WINTER 2017

GLOBAL
OUTLOOK

JANUS CAPITAL® Group

Opportunities Ahead?

THOUGHTS AND BONDS: MACRO VIEWS FROM THE JANUS FUNDAMENTAL FIXED INCOME TEAM

Fundamental-Informed Macro Views

Fundamental, independent research has been at the core of the Janus Fixed Income process for more than 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.

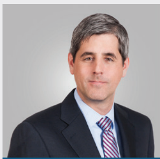
ABOUT JANUS FUNDAMENTAL FIXED INCOME

- **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 team based in Denver and London**
- **35 fixed income investment professionals**
- **$36.8 billion in assets under management as of 9/30/2016**

The opinions expressed are those of the authors as of December 2016 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.

> “If the U.S. had been in the latter innings of a credit cycle, the election of Donald Trump and a Republican-controlled Congress may have just extended the game.”

DARRELL WATTERS
HEAD OF U.S. FUNDAMENTAL FIXED INCOME



CHRIS DIAZ, CFA
HEAD OF GLOBAL FUNDAMENTAL FIXED INCOME

A Word from our Fundamental Fixed Income Team

For more than two years we articulated concern that the U.S. was in the latter stages of a credit cycle. Such periods are marked by the type of shareholder-friendly activity we've witnessed since 2014: widespread mergers and acquisitions (M&A), share repurchases and increased dividend payouts – generally financed via re-leveraging balance sheets at the expense of bondholders. A spike in defaults – although primarily commodity driven – also generated concern that the end of the cycle was looming.

Enter a new administration with President-elect Donald Trump and a Republican-controlled Congress. If successful, Mr. Trump's proposed tax cuts, infrastructure spending and deregulatory initiatives could drive increased growth and inflation in the U.S., enabling the recent earnings recession to shift toward improving corporate fundamentals in 2017.

Prospects of growth and the accompanying rise in operating earnings would allow companies to grow into their capital structures, making the elevated leverage that has kept bond investors up at night more manageable. If we had been in the latter innings of a credit cycle, the results of the recent U.S. election may have just extended the game.

We will closely monitor the difference between rhetoric and policy implementation throughout 2017, as well as the transition from policy intentions to growth. We remain wary of stretched valuations after spread tightening in 2016, yet with growth prospects on the horizon, we are taking a selectively opportunistic approach to U.S. corporate credit in the new year.

Our analysts conduct in-depth, bottom-up research to identify issuers with higher quality business models and strong fundamentals, particularly in sectors that may benefit from a change in fiscal policy. In this extended cycle, the importance of security avoidance remains a central aspect of our investment process. Even as we opportunistically add to credit, we intend to maintain a conservative bias, reflecting our commitment to deliver capital preservation and strong risk-adjusted returns for our clients.

KEY TAKEAWAYS

- We anticipate a steeper yield curve, with the front-end moving on Fed projections and the long-end rising further on increased inflationary expectations.
- We are generally constructive on U.S. corporate credit, especially shorter-dated issues within high yield and the lowest-rated tier of investment-grade securities.
- Our analysts are focused on identifying opportunities in sectors that may benefit from changes in economic policy, whether through fiscal stimulus and/or deregulation.

United States

Since the 2008 financial crisis, markets have endured a sustained period of accommodative central bank policy that failed to spur robust economic growth. A pivot to fiscal spending may be what the U.S. needs to stimulate its economy, and the incoming U.S. administration aims to deliver such initiatives. Mr. Trump's pro-business proposals have already generated a more positive outlook for the U.S. economy and triggered increased growth and inflation expectations even in the face of a stronger dollar and rising interest rates. Regardless of whether he is able to fully execute on his plans for corporate tax reform, industry deregulation and infrastructure spending, diluted versions of his proposals should still prove beneficial to the U.S. economy.

