JANUS CAPITAL® Group

JANUS MARKET GPS™ 2016

Insights from the Experts at Janus Capital Group

About Janus Capital Group

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Offices Worldwide

On the ground where our clients live and work, we have an in-depth understanding of local markets and investor needs to complement our global perspective.

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Investment Professionals

Our seasoned team of investment experts brings deep knowledge and experience to help us deliver on our commitment to provide better outcomes for clients.

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Investment Strategies

Actively managed equity, fixed income, alternative and multi-asset class strategies are designed to help clients in any type of market, with the goal of delivering strong risk-adjusted returns over time.

Introduction

The landscape for investors and financial markets alike remains apprehensive and uncertain as 2016 gets underway. At Janus Capital Group, we recognize the difficulties and complexities you face in this volatile climate, as well as the opportunities these may create.

Divergent global growth paths and monetary policies, disruptive technologies and business practices, and the hidden yet lurking risk of inflation are all obstacles of which investors should be mindful. They also serve as a reminder that stakeholders need insight into strategies designed to actively look for paths around potential pitfalls.

Here we present insights and thoughts from investment professionals at Janus Capital Group and its affiliates to help navigate the many uncertainties. They are organized around themes that we believe will influence the financial markets through the coming year. We invite you to read these discussions in any order you choose — explore interesting topics and data — as our investment experts provide guidance for the year ahead.

To learn more about our investment professionals, visit janus.com.

Fed Tightening

Gradual Fed Tightening Should Favor Equities in the U.S. and Globally

As the Federal Reserve (Fed) continues to lift its widely watched reserve rate from zero, Janus' investment professionals don't feel it will put a ceiling on equities. Janus Equities and Asset Allocation Chief Investment Officer **Enrique Chang** points out equities have generally done well in the majority of previous tightening environments. Mr. Chang believes that rising U.S. interest rates appear to be embedded into today's markets. He anticipates that a gradually improving economy, driven by stronger consumer spending, will help lift stocks.

The biggest beneficiaries of rising U.S. rates could be Europe and Japan, suggests **George Maris, CFA,** Portfolio Manager of the Janus Global Alpha Equity strategy. Rising interest rates and an associated stronger dollar would help fuel export growth in these economies, thereby lifting manufacturing activity and ultimately Gross Domestic Product (GDP). Just as important, it would provide a psychological boost, providing a proof point that knock-on stimulus efforts can still steer an economy in the right direction. Mr. Maris believes that tighter U.S. monetary policy would encourage European and Japanese businesses to invest before their own window of cheap borrowing costs eventually disappears.

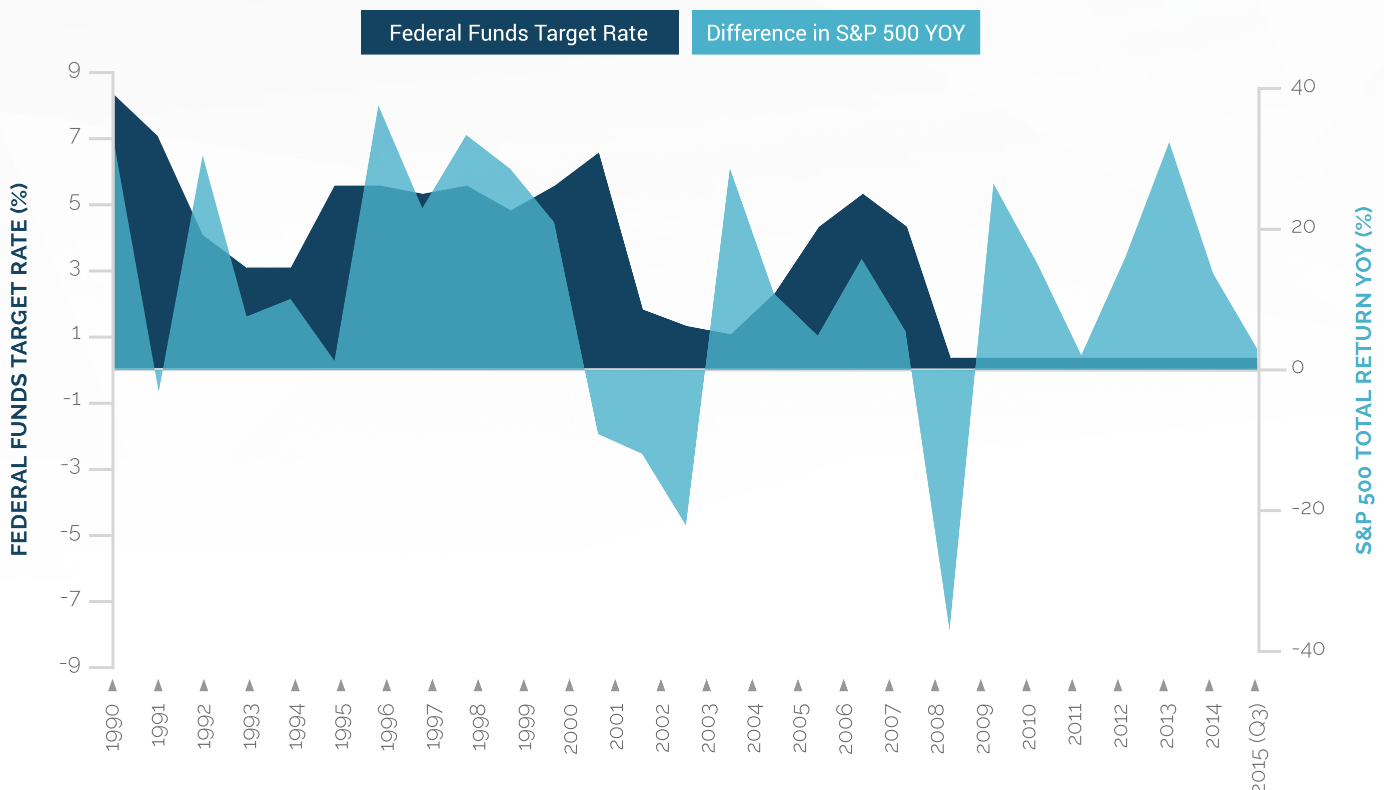
"I don't think interest rates are back to the races. Gradually rising rates with a renewed economy and a whiff of inflation is a good backdrop for equities and for growth stocks in particular. One area where investors will need to pay close attention is with dividend-paying stocks. A rising interest rate environment can separate the performance of companies growing their dividends versus those that just pay a high, but static dividend."

Marc Pinto, CFA, Portfolio Manager

Fed Tightening Cycles

Federal Funds Rate vs. S&P 500, 1990–2015

U.S. equities have generally performed well in tightening environments.



S&P 500® Index measures broad U.S. equity performance. | Source: Federal Reserve Bank of St. Louis, Bloomberg

While the broader equity market may do well in a tightening environment, a few names may face some challenges as companies reckon with rising costs of capital. **Jonathan Coleman, CFA,** Head of Growth Equities, warns that without cheap debt, those companies with an over-levered balance sheet may not have the financial flexibility to fund future growth initiatives or adapt to competition and disruption in the marketplace.

