June 2018

Janus Henderson
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GLOBAL SECTOR VIEWS

A Spotlight on Energy
and Highlights from other Sectors

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- 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 3/31/18
- 965 stocks covered across market capitalizations, styles and geographies as of 3/31/18
- Fundamental, independent research that seeks to identify best ideas in each sector
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Energy & Utilities: Will Oil's Rebound Last?

After a long decline, oil is finally showing signs of a recovery. Over the past year, Brent crude, a benchmark for global oil, has climbed as much as 83% and exceeded $80 per barrel (/b) for the first time in more than three years. Tight inventories and strong demand could help crude remain elevated, says Noah Barrett, CFA, Research Analyst and lead of the U.S.-based energy and utilities team. He notes that most analyst forecasts call for Brent to range from $65/b to $75/b this year – but even that outlook could prove too conservative. "Crude could fall to $65/b in the short term, but I think it's more likely the price moves outside the higher end of the consensus range over the next 12 to 18 months," he says.

Improving Fundamentals

The reason boils down to supply and demand. Globally, crude inventories have declined below their five-year average, largely as a result of coordinated production cuts by the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC producers such as Russia. Additionally, although U.S. shale production has been rising at a healthy clip, logistical hurdles are curbing runaway growth. As Mr. Barrett notes, 70% to 80% of U.S. production growth is coming from the Permian Basin in west Texas and New Mexico. "Whenever you have that much activity concentrated in one region, there's a greater risk of infrastructure constraints and bottlenecks," he says.

More recently, geopolitical risks have also become a headwind. The U.S.'s decision to reinstate sanctions on Iran could reduce investment in the country, which has significant oil reserves, as well as the amount of crude that Iran exports. At the same time, an economic crisis and sanctions in Venezuela have caused production there to plummet: In April, the country's output was 1.44 million barrels per day (mb/d), down from an average of 2.15 mb/d in 2016, according to OPEC.

While global supplies have declined, demand for oil continues to rise, largely as a result of the strong global economy. According to estimates by the International Energy Agency, oil consumption is expected to climb by 1.4 mb/d through 2018.

Higher Prices for Longer

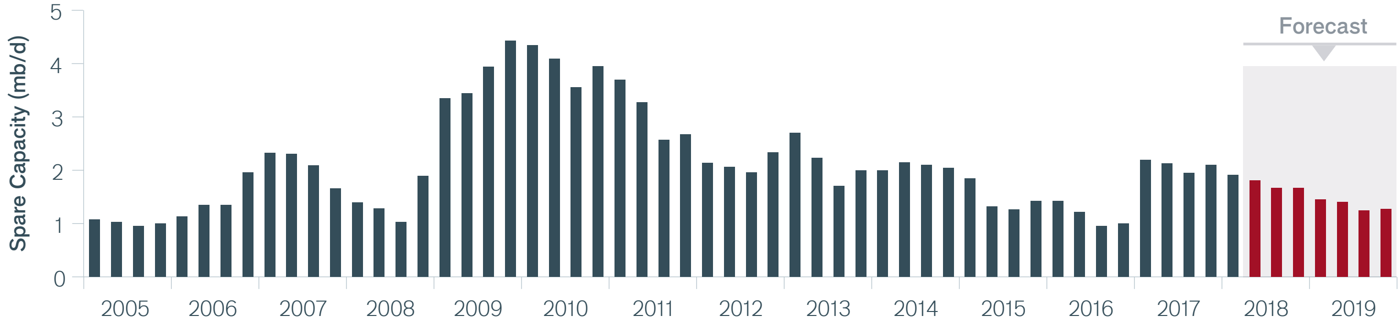
The question, of course, is how long this constructive supply/demand environment will last. Mr. Barrett believes it could have staying power. Although OPEC has said it might ease production cuts in the coming months because of supply disruptions in Iran and Venezuela, the move would likely add only 300,000 to 800,000 b/d to global output, Mr. Barrett says. Saudi Arabia also is taking its state-owned energy giant, Saudi Aramco, public in the next year or two; the country, as a result, may want to maintain a strong oil market. Furthermore, OPEC's spare capacity (production that can be brought on in 30 days and sustained for at least 90 days) is tight relative to historical levels, especially given rising demand for oil. "If we have a supply shock, oil prices could spike materially higher," Mr. Barrett says.

