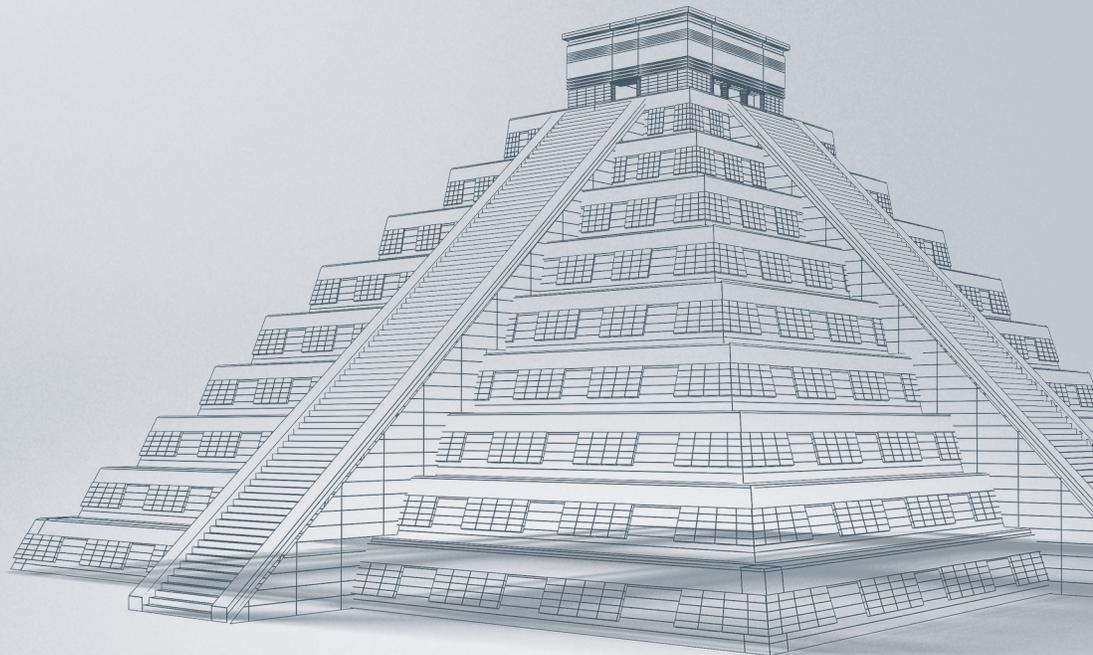


THOUGHTS AND BONDS

A Balancing Act



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 9/30/17
- \$36.6 billion in assets under management as of 9/30/17

“ We expect a low return environment in 2018, and carry to be the primary driver of returns. Given rich valuations and the asymmetric risk profile of credit investing, security avoidance will be critical in the months ahead.”

Mayur Saigal, Head of Fundamental Fixed Income Risk

A Word from our Fundamental Fixed Income Team

As we start a new year, the global economy is in a healthy place. Nearly all of the large developed and emerging economies are experiencing synchronous growth – something we have not seen since before the financial crisis. Corporate earnings growth has also been strong, and our outlook is constructive for the year ahead, particularly now that U.S. corporate tax reform has passed. We are optimistic given this momentum. Inflation, however, will likely remain subdued, and a number of the challenges that we have communicated over the last several quarters persist.

The end is closer than the beginning, in regards to both the monetary policy cycle and the business cycle. Accommodative policy has stripped investors of traditional sources of income. Central bank action has resulted in lower term premiums, reduced credit premiums and a lack of market volatility. The latter has encouraged risk taking and a buy-the-dip mentality. Investor complacency is high, especially as we enter an era in which, for the first time in a long time, central banks are removing stimulus.

Central bank accommodation also played a large part in extending the business cycle. Low rates have allowed companies to refinance and extend their debt maturities, as well as to borrow to fund shareholder-friendly initiatives. Yield-hungry investors have been willing to fund these efforts, even for companies that may not typically deserve it. While we do not expect a material increase in the default rate, active security selection – and avoidance – will be critical in the event risk sentiment reverses along with central bank policy.

Our base case is that a cautious approach to tighter monetary policy will lead to modestly higher but range-bound yields in the developed world. Relatively low rates should continue to drive demand for corporate credit, and, coupled with a successful pivot to fiscal stimulus, the asset class should provide incremental return opportunities in 2018. However, spreads are near post-crisis tights, leading us to expect a lower return environment compared with the previous two years. Spread tightening will be moderate, in our view, and carry will be the primary driver of returns.

