Janus Henderson INVESTORS

Thoughts and Bonds: Lower for Longer?

Quarterly Views on the Fixed Income Environment and Outlook

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Key Takeaways

- Core inflation remains elusive in the developed world, causing us to question whether central banks have the evidence they need to justify taking rates higher.
- Rate markets have priced this in to some degree, while risk markets remain exuberant - a disconnect that we believe presents cause for concern.
- We also find the general complacency across markets concerning and have therefore increased our emphasis on defensive, non-cyclical issuers.

A WORD FROM OUR FUNDAMENTAL FIXED INCOME TEAM

We've talked much about nearing the end of the U.S. credit cycle, and how the Trump administration's proposed growth-enhancing fiscal policies could have extended it. However, Washington's lack of progress on reform, coupled with flagging economic data, suggest it may be time to reevaluate how late in the cycle the U.S. actually is. U.S. inflation data have rolled over in recent months and investors' expectations for reflation have largely dissipated.

The U.S. Treasury market is pricing in a deteriorating U.S. economic picture, as well as potential policy error by the Federal Reserve (Fed), given its eagerness to elevate interest rates off historical lows.

In sharp contrast to the rates market, risk markets remain exuberant. Equity indices continue to climb higher and credit spreads continue to grind tighter. This disconnect is alarming, because such a disjointed view typically means that one side of the market is wrong. We also find the general lack of volatility across all asset classes concerning, as it contributes to growing investor complacency. We are addressing these concerns by emphasizing more defensive U.S. issuer and issuers that exhibit sustainable free-cash-flow stability. We remain thoughtful around position sizing, and are avoiding securities in which we believe downside risk outweighs potential reward.

While U.S. economic conditions are lackluster, fairly homogenous growth in Europe makes the region a bright spot in the global economy. We have shifted to a more constructive view on European credit, although we remain mindful of valuations stretched by quantitative easing (QE). It is worth noting that even with the healthier economic outlook, core inflation remains elusive in Europe too, as it does in most of the developed world. Exceptionally low commodity prices and the absence of significant wage pressure are holding back inflation around the globe. We believe this has thrown a wrench in the plans of developed-market central banks seeking to curtail their balance sheets and bring interest rates back into the realm of "normal." Indeed, we are questioning whether central banks have the evidence they need to justify taking rates higher. Even as they begin to withdraw accommodative policy, we anticipate these central banks will be actively involved in markets for many years to come.

ECONOMIC OUTLOOK

Reflation Reconsidered

Expectations for inflation picked up in July 2016 as deflation concerns receded. Then the election of President Trump and his plans to push growth-enhancing policy reforms through an all-Republican Congress further bolstered the improving outlook. The dollar strengthened, U.S. Treasurys sold off and investors began pricing in the potential for rising interest rates. Sentiment has largely reversed in 2017. Washington has failed to make significant progress on its platform promises, and attention has been diverted from such initiatives amid government staff departures, firings and investigations. As optimism around fiscal changes recedes, the U.S. dollar index has fallen more than 5% from its December peak. Inflation expectations, as measured by 10-year inflation breakevens, are just 30 basis points off of last summer's lows and rates (outside of the front end) have rallied this year. Inflation breakevens and 10-year nominal Treasurys are sending the same message, says Head of Fundamental Fixed Income Risk Mayur Saigal: Rates are going to be lower for longer.

Lower for Longer?