Key Takeaways

- Positive supply-demand fundamentals have led to a jump in oil prices over the past year.
- These fundamentals could persist in the near term, potentially lifting energy stocks, which so far have lagged the rise in crude.
- Further, higher oil prices are boosting the free cash flows of exploration and production companies. In turn, these firms could raise dividends, repurchase shares or pay down debt.

OPEC Spare Production Capacity

OPEC's spare capacity is declining, which could limit the oil cartel's ability to respond to changes in global supply.

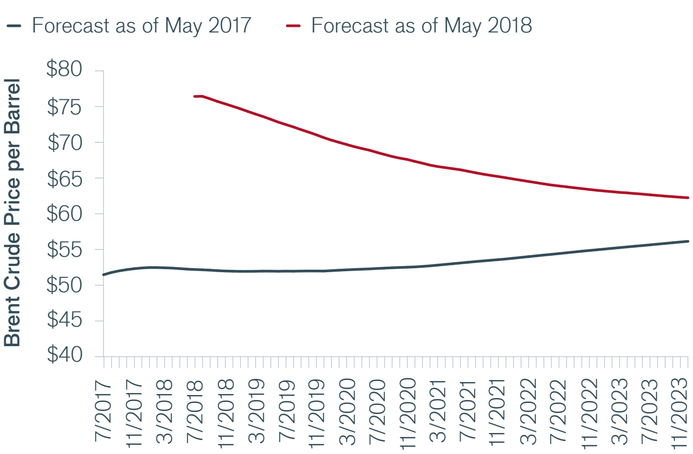


Source: U.S. Energy Information Administration and Thomson Reuters. Data are quarterly and as of 5/8/18

U.S. shale growth is another variable. But while crude oil and other liquids production is rising in the U.S. – climbing from 15.03 mb/d at the start of 2018 to an estimated 18.60 mb/d by the end of 2019 – the industry faces logistical constraints. Indeed, a lack of refining capacity, pipeline and infrastructure availability, and tightness in certain services are driving lower realized prices and higher costs for exploration and production (E&P) firms in the Permian Basin. So, even as Brent crude has climbed to $80/b, companies in the region are netting prices well below spot. This gap, known as the price differential, is keeping a lid on drilling. "I think the odds are growing that U.S. production will miss to the downside rather than surprise to the upside," Mr. Barrett says. Also, few long-cycle, capital-intensive projects are being greenlighted since forecasts for oil prices remain muted. Says Mr. Barrett, "The longer companies don't spend, the more likely we are to have a supply gap."

Market Expectations for Oil Prices

In 2017, the market did not forecast this year's jump in oil prices. Today, it still does not expect prices to rise over the next five years. As a result, companies could delay investment in new production, potentially leading to tighter oil supplies.



Source: Bloomberg. Data as of 5/25/18
Notes: Data reflect the term structure of Brent futures contracts, are monthly and range from July 2017 to December 2023.

Logistics are not the only challenge. U.S. unconventional oil is lighter crude that, once processed in a refinery, produces a higher percentage of products that today are experiencing less demand growth, such as gasoline. Also, refiners in the U.S. may be reaching the limit of light crude they can process. As a result, U.S. producers could be forced to export or discount their oil, creating another headwind to growth. "As long as demand is healthy, we could be in a situation where there's not enough supply of desired oil and too much supply of less-desired oil," Mr. Barrett says. "Ultimately, that leads to wider differentials and higher Brent oil prices."

