March 2018

Janus Henderson
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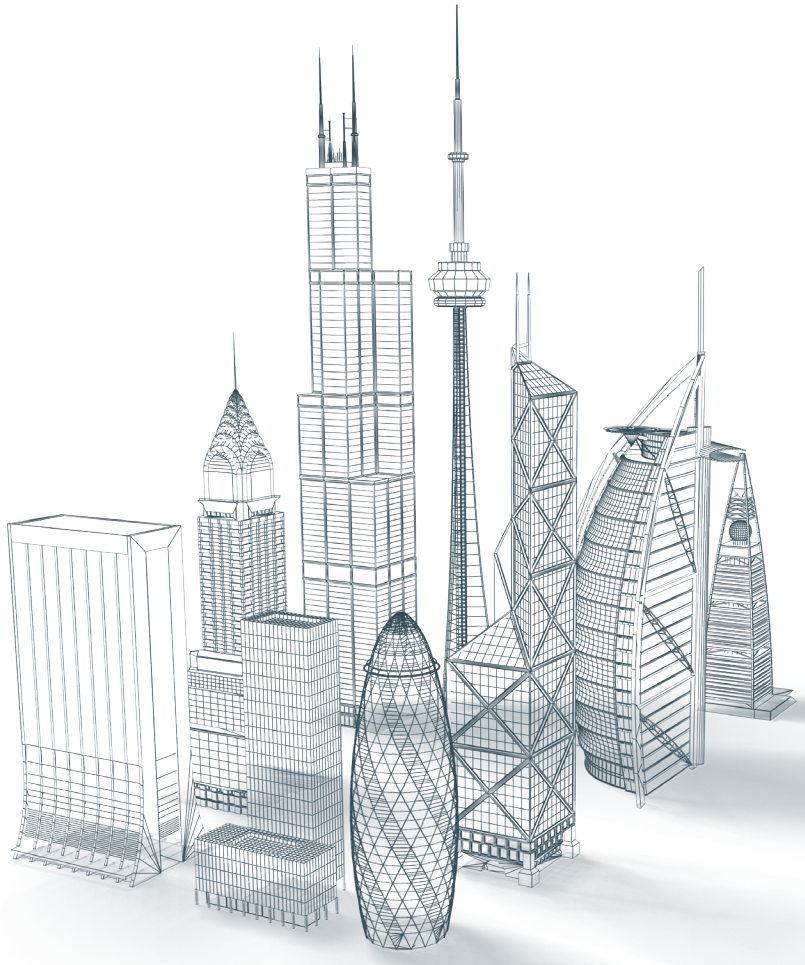
GLOBAL SECTOR VIEWS

A Spotlight on U.S. Financials 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 follow. Also included is an in-depth analysis of key trends in a single sector or industry, with this quarter focusing on the growth potential of U.S. financials. In addition, we cast a spotlight on the contributors to the piece: who they are, how they analyze stocks and bonds, and a bit about their lives outside the office. We invite you to explore these views on the following pages.



SECTOR OVERVIEW

Financials

Set for Growth

Earnings estimates for financials are moving higher as many companies benefit from U.S. tax reform. The recent return of market volatility could further augment earnings for brokerages, exchanges and investment banks, which earn fees from trading activity. On a global basis, rising yields and rate-hike expectations could help lift bank stocks, which tend to be positively correlated to rate moves. This trend has been especially apparent in the U.S., as the 10-year Treasury yield hit a four-year high in February. (For an in-depth look at trends benefiting U.S. financials, please see the Sector Spotlight on page 5.)

Equity Investment Implications

We continue to like financials with strong franchises that we think can profit from rising rates and an improving economy, or that are exposed to structural growth opportunities. Some of the country's largest banks are benefiting from low-cost deposits, significant digital and technological investments, and market share gains. These banks, as well as other financials, are also benefiting from the movement away from cash and checks to electronic and digital payments.

Fixed Income Investment Implications

We expect U.S. banks to profit from rising interest rates and tax reform. 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

Earnings Surprises

We see additional upside for the sector, not necessarily as a result of multiples expanding but because the market continues to underestimate the earnings growth potential of the generational shift occurring within technology. Financial performance has remained strong, led by secular forces such as the continued adoption of cloud computing and the Internet of Things. Artificial intelligence is also emerging as a secular growth driver. As it relates to tax reform, global technology firms, on balance, look to benefit from slightly lower blended tax rates and repatriation. Repatriation could very well result in elevated share repurchases or increased merger and acquisition (M&A) activity.