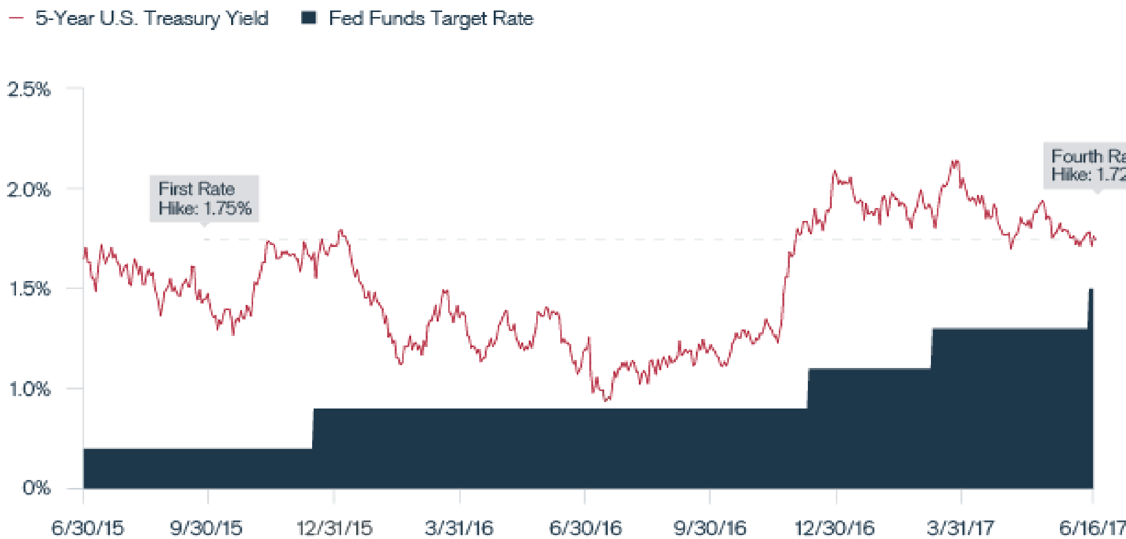
Flagging economic data have caught investors' attention, and nominal Treasury yields are pricing in the bad news, says Mr. Saigal. Core consumer price inflation, which excludes the more volatile food and energy sectors, touched post-crisis highs in January but has receded in recent months. May's 1.7% inflation rate was the lowest reading since June 2015. Headline inflation also retreated in March, April and May. Downward pressure on commodities pricing presents a significant problem for the inflationary outlook, says Head of U.S. Fundamental Fixed Income Darrell Watters. Moreover, despite a tight labor market and decent economic growth, accelerating wage growth remains elusive.

Even with stagnant economic trends, the Fed raised its target benchmark rate by 25 basis points in June, bumping the federal funds target range to 1.0% to 1.25%. The move was widely anticipated, but commentary from Fed Chair Janet Yellen and the dot plot – which encapsulates the funds rate projections of all members of the Federal Open Market Committee (FOMC) – were interpreted as hawkish. Although the Fed acknowledged the sequential slowdown in inflation, it was attributed to transient changes. FOMC officials therefore left the dot plot unchanged, indicating the central bank expects to raise its federal funds rate to 2.9% by the close of 2019.

Investors, however, are signaling drastically different expectations, says Mr. Saigal. He points to the yield on the 5-year Treasury note which is expressing extremely dovish hike expectations. The day of the Fed's June hike, its fourth in 18 months, the yield on the 5-year note was 1.72%, only 47 basis points higher than the upper boundary of the Fed fund's current range. This is very near where the 5-year yield was in December 2015, when the Fed began its most recent bout of tightening. If investors believed that more rate hikes were justified, the yield of the 5-year note should be moving higher.

A Dovish 5-Year

The yield on the 5-year Treasury note is little changed after four interest rate hikes, signaling markets' extremely dovish rate hike expectations.



Source: Bloomberg

Similarly, Fed funds futures are signaling a lower-for-longer environment. They are pricing in approximately two more 25 basis point hikes by 2019. When comparing market expectations to the dot plots in each of the previous three calendar years, the market view has been more accurate than the Fed's. Today it is in all likelihood more realistic as well, says Mr. Saigal. Ms. Yellen did, however, express the central bank's intention to closely monitor inflation developments, which could be a signal to markets that the dot plot needs to be reassessed.

