

Summer 2017

Janus Henderson  
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# GLOBAL SECTORS VIEWS






A Spotlight on U.S. Retail and  
Highlights from other Sectors

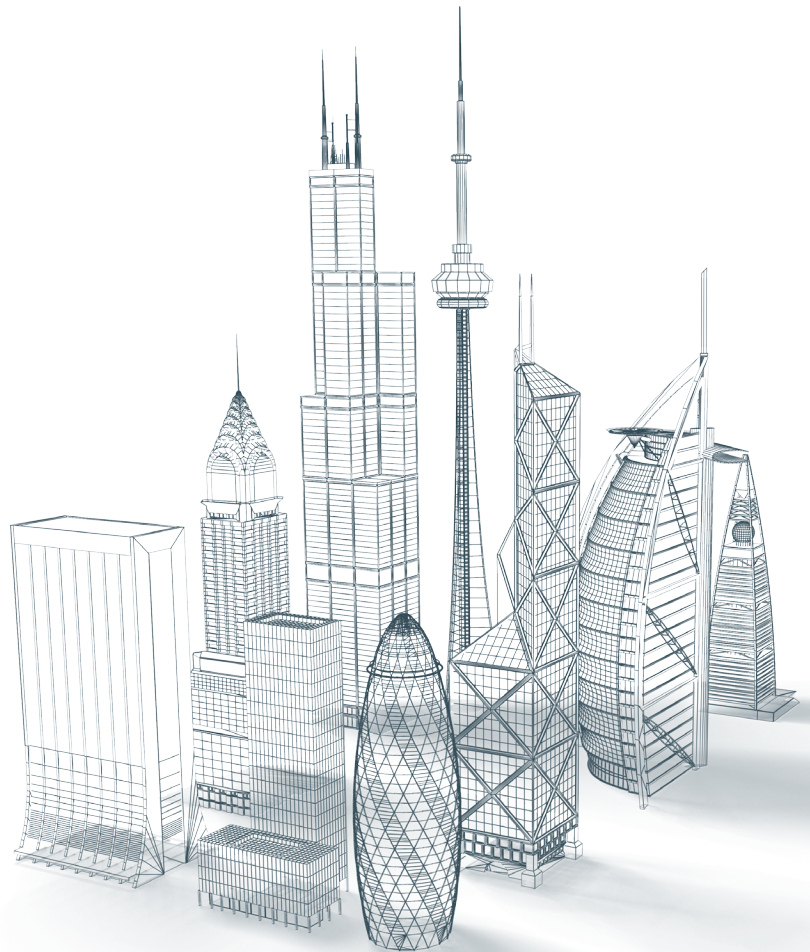




# INTRODUCTION

Welcome to the Janus Henderson Investors Global Sector Views, where our analysts share insights on the six sectors they assiduously follow. Also included in this report is a new in-depth analysis of a single sector, beginning this quarter with a discussion of the consumer sector's ailing U.S. retail industry. In addition, we cast a spotlight on key contributors to the piece: who they are, how they analyze stocks and bonds, and a bit about their life outside the office. We invite you to explore our updated piece in the following pages.

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# SECTOR OVERVIEW

## Energy & Utilities

### **Oil: Back in Balance?**

The Organization of the Petroleum Exporting Countries (OPEC) and certain non-OPEC countries have agreed to extend production cuts through March 2018 to bring the oil market back into balance. We remain concerned, however, about potential supply increases in Libya and Nigeria, as well as the rate at which U.S. shale operators are bringing supply back online. As efficiency gains for U.S. operators continue to evolve and the cost of drilling climbs, we are closely monitoring changes in the marginal cost of production for these companies.

### **Equity Investment Implications**

Midstream operators – transportation, storage and wholesale marketers – appear well positioned in the current environment. Should U.S. shale continue to ramp up production, these firms will benefit from higher volumes.

### **Fixed Income Investment Implications**

We favor the asset-heavy, U.S.-facing issuers in the midstream sector. More broadly, companies with liquidity and those that have repaired their balance sheets, or those looking to do so, are also attractive. We believe these issuers are better positioned to succeed in varying oil price environments.