Equity Investment Implications

We favor innovative companies writing the operating system of a digital global economy. For similar reasons, we like the semiconductor companies that are providing the circuitry through which the digital economy flows. Application software companies, we believe, are attractive due to their role in enabling firms to leverage technology to drive sales, as they shift from back-office to front-office spend, thus creating a virtuous circle. We continue to see opportunity in other tech themes, including the rapid digitalization of China's economy, as well as the global growth of online gaming.

Fixed Income Investment Implications

The business model disruption is pressuring earnings of some legacy companies and driving them 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. Meanwhile, in the wake of U.S. tax reform, we are closely monitoring how the repatriation of foreign cash could result in lower future debt issuance and potentially be used to reduce outstanding debt balances.

Consumer

Positive Trends for Restaurants

After three months of positive or flat same-store sales growth, restaurants saw both same-store sales and traffic slip in the first month of the year. However, the decline did not change the generally upward trajectory for both metrics since December 2016. Indeed, dining out continues to take secular share from dining in. Additionally, food-away-from-home inflation is trending up at a faster rate than that of food-at-home inflation, suggesting that restaurants have been able to raise prices, which should help offset the potential negative impact of wage inflation.

Equity Investment Implications

In our view, fast-food restaurants, or quick-serve restaurants (QSRs), offer some of the more attractive growth opportunities within the consumer sector in general. We believe these restaurants' customers are benefiting from low unemployment, wage growth and benign credit conditions, helping to drive demand. Moreover, as franchised concepts, large public QSRs are minimally exposed to inflationary pressures in both food prices and wages that could weigh on owner-operated restaurants. We especially favor firms that are experiencing global unit growth and have high or rising free-cash-flow margins and defensive business models.

Fixed Income Investment Implications

In our view, wage inflation could have a far-reaching impact on the restaurant segment. In order to offset the cost of higher wages, same-store sales need to rise by 2% to 3% year over year. We are also concerned about the potential impact of higher food prices on margins. Therefore, we appreciate issuers with substantial scale and brand diversification, as well as management teams that maintain conservative leverage targets and financial policies.

Industrials & Materials

Synchronized Global Growth

Organic growth and industrial production accelerated in 2017. Moreover, recent trends point to increased optimism and a synchronized recovery across the U.S., Europe and China, which should act as a cyclical tailwind for the sector. We believe there is considerable momentum behind these improving fundamentals. However, the Tax Cuts and Jobs Act passed at the end of 2017 will likely have impacts beyond tax rate changes; we are also mindful of the implications for repatriation and capital deployment.

Equity Investment Implications

Given elevated multiples relative to historical norms, we continue to focus on identifying company-specific drivers of value, such as opportunities for margin expansion. We also appreciate 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

Steady global economic growth has helped boost commodity prices. That, in turn, has been positive for the profit margins of miners, whose fixed costs remain static. We continue to find strong opportunities from a relative value perspective. In particular, we favor opportunities related to metals that we believe have a favorable supply/demand dynamic, including aluminum and copper.

Energy & Utilities

Discipline Reigns

Crude oil prices have recovered on the back of capital discipline. Indeed, in January, the Organization of the Petroleum Exporting Countries' (OPEC) production level was 5.1% below its most recent peak, with cuts exceeding the cartel's target for the fourth consecutive month. U.S. exploration and production (E&P) companies are also exercising restraint, prioritizing returns over output growth. However, as the globe's marginal producers, U.S. E&Ps are altering the calculus of the industry. U.S. production now exceeds 10 million barrels per day, and is on pace to reach 11 million by the end of 2018. Much of this is attributable to unconventional formations, including shale. The shorter-cycle nature of unconventional plays gives producers the ability to respond quickly to price signals. We believe this will lead to range-bound trading in crude prices, with lower peaks and higher floors.