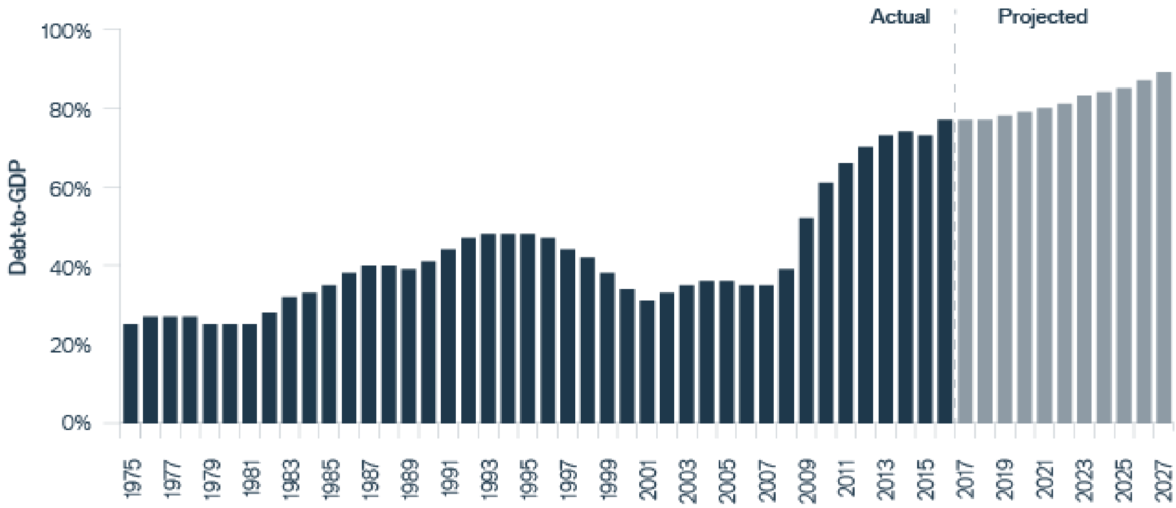
Potential for Policy Error

Mr. Watters agrees that the Fed's desire to tighten further will be tested. If inflation continues to
decelerate at the current pace, deflation may once again become a concern, he says, and the Fed will be forced to extend the process of normalization. In our view, the odds of a recession are now higher than the odds of the reflation trade returning. As such, the Fed could risk policy error in tightening further when the economy is not yet strong enough to handle it.

The economy expanded at an annualized rate of 1.4% in the first quarter of 2017. A hike at the wrong time could hinder already fragile growth, which the U.S. needs to manage its mounting debt pile. Federal debt held by the public represented 76.5% of GDP at the end of 2016. While that level is not critical, the Congressional Budget Office projects deficits to rise and the debt-to-GDP figure to double in the next three decades. The longer the U.S. struggles to achieve sustainable growth, the more vulnerable the economy becomes, says Mr. Watters.

U.S. Debt-to-GDP Continues to Grow

A Fed hike at the wrong time could risk derailing the growth the U.S. needs to manage its mounting pile of debt.



Source: Congressional Budget Office
Note: Figures based on federal debt held by the public

Through the remainder of the year, Mr. Watters and Mr. Saigal expect the Treasury curve to continue to flatten amid robust global demand for the relative yield offered by U.S. Treasurys, and as the interest-rate market expresses fear of policy error. The caveat is if the Trump administration successfully executes growth-enhancing reforms. Should that happen, we would expect rate expectations to ratchet up again and Treasury yields to sell off. With the current consensus being that the reflation trade is over, this turn of events would likely be a significant shock to the fixed income market.