What it Means for Investors

Although energy stocks have rebounded over the past year, their performance so far has lagged the recovery in oil. Should crude prices stay near consensus estimates, this gap could potentially close, Mr. Barrett says.

A Boom for Midstream Operators

However, some firms may be better positioned to take advantage of today's supply/demand fundamentals. For one, midstream operators could see significant growth since these companies process, store and transport crude, services that currently are in high demand. Upstream firms (or E&Ps) also stand to profit from higher oil prices, especially since many E&Ps lowered their cost structure when oil slumped. As a result, free cash flows are rising, and firms are using the windfall to raise dividends, buy back shares or reduce leverage, rather than drill new wells. In February, for example, Anadarko Petroleum announced it would quintuple its quarterly dividend from 5 cents to 25 cents per share and increase its stock buyback program by 20%. "We've seen a shift in mindset in terms of companies being more disciplined," Mr. Barrett says.

Refiners also stand to benefit from healthy oil demand and consistently wider price differentials. However, Mr. Barrett notes that these stocks now trade at a premium to their historical multiples, making them less attractive. Oil field services also tend to thrive during a bullish oil market, but with E&Ps reluctant to increase spending, servicers have not been able to raise prices materially. "There remains a decent amount of excess capacity in key services, such as pressure pumping," Mr. Barrett says.

Long-Term Benefits for Industrials

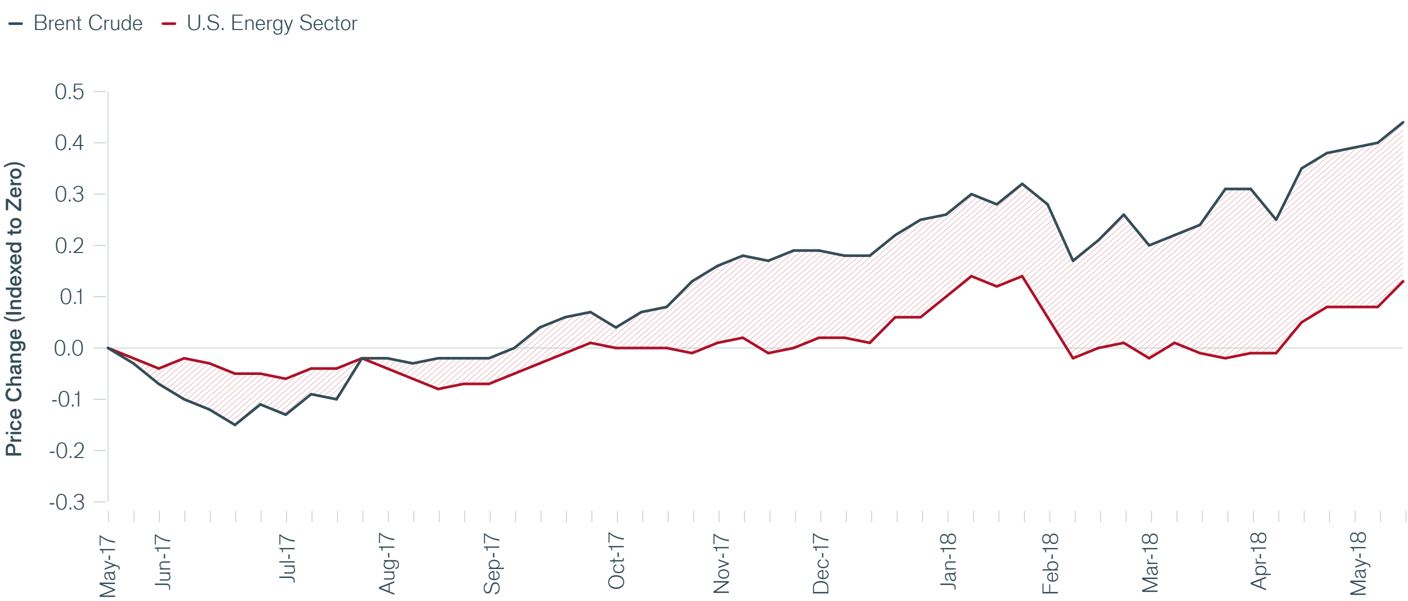
Looking more broadly, oil's rebound is being felt across the market. Among industrials, higher oil prices have increased costs for many companies. But over time, firms should be able to adjust. "And once you raise prices, there are several industries in which companies rarely give it up on the downside," says David Chung, CFA, Research Analyst and lead of the U.S.-based industrials and materials team. Furthermore, a meaningful portion of industrial manufacturing and production is tied to energy. "There is a lot of hidden exposure to the oil complex, a fact that the 2016 downturn in crude crystalized when companies with 'general industrial' businesses got hit," he says. With crude rebounding, these same firms could thrive.