Equity Investment Implications

We favor high-quality E&Ps that are well positioned on the global cost curve as a result of their technological prowess and access to attractive basins. We believe unconventional production is a long-term theme, creating opportunities for oil field services firms and midstream companies with infrastructure in key regions. At the same time, continued investment in conventional production is necessary, as a lack of industry investment could lead to a supply gap over the next decade. This should benefit global, diversified service companies that provide products and services to all asset categories.

Fixed Income Investment Implications

We favor energy companies with high-quality and defensible assets or services, good growth prospects, capable managers, a good liquidity runway, and an ample margin of safety in bond valuation. We believe these investments are better positioned to succeed in varying commodity price environments.

Health Care

M&A Heats Up

We believe U.S. tax reform is helping spur M&A activity within the sector, now that management teams have clarity on tax policy and can repatriate earnings at an attractive tax rate. Indeed, in January, three major M&A deals were announced, and we think more could be in the offing for the remainder of 2018. The acquisitions should help firms capitalize on the sector's high level of innovation: In 2017, the Food and Drug Administration (FDA) approved 46 novel therapies, the highest number in more than two decades. Longer term, rising health care costs and regulatory changes could affect utilization and drive market competition, but we think an aging population and new technology should support demand.

Equity Investment Implications

We remain committed to identifying innovative companies addressing high, unmet medical needs. The FDA approved the first gene therapy in the U.S. in 2017, and we anticipate results from key immuno-oncology (IO) trials in 2018. If positive, these trial results could benefit certain pharmaceutical companies and give clarity on possible market expansion for IO therapies.

Fixed Income Investment Implications

We are identifying opportunities in firms that are allocating capital to reduce leverage after engaging in debt-funded acquisitions. However, we are avoiding names in need of a more robust drug pipeline that are likely to increase leverage to obtain it. At the same time, pricing pressure in generics appears to be stabilizing, with complex generics and sterile injectables offering some of the best potential for growth. As a result, we favor companies focused on these product areas. Similarly, the rollout of biosimilars in the U.S. could benefit firms such as pharmacy benefit managers and insurers.

SECTOR SPOTLIGHT

Financials: U.S. Financials

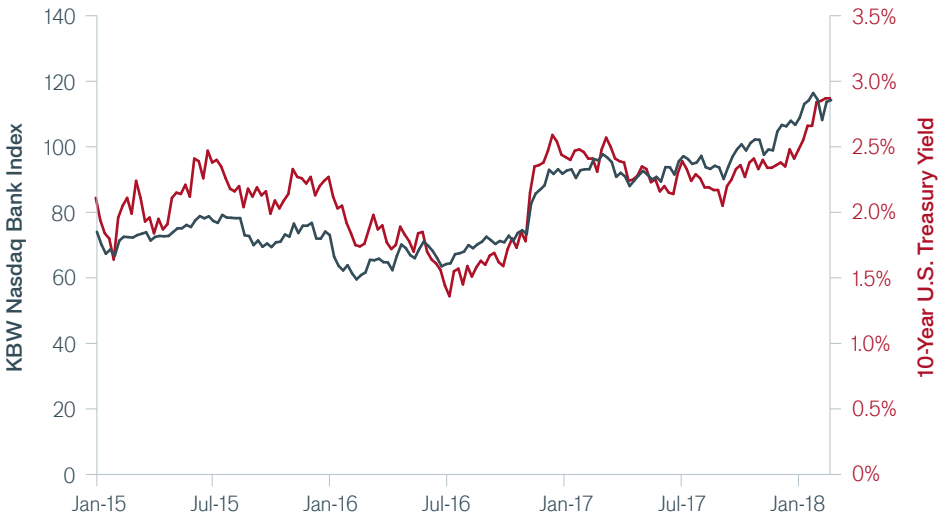
Since 2008, U.S. financials have faced a bevy of headwinds, from sharp loan losses and stringent regulations to years of sluggish economic growth and ultra-low interest rates. But a decade later, the winds may finally be shifting. "The era of balance sheet repair and heavy regulation appears to be ending," says Ian McDonald, CFA, Research Analyst and co-team leader of the U.S.-based equity Financials team. President Trump's election in November 2016 was a turning point, as investors cheered the administration's plans to ease regulation and lower corporate tax rates. At the same time, the Federal Reserve (Fed) has continued to normalize monetary policy, lifting short-term rates and trimming its balance sheet. Bank stocks have responded: Since the election through the end of 2017, the KBW Nasdaq Bank Index, a benchmark of 24 major U.S. bank stocks, delivered a total return of 38.4%. Similarly, spreads on corporate bank debt in the Bloomberg Barclays U.S. Aggregate Bond Index tightened 35.4%. Can the momentum continue? The Janus Henderson analysts covering the sector argue it may come down to which companies can best capitalize on the following five trends.