In our attempt to balance a constructive outlook with the current valuation environment, we remain opportunistic. In particular, we are seeking to identify and capitalize on potential price dislocations created by industry disruptions and U.S. tax reform. As we navigate the challenges of this new year, we aim to participate in spread tightening, but our focus remains 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

Cautious Tightening

Even as major central banks become less accommodative, their willingness to revert policy is a factor in keeping a lid on long-term rates, says Head of Fundamental Fixed Income Risk Mayur Saigal. In the U.S., the Federal Reserve (Fed) has emphasized tapering without the tantrum by diligently telegraphing its plans for a gradual balance sheet normalization. The central bank has also made investors well aware of its rate hike intentions and clearly articulated its readiness to take action to maintain stability, if necessary. Likewise, while the European Central Bank (ECB) plans to reduce asset purchases, it has assured the market of its willingness to extend the time horizon of quantitative easing, should conditions merit it. These cautious approaches are contributing to range-bound yields, and we believe the trend will continue in 2018.

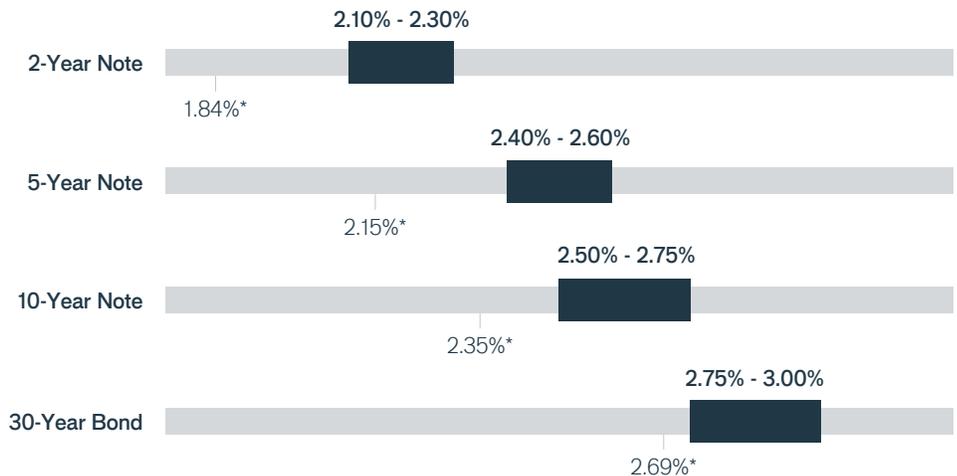
Range-Bound Treasurys

The implicit “Fed put” – the central bank’s willingness to assist in maintaining market stability – has helped to cap Treasury yields, even as it raises interest rates, explains Darrell Watters, Head of U.S. Fundamental Fixed Income. If the “put” remains, and markets anticipate continuity in the pace of both rate hikes and the balance sheet unwind, investors will be content to invest in U.S. Treasury securities. Lower yields outside of the U.S. will also continue to foster demand for Treasurys, which are currently providing more attractive yields than those of developed market peers. These dynamics suggest that any monetary tightening by the Fed will put only marginal upward pressure on U.S. rates in 2018.

Jerome Powell’s widely anticipated confirmation as the next Fed chairman further supports our view of range-bound U.S. rates. Mr. Powell’s consensus-driven approach should bring more of the same from the Fed, says Mr. Watters. The multiple vacancies on the Fed’s Board of Governors, however, remain concerning. Markets are used to an extremely dovish committee, notes Chris Diaz, CFA, Head of Global Aggregate. We are closely monitoring whether appointments to these seats will sway the Fed toward a more hawkish stance.

U.S. Treasury Yield Forecasts

Curve flattening could continue in 2018, as moderate Fed tightening pushes front-end yields higher, while a cautious Fed, the demand for yield and growth without inflation keep the long end in check.



Source: Janus Henderson Investors, Bloomberg
*Yields as of 12/15/17

Our base case is for two, possibly three, Fed hikes in 2018, says Mr. Watters. Range-bound to modestly higher yields should persist, he adds. While the impact of tax reform remains to be seen, for now, we expect a continuation of steady U.S. economic growth and tepid inflation. The front end of the yield curve will rise as the Fed hikes, while a cautious Fed, the demand for yield and growth without inflation will push long-term yields lower, leading to a flatter curve.

