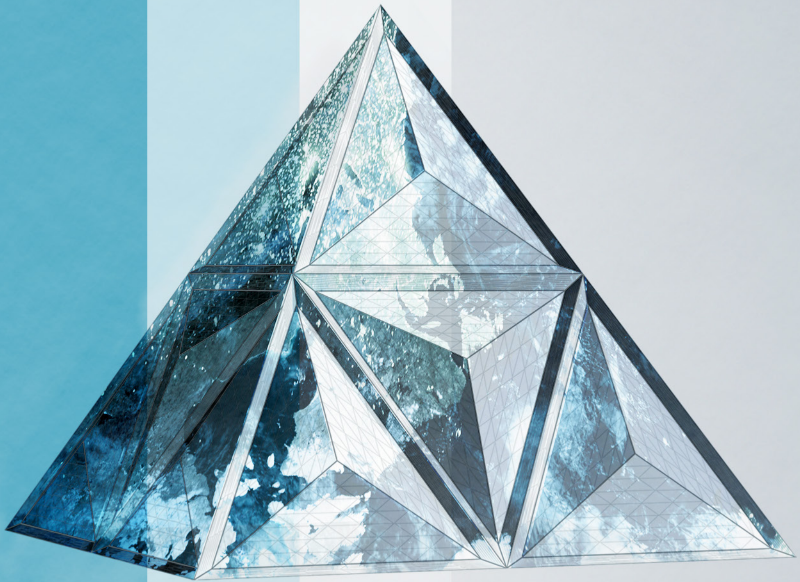

Janus Henderson
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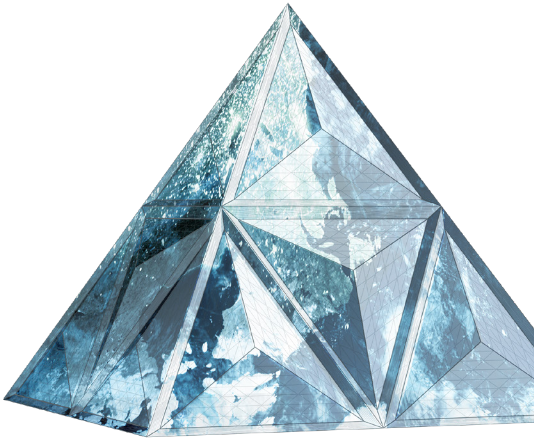
MARKET GPS
FIXED INCOME OUTLOOK 2020

For professional investors only



STAYING POSITIVE AMID THE NEGATIVE

Negative rates and weak economic data paint a challenging backdrop for investors, but Global Head of Fixed Income Jim Cielinski argues there is room to be positive within Fixed Income, an asset class that can tolerate mundane conditions.

The outlook for Fixed Income in 2020, we believe, boils down to whether central bankers' accommodative policy can retain its efficacy and stave off a global recession. We believe it will. So long as central banks do not make a mistake, real equilibrium rates should remain low and depress the risk premia required to own riskier assets. We expect to see an extension of the credit cycle, which should support corporate bonds and Equities.

Valuations are stretched, however, and with credit spreads tight and risk-free rates at such low levels, there exists little room in some countries for falling rates to offset spreads moving wider. As such, credit prices will be sensitive to shocks, which may be likely in a US presidential election year, with volatility creating opportunities for active managers. For now, economic data is showing tentative signs of inflecting. This would make for mundane global economic conditions in 2020, and investors will likely have to be content with modest returns.

Incongruous highs and lows

The latter half of 2019 was full of contradictions. US equities hit record highs with labour markets in robust health, yet many purchasing manager indices were in contraction territory and the Chinese economy grew at its slowest pace in 27 years. Worryingly, the US yield curve inverted, with the widely followed 2s10s spread (the difference between the yield on the 10-year US Treasury and the 2-year US Treasury) turning negative in August – historically, a harbinger of recession.

It is a difficult chart to ignore, and it would be courageous to say it is not important. It has correctly signalled a fragile global economy. Yet it also reflects why the US Federal Reserve (Fed) has been swift to act, rapidly cutting rates to reverse the (overly aggressive) tightening in 2018. Central banks worldwide have mirrored the US pivot: in Q3 2019, 56 out of 62 rate moves were cuts, whereas in Q3 2018, 27 out of 31 adjustments were hikes.