## Financials

### **Economic Growth Set to Benefit Banks**

If economic growth continues to improve, the Federal Reserve may accelerate plans to shrink its balance sheet and the European Central Bank and Bank of Japan could begin reducing asset purchases sooner than anticipated. Any curtailment in central bank balance sheets stands to drive up term premiums and thus improve the profitability of financials. U.S. firms could also benefit from the potential loosening of regulation and rising interest rates.

### **Equity Investment Implications**

We continue to like financial stocks exposed to structural growth opportunities. For example, Asian insurers stand to benefit from the region's rising middle class and the desire of consumers in those countries to protect newfound wealth.

### **Fixed Income Investment Implications**

We expect U.S. banks to profit from rising interest rates. Regulatory rollbacks, if executed thoughtfully, could improve the earnings and therefore credit profiles of these companies. However, we are mindful that an excessive loosening of regulations could reverse creditor-friendly directives implemented in the wake of the financial crisis.

## Technology

### **Transition to the Cloud Accelerates**

Companies are increasingly moving workloads from physical servers to the cloud and deploying programs such as Software as a Service. This has resulted in impressive growth rates for industry leaders. The same dynamic, however, has placed legacy software and hardware companies under increasing pressure.

### **Equity Investment Implications**

We continue to avoid larger legacy companies that have not adequately adapted their business models to meet the transition to the cloud.

### **Fixed Income Investment Implications**

The business model disruption from this shift is driving many legacy companies toward acquisitions in reaction to the changing landscape. We continue to avoid companies that will see balance sheet deterioration as a result of debt-funded acquisitions and those at risk of credit-rating downgrades.

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 **Health Care****Near-Term Uncertainty, Long-Term Opportunities**

Rising drug prices continue to attract negative attention, but we believe any regulatory changes to reimbursement policies will not have a materially negative effect on the industry. Meanwhile, Food and Drug Administration approvals have been robust recently and illustrate companies' commitment to delivering growth through innovation.

Debate over the American Health Care Act of 2017 – legislation that would repeal and replace the Affordable Care Act – creates uncertainty for the sector in the near term, particularly for managed care and health care providers. Nonetheless, fundamental trends within health care, such as a focus on reducing costs and improving efficiencies, are creating long-term investment opportunities.

**Equity Investment Implications**

Pharmaceutical companies are readjusting their portfolios to accommodate an increasing focus on value, not just safety and efficacy. As a consequence, we're witnessing a high and sustained level of licensing activity, with a focus on areas such as oncology, immunology and rare diseases. We believe this portfolio rationalization process will help bolster the biotech sector, giving companies the opportunity to pursue non-dilutive financing alternatives and maximize the value of their portfolios.

**Fixed Income Investment Implications**

Many investment-grade pharmaceutical companies are merging in an effort to augment research and development pipelines and offset drug pricing pressures. We are identifying opportunities in companies that are allocating capital to reduce leverage after engaging in debt-funded acquisitions. We are avoiding names in need of a more robust drug pipeline that are likely to increase leverage to obtain it.

We are also finding opportunities in certain highly levered hospitals, many of which are opting to conserve capital and pay down debt as they consider the implications of still-undecided reforms.

 **Industrials & Materials****Favorable Trends in Defense Spending**

The federal government's recently passed omnibus appropriations bill bolsters the outlook for defense contractors. Since budgets are spent over several years, actual revenues recognized by defense contractors will lag the budget pickup. Recent budgets reflect meaningful increases, which we believe provide a visible growth outlook for defense spending over the next several years.

Trends across Europe are favorable, with broad-based strength in orders and revenue across industries and countries. Although the impact of Brexit is still unknown, company commentary remains constructive for year-ahead industrial growth.

Industry consolidation and merger and acquisition activity remain robust. In addition, activism is a persistent force, resulting in more companies exploring strategic reviews of their businesses, including spin-offs and/or selling businesses to attempt to unlock value.

**Equity Investment Implications**

We continue to focus on company-specific drivers of value, such as opportunities for margin expansion, as well as management teams with a track record of superior capital allocation and ample cash to deploy. These factors tend to determine outperformance regardless of the economic environment.