Marc Pinto, Portfolio Manager of the Janus Balanced strategy, explains that a slow advance in interest rates, coupled with steady economic growth and some inflation, could be favorable for equities, especially growth stocks.

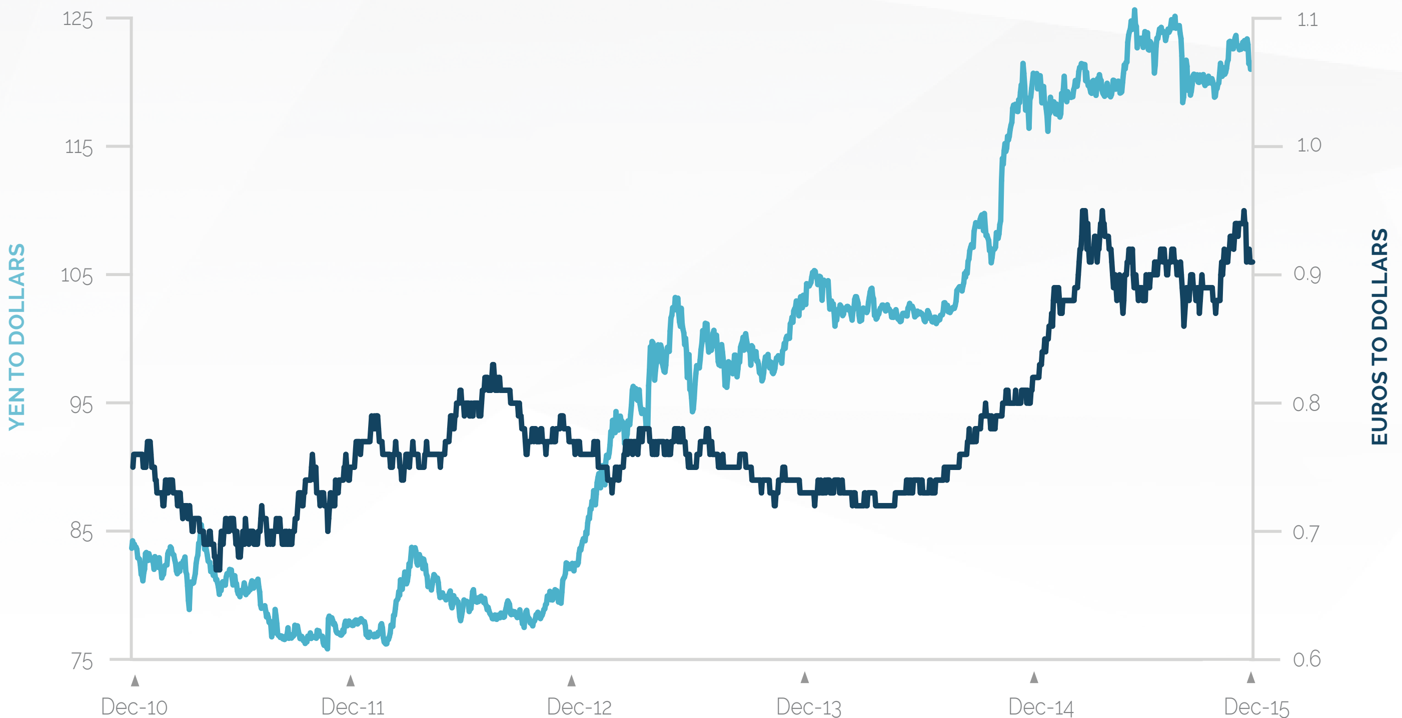
"As rates rise, investors need to pay closer attention to a company's balance sheet and ability to generate cash flow. Investors need an understanding of whether a company that has cash offshore will be able to bring it back, whether it has any near-term debt maturities coming up, and whether it has floating or fixed-rate debt. These considerations take on greater meaning at this stage in the cycle."

Brian Demain, CFA, Portfolio Manager

Currency Comparison

Euro to Dollars and Yen to Dollars

The dollar should continue to appreciate against the euro and yen as the Fed tightens, thereby providing a lift to European and Japanese exporters.