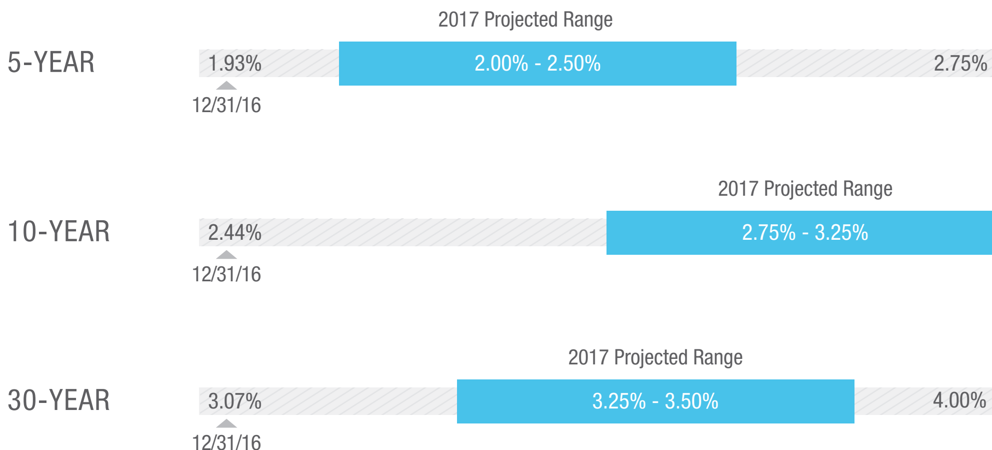
REFLATIONARY POLICIES AND AN ACTIVE FED CHALLENGE THE RATE MARKET

Following the U.S. election, Treasurys generally sold off, pushing rates higher as market participants honed in on the potential for reflationary policies. Concern that elevated fiscal spending will be funded via debt issuance is also driving the recent backup in rates. The Federal Reserve's (Fed) forecast for three interest rate hikes in 2017 presents further challenges for the asset class. Risk of Fed policy error remains strong as the U.S. attempts to extricate itself from a seven-year stint of accommodative and unconventional monetary policy, along with a recent string of fragile economic data.

However, three hikes are in line with our expectations, and more could be warranted in a reflationary environment. The Fed's new benchmark rate of 0.5% to 0.75% remains well below the long-term average, providing a long runway before monetary policy becomes a headwind. Confidence in the economy and rising inflation, in combination with the expectation for fiscal stimulus, fuels our forecast for a controlled move higher in rates across the curve through the first quarter of 2017. We anticipate a steeper yield curve, with the front-end moving on Fed projections and the long-end rising further on increased inflationary expectations.

U.S. Treasury Yield Forecasts

We anticipate a steeper yield curve with front-end rates moving on Fed projections and the long-end rising on increased inflationary expectations.



Source: Bloomberg, Janus

SELECTIVELY OPPORTUNISTIC ON CORPORATE CREDIT

While rates sold off abruptly, risk assets such as corporate credit have remained in favor during the "Trump Tantrum." The third quarter of 2016 produced a modest improvement in company earnings; if the Republicans are successful in implementing pro-growth policies, fundamentals should strengthen further in 2017. A healthier earnings growth trajectory and improved free cash flow for companies would help validate current spread levels, which tightened dramatically in 2016. Robust demand for U.S. corporate credit should continue, due to comparatively higher yields versus other segments of global fixed income markets. This technical dynamic further supports our modestly improved outlook. We are generally constructive on corporate credit in the coming year, especially shorter-dated issues within high yield and the lowest-rated tier of investment-grade securities. Higher rated investment-grade credit is less attractive, as it does not have sufficient spread cushion to withstand a rising rate environment.

Many fixed income asset classes will find it difficult to generate upside as rates rise over the next 12 months, but our base case for high yield is a 5% to 6% return with a watchful eye toward the downside. Our return expectation for high yield ranges from a bullish 8% to a bearish 4%, acknowledging that business-friendly measures should lead to further spread tightening, but that spreads at current levels cannot sustain another dramatic move upward in rates. While a rising default rate – primarily led by the commodities sector – generated concern early in 2016, steady inflows into high yield, and an increase in commodity prices, prevented widespread defaults in recent months. We saw the default rate crest in 2016 and taper off later in the year – a downtrend that we believe will continue into 2017.