**Fixed Income Investment Implications**

We have sought out companies that are exposed to the multiyear tailwind of increased defense spending, while focusing specifically on finding management teams that will utilize the increased earnings and free cash flow to improve the quality of the balance sheet.

# SECTOR SPOTLIGHT

## Consumer: U.S. Retail

Low unemployment. Rising wages. Healthy spending. By many measures, the U.S. consumer is thriving. Yet, one of the most recognizable industries within the sector – retail – is seriously ailing. Foot traffic at many U.S. malls and shopping centers is dropping and sales have cratered as a result. Macy's, for instance, has reported same-store sales declines for nine consecutive quarters. Bankruptcy filings are on the rise, with BCBG Max Azria, The Limited, Payless ShoeSource and rue21 just some of the companies seeking Chapter 11 protection this year. Retailers, in turn, are shuttering stores at a rapid pace. During the first quarter of 2017, approximately 2,880 store closures were announced, more than double the number for the same period the previous year, according to one industry report.

Despite the dire headlines, this is not a new phenomenon. The equity and fixed income analysts who cover the sector say retail's demise has been unfolding for years, pointing to e-commerce and a glut of retail space in the U.S. as culprits. "If you can shop from the comfort of your living room, why would you spend a Saturday afternoon at the mall?" says Josh Cummings, CFA, head of consumer equity research. Less foot traffic in stores leads to slower sales and forces retailers to either compete online, where profit margins are tight, or to close stores. "We are seeing this slow, gradual decline as retailers have to shift the same sales base to a lower-margin business," says Richard DeGaetani, CFA, an analyst on the fundamental fixed income team. Understanding this decline, says the consumer team, is key to managing exposure to the industry.

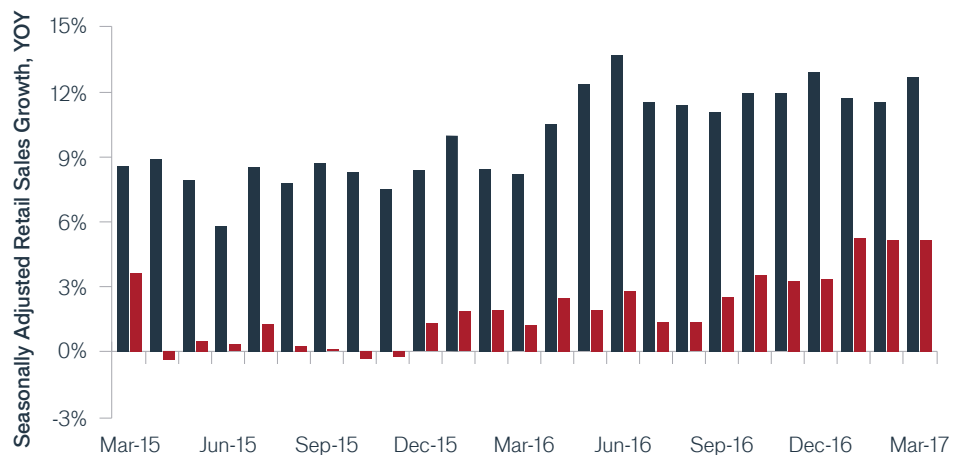
### Shifting Shopping Habits

To understand e-commerce, you have to begin with Amazon. What started as an online bookstore some 20 years ago is now one of the world's largest marketplaces, selling everything from clothing and beauty products to electronics and power tools. It has done so by relentlessly focusing on the customer experience, offering perks like free two-day shipping to Amazon Prime members (who pay a \$99 annual membership fee) and making it easy for users to comparison shop. The company is not done, either. In select locations, Amazon now offers free one-day – or even same-day – shipping. Consumers can place orders using Alexa, the firm's voice-operated virtual assistant. Amazon has also rolled out Dash Button devices and virtual Dash Buttons, both of which function as shortcuts allowing shoppers to quickly reorder products.

### Digital Takes Off

Even when total retail sales growth turns negative, digital sales continue to rise.