Opportunity for Select Retailers

Conversely, higher oil can be a potential headwind for the consumer sector. Rising freight costs, for example, eat into the bottom line of retailers, while consumers spend less as prices rise at the gas pump. So it's important for investors to consider which firms can absorb a jump in oil, says Josh Cummings, CFA, Research Analyst and lead for the U.S.-based consumer team. Businesses whose services are used infrequently – say, Terminix, the pest-control firm – may be better able to pass on price increases than grocers, where consumers can track prices weekly, if not daily. "The more infrequent the shopping experience is, the more pricing power a company has," Mr. Cummings says. He also notes that retailers located near oil and gas operations could be well positioned. "It's a multiplier effect: When energy does well, employees in these regions will spend more," he says.

Performance Gap

Energy stocks have lagged the run-up in oil prices over the past year, creating potential for more upside.



Source: Bloomberg. Data as of 5/15/18
Notes: Returns are calculated weekly and reflect price change. Brent crude reflects forward month futures contracts. U.S. energy sector based on returns for the Energy Select Sector SPDR® Fund ETF.

SECTOR OVERVIEW

Consumer

Opportunities in Cable

Tax reform and low inflation helped to lift consumer spending early in the year. But now as costs, such as rising gasoline prices, offset tax breaks, we think it is important to focus on high-quality companies that can deliver growth late in the economic cycle. Cable operators are one example. Growth in broadband (high-speed Internet) subscriptions is helping lift free cash flows for these companies, as cable operators continue to take market share. We believe this trend could continue in the near term, especially given the competitive advantage cable has in terms of speed of Internet service.

Investment Implications

Falling paid-TV subscriber rates, along with uncertainty around potential mergers and acquisitions (M&A), have weighed on cable stocks this year. While the trend has made valuations more attractive, we remain selective, looking for companies that have a strong competitive advantage, are reducing costs and growing free cash flows.

Energy & Utilities

Rising Oil Prices

Crude oil prices have risen as a result of favorable supply/demand fundamentals. We expect this dynamic to persist in the near term, given production cuts by the Organization of the Petroleum Exporting Countries (OPEC), as well as Russia, and worries that new, U.S.-imposed sanctions on Iran could curb oil exports from the country. Demand for crude also remains positive, thanks to a strong global economy. Looking ahead, we believe crude prices could remain elevated, as many large-cap exploration and production (E&P) companies are exercising restraint when it comes to capital spending. Even if OPEC and Russia bring supply back into the market in light of U.S. sanctions, production declines from Iran and other countries under duress could partially offset any supply increases. And although U.S. shale production continues to expand by meaningful amounts, rising input costs and logistical bottlenecks could keep growth from accelerating too quickly.

Investment Implications

We favor high-quality E&Ps that are expanding production while staying disciplined about capital spending. With 70% to 80% of U.S. growth now concentrated in the Permian Basin, we believe midstream companies with operations in the region are well positioned. We still see limited upside for companies exposed to offshore-drilling since these firms require consistently higher oil prices in order to see a meaningful return in activity. Finally, while fundamentals for refiners look solid over the medium term, valuations are expensive relative to historical levels.