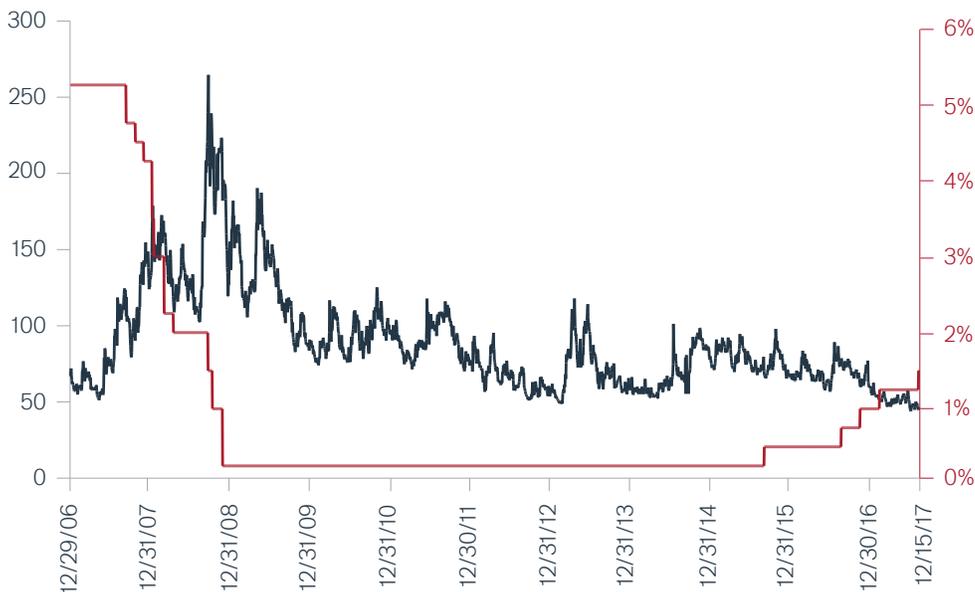
Volatility Drivers

One of the unintended consequences of quantitative easing (QE) is that volatility has been driven lower across markets. However, low volatility does not equate to low risk. As tightening ramps up, it's difficult to overlook the possibility that volatility could return, cautions Mr. Diaz. While we have not yet seen material volatility spikes from the reversal of accommodative monetary policy, we cannot be complacent, agrees Ryan Myerberg, Portfolio Manager of the Global Multi-Sector Income strategy. Fed Chairwoman Janet Yellen has previously cautioned the market that more rate hikes are necessary in order to prepare for the next recession. Since the market is pricing in approximately three rate increases through 2019, while the Fed is indicating five, the risk remains that the Fed could tighten faster than the market expects, Mr. Saigal says. If the Fed adopts a more aggressive than expected tightening path when the economy lacks sufficient resilience, we could be in trouble, adds Mr. Watters. That situation could result in policy error, an inverted Treasury curve and dramatic disruption in the rate market. Central banks need to approach rate hikes with caution, explains Mr. Diaz, and be careful not to stifle the global recovery, as they often do.

Low Interest Rates Have Led to Low Market Volatility

Bond market volatility, as exhibited by the MOVE Index, has waned in this low interest rate environment. Will it return as the Fed hikes?

— MOVE Index — Fed Funds Rate



Source: Bloomberg

Notes: Index shown is the Merrill Lynch Option Volatility Estimate (MOVE) Index.

Takeaways

- ▶ Even with the deceleration – and in the case of the U.S., reversal – of accommodative monetary policy, cautious central banks should help sustain range-bound yields in 2018.
- ▶ U.S. economic growth is merely steady and inflation remains elusive, leading us to expect two to three Fed hikes this year.
- ▶ Investors should not be complacent, as an aggressive reversal of central bank accommodation could trigger an upward spike in volatility.

Takeaways

- ▶ Low inflation in the eurozone's core will likely keep the ECB on hold in coming months.
- ▶ Central banks in certain smaller European economies may need to upwardly revise rate paths to keep up with inflationary pressures.
- ▶ Stronger-than-expected growth in Japan may give the BOJ flexibility to adjust the bounds of its yield curve control.