■ Non-Store Retail Sales ■ Total Retail Sales (excluding auto)



Sources: U.S. Census Bureau, Janus Henderson

These features have helped change what consumers expect from their shopping experience. In a recent survey by Capgemini, 71% of respondents worldwide said they were frustrated by the difficulty of comparing products in physical stores. Three-quarters said they want the ability to check product availability before they visit a store and 61% reported that they would like physical retailers to offer lower prices with a membership, à la Amazon Prime.

## Catching Up is Hard to Do

Retailers recognize these changes and are taking steps to build so-called omnichannel capabilities, such as buy-online/pickup-in-store or mobile shopping apps. But it is an expensive undertaking and companies already carry substantial fixed costs to operate physical stores. Digital sales are growing across the industry, but profit margins for online transactions tend to get squeezed by competitive pricing and the cost of free or expedited shipping, which consumers increasingly expect. Margins can come under pressure even more if a retailer's online channel cannibalizes sales that would have otherwise occurred in person.

Some retailers have tried to get around this by acquiring web-based competitors. This year, PetSmart announced it would purchase the online pet supply store Chewy.com for a reported \$3 billion, making it one of the largest e-commerce deals on record. Mr. DeGaetani believes the acquisition will help PetSmart defend market share against Amazon, but that the company paid "a very high" price for the asset. "So much investment is going into omnichannel initiatives but it may just be keeping the boat afloat, as opposed to spurring attractive returns," he says.

The market's concern about the challenges that retailers face is reflected in bond yields. The spread between 30-year and 10-year bonds issued by investment-grade retailers is relatively wide, suggesting that investors are calling into question the long-term viability of these companies and their business models, Mr. DeGaetani says. Although he recognizes the risks, he also notes that a retailer's demise can take years, if not decades. In the meantime, select retailers are deleveraging their balance sheets, refinancing debt and maintaining free-cash-flow cushions, all attractive qualities from a fixed-income perspective. Companies with liquidity levers can also be appealing. They might, for example, own their storefront real estate, which could be sold for additional sources of cash.

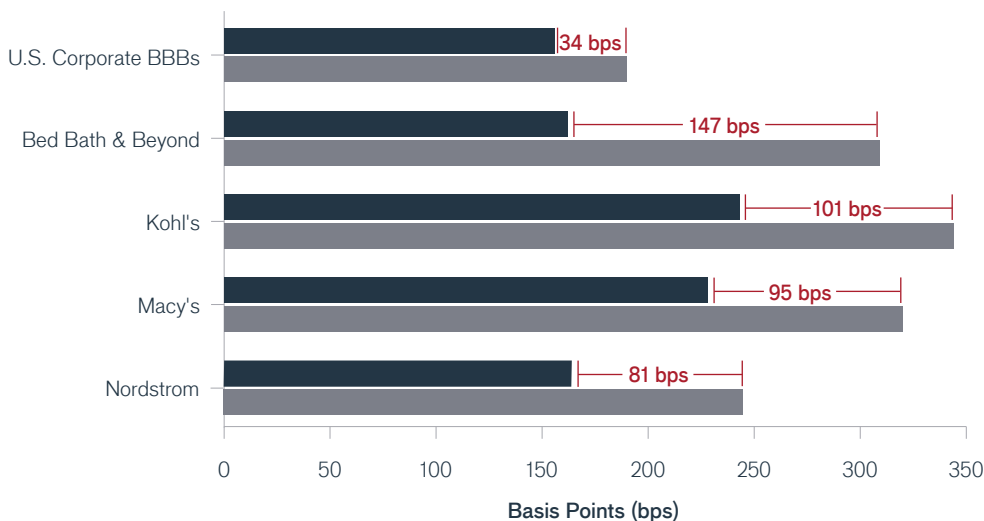
“ So much investment is going into omnichannel initiatives but it may just be keeping the boat afloat, as opposed to spurring attractive returns.”

**Richard DeGaetani, CFA**  
Fixed Income Analyst

## A Future in Question

The spread between 30- and 10-year bonds issued by certain investment-grade retailers is wider than similarly rated U.S. corporate bonds.

