December 2018

Janus Henderson
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GLOBAL SECTOR VIEWS

Quarterly Equity Overview and Sector Highlights

About Janus Henderson U.S.-Based Sector Research

- Six analyst-led teams: Consumer, Energy & Utilities, Financials, Health Care, Industrials & Materials, and Technology
- Average tenure of nine years at the firm and 16 years of financial industry experience as of 9/30/18
- 951 stocks covered across market capitalizations, styles and geographies as of 9/30/18
- Fundamental, independent research that seeks to identify best ideas in each sector
- Stocks with strong-buy or buy ratings considered for inclusion in Janus Henderson equity strategies

MARKET OVERVIEW

The Upside to Market Volatility

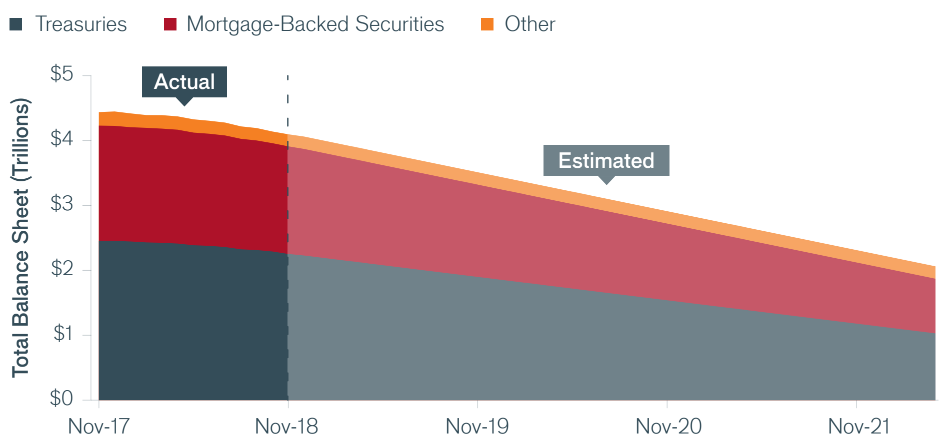
The momentum carrying U.S. stocks came to an abrupt end in October when Federal Reserve (Fed) Chairman Jerome Powell suggested the central bank was a ways off from ending rate hikes and trade tensions began to negatively impact company guidance. Since then, Mr. Powell has backpedaled, saying the central bank may be closer to its "neutral rate" than first thought, and President Trump and President Xi Jinping of China have agreed to a temporary cease-fire on tariffs. Even so, volatility persists, and market participants could be wondering, what's next?

Volatility: The New Norm

We think equity investors should brace themselves for more uncertainty, as uncomfortable as it may be. Since 1945, the average U.S. economic expansion has lasted just over 58 months; the current one is 114 months and counting. In short, the business cycle is aging, and with that can come change. The U.S. unemployment rate, now at its lowest level in decades, is starting to place upward pressure on wages. Rate hikes aside, monetary policy continues to normalize as the Fed gradually unwinds its balance sheet. Housing prices have started to ease, and some forward-looking indicators, such as new business orders, are off recent highs.

Fed Balance Sheet Reduction

Even if the Fed stops raising interest rates, the central bank is set to continue reducing the size of its balance sheet, another form of monetary policy tightening.



Source: Bloomberg. Data are from 11/30/17-4/30/22 and as of 11/30/18.

On top of economic factors, geopolitical risks are adding to market volatility. Although the U.S. and China agreed to a 90-day hiatus on additional tariffs, we remain doubtful that the truce will last for the full period, especially as bigger trade issues must still be worked out. Consequently, more and more companies are putting capital expenditures (capex) on hold or considering moving supply chains out of China. Meanwhile, China's economy is feeling the pinch from trade restrictions, while contentious Brexit negotiations, violent protests, budget deficits and other political troubles continue to overshadow Europe.

Key Takeaways

- U.S. equities have retreated along with global stocks on worries about rising interest rates, trade disputes and potentially slowing economic growth.
- We believe market volatility could persist in the coming months, especially as the business cycle ages and uncertainties related to U.S.-China trade tensions linger.
- However, volatility has led to a dramatic improvement in the valuations of global equities, including many technology stocks with exposure to attractive secular growth trends.