Financials

A Strong Backdrop for Financials

We believe the outlook for financials is promising. Bank net interest margins, which tend to be tied to the short end of the yield curve, continue to move higher with rising interest rates. Costs are also improving, thanks to a healthy global economy (minimizing credit losses) and an improving regulatory environment: In May, for example, President Trump signed into law a partial rollback of the Dodd-Frank Act, freeing small and midsize banks from certain regulatory burdens. Further, we believe the sector has several long-term tailwinds, including the digitalization of global payments and a rising middle class in emerging markets, which is creating demand for financial services in these regions.

Investment Implications

We continue to focus on finding companies with strong competitive advantages, structural growth opportunities, high or improving returns, and good management teams. For example, customers increasingly are moving to digital payments and applications. Mega banks are capitalizing on this trend by shifting their focus from bank branches to digital offerings. Given that these banks tend to have more consumer data and better digital applications, we believe there will continue to be an organic market share shift to mega banks. In addition, we also favor companies that could benefit from moderately higher interest rates, while we believe China's efforts to formalize its banking sector and invest in less capital-intensive growth is benefiting high-quality financials there.

Health Care

Drug Price Scrutiny

A new set of Trump administration proposals for lowering drug prices has created uncertainty for pharmaceutical stocks. But we believe the overhang has more to do with market sentiment than fundamentals. For one, drug price increases are spread across the supply chain, limiting the direct impact to big pharma. Also, one of the administration's goals is to improve patient access and affordability through lower copayments, which we think could help drive higher demand. The proposals also favor market competition over direct negotiations between the government and manufacturers, another positive, in our opinion.

Investment Implications

We continue to find attractive opportunities among the many health care companies developing innovative therapies for high, unmet medical needs. These medicines often serve large addressable markets and could face less pricing pressure. In addition, U.S. tax reform is helping drive a surge in M&A, leading some firms to be acquired at significant premiums. Further, we think companies that are developing new solutions to combat the opioid crisis could benefit, as the Trump administration has made addressing the epidemic a top priority.

Industrials & Materials

Improved Valuations

Higher prices for steel, oil and other raw materials have squeezed profit margins for some industrials, weighing on the sector. But we believe the headwind should be a short-term one, especially for firms able to raise prices. Clarity around trade rules and tariffs would also help minimize volatility. In the meantime, we think stock valuations have become more attractive and that industrials will continue to benefit from a strong global economy. Also, we expect to see healthy dividend increases and/or more share repurchases now that firms have better insight to the impact of U.S. tax reform.

Investment Implications

We think firms with strong brands or differentiated products are best positioned to raise prices and defend profit margins. Cyclical industrials are also likely to benefit from the economy's continued expansion, while higher oil prices could drive growth at companies that sell products to refiners, producers and other firms in the oil-supply chain.

Technology

More Growth Drivers

Data privacy concerns and U.S.-China trade tensions have weighed on some technology stocks, as investors worry about potential regulation and supply disruptions. But the sector continues to have several growth drivers. Gaming, for example, is accelerating, with multiplayer games such as Fortnite and PlayerUnknown's Battlegrounds (PUBG) attracting millions of consumers globally. Also, after years of flat to decelerating growth, corporate spending on laptops, servers and other on-premises IT is picking up, as firms use newfound savings from U.S. tax reform to refresh outdated systems and meet data needs.

Investment Implications

We favor the innovative companies writing the operating system of a digital global economy and the semiconductor companies helping to power it. We also think gaming has a long runway of growth as consumers spend more time playing games and interacting with players versus other forms of entertainment. Corporate spending on cloud computing continues to hit new records, while legacy tech players could get a boost as an explosion in data forces businesses to update on-premises IT infrastructure.

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C-0618-15710 06-15-19

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