THE BENEFITS OF ACTIVE MANAGEMENT IN A CHANGING REGIME

We are opportunistically adding to credit across sectors where we can identify companies that exhibit higher quality business models and attractive valuations. Within oil and gas – particularly oil field services and offshore drillers – we continue to uncover opportunities in companies that have repaired their balance sheets and are poised to succeed in varying oil price environments. Companies with a quality asset base, or those purchasing top tier assets, are particularly attractive. Consolidation in this industry should lead to stronger balance sheets, more stable day rates – the daily price paid to operate a drilling rig, and improved earnings profiles. Additionally, we believe the price of crude oil could potentially break through the upper bound of its range, should OPEC and other large oil-producing countries follow through on and sustain promises to curtail production.

Our analysts are also focused on identifying opportunities in sectors that may benefit from changes in economic policy. For example, fiscal stimulus should spur improved fundamentals in the industrial and consumer sectors. Reduced regulation should prove advantageous for financials, a sector also set to benefit from a steepening yield curve. Pharmaceuticals and technology companies may benefit from the repatriation of foreign capital, but we are leery of potential mandates on how such capital is used. Hospital cash flows should improve if Mr. Trump succeeds in dropping the corporate tax rate. Additionally, while hospitals will be impacted by a potential revocation of the Affordable Care Act (ACA), we believe the market is overreacting given the societal need for hospital services, and leaving asset-rich hospitals at attractive valuations.

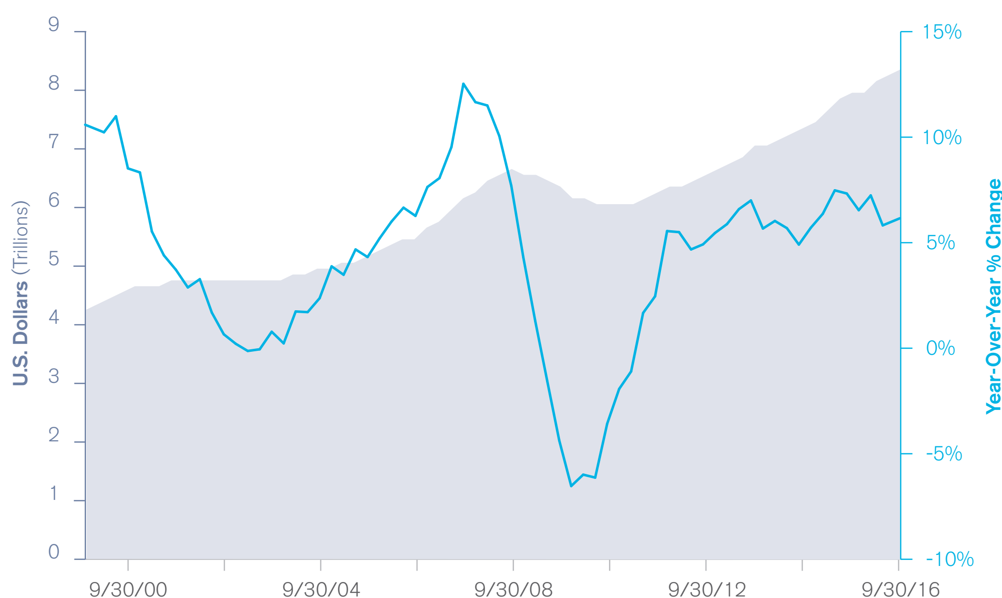
We are mindful, however, that not all reforms will be beneficial. If the U.S. moves to tax goods based upon where they are consumed as opposed to where they are produced, pharmaceutical issuers with inverted tax structures would be punished, as would retailers and manufacturers that import a meaningful percentage of their cost of goods sold.

In terms of issuance, we expect 2017 levels to be in line with 2016's record year. Issuers generally have already taken advantage of the low-rate environment to reinforce balance sheets. Increasingly, incremental leverage is used for share repurchases and dividend payments, to the detriment of bondholders – a scenario that reminds us that even if the credit

cycle has been extended, we are still facing its later stages. Issuance levels could see a slight boost if M&A approvals are granted more freely from a business-friendly administration, in which case active security selection remains of the utmost importance in order to discern accretive deals and to identify management teams committed to post-acquisition delevering. Companies may have less need to borrow if the new administration allows for the repatriation of foreign capital back to the U.S. A change in interest expense deductibility would also push up the cost of debt, and we could see fewer companies willing to issue as a result.