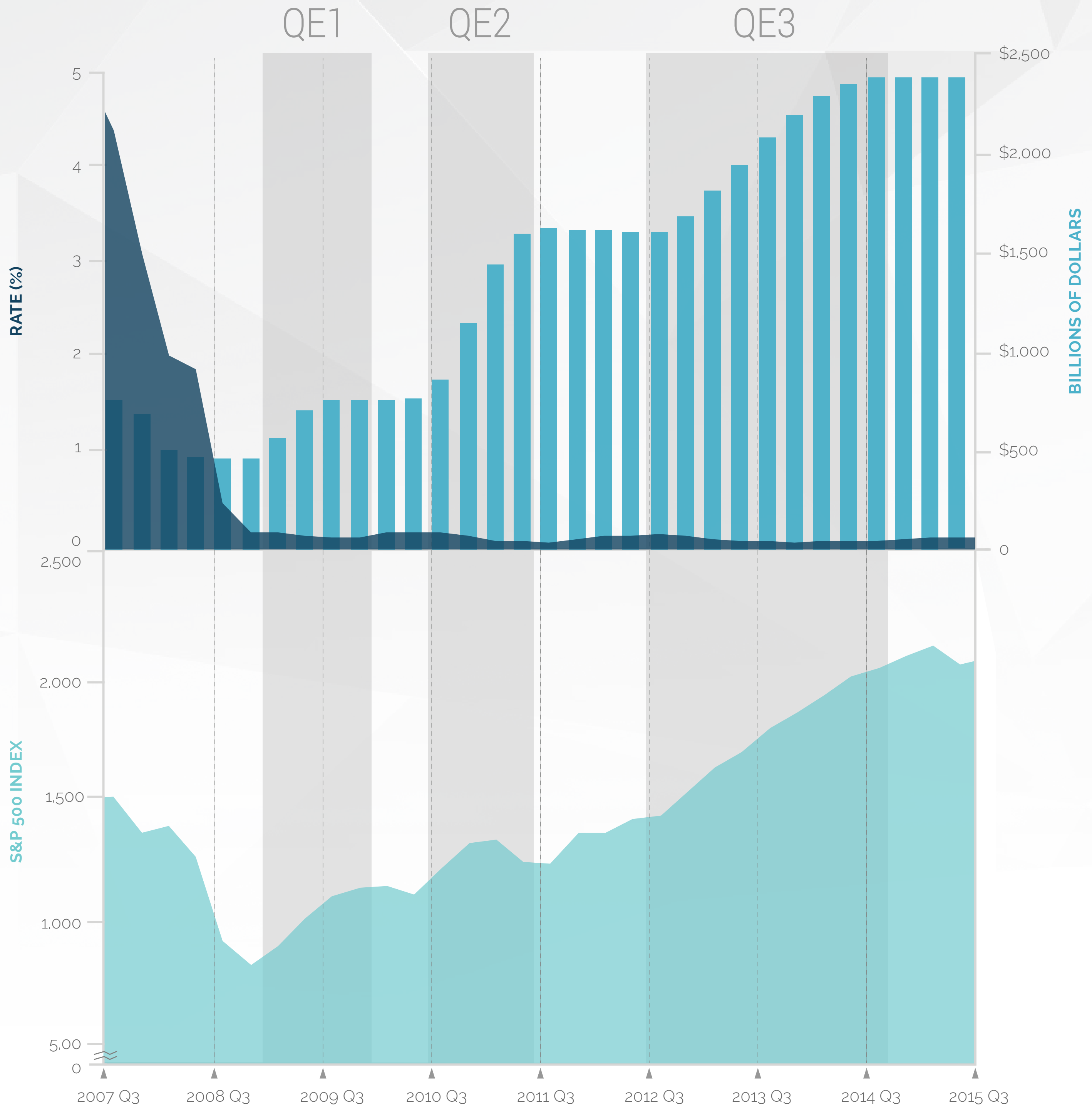


Source: Bloomberg

Quantitative Easing (QE) Timeline

2008–2015 Q3

The Fed's easy money has been a boon to U.S. equities.



Source: Federal Reserve Bank of St. Louis

Fixed Income

Yellow Lights Flashing

Fixed income markets merit an abundance of caution heading into 2016, but not for the reasons on the forefront of many investors' minds. We feel the likelihood of rising rates is already reflected in pricing, as is the likelihood that the resulting upward trajectory will be measured. Of greater concern are the underlying imbalances that are leading developed countries' central banks down separate paths. Chief among these are the growth differentials among major economies, along with a discomforting increase in leverage. While less accommodative policy in the U.S. reflects greater confidence in its economy, it by no means gives the "all clear" sign globally. **Gibson Smith**, Chief Investment Officer of Janus Fixed Income, expects the U.S. to continue to do what it's done for the past few years: deliver steady — though not breakout — economic growth. Europe and Japan, he continues, are facing a period of low, if not zero growth. That leaves China. And herein lies the risk. As **Seth Meyer, CFA,** a Global Research Analyst and Porfolio Manager, views it, for well over a decade, the world economy was configured to rely upon near double-digit growth from China. Now, Chinese GDP may be tracking at 6.5%, if it's lucky. Losing this source of incremental growth translates to tremendous slack in global supply chains. While this impacts revenues across many sectors, Mr. Meyer sees the pain most acutely felt by commodities producers that invested in capital expenditure to provide materials to China's manufacturers and growing middle class.

> "Core bond portfolios are at risk of heightened volatility. One way to combat this is with active management, namely avoiding the most richly valued securities and actively managing duration relative to the benchmark's extended level."
>
> Darrell Watters, Fundamental Fixed Income Portfolio Manager

Fixed Income Trends

Nominal Yield Spread Against 10-year U.S. Treasuries

Spreads began to widen in anticipation of the Fed's tightening, but remain narrow on a historical basis.

Source: Bloomberg

Diverging growth trajectories — and thus monetary policy — are likely to be with us for the next few years. Mr. Smith warns that the global economy can function under such conditions, but from an investor's perspective, when valuations across risk assets are stretched, as is presently the case, shifts in policy are amplified, resulting in large potential swings in investment returns.

Magnifying these risks is the leverage piled onto global balance sheets. The standard policy response to debt crises has been to add liquidity, which fuels risk taking, ultimately leading to higher debt loads. **Darrell Watters**, Fundamental Fixed Income Portfolio Manager, finds this debt overhang alarming. He sees emerging markets — especially those reliant upon commodities exports — as most vulnerable. Emerging market debt has more than doubled since 2008, yet much of the proceeds were spent on transfer payments to citizens, rather than on infrastructure and education aimed at boosting productivity.

The situation is equally disquieting with corporate credits. Artificially low interest rates have incentivized companies to favor debt financing, resulting in an explosion of new issuance and overly levered balance sheets. Heavy doses of debt, coupled with narrow credit spreads and extended durations, are signs of the later stages of a credit cycle and justify defensive positioning. According to **Mayur Saigal**, Global Head of Fixed Income Risk Management and Portfolio Manager, this situation can be improved by pro-growth policies and adjusting monetary policy so that real interest rates are positive. Such a move will give managers greater confidence to invest in their business, ultimately increasing productivity and profitability.

With this backdrop, Seth Meyer, CFA prefers exposure to the U.S. consumer and seeks to avoid sectors exposed to commodity weakness. Solid automotive sales are expected to continue, as is spending on restaurants and travel. While retailers stand to benefit from steady consumption, individual company prospects will vary as firms continue to be upended by the disruptive force of online shopping. Investors should focus on companies that are judiciously adding debt, often combined with equity financing, to fund expansion. Mr. Meyer believes it is best to stay

Corporate Debt Issuance

Volume of High-Yield and Investment-Grade Bond Issuance, 2006–2015 Q3

Corporate debt issuance continues to grow, raising concerns about overly levered balance sheets.

Source: Bloomberg

conservative, preferring stable companies with visible cash flows to those whose fortunes are subject to the whims of a still-unsettled global economic picture.

Mr. Watters warns that core bond portfolios are at risk of heightened volatility. One way to combat this is with active management, namely avoiding the most richly valued securities and actively managing duration relative to the benchmark's extended level. He continues to view illiquidity as a significant risk. Should consensus views on rates or economic growth prove incorrect, forced selling into a market with substantially fewer participants could lead to significant capital losses.

"The market is still more dovish than the Fed. The Fed's guidance remains substantially higher than that of the market relative to where policy and the economy will be one, two and three years from now. If the Fed does not move and the market gets repriced to Fed expectations, that's not a good scenario. Investors will all want to redeem their money, and managers will do the same thing as well, which is selling into an illiquid market."