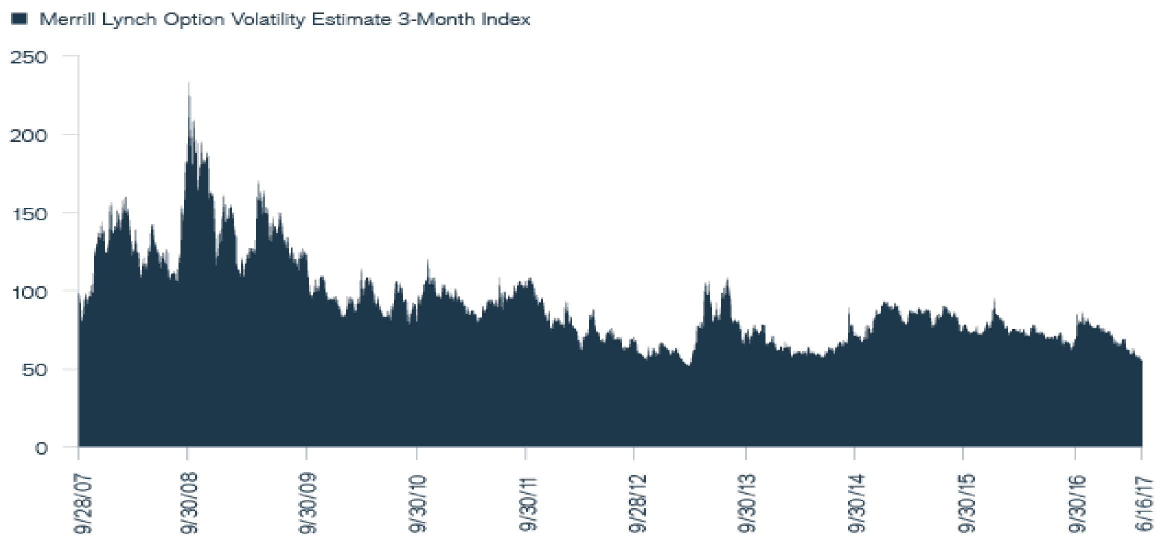
Danger in the Disconnect

Yields on 10- and 30-year U.S. Treasury securities are beginning to price in a slowdown in economic growth which would be inherently bad for credit. Yet a “risk-on” mindset has prevailed in 2017, as shown by investors’ ongoing interest in corporate credit and equities. The disconnect between the credit and rate markets is alarming, Mr. Saigal says. Such a disjointed view typically means that one side of the market is wrong. However, historically low rates around the globe have initiated an insatiable demand for yield, and U.S. Treasury yields remain attractive relative to other safe-haven debt. Perhaps both can be right, for a time, he says.

The danger is in the contrarian view – the mindset that low volatility equates to a lack of potential tail risks – becoming consensus, Mr. Saigal cautions. Volatility has generally been low year to date, in both risk assets and rates. High-yield credit volatility recently reached the lowest level on record and volatility on investment-grade credit is approaching all-time lows. We have simultaneously witnessed U.S. rate volatility sink to its lowest level since the 2013 taper tantrum. As investors are drawn into this complacency, markets become mispriced, and if a sufficiently problematic tail event comes along, we could see a significant drawdown, he says. Markets have recently bucked a number of potentially “risk-off” catalysts, notes Mr. Watters, but these events aren’t a problem for credit, until one is.

Rate Volatility is on the Decline...

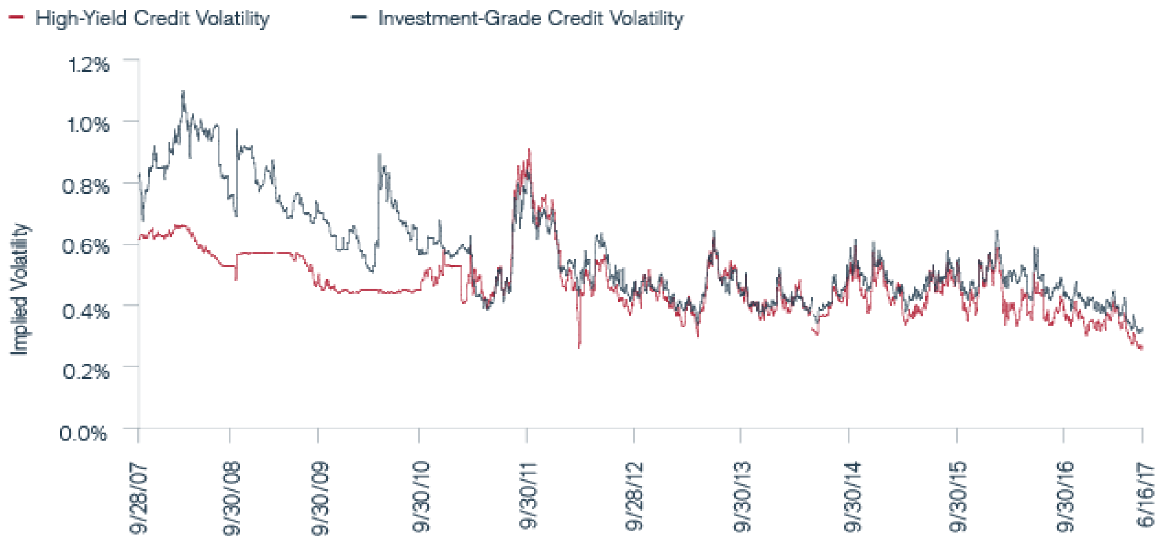
Low volatility does not equate to a lack of potential tail risks.