U.S. Corporate Debt Outstanding

Following a brief period of de-leveraging in the wake of the 2008 financial crisis, debt on corporate balance sheets has continued to climb as management teams take advantage of low interest rates. (12/31/99-9/30/16)



Source: Bloomberg

MORTGAGES AND DURATION EXTENSION RISK IN THE INDEX

With an actively tightening Fed, we anticipate volatility for mortgage-backed securities (MBS). The recent sell-off in rates has driven the duration of the MBS index up, to just under five years. Given that MBS represents over a quarter of the Bloomberg Barclays U.S. Aggregate Bond Index, the duration of the index has increased in stride over the same period. As a result, investors passively tracking the index are now exposed to greater interest rate risk. We view mortgage-backed securities as ballast for our actively managed core portfolios. Our exposure is concentrated in generic agency pass-throughs with less negative convexity than the index, high coupons and high loan-to-value.

As financing costs tick higher, borrower refinancing and new home purchases are likely to decline. We are closely monitoring how declining issuance will affect the Fed's reinvestment of its $1.74 trillion MBS portfolio, as its existing holdings mature. We do not anticipate a policy change in 2017, which supports our outlook for decent performance in the coming year. Fundamentals remain attractive, and prepayments should be limited in a rising-rate environment. Continued interest in MBS from banks and foreign buyers should also support the asset class.

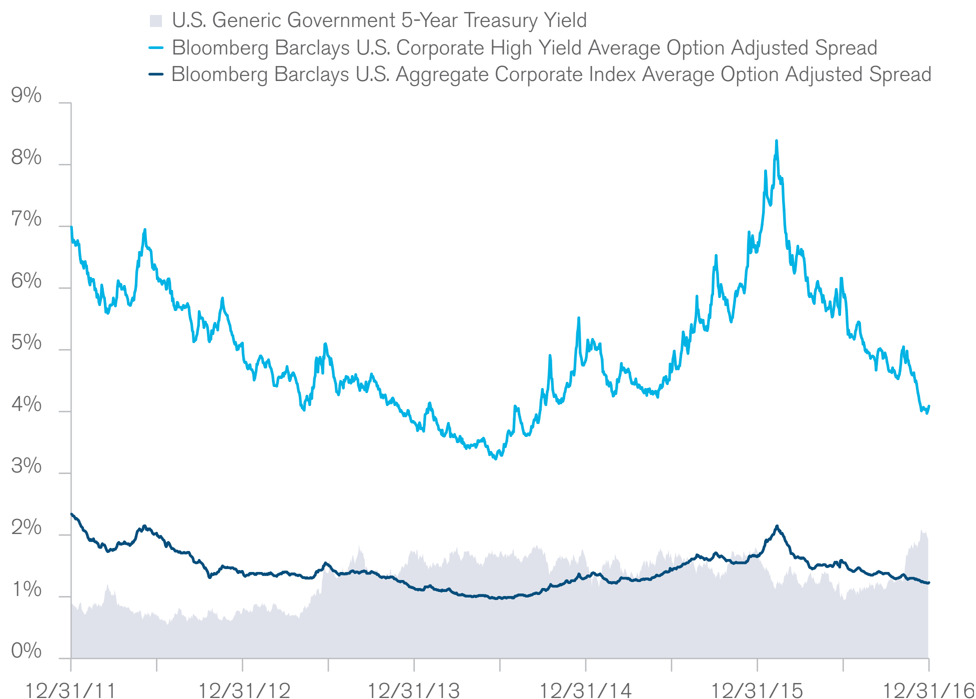
WAIT AND SEE

Market moves in 2017 will be determined by the success of Mr. Trump's policy execution. Despite Republican control, the president-elect is likely to face fiscally conservative resistance in Congress, and legislative opposition could surprise markets to the downside. Significant risk could also emerge if excessive fiscal spending by the new administration does not result in strong growth. A more subdued economy should force the average maturity of U.S. debt to extend. While the probability is low, this – coupled with deterioration in the fiscal picture – could potentially lead to a U.S. downgrade. In either scenario, we expect that failure to stimulate growth would generate a sell-off in stocks and credit, as well as in rates. Over the long run though, Treasurys should ultimately benefit, and again become the "risk-free" choice of global investors.