An unexpected, material upswing in inflation would also propel volatility higher, says Mr. Saigal, as it could put central banks behind the curve. Given the growth outlook, stabilizing oil prices and tight labor markets, Mr. Diaz believes that inflation could move closer to targeted levels. However, we view material upward pricing pressures as unlikely at this juncture. U.S. wage pressures remain soft, and there are many other deflationary forces in play. Demographics, globalization, automation and e-commerce are all holding back inflation, as are continued efficiency gains in shale extraction. U.S. tax reform could also have deflationary implications, says Mr. Watters, depending on whether companies opt to apply benefits from lower tax rates toward price cuts or capital expenditures.

Global Opportunities

We expect low inflation in core Europe as well, which should keep the ECB on hold. While confidence in the currency bloc's recovery is growing, the ECB's plan for curtailed asset purchases is primarily due to the limited number of securities available to buy, says Mr. Diaz. But other idiosyncratic upticks in inflation are probable. A handful of central banks in smaller European economies may need to consider tightening or revising rate paths to keep up with inflationary pressures, explains Mr. Myerberg. In particular, we are watching firming economic growth in the Nordic countries and extremely tight labor markets in Eastern Europe. Central banks positioning to hike ahead of the ECB could create compelling currency opportunities.

The outlook is less clear for the Bank of England (BOE) and the Bank of Japan (BOJ). The UK's divorce from the EU may damage economic conditions long term, but an uptick in inflation due to a weaker sterling has already forced one rate increase by the BOE. We anticipate the economic situation will continue to deteriorate, Mr. Myerberg says, making further hikes imprudent. However, bank officials have indicated more hikes could be coming.

In Japan, growth looks promising, even as inflation continues to be elusive. The BOJ has successfully pegged the yield on the country's 10-year bond near zero. Now that growth is picking up, however, we believe investors should consider the possibility of the BOJ readjusting its yield curve control to higher bounds.

National Macroeconomic Indicators

Market inflation expectations in most of the developed world echo low actual data as economic growth remains subdued.

	U.S. 2.36% 10-Year Note 1.89% 10-Year Inflation Breakeven	2.20% Headline Inflation 2.30% GDP Annual Growth Rate
	Germany 0.30% 10-Year Note 1.29% 10-Year Inflation Breakeven	1.80% Headline Inflation 2.80% GDP Annual Growth Rate
	UK 1.15% 10-Year Note 3.03% 10-Year Inflation Breakeven	3.10% Headline Inflation 1.50% GDP Annual Growth Rate
	Japan 0.05% 10-Year Note 0.47% 10-Year Inflation Breakeven	0.20% Headline Inflation 2.10% GDP Annual Growth Rate

Source: Bloomberg

Notes: 10-year yield and 10-year inflation breakeven data as of 12/15/17. Inflation data as of November 2017, except Japan as of October 2017. GDP growth rate as of 3Q17.