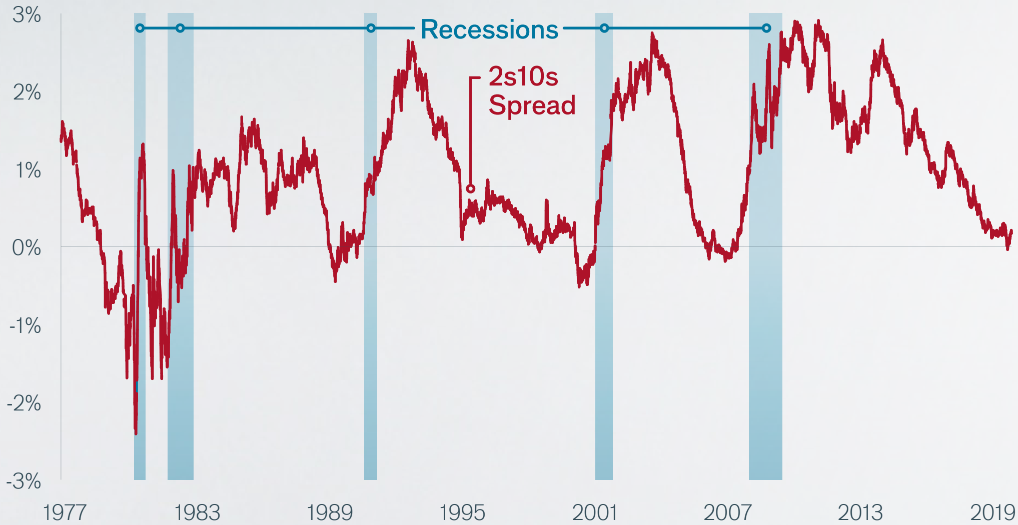
The trade smokescreen

In our view, the economic weakness in 2019 was a lagged response to earlier monetary tightening in the world's two largest economies – the US and China. With both now firmly in easing mode, we would look for some recovery. The trade war, by raising costs and reconfiguring investment flows, exacerbated the global slowdown, but it did not cause it. If trade is resolved, but weak growth persists, expect credit spreads to widen and government bonds to rally, as it would indicate that the global slowdown is more structural than originally envisaged.

The market's consensual calm could be disturbed if the unemployment shoe were to drop. Consumption has been pivotal in protecting the US economy and can be contrasted with weakness in export-driven Germany. The latter's sensitivity to fragile global growth means the European Central Bank (ECB) is expected to stay highly accommodative. The stark defence of negative rates by Christine Lagarde, the new ECB president, suggests no departure from her predecessor's policies. This should anchor eurozone

EXHIBIT 1: 10-YEAR TREASURY CONSTANT MATURITY MINUS 2-YEAR TREASURY CONSTANT MATURITY

A negative 2s10s spread has often indicated a recession; since 1978, a recession has occurred, on average, 22 months after the inversion.



Source: FRED Federal Reserve Bank of St Louis, 2s10s (T10Y2Y) and NBER-based Recession Indicators for the United States from the Peak through the Trough (USRECM), 31 October 1977 to 31 October 2019.

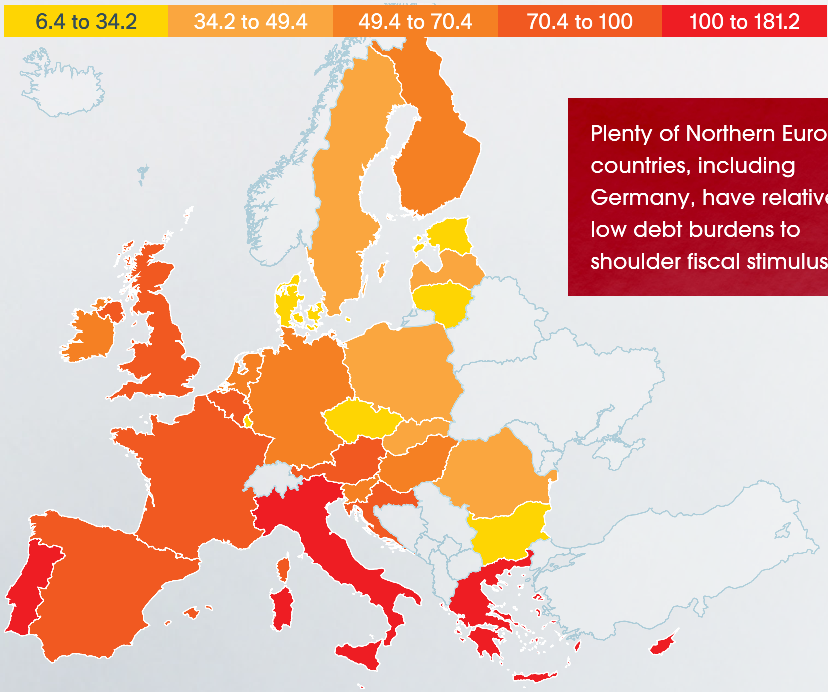
sovereign yields around the zero bound. We also expect Lagarde to repeat calls for more fiscal stimulus to assist the bank's monetary policy – low government debt burdens in Northern Europe at a time of political angst will make these calls increasingly difficult to ignore.

Elsewhere, policy effectiveness is struggling in China. A string of regional bank failures has led to tighter credit conditions, dampening the impact of policy easing. Emerging market debt – so closely linked to China's fortunes – could become more attractive if the transmission mechanism of looser policy can gain traction.