Valuations Improve

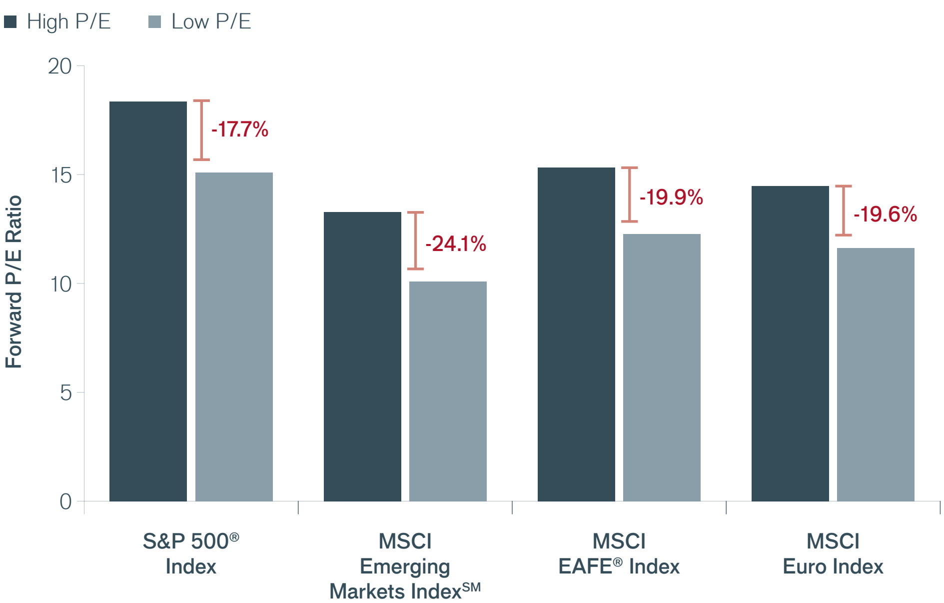
To be sure, clear signals of an impending recession remain far off. But current trends suggest the global economy could deliver slower growth in 2019. In such an environment, we believe stocks sensitive to economic growth or interest-rate moves will be challenged, especially as the benefits of U.S. tax reform and other stimulus measures start to wane from corporate earnings. Already, some management teams report that while demand remains strong, year-over-year comparisons are likely to become harder, which could further add to market jitters.

Still, we continue to find growth stories that we think will persist irrespective of the business cycle, including innovation in health care and the shift to a digital economy. Also, valuations for many equities have re-rated dramatically. For the year through November, the forward price-to-earnings (P/E) ratio of the S&P 500® Index has declined as much as 17.7%, one of the largest calendar-year drops in recent history. Many non-U.S. markets have moved in kind, with the forward P/E of the MSCI Emerging Markets Index℠ pulling back as much as 24.1% and the MSCI Europe, Australasia and Far East® (EAFE) Index declining 19.9%.

> "For the year through November, the forward price-to-earnings (P/E) ratio of the S&P 500 Index has declined as much as 17.7%, one of the largest calendar-year drops in recent history."

% Change in P/E Ratios, 2018

Uncertainty about economic growth has helped lead to a significant re-rating in global stock valuations.



Source: Bloomberg

Notes: The percent change uses the highest and lowest forward P/E for each index from 12/31/17-11/30/18. P/Es are weekly and based on forward, 12-month earnings estimates.

As multiples improve, we think investors can take advantage of secular growth stories that previously looked expensive. Technology companies exposed to long-term tailwinds such as the Internet of Things and cloud computing are one example. At the same time, new opportunities may arise. Select emerging-market stocks, for example, could benefit from the potential diversification of global supply chains. And companies with ample free cash flow may decide to reward shareholders with dividend increases or share repurchases rather than use the cash for capex. In our experience, focusing on these types of fundamentals makes it easier to ride out periods of market volatility – and often leads to better results over the long term.

Carmel Wellso
Director of Research

Consumer

Turning Cautious

The backdrop for consumer spending appears strong, in our opinion, with unemployment rates throughout the U.S. workforce at multiyear lows, wages climbing and gas prices in retreat. In addition, many consumers continue to benefit from lower tax rates. As such, the National Retail Federation forecasts holiday sales to increase as much as 4.8% this year compared with an average annual jump of 3.9% over the past five years. However, retail stocks have sold off in recent months on worries that higher interest rates and ongoing trade tensions could weigh on consumer spending and global growth in 2019.

Investment Implications

We have grown cautious about firms whose earnings are dependent on a robust economy. Nearly 10 years into the current bull market, wages are picking up and the Fed is normalizing monetary policy. Wage pressures and potentially rising interest rates, as well as tariffs, could chip away at corporate profit margins. As a result, we increasingly favor companies that we think could see continued demand even if the economy cools, such as food service, pest control and Internet service providers. We also continue to look for firms with sound fundamentals and brands that resonate with consumers.

Energy & Utilities

Oil Prices Under Pressure

From October to November, West Texas Intermediate (WTI) and Brent oil prices declined by more than 30%, driven in part by worries about slowing demand for oil. (WTI is a benchmark for U.S.-produced oil, while Brent measures global crude prices.) In addition, although Canada recently announced production cuts and the Organization of the Petroleum Exporting Countries (OPEC) and Russia agreed to curb output in 2019, concerns have grown about a global supply glut led by U.S. shale production and larger-than-expected exports from Iran and Venezuela.