Mayur Saigal, Global Head of Fixed Income Risk Management & Portfolio Manager

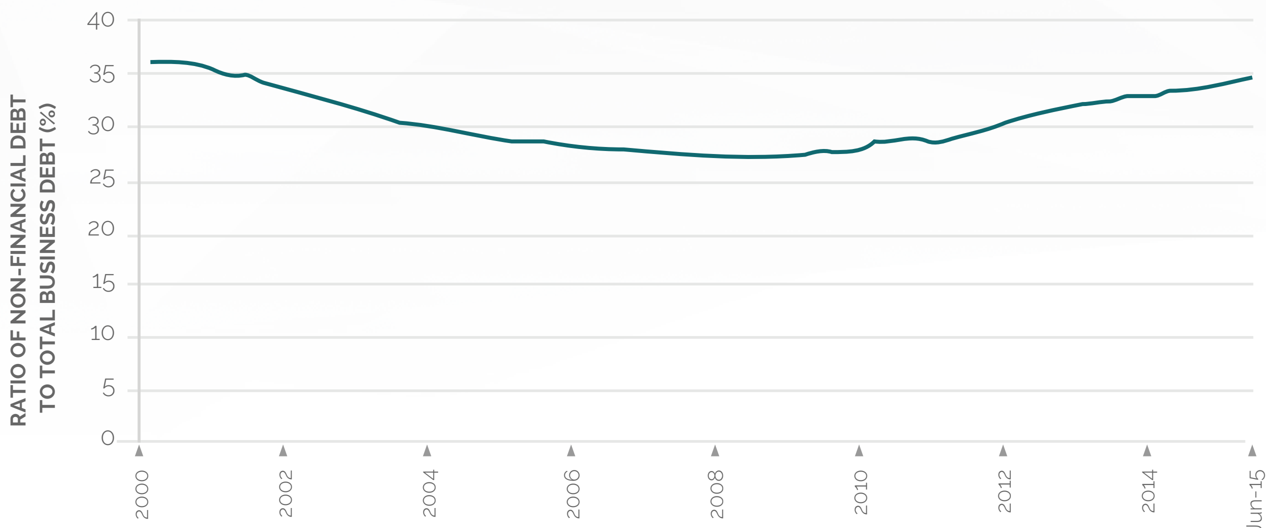
"Chinese central bank policy can have an impact of much greater magnitude on market volatility than the Fed. A large unexpected policy change out of China would likely have massive market implications."

Gibson Smith, Chief Investment Officer, Fixed Income

Ratio of Non-Financial Debt to Total Business Debt

Non-financial Corporate Debt

Non-Financial firms delevered, but have since re-levered their balance sheets.



Source: Bloomberg

Disruption

Schumpeter Strikes Again: Is Creative Destruction the Path to Growth in a Slow-Growth Environment?

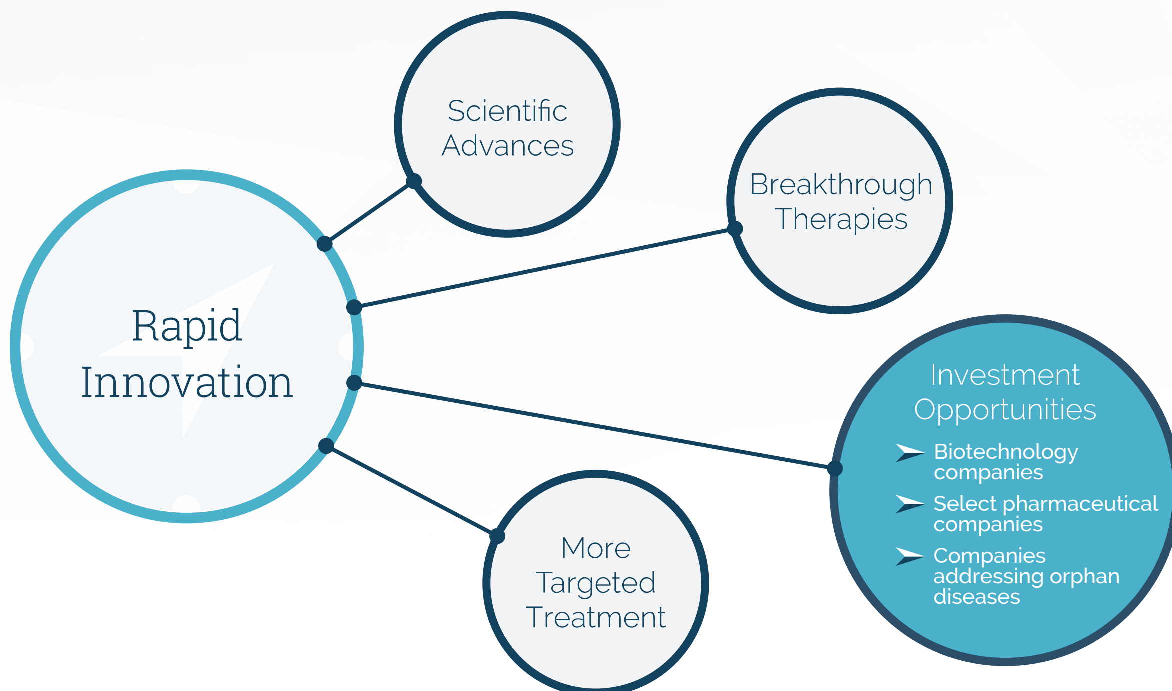
The U.S. and global economies continue to grow only modestly, but the pace of innovation is accelerating. New technologies disrupt old business models and transform entire industries. We believe companies at the heart of this disruption may present some of the best opportunities for growth in a persistently low-growth environment. But the current wave of disruption has further implications: understanding the disintermediation triggered by today's disruptors is critical to gauging the underlying potential of the modern dynamic economy.

The health care sector offers perhaps some of the most impactful platforms for innovation. Biopharmaceutical companies are just scratching the surface of immuno-oncology, explains **Andy Acker**, Portfolio Manager of the Janus Global Life Sciences strategy. New therapies unlocking the immune system's ability to recognize and fight cancer cells could replace chemotherapy and offer long-term functional cures for many previously incurable cancers. Innovative cardiovascular treatments could significantly extend patients' lives and alter the total picture of health care spending. Gene therapy also holds vast promise, Mr. Acker says, and could lead to cures for genetic diseases such as hemophilia by allowing the body to replace a defective protein with a functional copy.

"The dispersion between what's happening at the macroeconomic level and the company level is at an all-time high due to the pace of change happening in today's economy."

Brian Demain, CFA, Portfolio Manager

Innovation is Creating Significant Growth Opportunities in the Health Care Sector



Discovery and change, however, isn't limited to the health care sector. The consumer migration from brick-and-mortar stores to online shopping is still in its infancy. Companies that created the platforms to facilitate this shift have and will likely continue to experience rapid growth opportunities, but at the expense of many other consumer discretionary companies that have been slow to adapt, says **Doug Rao**, Portfolio Manager of the Janus Concentrated Growth strategy.

Furthermore, the transition of IT architecture from hardware servers and on-premises data centers to the cloud is another secular growth trend still in its nascent stage, but poised to significantly expand and further reduce corporate IT costs for small and large firms alike. As **Marc Pinto,** Portfolio Manager of the Janus Balanced strategy, explains, IT costs account for as much as 10% of revenues for some companies. He explains that transitioning core computing functions to the cloud has the potential to slash those costs by more than half, which should have a meaningful impact on the bottom line. Similarly, fracking technologies effectively put a near-term ceiling on oil prices, lowering input costs for some companies and increasing revenue for others as consumers spend their "gas dividend," Mr. Pinto says.