Source: Bloomberg

...Credit Volatility is also Remarkably Low

But Investors Should Not Be Complacent.



Source: Barclays Live

Note: Credit volatility is based on credit default swap index (CDX) options.

Getting Defensive

Companies are challenged by weak top-line growth, moderate wage pressures and climbing health care costs. Many companies purchased growth through consolidation activity, while organic margin growth remains anemic, says Mr. Watters. Additionally, much of the recent rally in credit was predicated on help from the Trump administration, but uncertainty remains on whether relief – in the form of fiscal spending, tax cuts or health care reform – is coming. Without it, the sustainability of margins comes into question.

First quarter earnings were widely positive. However, we can’t expect that moving forward, says Mr. Watters. Many companies revised earnings estimates downward for the second quarter. If the upcoming earnings season is considered successful, we could see further support for moderate spread tightening and a continued sideways grind in the credit markets. If it disappoints and companies put off business investment until 2018, that could be the catalyst for the equity market to crack and for corporate credit spreads to widen, says Mr. Watters.

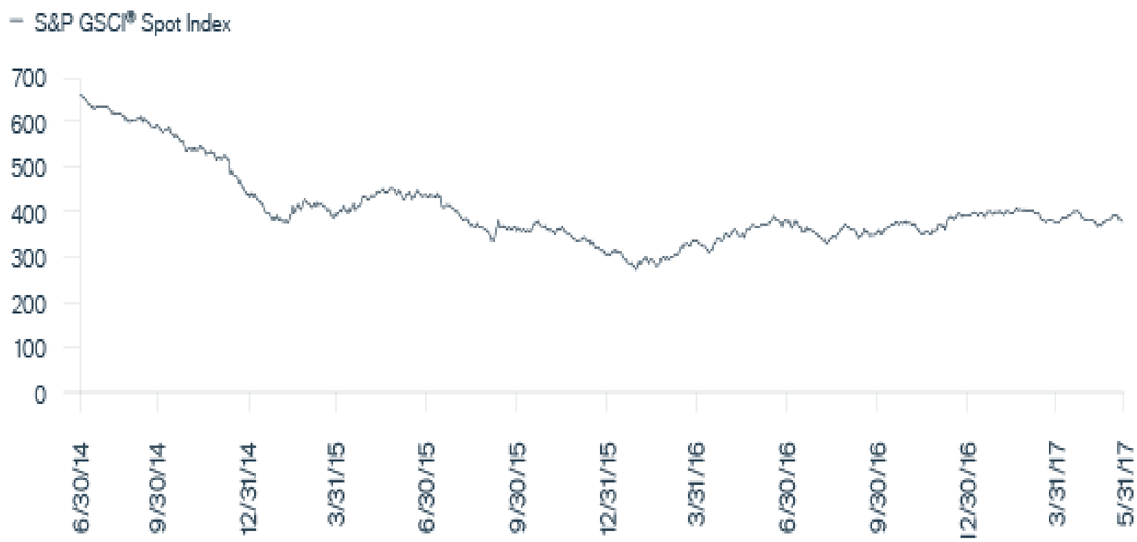
Still, the yield investors are paid to own corporate credit over Treasurys is diminishing. As both investment-grade and high-yield corporate credit spreads encroach on cycle tights, we are emphasizing non-cyclical names with the ability to generate sustainable free cash flow even in an economic downturn. Our analysts are focused on finding opportunities in traditionally defensive sectors such as banking, utilities, cable, and food and beverage. We are also mindful of both the decline in compensation for owning securities down in the capital structure and abating term premiums – the spread between short- and long-term bond yields. At this juncture, we prefer to own senior secured debt over subordinated debt, and we continue to believe many of the best risk-adjusted opportunities reside in shorter-dated corporate credit.

Where in the World is the Reflation?