For now, however, our largest concern for corporate credit is not economic: It's rising rates. Credit's spread cushion is dissipating as credit absorbs the upward adjustment in rates. Once the minimal acceptable premium over the risk-free rate dissolves, corporate-credit spreads could begin to widen as investors are no longer compensated for taking credit risk. We do not believe the asset class can sustain another dramatic shift higher in risk-free rates. For MBS, the biggest risks stem from the Fed. A more hawkish approach and faster-than-expected tightening could prove detrimental to the asset class, as would a decision to pare down its MBS portfolio as volume declines.

Dissolving Spread Cushion

Once the minimal acceptable premium over the risk-free rate dissolves, corporate-credit spreads could begin to widen as investors are no longer compensated for taking credit risk.



Source: Bloomberg

Developed Markets

The divergence in monetary policy we expected in 2016 could take tangible form in the coming year, as the Fed is set to keep tightening and most other developed central banks remain accommodative. Yet questions around the effectiveness of ultra-low and negative interest rates, and their unintended consequences, make it unlikely that many developed nations will pursue such accommodative policies any further. Quantitative easing (QE), however, continues in Europe, the UK and Japan.

KEY TAKEAWAYS

- Quantitative easing by the ECB coupled with reflationary pressure from growth in the U.S. should lead to rising rates and a steeper yield curve in Europe.
- Asset purchases by the ECB and the BOE have led to spread tightening in corporate credit; on a risk-adjusted basis, we are identifying more attractive opportunities elsewhere.
- We anticipate the BOJ will successfully maintain a pegged yield curve, setting up Japanese rates to outperform most rates in the developed world.

EUROPE: POPULISM'S RISK TO SPROUTING GROWTH

The European Central Bank (ECB) recently broadened the assets available for purchase under its QE program to those with maturities of one to 30 years. With this adjustment, we expect the bank to have sufficient inventory to buy through the end of 2017. Continued QE will cause further expansion of the ECB's balance sheet, and should lead to a steeper yield curve. Buying newly available shorter-dated securities will effectively anchor the short end of the curve, and with fewer long-dated bonds available, we anticipate the long end of the curve to rise. Reflationary pressure from growth in the U.S. is also liable to propel rates higher.

The ECB will begin trimming the volume of its purchases in 2017, signaling that the bank is more comfortable with its inflation target. A strengthening U.S. dollar and waning deflationary forces out of China could also spur reflation in the region. We do not, however, expect the ECB to tighten within the next two years. Our base case is that the ECB will continue to taper quantitative easing as economic data supports such a move.

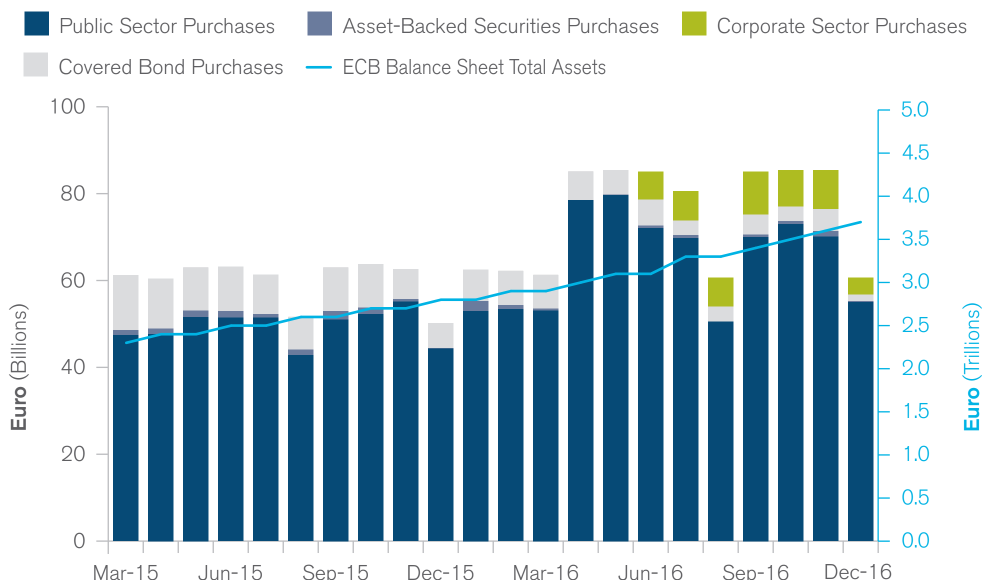
Signs of growth are sprouting in core Europe, but not to the levels we are witnessing in the U.S. ECB President Mario Draghi along with the European Council, which sets the European Union's (EU) political priorities, continue to implore local governments for fiscal stimulus. Generally speaking, many countries are not in a position to spend, and those that are capable are unwilling. The European economy could see a surprise to the upside if countries, particularly Germany, begin to loosen their fiscal constraints. With a number of important elections in 2017 and populism rising, we will be watching major parties to see if their rhetoric shifts in favor of fiscal spending in order to garner votes from the far right. If the specter alone can fuel growth prospects in the U.S., the pairing of accommodative monetary policy with fiscal reform could be truly beneficial to the region.