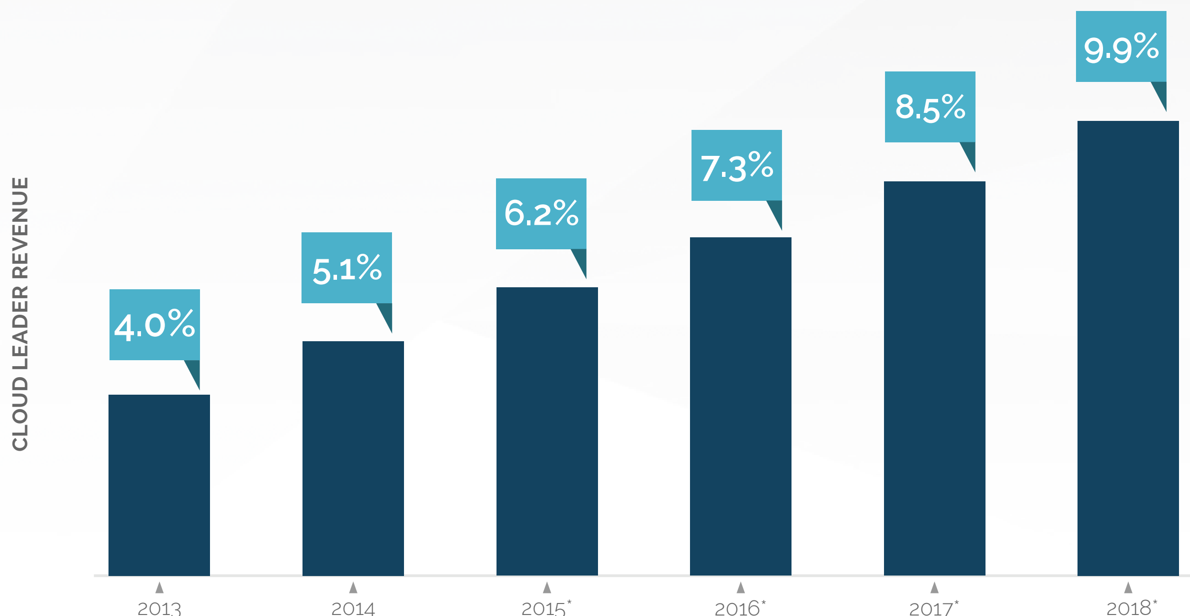
Mr. Rao points out that innovation and disruption have also made it harder for traditional economic metrics to provide reliably accurate readings on the U.S. economy. Inflation has remained low for an extended period, in large part because automation acted as a governor on wage growth. But, according to Mr. Rao, automation and other efficiencies have made a number of goods and services cheaper, arguably leaving the consumer in a better position than they were a decade ago. As innovation continues to drive change, understanding how disruptive companies are revolutionizing the status quo will play an increasingly important role in growth investing and understanding the shifting dynamics of the U.S. and global economies.

The multiplier effects from such changes have broader implications for the economy. Disruptive technologies are a key reason why Janus' portfolio managers believe that even after years of margin expansion, profits for U.S. companies have not peaked.

"Pure Play" Cloud Leader Market Share

Percentage of Overall Enterprise Application Software Spend

Businesses are quickly migrating to cloud from hardware, servers and on-premises data centers.



*Estimated | Source: Janus Capital Group

"Our job is to find the disruptors or companies that are hard to disrupt. These companies can grow by taking market share, and don't need a strong economic backdrop to thrive."

Doug Rao, Portfolio Manager

E-Commerce vs. Brick-and-Mortar Retail

Total Online Sales vs. Other Retail Sales

E-Commerce sales growth continues apace, vastly outperforming their brick-and-mortar rivals/channels.

E-Commerce Retail Sales | E-Commerce as % of Total Retail Sales

E-COMMERCE SALES (USD, MM): 0, 50,000, 100,000, 150,000, 200,000, 250,000, 300,000, 350,000

E-COMMERCE AS A % OF TOTAL RETAIL SALES: 0, 1, 2, 3, 4, 5, 6, 7, 8

2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015 (Q3)

Source: St. Louis Fed

China and India

China in Transition, India Rising

China is transitioning from an export-led industrial economy to a consumption-driven model. India, meanwhile, is gradually introducing long-needed reforms that, if successful, will unleash and modernize its economy. The outcome of these transformations will have broad implications for the global economy and financial markets in 2016 and beyond.

While China's transition to a consumer-led economy will take time to complete, consumption is already making up a growing portion of GDP growth. According to **Carmel Wellso**, Janus' Director of Research and Portfolio Manager, we expect that trend to continue and see consumer demand as ultimately helping China's economy avoid a hard landing. Many factors favor growth in consumption: the tight labor market is putting upward pressure on wages, while household balance sheets are healthy. Yet the Chinese market for many amenities remains underpenetrated.

A key concern for **Guy Scott**, Portfolio Manager of the Janus International Equity strategy, is whether China remains socially, politically and financially stable. The challenge is in shifting away from manufacturing and export-led growth toward a consumption-based economy, as well as weaning off dependence on government investment, specifically through state-owned enterprises (SOEs). Propping up SOEs that have been the backbone of the economy for decades created heavy debt loads for banks and municipalities, as well as overcapacity in many industries.

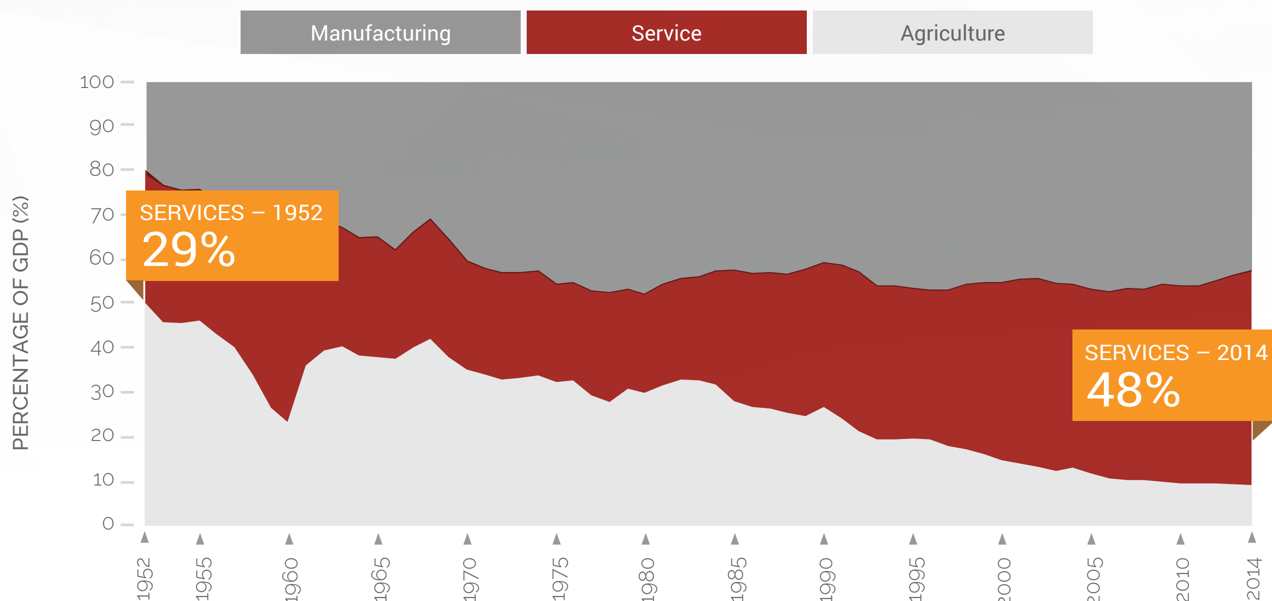
Many factors favor growth in consumption in China: the tight labor market is putting upward pressure on wages, while household balance sheets are healthy. Yet the Chinese market for many amenities remains underpenetrated.