When labor markets are strong and unemployment is low, we would typically see upward pressure on wages. When economic growth is accelerating, we expect to see inflation. Yet in most of the developed world, the former scenario is present, but not the latter. Realized inflation is stubbornly low, and this phenomenon is creating confusion for central bankers, says Head of Global Aggregate Chris Diaz, CFA. In the U.S., Europe and Japan, central banks are eager to normalize interest rates; however the lack of sustainable inflation partly obscures the path forward. Exceptionally low commodity prices and the absence of significant wage pressure are holding back inflation across the map, says Mr. Diaz. We question how much higher global rates can go, and whether central banks have the evidence they need to raise interest rates.

Stubbornly Low Commodity Prices

Weaker commodity prices are holding back inflation in the developed world.



Source: Bloomberg

Similar to the rest of the developed world, the reflation trade is questionable in Australia. Stubbornly low wage growth and the arrival of online retail competition, including Amazon, continue to restrain core inflation. Further, with China stockpiling iron ore, we are concerned with the profitability of Australia's mining industry as iron ore prices continue to decline. We anticipate the Reserve Bank of Australia will need to reduce interest rates in the coming months in an attempt to keep the economy growing, which presents an attractive duration opportunity, in our view.

Ballooning Balance Sheets

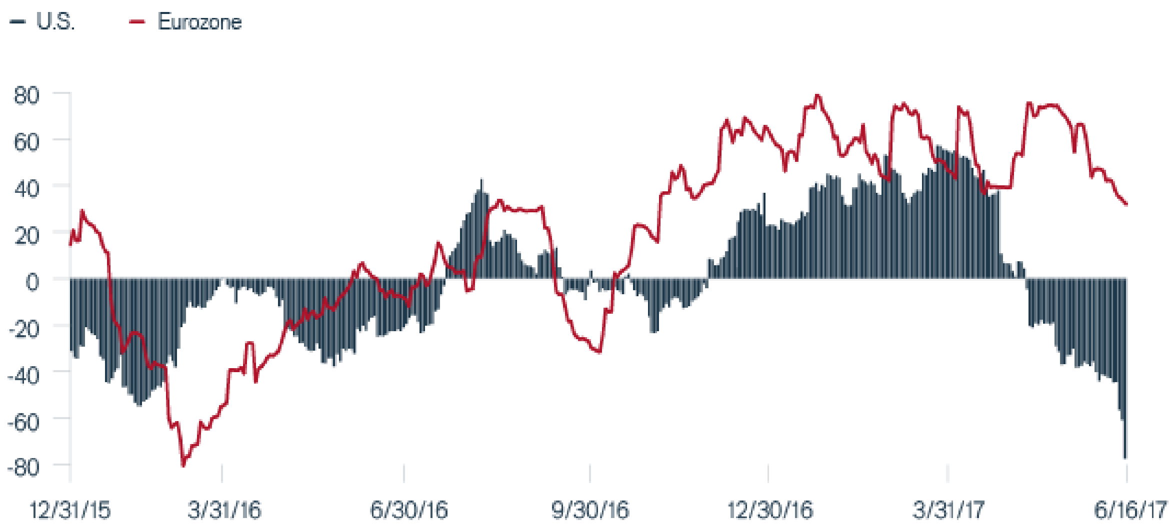
While interest rate hikes may prove challenging, we do expect the European Central Bank (ECB) and the Bank of Japan to (BOJ) to communicate plans for reducing their asset purchases in the near future. The BOJ holds roughly 40% of the Japanese government bond market and ¥3.2 trillion in corporate bonds. It also owns approximately two-thirds of the local exchange traded funds market, making the BOJ a significant stakeholder in many of the companies in the Nikkei 225 Index. Frankly, they are running out of assets to buy, says Mr. Diaz. In Europe, the ECB owns approximately 10% of the European corporate bond market, and nearly €1.6 trillion in sovereign bonds across 19 different countries. The central bank reduced purchases, starting in April, from €80 billion to €60 billion per month. We believe it will share plans at its September meeting to further taper QE. However, with low inflation and outsized balance sheets, neither of these central banks is going away anytime soon, says Ryan Myerberg, Portfolio Manager on the fundamental fixed income team.

Europe Takes the Lead

Eurozone data continues to surprise to the upside, says Mr. Diaz. He points to the Citigroup Economic Surprise Index, which shows European economic data faring well versus expectations, whereas U.S. data is coming in below consensus estimates. The first quarter registered the strongest eurozone GDP expansion in two years and, in April, euro area unemployment fell to its lowest level since early 2009. The ECB removed the downside bias from its growth outlook in June, and we are becoming increasingly more positive on the region, says Mr. Diaz.