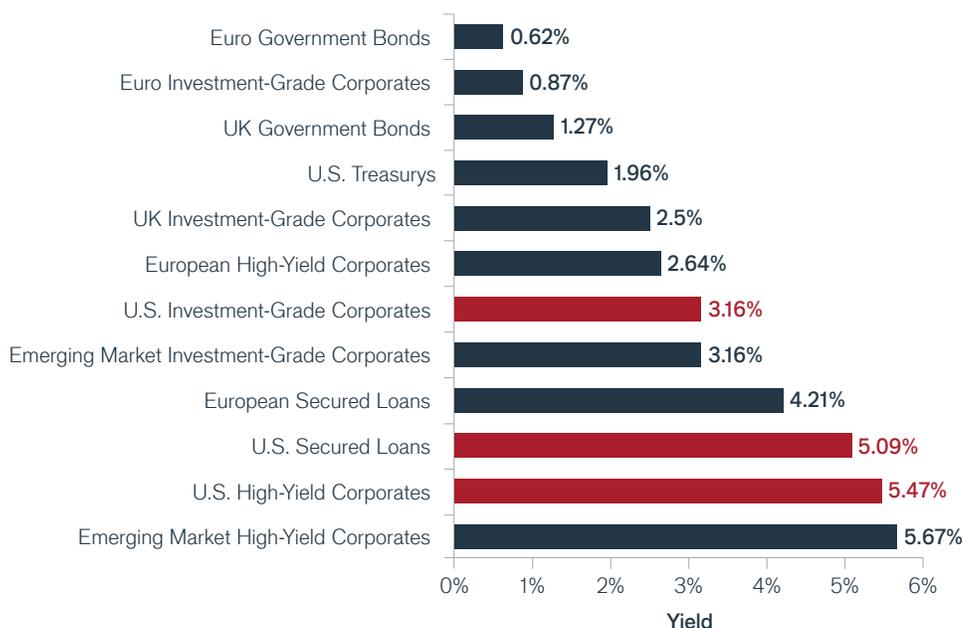
Incremental Return Opportunities

The moderation of accommodative monetary policy is not necessarily a negative for risk sentiment, explains Mr. Myerberg. The potential implications from the Fed's balance sheet roll-off and the normalization of interest rates, as well as the ECB's plans to taper asset purchases, may have created angst in 2017, but neither factor materially impacted risk appetite. In fact, we believe that as central banks focus on tapering without the tantrum, range-bound rates and low volatility should continue to drive investors' reach for yield and demand for "riskier" asset classes, including corporate credit.

Fundamentals also remain supportive: companies strung together a series of decent earnings reports last year, issuers are adequately covering their interest expense, and a material uptick in the default rate is unlikely. With the passage of U.S. tax reform and global growth trending in a positive direction, corporate fundamentals should continue to improve. Assuming policy makers can successfully pivot to a gradual normalization of monetary policy and an increase in fiscal stimulus, corporate credit should provide incremental return opportunities in the months ahead.

Investing in a Low-Yield World

Investors are starved for income, but U.S. corporate credit continues to offer relatively attractive yields.



Source: Bank of America Merrill Lynch, Credit Suisse, Bloomberg. Data as of 9/30/17.

A Critical Balance

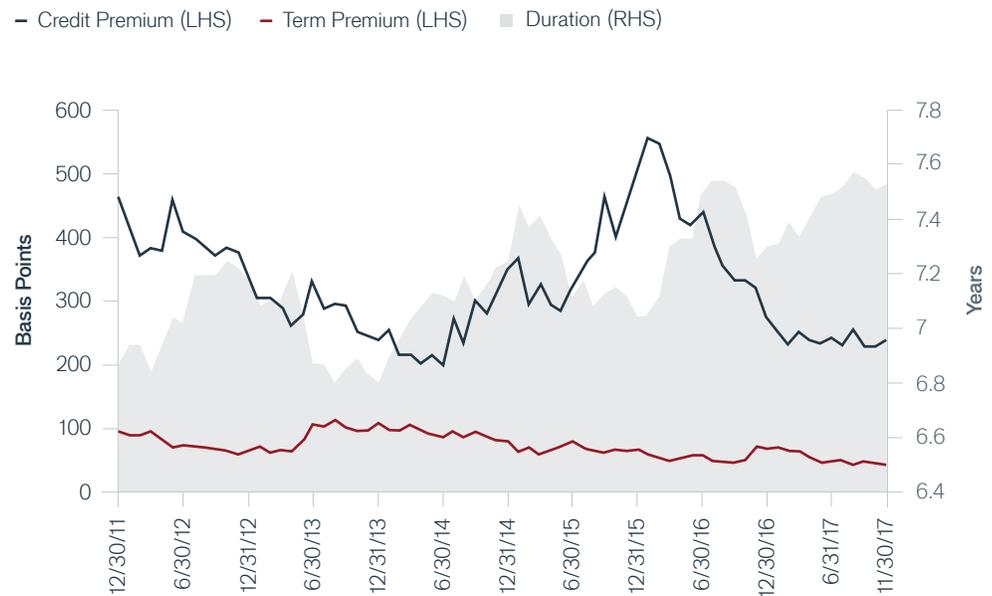
While there are tailwinds for corporate credit, it's challenging to find compelling valuations at current levels, says Mr. Watters. Strong risk market returns stretched valuations across most spread products in 2017, and we are closely monitoring whether corporate valuations can absorb rising rates. Additionally, Mr. Myerberg reminds us that we are closer to the end of the business cycle than its beginning.

Takeaways

- ▶ Range-bound rates and low volatility should continue to drive investors' reach for yield and demand for "riskier" asset classes, including corporate credit.
- ▶ Sufficient earnings, minimal defaults, positive global growth and U.S. tax reform are also supportive of corporate credit; however, valuations are already rich.
- ▶ We expect modest spread tightening; carry will likely be the primary source of returns this year.