Carmel Wellso, Director of Research & Portfolio Manager

Composition of Chinese GDP

Percentage of GDP by Industry, 1952–2014

Services' share of Chinese GDP has expanded rapidly, while agriculture's has fallen. Beijing would like to see that share continue to expand, but at manufacturing's expense.



Source: National Bureau of Statistics; CEIC

Barrington Pitt Miller, a Janus Equity Research Analyst covering the financial sector, believes that the structure of China's financial system and the tools at the central government's disposal give the country time to resolve these issues. A large cushion of domestic deposits and relatively modest wholesale financing exposure affords China's banking system breathing room to manage concerns around excessive and unproductive loan growth without wholesale funding and mark-to-market pressures, as witnessed in Europe and the U.S.

Mr. Pitt Miller also believes that the government has room to further lower its reserve requirement for financial institutions and can increase the eligible collateral pool that commercial banks can pledge to the Chinese central bank. These are similar to moves that proved successful in stabilizing the U.S. and European economies. However, he cautions that a key issue China must address is the deterioration in credit productivity occurring over the past seven years, and the resulting buildup of non-performing assets.

India may provide the brightest spot among emerging markets. Unlike many developing economies,

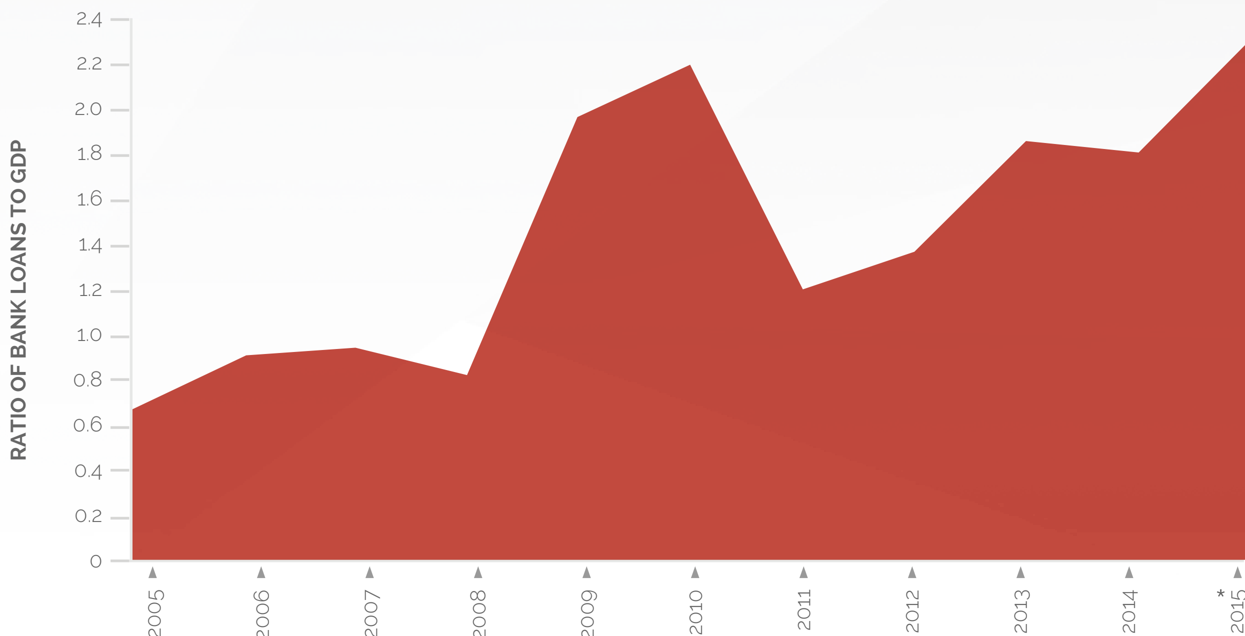
"Decisions around China's currency will be important to watch next year. Historically, China has weakened its currency and exported its way out of periods of excess capacity, but that may not be an option this time because China needs a stable yuan after becoming a reserve currency of the International Monetary Fund. An accelerated depreciation would mean China has abandoned its desire to be a stable, global currency due to more serious concerns about its economy."

Guy Scott, CFA, Portfolio Manager & Equity Research Analyst

Chinese Loans vs. GDP

Ratio of Chinese Bank Loans to GDP, 2005–2015

The productivity of Chinese lending continues to deteriorate, leaving a growing number of nonperforming assets in its wake.



*Estimated | Source: CEIC

India no longer faces the threat of high inflation and may actually lower rates to stimulate growth. **George Maris**, Portfolio Manager of the Janus Global Alpha Equity strategy, believes the economic technocracy across India's ministry of finance and reserve bank is as strong as anywhere in the world, and he is encouraged by the Reserve Bank of India's (RBI) efforts to encourage financial transmission of monetary policy to the real economy. He also feels that a focus on growing its private banking sector is positive for India. These sentiments are echoed by Mr. Pitt Miller, who feels that the RBI's efforts mark a secular change in the way Indian monetary authorities target inflationary pressures.

