainty of cash flows and seek to optimize carry per unit of convexity.
- When seeking commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS), 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.
- Economic momentum, low unemployment, the strength of consumer balance sheets and personal tax reform give us confidence in the consumer and we are finding strong relative value opportunities in consumer-driven ABS stories.

Developed Markets

- We anticipate positive growth trends across Europe will spur the ECB to terminate its QE program by year-end. Low inflation in the eurozone’s core, however, will likely keep interest rate hikes on hold until mid-2019. Negative policy rates are becoming unsustainable, in our view, and we intend to remain underweight core European duration.
- While the ECB’s QE measures are likely to support tighter spreads and continue to dampen volatility, valuations in European corporate credit are uncomfortably tight.
- Due to Brexit-related uncertainty, sterling, gilts and UK corporate credit generally remain unattractive.
- With the Japanese unemployment rate still near 25-year lows, we see potential for wage pressures to accelerate. Inflation-linked securities remain attractive.

Emerging Markets

- Our outlook is cautiously optimistic. Barring a major shift higher in developed market interest rates, the upward trajectory in global growth, a commensurate rise in commodities prices and the weaker dollar should continue to provide a favorable backdrop for emerging markets.
- We are emphasizing exposure in economies with limited ties to commodity prices, and seeking opportunities in countries with minimal potential political volatility.

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

Janus Henderson INVESTORS

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