Europe Surprises to the Upside

According to the Citigroup Economic Surprise Index, euro area economic data is beating consensus estimates, while the U.S. is falling behind.



Source: Bloomberg
Note: The Citigroup Economic Surprise Index measures how economic data is performing relative to expectations.
The index is positive when economic data exceed consensus estimates and negative when data disappoint.

Political risk has also subsided, says Mr. Myerberg. Fears of a negative outcome in France were assuaged when Emmanuel Macron defeated populist Marine Le Pen to become France's next president. Moreover, his La République en Marche party won a strong majority in the country's June parliamentary elections, which should enable Mr. Macron to push through his pro-business reforms. That will afford France a seat at the table with other serious negotiators like Germany, and could motivate Germany to loosen its own fiscal constraints, says Mr. Myerberg. We believe looser fiscal policy across the continent would augment the economic recovery and be favorable for European risk assets.
The next potential landmine is Italy, cautions Mr. Diaz. While the general election (which must be held before May 20, 2018) will likely not occur this year, we are closely monitoring developments that could portend a negative outcome. The anti-establishment, Eurosceptic Five Star Movement was recently defeated in local elections, which bodes well for the general election. But even if the mainstream Democratic Party prevails, they will need a clear victory in order to establish an effective government, says Mr. Myerberg. We also remain mindful that the country's debt represents approximately 132% of GDP and much of it is backed by ECB QE that may soon be tapered.

May's Misstep?

UK Prime Minister Theresa May's call for a snap election backfired in June as her Conservative Party failed to garner enough votes for a parliamentary majority. As a result, the UK finds itself dealing with political unknowns, says Mr. Myerberg, in regards not only to the prime minister's seat but also to the fate of Brexit. Ms. May is facing pressure to resign from the opposition as well as her own party, and Mr. Myerberg believes her tenure as prime minister may be cut short. In the meantime, her partnership with the Democratic Unionist Party of Northern Ireland (DUP) gives her a fragile majority. She will find herself beholden to the hard-core Eurosceptics of her own party, the Scottish Tories that prefer to remain in the Single Market and the right-wing DUP which favors an open border policy.

We are mindful that where Brexit is concerned, the lack of cohesion in the government and in the negotiating mindset could lead to a "no deal" scenario in which the UK is unable to reach an agreement with the EU. But both tails have fattened, says Mr. Myerberg. On the other side of the spectrum, the election results could be positive for the UK. Politicians are acknowledging the outcome as public pushback on both austerity and Brexit. This opens the door for a loosening of fiscal purse strings as well as a softer form of exit from the European Union.

Fiscal spending would be beneficial to the UK economy. Risk assets should ultimately benefit, while the yield curve is likely to steepen. For now however, economic uncertainty remains, which puts the Bank of England in a difficult position, says Mr. Myerberg. Some members of the central bank's monetary policy committee favor raising rates soon, to stem inflation that has ticked higher after the Brexit vote. In our view, until the risk of a hard Brexit and any related economic contraction is completely quelled, it makes more sense for the central bank to let inflation run its course.

An Enticing Landscape

Our outlook for emerging markets is positive, but cautious. This year's general lack of market volatility, along with the weakness in the U.S. dollar, has enticed investors into the higher yielding asset class. While the backdrop is favorable, we are mindful that any pick-up in volatility could result in a quick departure from the space for many investors. Given that it has historically been difficult for the asset class to compartmentalize risk, we are closely watching the potential for far-reaching effects of idiosyncratic events in individual countries, says Mr. Diaz.

However, negative news this year out of Brazil and China has yet to have widespread impact. Investors are in the process of digesting Brazilian President Michel Temer's involvement in a corruption scandal, which could lead to his impeachment. Since there is no clear replacement waiting in the wings, we are keeping a close eye on the potential fallout and its effect on the economy. We have, in turn, recently exited our positions in the real and the country's sovereign debt and have limited exposure to companies that may be impacted by these proceedings.