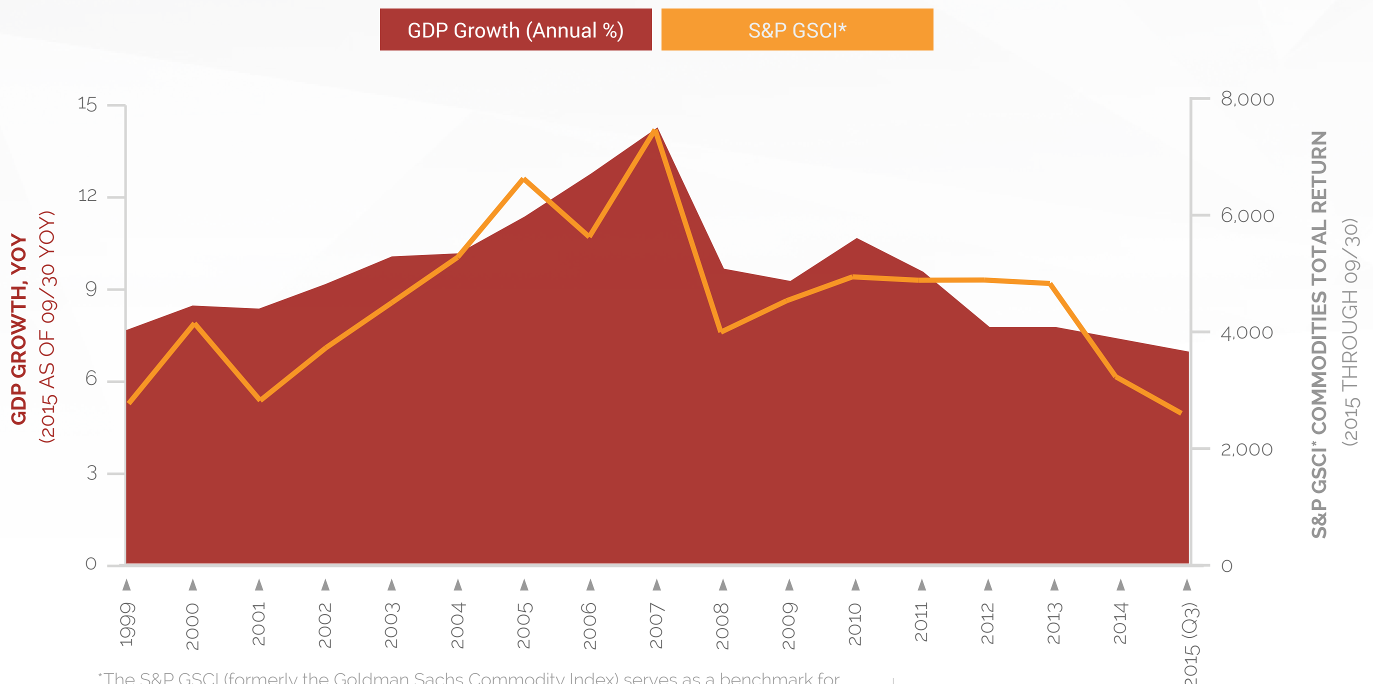
"The Chinese government is putting building blocks in place to increase consumption by allowing private enterprises to establish dominant e-commerce and Internet platforms. In a country with a poor retail infrastructure, this subtle change can play a big role in driving purchases. Going forward, I will be looking for tax incentives and other policy initiatives from China's government to spur consumption activity."

George Maris, CFA, Portfolio Manager

Deceleration of Chinese Economy

GDP Growth and Commodity Prices

As Chinese economic growth slows, demand for commodities weakened, resulting in lower prices.



*The S&P GSCI (formerly the Goldman Sachs Commodity Index) serves as a benchmark for investment in the commodity markets and as a measure of commodity performance over time. | Source: Bloomberg

Navigating Volatility

Are We Heading for Mr. Market's Wild Ride?

While opportunities for generating positive returns exist, we continue to monitor potential risks of which investors must be cognizant heading into 2016. Many of the causes of last summer's spike in equity market volatility are still present. Among these is the recent trend of stagnating corporate earnings. Much of the earnings growth during the post-crisis era has been propelled by streamlined operations. With companies running lean, revenue growth is needed to support further gains in the bottom line. This has been lacking and is a troublesome trend.

One factor exacerbating lean revenue growth has been the increase in highly levered balance sheets. **Greg Kolb**, Chief Investment Officer at Perkins, states that companies with healthier balance sheets can likely weather a disappointing earnings report as management maintains financial flexibility, including liquid assets and capacity for additional debt. That possibility dwindles, however, as companies extend their leverage during the good times. Such risks are most acute in the energy sector, according to Mr. Kolb. Much of the expansion in drilling over the past several years was financed through borrowing, making the worst offenders especially vulnerable to chronically lower crude oil prices.

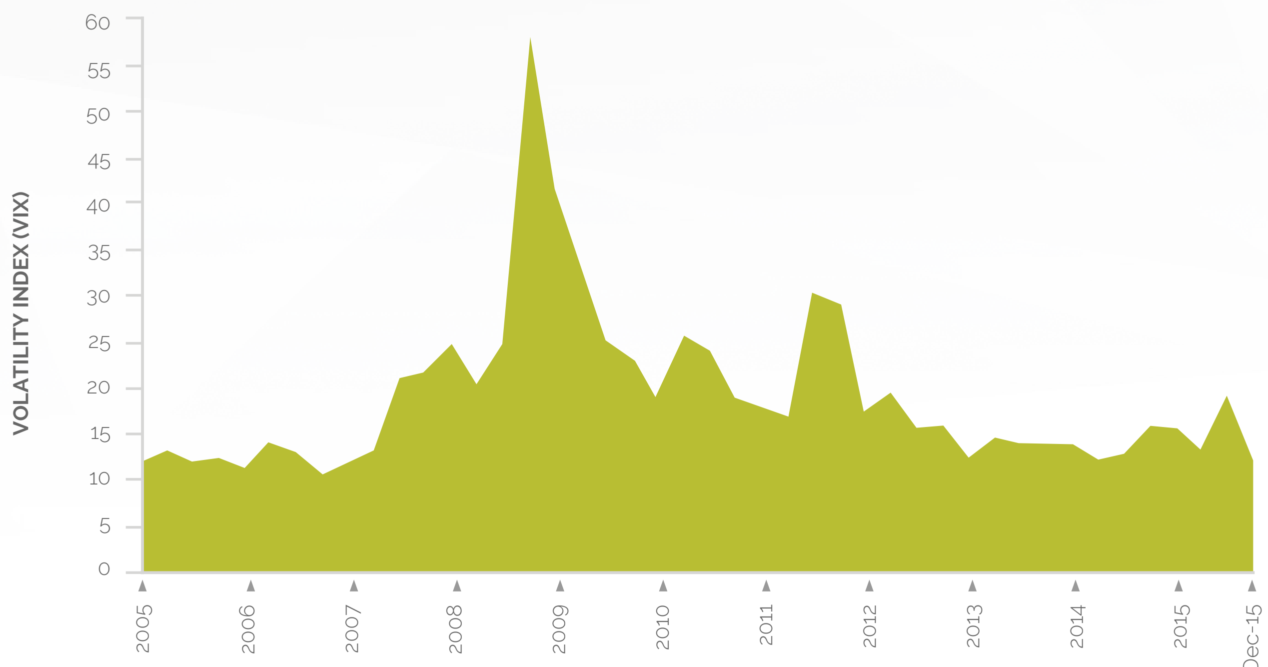
"If a company is levered up to the gills and creditors need to be repaid, there's less financial wiggle room, and that just makes the challenge for company management that much more difficult."

Greg Kolb, CFA, CIO, Perkins Investment Management.

Equity Market Volatility

Volatility Index (VIX), 2005–2015

Although volatility remains generally well behaved, we are carefully monitoring signs of a resurgence.



The Chicago Board of Options Exchange (CBOE) Volatility Index ("VIX") shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options and is a widely used measure of market risk and is often referred to as the "investor fear" gauge.