■ 10-Year Option-Adjusted Spread ■ 30-Year Option-Adjusted Spread + Spread Difference



Sources: Bloomberg, Janus Henderson. Data as of 4/28/17

Still, those trades are opportunistic, says Mr. DeGaetani, and the digital overhang isn't going away. In fact, online sales are rising at a double-digit rate, well above the pace of traditional retail, and it may be difficult for stores to catch up with Amazon's already impressive market share. Mr. Cummings calculates that the e-tailer's slice of U.S. digital sales was 35% in 2016 and that the company gobbles up an increasingly higher percentage of growth in retail dollars spent every year. By contrast, Walmart, the largest physical retailer in the world with more than 700 million square feet of store space in the U.S. alone, accounted for just 12.5% of traditional U.S. retail sales for the same period, excluding auto and food. Of just digital sales, the company's share is still less than 4%. "The whole world is shifting from physical to digital, but the market share is far more concentrated in digital," Mr. Cummings says. "Online, it's winner just-about take all."

“ Market share is far more concentrated in digital. Online, it's winner just-about take all.”

**Josh Cummings, CFA**  
Research Analyst



“ If you get a consumer to sign up for Tide laundry detergent, he or she may never think about price again. ... That’s a wonderful dynamic for brand owners.”

**Gregory Kuczynski, CFA**  
Research Analyst

## Brands vs. Boxes

Companies that have to compete directly with Amazon, such as department stores and general merchandisers, face the biggest challenges, says the consumer team. As such, the team generally prefers to invest in “brands” rather than “boxes.” A brand can be sold online or in stores – it is not dependent on a specific channel. And stable brands can shift distribution away from troubled channels (i.e., brick and mortar) toward those mediums capturing a growing share of consumer attention, such as digital.

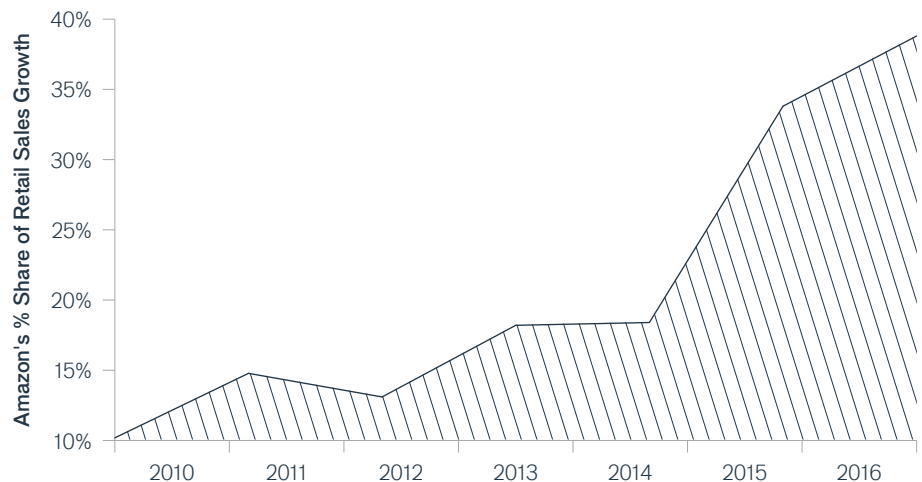
E-commerce tools could even help drive sales growth, especially in consumer staples. Indeed, online features such as subscription services and saved baskets make it easy for users to automatically reorder everyday products, from shampoo to pet food. “If you get a consumer to sign up for Tide laundry detergent, he or she may never think about price again. The detergent just shows up once a month. That’s a wonderful dynamic for brand owners,” says Gregory Kuczynski, CFA, an equity research analyst. In addition, by selling directly to consumers, brands might not have to spend as much on coupons and other so-called trade promotions used to push products in grocery stores and general merchandisers, potentially adding to profit margins. Still, Mr. Kuczynski cautions that e-commerce penetration in consumer staples is just starting to ramp up. “It’s very early days and there’s the risk that prices crater online,” he says.