Political risk is our primary concern in Europe. France votes for a new president in April; Germans will decide whether to re-elect Chancellor Angela Merkel for a fourth term as early as August. In both countries – the EU's largest economies – far-right, anti-EU parties have become increasingly popular among voters. A win by Marine Le Pen, president of the National Front in France, presents the biggest risk to the downside, in our view. If French and German leaders are unwilling to work in partnership, the dissolution of the EU becomes more probable. We believe the bond market would crack under the potential breakup of the single currency. At this time, there is no redenomination risk priced into European assets.

While we continue to seek idiosyncratic opportunities in Europe, corporate credit valuations, appear relatively expensive as a result of QE measures. Additionally, we do not believe there is sufficient compensation for the level of risk. Bond buying, coupled with Europe's heightened political risk, will continue to weigh on rates as well as the currency, likely pushing the euro to parity with the U.S. dollar and further incentivizing investors to look toward U.S. investment.

ECB Asset Purchase Program

Since the program began in June 2016, the ECB has purchased more than €51 billion worth of corporate bonds, contributing to rich corporate credit valuations in the region.



Source: ECB, Bloomberg

UK: A FATE IN LIMBO

Similar to Europe, corporate credit has tightened with the help of the Bank of England's (BOE) asset purchase program, and on a risk-adjusted basis, we are identifying more attractive opportunities elsewhere. The yet-to-be-known fate of Brexit is the biggest driver of uncertainty for UK assets, including rates, credit and the pound.

The massive depreciation in the currency is creating upward price pressure, but we anticipate the BOE to hold rates steady until clarity is gained around the Brexit process. UK economic data should deteriorate in 2017, accounting for the lag following the Brexit vote. If so, we would expect the central bank to expand QE, or – depending on the severity of the downturn – perhaps cut interest rates.

JAPAN: BUSINESS AS USUAL

In sustained attempts to generate growth and inflation, the Bank of Japan's (BOJ) most recent tactic focuses on targeting yields across a range of government bond maturities. We anticipate the bank will successfully maintain a pegged yield curve, setting up Japanese rates to outperform most rates in the developed world – particularly as U.S. Treasurys sell off. Continued weakness in the yen should carry through to higher inflation in the near term, but it will eventually take its toll on Japanese consumers.

Emerging Markets

KEY TAKEAWAYS

- The level of uncertainty around future protectionist trade policy from Mr. Trump's administration limits our confidence in emerging market debt.
- Policy missteps from Beijing, or an unexpected downturn in China's growth, could have significant impact for its trading partners, as well as commodity prices.
- A slowdown in inflationary pressures in certain emerging market economies may create an opportunity to take interest rate risk in local currencies.