Disappearing Credit and Term Premiums in U.S. Corporate Credit

Central bank bond buying has resulted in collapsing credit and term premiums, while companies take advantage of lower interest rates to extend the maturity of their debt profiles.



Source: Bloomberg

Notes: Basis Point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%.

Credit premium reflects the Bloomberg Barclays U.S. Corporate High-Yield yield-to-worst (YTW) minus the Bloomberg Barclays U.S. Aggregate Corporate YTW. Term premium reflects the Bloomberg Barclays U.S. Corporate 3-5 years YTW minus Bloomberg Barclays U.S. Corporate 1-3 years YTW. Duration measures a bond price's sensitivity to changes in interest rates and is depicted by Bloomberg Barclays U.S. Aggregate Corporate modified adjusted duration.

We expect a lower return environment for corporate credit in 2018. In contrast to the spread tightening we've seen in recent years, carry will likely be the primary driver of returns, says Mr. Saigal. Balancing alpha-generating opportunities with capital preservation remains critical, and we believe a diversified portfolio and emphasis on security avoidance can help maintain such a balance.

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 shorter- 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, explains Mr. Watters.

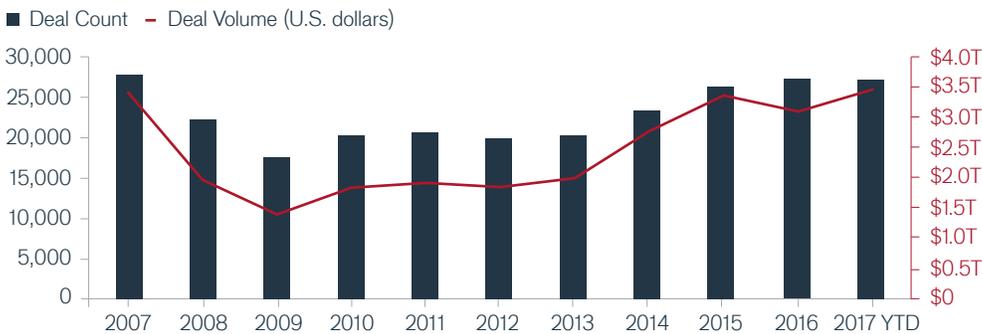
Opportunity in Disruption

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. Industry disruptions will likely be one source of such opportunities, Mr. Watters says. Many industries are facing disruptive forces such as the increased adoption of technology and the proliferation of the "Amazon effect," to name a few. These trends are impacting profit pools and forcing management teams into action. The necessary evolution of business strategies to combat disruption may result in sustained debt-funded consolidation activity as issuers seek to diversify their business models and increase scale.

Our analysts are evaluating disruptive trends in their respective industries and digging into company fundamentals, attempting to identify which issuers are prepared to adapt and which may not survive. While we seek to avoid the downside risk surrounding merger and acquisition (M&A) activity, we believe entities committed to deleveraging post-transaction can offer strong risk-adjusted opportunities, explains Mr. Saigal.

Elevated Global M&A Activity

Companies have been engaging in elevated M&A activity for the past three years. As companies seek to diversify their business models and increase scale to combat industry disruptions, we could see this trend continue.



Source: Bloomberg. 2017 YTD data as of 11/30/17

The Uncertain Impact of Tax Reform

U.S. tax reform may also create incremental return opportunities. A considerable drop in the corporate tax rate and incentives for companies to repatriate capital should be positive for corporate credit. With these provisions likely to boost free cash flow, the need to issue debt would be minimized. In particular, industries such as technology and pharmaceuticals, which have historically held large amounts of cash overseas and issued debt to compensate shareholders, would have less frequent need to access debt markets. The resulting reprieve from recent elevated issuance should be a tailwind for valuations. However, spreads are already at multi-year lows, cautions Mr. Saigal, so it's important to consider how much of this good news might already be priced in.

Further, it is unlikely that all implications of tax reform will be beneficial. For one, the allowance for immediate deduction of capital expenditures could pull forward issuance by companies looking to build factories or increase capacity. And while tax reform should be generally positive for investment-grade issuers, limitations on interest deductibility are likely to have negative implications for highly levered, capital-intensive businesses.