## Focus on Value

The consumer team says another way for companies to survive the e-commerce onslaught is to prioritize offering value to customers. That has been a key part of Amazon’s strategy: cutting prices and providing free shipping – even at the expense of profits – in order to win over shoppers. “Amazon is willing to subsidize these things at a loss for an extended period of time,” Mr. Kuczynski says. In contrast, department stores have traditionally focused on maximizing the initial markup of products, which is good for profit margins but bad for shoppers. Given the myriad choices available to consumers, this business model is becoming increasingly hard to defend.

## Retail Takeover

More and more of the incremental dollars spent on retail are going to Amazon.



Sources: U.S. Census Bureau, company reports, Janus Henderson

Note: Data based on annual growth in total U.S. retail sales and exclude auto, gas, food and food service.

To understand just how much consumers want value today, Mr. Cummings points to Costco, which he describes as “basically Amazon Prime before it was cool.” Like Amazon, the wholesale club requires consumers to pay a membership fee in order to access its cavernous stores. In return, shoppers get a slew of benefits: competitive prices, a broad range of products, and ancillary services, such as auto and home insurance. Costco, as a result, has generally continued to deliver same-store sales growth despite the weakness in retail. “The whole premise starts from the consumer,” Mr. Cummings says. “These types of companies don’t look at a product and ask, ‘How do we make money selling it?’ They look at it and say, ‘Would our members enjoy consuming this?’”



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## Location, Location, Location

Other companies have not fared as well and are closing stores. Strategies that rescued retailers in previous downturns, such as leveraged buyouts – a company takeover financed through debt – are not working as well now because slowing sales cannot keep pace with elevated debt payments. All of these trends put pressure on malls and shopping centers. This pressure is compounded by the fact that the U.S. already has too much retail space, says Jason Brooks, a securitized products analyst on the fundamental fixed income team. In the U.S., there are 23.5 square feet of retail space per person, compared with 16.4 in Canada and 11.1 in Australia, according to a Morningstar report. Mr. Brooks estimates that about 30% of the 1,200 or so malls in the U.S. should be shuttered in order for supply to match demand.

That contraction is weighing on commercial mortgage-backed securities and leading to an uptick in loan losses. But Mr. Brooks is quick to point out that not all malls are the same. Location matters. In cities such as Lubbock, Texas, the local mall is thriving because there is not another competitor within 70 miles. “It’s location, location, location,” he says. “To the extent that sales in a mall are still doing well, there are going to be tenants who want to be in those centers.”

Malls could also be reconfigured to create new opportunities. Historically, department stores have served as mall anchors, paying low rent in exchange for drawing in foot traffic. But these spaces could be subdivided into more “experiential” tenants – restaurants, fitness, entertainment – that pay higher rent per square foot, Mr. Brooks says. In turn, store traffic at these locations could improve, as the new tenants draw in consumers and potentially spur impulse purchases. “Mall real estate is still real estate,” he says. “And real estate is a living, breathing thing that you can repurpose as long as there’s demand at the location.”

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**Jason Brooks**  
Securitized Products Analyst

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## Experiences Attract

The majority of consumers desire experiential retail in regional shopping centers.



Source: GGP

Note: Survey was conducted in 2017 and based on a sample size of 14,000.

Mr. Brooks points to the American Dream mall, under construction in northern New Jersey, as one example of a next-generation shopping center. Once the initial phase of building is complete in 2018, American Dream will have roughly 3 million square feet, about half of which will be dedicated to experiences and entertainment, including an 800-foot ski slope and one of the world’s largest indoor waterparks. Like the Mall of America in Bloomington, Minnesota, American Dream has the potential to attract tens of millions of people per year, Mr. Brooks says.

These kinds of individual opportunities will likely continue to exist no matter what happens to retailers over the long term, says the consumer team. “There are going to be exceptions to the aggregate,” Mr. Cummings says. “But the general trends in retail are not good, and that’s probably going to be the case for a very long time.”

# CONTRIBUTOR PROFILES



**Josh Cummings, CFA**  
Research Analyst

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**What is your favored metric for analyzing a stock?**

Return on total assets. It accounts for the entire balance sheet, including intangibles (goodwill) and is not flattered by leverage. It's the strictest way to measure returns and allows for accurate comparison across consumer companies.