Wage growth appears to be topping out and forward rates suggest inflation will be contained in most developed markets. We believe the consensus is correct, with central bankers continuing to undershoot their inflation targets. We think the Fed will make one or two further rate cuts in 2020, bringing its federal funds rate closer to 1.25%, which should bring the real (after inflation) rate more firmly into negative territory.

With the US in cutting mode, the yield curve should steepen, offering potentially welcome news for bank margins. For insurers and pension schemes, for which the nominal level of sovereign bond yields is important, the search for yield will continue. This could drive investors further down the credit spectrum and further out in duration, building up risk in the system.

EXHIBIT 2: GROSS GOVERNMENT DEBT AS A % OF GDP WITHIN EUROPEAN UNION COUNTRIES



Plenty of Northern European countries, including Germany, have relatively low debt burdens to shoulder fiscal stimulus.

Source: Eurostat; government debt outstanding as a percentage of gross domestic product at current market prices (code sdg_17_40). Annual figure at end 2018.

Active management

Where we preach particular caution is towards valuations. The decline in rates brought forward gains in 2019. With risk-free rates measured in basis points rather than percentage points in many developed markets (and negative in swathes of Europe), it is a meagre foundation on which to build returns.

A more active investment approach will be required. This will involve identifying markets where real yields persist and where central bank policy rates are expected to head lower. We are not predicting a global recession in 2020, but that does not preclude individual sector recessions such as the one experienced by energy in 2015, which led to a sharp widening of credit spreads within this sector.

We are concerned that the market is scarcely distinguishing between BBB investment-grade issuers and BB sub-investment-grade issuers in terms of cost of capital, creating little

EXHIBIT 3: GLOBAL CREDIT SPREADS IN BASIS POINTS OVER THE LAST 10 YEARS

	INVESTMENT GRADE (G0BC)	HIGH YIELD (HW00)
HIGH	267	897
AVERAGE	140	519
LOW	86	318
CURRENT (11.11.19)	108	419

Source: Bloomberg, ICE BofAML Global Corporate Index (G0BC), ICE BofAML Global High Yield Index (HW00), spread to worst versus government, 1 basis point = 100th of 1%, i.e., 0.01%. Spread to worst over government bonds is the difference in yield of corporate bonds over equivalent government bonds, taking into account features such as call options that could cause the yield to be lower. Data from 11 November 2009 to 11 November 2019

> "A low-yielding world might reduce nominal returns, but it will not eliminate opportunities, except for those that refuse to adapt."
> **JIM CIELINSKI**
> GLOBAL HEAD OF FIXED INCOME

incentive for companies to retain investment-grade metrics. With credit spreads moving close to the tightest levels of the cycle in both investment grade and high yield, there is also little to cushion investors should markets be hit by a shock. And with politics being the source of recent shocks, a US presidential election year is a hurdle.

A focus on fundamentals

Dispersion should remain a feature, and avoiding losses will be critical as disruption continues apace. The defaults in 2019, such as Thomas Cook, the travel company, were symptomatic of how technology and shifting consumption patterns are reshaping the world. Lending to companies that will be around in the future requires investors to be on the right side of change. In our view, that means paying attention not only to traditional metrics but also to what matters to future investors and consumers, including a deeper focus on environmental, social and governance (ESG) factors.

While the low real yield environment lessens default risk, we see diminishing gains from refinancing, particularly in Europe. Corporate borrowers must increasingly rely on cash flow rather than financial engineering to support their debt. In the US, the return on equity remains below the cost of equity capital, and this will continue to encourage share buybacks over capital expenditure. Bond investors will need to monitor whether proceeds from borrowing are being used for bondholder-friendly purposes or are worsening the balance sheet.

No repeat offenders

The search for yield will force investors to look across the entire range of Fixed Income, and that may result in increased interest in asset- and mortgage-backed securities. Excessive mortgage debt was behind the Global Financial Crisis, but it is atypical for a sector to reoffend so soon. US mortgage credit has not been where the debt build-up has been this cycle, unlike corporate credits.

The global economy is at a critical juncture. Investors must not become anchored and should keep an eye on key signposts. Labour markets and incomes will be important corroborating indicators of recession while geopolitics and sentiment shifts will likely produce market disruption. Even at low yields, developed market sovereign bonds should continue to offer diversification to Equities, although more credit-sensitive areas such as high yield bonds would be vulnerable in an equity correction. A low-yielding world might reduce nominal returns, but it will not eliminate opportunities, except for those that refuse to adapt to the new framework.

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At Janus Henderson, our investment teams discuss and debate their views regularly but are free to form their own opinions of opportunities and risks in the marketplace. We feature commentary from individual portfolio managers on the Insights section of the Janus Henderson website as part of our *Knowledge. Shared* approach.

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