Investment Implications

Unsurprisingly, energy stocks have come under pressure. However, we believe oil's fall has underscored the importance of capital discipline, reducing worries that exploration and production companies could be tempted to overspend in 2019. We also think the sector's pullback has created attractive entry points for some refining stocks, which earlier this year traded at lofty multiples. And despite worries about a slowing global economy, the International Energy Agency still expects oil demand to rise by 1.4 million barrels per day (mb/d) in 2019, up from an estimated 1.3 million mb/d in 2018. Should U.S. production remain strong, we think midstream operators (which manage oil pipelines and other transport systems) could benefit, as well as U.S. refiners, which could capitalize on a potentially widening differential between cost-advantaged crude and more expensive global distillates such as diesel and jet fuel.

Financials

Trading Volumes Rise

Worries about a potential slowdown in the global economy have weighed on the financial sector, along with other perceived cyclical stocks. And in Europe, lackluster economic growth, money-laundering scandals and political headwinds have weighed on banks there. However, U.S. bank earnings estimates generally remain positive for 2019 while the ongoing digitization of financial services and investments in new technology could help banks realize cost efficiencies and unlock growth. In the meantime, market volatility is proving to be a tailwind for exchanges, which have seen average daily trading volumes rise significantly in recent months.

Investment Implications

While we are finding attractive valuations and growth stories throughout the global financial sector, we believe exchanges are especially well positioned for the current environment. Already, many of these firms are benefiting from long-term growth drivers, including a rising number of users worldwide, favorable regulation and the electronification of fixed income markets. More recently, market volatility has led to higher trading volumes, boosting revenues. Trading volumes tend to stay elevated during periods of market uncertainty. As such, we believe exchanges could continue to benefit, especially if worries about an economic slowdown persist into 2019.

Health Care

Drug Launches Ramp Up

Drug pricing remains a focus in the U.S., but so far we believe most regulatory proposals face significant hurdles to being implemented or could have little impact on drug makers' bottom lines. At the same time, innovation within the sector remains robust, with the U.S. Food and Drug Administration approving more than 100 new drugs over the past two years, including a record number in 2018. Given that the typical therapy has an average life cycle of 10 years, these medicines, now in the early stages of launching, could provide years of growth. In addition, we expect to see additional approvals in the coming year, including a gene therapy and a new oral therapy for spinal muscular atrophy, the leading genetic cause of infant death.

Investment Implications

We continue to favor companies focused on developing innovative medicines that address unmet medical needs or that improve efficiencies within the health care system. Many small-cap biotechnology stocks were particularly hard-hit during the recent market rout; we believe some of these companies may now be attractively valued, potentially leading to a pickup in mergers and acquisitions within the group. At the same time, investors tend to favor the perceived safety of managed care and pharmaceutical stocks during periods of market volatility, and the recent sell off was no exception. We believe some of these stocks can provide ballast to a portfolio late in the business cycle.

Industrials & Materials

Heightened Volatility

A strong dollar, uncertainty over global trade and rising input costs continue to buffet the industrials sector. The recent oil rout also threatens to become a headwind, as a meaningful portion of the industrial manufacturing and production complex is tied to energy. Even so, a number of areas within the sector are still enjoying strong demand, including heavy manufacturing, general industrial and machinery, which continue to rebound from their 2015 downturn. Many companies have also been able to pass on higher costs in the form of price increases while activist investors increasingly are pushing industrial conglomerates to spin off business segments and improve profitability.

Investment Implications

Given rising uncertainties in the global economy, we are beginning to favor companies with less exposure to tariffs or firms whose earnings are not overly tied to the business cycle. While mindful of weaker crude prices, we believe the energy industry has become more disciplined, potentially mitigating losses for industrials whose customers operate in oil and gas. In addition, we continue to focus on company fundamentals, seeking out firms that appear undervalued, in our opinion, or that could become targets for activist investors.

Technology

Geopolitical Headwinds

Worries about global trade and the subsequent impact to economic growth are beginning to materialize in company fundamentals, with a growing number of tech firms reporting weakness during the latest quarterly earnings period. In addition, a disappointing product cycle has created headwinds for smartphone suppliers while social media platforms face ongoing regulatory scrutiny. On a positive note, spending on equipment for the buildout of 5G networks is starting to rise, and growth in Software as a Service (SaaS) and cloud computing remains particularly strong.

Investment Implications

We continue to favor providers of cloud technology and SaaS applications, areas that we view as having a long runway of growth. In addition, we believe these industries are more insulated from trade negotiations and the economic cycle. We have long avoided the iPhone supply chain on worries about limited innovation at Apple and will continue to do so. A slowdown in autos and factory automation, along with potential regulation limiting the export of key technology to China, has weighed on semiconductors. Still, we believe today's geopolitical tensions are largely short-term headwinds and expect supply chains to eventually adjust, no matter the outcome. In addition, secular trends such as the Internet of Things, artificial intelligence and the cloud should remain long-term tailwinds for semiconductors, many of which now appear attractively valued, in our opinion.

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