Mr. Watters also cautions that tax reform may not have the impact investors are expecting. At roughly 3%, quarter-over-quarter U.S. economic growth is good, but is constrained by high debt levels, regulatory uncertainty and deflationary forces. This level of growth might not be enough to incentivize companies to reinvest in the business, he says, so the possibility that the benefits of lower tax rates are put toward price reductions – which would impact top-line growth – is very real. Further, if the spending class experiences a tax hike via the elimination of personal exemptions and limitations on state and local deductions, we could see consumers begin to shy away from big purchases. This would be another hit to top-line growth, as well as to the U.S. economy, which is primarily consumer driven.

Takeaways

- ▶ Spread tightening opportunities could arise from U.S. tax reform and trends disrupting traditional industry fundamentals.
- ▶ While tax reform should benefit investment-grade issuers, limitations on interest deductibility are likely to have negative implications for highly levered, capital-intensive businesses.
- ▶ We see potential for both businesses and consumers to surprise markets with their reactions to tax reform.

Road Map to Fundamental Fixed Income

Portfolio Positioning

- The U.S. economy appears to be on solid footing and global growth is steady. Our corporate earnings outlook is also constructive, particularly now that corporate tax reform has passed. We are cautiously optimistic for corporate credit and intend to maintain our opportunistic approach.
- Fed rate hikes should pressure short-term Treasury yields modestly higher, but we expect its cautious approach to tightening, coupled with strong demand for Treasury securities, to keep yields range-bound. We will actively manage yield curve positioning with a focus on shorter- and intermediate-dated corporate credit balanced by longer-dated Treasury exposure.

U.S. Corporate Credit

- Leverage trends on corporate balance sheets have stabilized, and we maintain a constructive outlook for earnings growth. Corporate tax reform should also be positive for fundamentals. We are cautiously optimistic for the asset class.
- However, we remain in the extended innings of the credit cycle and valuations are rich. We expect moderate spread tightening in 2018, and carry to be the primary driver of returns. Given the asymmetric risk profile of credit investing, security avoidance and managing idiosyncratic risk will be critical.
- Our analysts are emphasizing issuers within defensive sectors that maintain higher-quality business models, consistent free cash flow and management teams committed to sound balance sheets. These issuers should offer steady carry and minimize downside risk.
- As we balance our constructive fundamental outlook with the valuation environment, we remain opportunistic, attempting to identify and capitalize on dislocated valuations. We expect industry disruptions and tax reform to be potential generators of return opportunities.
- We expect bank loans – which benefit from a senior position in the capital structure and can offer protection against rising rates – to offer stable and attractive risk-adjusted opportunities in the months ahead.

Securitized

- Fed balance sheet normalization is underway. The process will be painstakingly slow, and the long-term impact on mortgage-backed securities (MBS) should be limited.
- We utilize MBS as ballast for our core portfolios, to act as a diversifier when 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 strive to identify opportunities with favorable optionality, liquidity and upgrade potential. 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.

Yield Curve/Duration

- We expect growth to remain steady and inflation subdued. Two to three Fed interest rate hikes are likely. The front end of the yield curve should rise as the Fed raises, while a cautious Fed, the demand for yield and growth without inflation will push long-term yields lower, leading to a flatter curve.
- We expect modestly higher, but range-bound rates. However, we are mindful that the market may be underestimating the Fed. A more aggressive than expected tightening path could result in policy error, an inverted Treasury curve and dramatic disruption in the rate market.
- We intend to maintain 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 Treasuries to balance our corporate exposure. Short-duration Treasuries act as a source of liquidity, allowing us to potentially capitalize on attractive securities experiencing price dislocations.

Developed Markets

- Despite confidence in the currency bloc's recovery, low inflation in the eurozone's core will likely keep the ECB on hold. We intend to remain underweight core European duration. However, growth and inflation in smaller European economies could result in central banks positioning to hike ahead of the ECB, which may create compelling currency trades.
- We maintain a constructive view on European corporate credit; however, QE measures have left valuations uncomfortably tight.
- Due to the unknowns surrounding Brexit, and the potential for the BOE to raise interest rates, sterling, gilts and corporate credit generally remain unattractive, in our view.
- We are closely monitoring stronger-than-expected growth in Japan, which could allow the BOJ to readjust its yield curve control to higher bounds.

Emerging Markets

- Our outlook is cautiously optimistic. Low volatility, the upward trajectory in global growth and the underperforming dollar are supportive of emerging markets. In this environment, the real rate differentials between emerging and developed markets should remain compelling.
- 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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