Source: Bloomberg

Stagnating earnings also pose risks for corporate credits. **Seth Meyer, CFA,** a Global Research Analyst and Portfolio Manager at Janus, believes that with credit valuations richly priced, there is little room for error. If a company misses consensus earnings estimates, even if it posts positive results, bond prices are likely to fall — potentially dramatically. Magnifying this risk is the lack of yield cushion to absorb losses in principal. Mr. Meyer calls this an era of mass discrimination in the credit markets.

Gibson Smith, Chief Investment Officer of Janus Fixed Income, highlights that the convergence of stretched valuations and low returns, by definition, leads to higher volatility. Similarly, the extended duration of Treasurys puts those securities at risk. The combination of historically low yields and long durations means that impending rate hikes will likely result in material losses as meager coupon payments are insufficient to compensate for declining Treasury prices.

Another risk on our radar is the threat of what we refer to as "Fed Error." The Fed's impending tightening cycle is the first of its kind as it comes with wage growth that is generally stagnant, inflation showing no signs of increasing, and the Institute for Supply Management's activity index slipping below the "boom-or-bust" mark of 50 in November, thereby pointing to a marked slowdown in manufacturing activity. Mr. Meyer says the team is closely monitoring the long-end of the yield curve. Any significant flattening over the tightening cycle could signal that the markets also fear the Fed may be tightening at the wrong time in the cycle.

When attempting to identify sources of volatility, it is often helpful to determine where market consensus has led to a crowded trade. At present, **Ashwin Alankar**, Ph.D., Global Head of Asset Allocation and Risk Management for Janus, views longer-dated Treasurys as the most prevalent "crowded trade." Driving this is the expectation that inflation will remain muted for the foreseeable future. Mr. Alankar recognizes the possibility that this may not be the case. Few, if any, financial assets are pricing in inflation at present, despite a strong run of employment gains in the U.S. Of greater consequence, he continues, is the recent slowdown in productivity gains. With new workers producing fewer units per hour, costs — and thus prices — may be positioned to go up. Ultimately, this could result in increasing demand for higher wages. Mr. Alankar believes the U.S. economy is potentially closer to this point than many recognize. And should inflation materialize, the exit from the trade could be violent.

Adrian Banner, Ph.D., Chief Executive Officer and Chief Investment Officer of INTECH, sums up the situation nicely. He believes there's every reason to expect these spikes in market volatility to continue to occur, so portfolios with the ability to dynamically adjust to the given volatility climate can be extremely important in managing total risk.

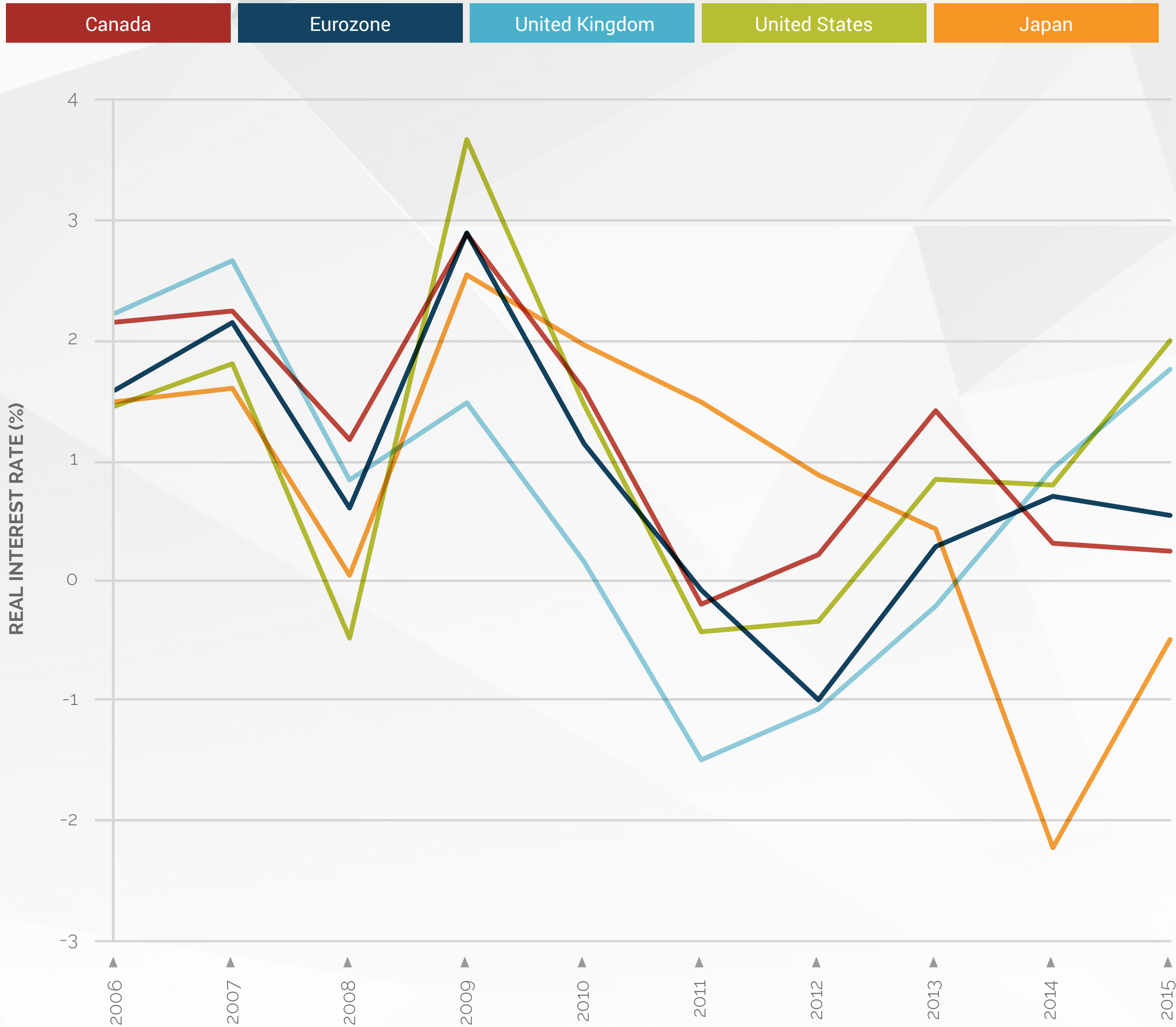
"With mounting risks, global debt levels need to be either repaid or rolled, which is dependent on yields, credit, currency and liquidity. Any roll would also rely on the ability of central banks to engineer it. I worry that central banks may be ineffective in stimulating growth and managing the inevitable roll or payment of such debt levels."

Bill Gross, Portfolio Manager

10-Year Real Interest Rates of Select Developed Economies

2006–2015

It remains to be seen whether negative real interest rates can help lift struggling economies and deter deflation.



Source: Bloomberg

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Past performance is no guarantee of future results

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