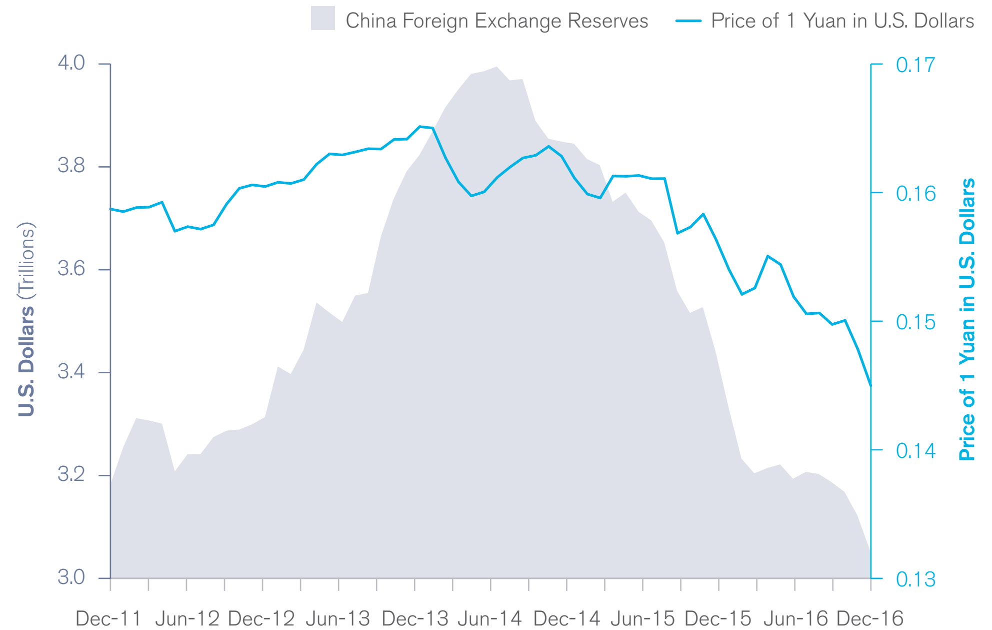
CAUTION WARRANTED

Our outlook for emerging markets remains cautious. U.S. growth should provide a tailwind for emerging economies as commodity prices benefit from inflationary pressures and rising demand. However, the level of uncertainty around future protectionist trade policy from Mr. Trump's administration limits our confidence in the asset class. An imposition of outsized tariffs on goods imported to the U.S. could hinder growth in the economies of U.S. trade partners. The potential dismantling of the North American Free Trade Agreement and collapse of the Trans-Pacific Partnership would be detrimental to emerging market investments.

Slowing growth in China also continues to be of concern. The country's commitment to monetary and fiscal stimulus has been the growth engine of the global economy since the financial crisis. Policy missteps, or an unexpected downturn in growth, could have significant impact on its trading partners, as well as commodity prices. Additionally, as the dollar strengthened throughout 2016 Beijing has spent a large portion of its foreign currency reserves, attempting to keep the yuan from rapid decline. We believe a shift in policy to let the currency slide would create a risk-off environment, dragging down emerging markets and commodities.

Declining Yuan Could Drag Down Emerging Markets

Throughout 2016, Beijing has spent a large portion of its foreign currency reserves, attempting to keep the yuan from rapid decline.



Source: Bloomberg

Despite the challenges, we continue to seek opportunistic investment in the asset class. A slowdown in inflationary pressures in certain emerging market economies may create an opportunity to take interest rate risk in local currencies. In Colombia, for example, we believe the narrowing of the country's current account deficit and a downtrend in inflation make a case for an interest rate cut by the local central bank. We also appreciate the country's commitment to maintaining its investment-grade rating. Still, until clarity can be gained around U.S. trade policies, we intend to maintain limited emerging market exposure.

PORTFOLIO POSITIONING: DEFENSIVE ON RATES, NEUTRAL ON CREDIT

- Following the U.S. presidential election, the prospect of fiscally driven pro-growth initiatives has extended the credit cycle, and our view on credit has turned modestly more opportunistic.
- We are incrementally adding to our credit allocation as we identify companies that exhibit solid fundamentals and attractive valuations. Yet our credit mix remains conservative. We are focused on companies with higher quality business models and U.S.-driven cash flows. Security avoidance remains a key tenet in our investment process.
- New fiscal policies, if properly implemented, should have greater success in driving GDP and inflation higher in the U.S., putting further upward pressure on rates. We will continue to actively manage duration and yield curve positioning, with the expectation of maintaining underweight duration positioning until the new administration's policy measures are clarified.