The recent downgrade of China's debt by Moody's from A1 to Aa3 also barely caused a hiccup in investors' interest in the broader asset class. The tepid response was due in part to the fact that investors had made peace with the likelihood of the action long before the downgrade was actually announced, says Mr. Diaz. Moreover, the country's sizable reserves should enable it to service its debt for years. While the government appears to be committed to doing what they must in order to keep the economy stable, we cannot ignore the fact that the economy is slowing to some degree. The state of China's economy has the potential to significantly impact its trading partners, as well as commodity prices.

Continued downward pressure on commodity prices could be the catalyst that unglues the recent strength within the emerging market space, says Mr. Diaz. We are therefore avoiding investment in economies with significant reliance on commodity exports and focusing on investment in countries that are less likely to be impacted by idiosyncratic events. Additionally, we are seeking duration and currency exposure in countries where we see a strong case for interest rate cuts by local central banks. The higher yields available from some of these emerging market currencies are also attractive.

ROADMAP TO FUNDAMENTAL FIXED INCOME INVESTING

Portfolio Positioning

- The Trump reflation trade has almost wholly reversed and rates are pricing in concerns around weak economic data and potential policy error by the Fed. Yet investor interest in U.S. corporate credit remains strong.
- While we continue to look for opportunities in U.S. corporate credit, the disconnect between the credit and rate markets keeps us mindful of catalysts that could lead to spread widening. We are emphasizing defensive companies that exhibit solid fundamentals and sustainable free-cash-flow generation.
- We expect U.S. growth and inflation to remain subdued for the balance of the year, and believe the Treasury yield curve will continue to flatten. 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

- We are opportunistically adding to credit, including high yield. However, we are focused on non-cyclical, defensive issuers and bonds that are senior in the capital structure as we seek to participate in spread tightening while keeping capital preservation at the forefront.
- Across the quality spectrum, our focus remains on shorter- and intermediate-dated issuers with ample liquidity, strong free-cash-flow generation potential and management teams committed to a sound balance sheet.

- 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.

Yield Curve/Duration

- We anticipate the yield curve will flatten further in coming months, with Fed-driven volatility pushing front-end Treasury yields higher and concerns around the U.S. economic outlook leading to a decline in yields farther out on the curve.
- We use long-end Treasurys to hedge our underweight in long credit, as well as to adjust our overall portfolio duration. 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 their ability to pay down debt.
- We intend to maintain an active approach to duration and yield curve positioning with a focus on capital preservation.

Securitized

  - The Fed outlined a plan to shrink its balance sheet, possibly beginning before year-end. The central bank intends to reinvest proceeds on its investments that exceed a set of rising caps, which will curtail the Fed's purchases of mortgage-backed securities (MBS). However, the Fed will continue to be active in the market for some time, and, in our view, the caps should limit impact on the asset class.
  - We utilize MBS as ballast for our core portfolios. We emphasize securities with high coupons, high loan-to-value and pre-payment resistant characteristics. Our exposure is concentrated in generic agency pass-throughs.
  - We invest in commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) 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, we believe certain whole business securitizations including franchise revenue-backed securities continue to present unique opportunities.

Developed Markets

- We have shifted to a more constructive view on European risk assets as a result of the waning political risks and the region's expanding economy. Yet we remain mindful of the impact QE measures have had on valuations.
- The ECB's asset purchase program should effectively anchor short-term sovereign yields, while a stronger economic outlook could push long-term yields higher. We intend to remain underweight core European duration.
- In the UK, we believe the increased likelihood of looser fiscal policy should ultimately be favorable for risk assets and lead to a steeper yield curve. However, due to the unknowns surrounding Brexit, we intend to remain underweight sterling, gilts and risk assets.
- We are actively seeking investment opportunities in countries where we expect the central bank to hold or reduce interest rates in the coming months, including Australia.

Emerging Markets

- Our outlook is cautiously positive. While low volatility and the underperforming dollar are typically supportive of emerging markets performance, we are concerned with the instability in commodities prices and the impact that could have across the asset class.
- We are emphasizing exposure in countries with limited ties to commodity prices, and seeking opportunities in countries with minimal expected political volatility.
- We continue to evaluate whether easing inflationary pressures in certain emerging market economies could lead to interest rate cuts, thereby creating attractive risk-adjusted duration opportunities.