**Talk to us about the formative experiences of your career or how you got started in the industry.**

The Great Recession of 2008-2009 provided many learning experiences. One lesson that I've continued to draw upon is to focus on similarities, not differences. We are trained to search for insight, which we instinctively assume means figuring out what is different about a particular fundamental situation or macro backdrop. Although that can certainly be valuable, history has a way of repeating itself, and focusing on the bigger-picture similarities about a given situation can help investors avoid mistakes.

**What are you passionate about outside the office?**

Outside of the office, I enjoy skiing with my family.



**Gregory Kuczynski, CFA**  
Research Analyst

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**What is your favored metric for analyzing a stock?**

My favorite metric is relative free-cash-flow yield. I look at earnings after capital expenditures and working capital requirements – earnings that will be available to distribute to shareholders in the form of dividends or buybacks or that can be used to finance mergers and acquisitions. I like to find high-quality companies that are trading at depressed valuations relative to their peers and identify situations where that dislocation is likely to be temporary.

**Talk to us about the formative experiences of your career or how you got started in the industry.**

I started in the industry after the tech bubble collapsed in the early 2000s. I joined Janus right as Lehman Brothers was going under in 2008 and the Great Recession was beginning. So my eyes are wide open to the periodic storms that occur in the financial markets. As a result, I look for resilient businesses that can navigate that external volatility.

**What are you passionate about outside the office?**

I try to maximize the time I spend with my wife and children. In terms of personal interests, I'm passionate about cooking and fitness, and I spend whatever free time I have reading (history, psychology, science, ethics and religion).



**Jason Brooks**  
**Securitized Products Analyst**

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**What is your favored metric for analyzing a bond?**

Debt yield, particularly when it comes to mortgages. Debt yield is the property's net operating income divided by the total amount of outstanding debt. So, the higher the debt yield, the lower the overall leverage of the property. Some people may use the loan-to-value ratio to assess leverage, but I've found that the denominator in that calculation (i.e., the appraisal) is not always reliable.

**Talk to us about the formative experiences of your career or how you got started in the industry.**

I spent my first two years out of college at MCI WorldCom and quickly realized that I wanted to shift to the capital markets side of finance. I moved to New York City with a duffel bag and stayed on friends' couches until I landed an analyst job in TIAA-CREF's mortgage and real estate division. As one of the world's largest institutional holders of, and lenders on, commercial real estate, TIAA-CREF helped expose me to pretty much every aspect of the industry, and I realized it was something I could be really passionate about. Within my first year there, my boss let me put a bit of my own money into a multifamily project in Greenwich, Connecticut, so I was able to get even more hands-on through that investment.

**What are you passionate about outside the office?**

Outside the office, I'm most passionate about my two boys, aged 9 and 6. They are both avid junior golfers, so I spend a lot of the non-winter months caddying for them at their tournaments or just going out on a Saturday afternoon to play a round with them.



**Richard DeGaetani, CFA**  
**Fixed Income Analyst**

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**What is your favored metric for analyzing a bond?**

I use many metrics when analyzing bonds, but my favorites are debt to earnings before interest, taxes, depreciation and amortization; free cash flow to debt; and debt to enterprise value. These data points, together with my assessment of a management team's desire to protect the balance sheet, help me to identify companies that may offer attractive fixed income investment opportunities.

**Talk to us about the formative experiences of your career or how you got started in this industry.**

I started my career as a sell-side fixed income research analyst at JPMorgan, where I learned the various moving parts of the business. Although I enjoyed specializing in specific sectors, publishing reports with investment recommendations always fell short of my desire to actually put money to work behind my ideas. This led to my transition over to the buy-side, which has provided me the opportunity to use my ideas, experience, and specialized sector and product knowledge to contribute tangible value to investment funds.

**What are you passionate about outside the office?**

Spending time with my family and staying active through various outdoor activities. My favorites include snowboarding, golf and hiking.

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For more information, please [visit janushenderson.com](http://janushenderson.com).

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