U.S. CORPORATE CREDIT

- With the new administration focused on pro-growth initiatives, our concerns over lower GDP and the end of the credit cycle have moderated. Global demand for U.S. corporate credit – due to its comparatively higher yields versus other global fixed income asset classes – also contributes to our modestly improved outlook.
- We are focused on investing in securities and sectors that could benefit from a change in economic policy, whether through fiscal stimulus and/or reduced regulation.
- We expect bank loans – which benefit from a senior position in the capital structure and offer protection against rising rates – to offer stable and attractive risk-adjusted opportunities with lower volatility than the high-yield market.
- We are opportunistically adding to credit, including high yield. However, our allocation remains conservative, as we seek to participate in spread tightening while keeping capital preservation at the forefront. Across the quality spectrum, our focus remains on higher quality issuers with ample liquidity, strong free-cash-flow generation potential and commitment to a sound balance sheet.

YIELD CURVE/DURATION

- An improved economic outlook coupled with the recent increase in both rate hike and inflation expectations lead us to expect a steeper yield curve in the first quarter of 2017, with the front end moving on Fed projections and the long end rising on increased inflationary expectations.
- While we are reducing duration exposure from Treasurys, longer-dated maturities continue to serve as a hedge for our underweight allocation to long credit. Short-duration Treasurys act as a source of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations.
- 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 the ability to pay down debt.
- We expect to maintain duration below that of the benchmark as we start the new year. We will actively manage duration and yield curve positioning with a focus on capital preservation.

TREASURY

- With a stronger U.S. dollar, relatively higher oil and the president-elect's pro-growth promises, we believe nominal Treasury rates will continue to rise into the first quarter of 2017.
- We reduced our Treasury allocation and our duration exposure from the asset class and diversified our duration profile with the addition of Treasury Inflation-Protected Securities (TIPS).
- We use long-end Treasurys to hedge to our underweight in long credit. Short-duration Treasurys act as a source of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations.

SECURITIZED

- We view mortgage-backed securities as ballast for our core portfolios. Our exposure is concentrated in generic agency pass-throughs. We seek securities with high coupons, high loan-to-value and pre-payment resistant characteristics.
- In a rising-rate environment, borrower refinancing will likely decline, as will new mortgage issuance. While we do not anticipate a policy change in 2017, we are closely monitoring how a reduction in volume will affect the Fed's reinvestment into MBS as its existing holdings mature.
- We view commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) as opportunistic investments, seeking those where our analysts can form a constructive fundamental view on the underlying assets. Within CMBS, we allocate to higher quality, shorter duration positions that we believe can offer cash flow stability. In our view, single-asset, single-borrower deals offer better relative value than conduit, or multi-loan, deals. Within ABS, valuations on auto securitizations appear expensive, while certain franchise revenue-backed securities continue to present unique opportunities.

DEVELOPED & EMERGING MARKETS

- The ECB faces a diminished inventory of longer maturity bonds to purchase and now plans to buy shorter-dated paper, a scenario which would effectively anchor short-term rates, while pushing up long-term rates. We intend to remain underweight duration in the region.
- While we continue to seek idiosyncratic opportunities in Europe, overall corporate credit appears relatively rich as a result of quantitative easing. Additionally, valuations are not sufficiently compensating investors for the abundant political risk in the region.
- In the UK, the manner in which the Brexit proceedings unfold will be the biggest driver of risk to rates, credit and the currency. General uncertainty has led to our defensive positioning.
- We are evaluating whether easing inflationary pressures in certain emerging market economies could lead to interest rate cuts and therefore attractive risk-adjusted duration opportunities. However, until clarity can be gained around U.S. trade policies, we intend to maintain limited emerging market exposure.

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Janus Distributors LLC 151 Detroit St. Denver, CO 80206

FOR MORE INFORMATION CONTACT JANUS

151 Detroit Street, Denver, CO 80206 / 800.668.0434 / www.janus.com

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