Rising Treasury Yields

After years of ultralow rates, yields are starting to climb. In February, for example, the 10-year Treasury yield hit 2.94%, its highest level in four years. Rising yields allow financials to increase loan pricing and better monetize low-cost deposits, resulting in higher net interest margins. But banks and other financials are likely to benefit more if yields are rising for the right reasons, says John Jordan, Portfolio Manager, Research Analyst and leader of the U.S.-based equity Financials team. If rate moves are due to investor concerns about accelerating inflation or volatility, demand for bank services and products could slow. The better scenario: rates climb because of economic growth. With inflation still coming off recent lows and volatility hovering near the long-term average (despite a short-term spike in February), Mr. Jordan believes economic growth is the main reason for rising yields thus far.

U.S. Bank Stocks and Treasury Yield Correlation

Bank stocks tend to track the 10-year U.S. Treasury yield, which has been rising.



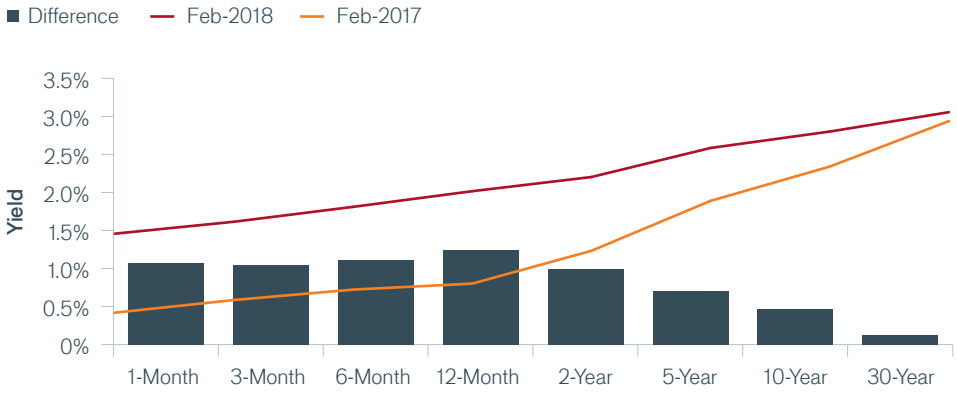
Source: Bloomberg. Data as of 2/23/18

The Fed has also cited economic growth as one impetus for increasing its benchmark rate, and the central bank is expected to make additional hikes in 2018. Mr. Jordan and Mr. McDonald note that roughly two-thirds of assets at large banks are tied to shorter-dated yields, which tend to track Fed moves. As these assets come due within the next few months and years, firms should be able to take advantage of higher yields. For companies with longer-dated maturities, the benefit will likely take more time to realize. "It's important to see which companies will be able to translate higher rates into improving earnings estimates and return on equity," Mr. McDonald says. "Other firms' stocks may benefit from a rising 10-year, but their earnings won't change as quickly."

> "The era of balance sheet repair and heavy regulation appears to be ending."
>
> **Ian McDonald, CFA, Research Analyst**

U.S. Treasury Yields

Yields have been rising across the curve, especially among shorter-dated maturities.



Source: Bloomberg
Notes: For 2017, data are for 2/28/17. For 2018, data are for 2/28/18. Difference is percentage-point change.

Similarly, rising yields require scrutiny from fixed income investors, particularly since bond prices move opposite to yields. A strong economy and improving earnings outlook for financials provides a solid fundamental backdrop for owning subordinated debt, which rank lower in the capital structure but pay higher yields, says Jonathan Aal, a U.S.-based Fixed Income Analyst covering U.S. banking, brokerage and finance. However, valuations for these credits are now fairly rich. In addition, should interest rates rise faster than market expectations, spreads on subordinated debt would likely widen more than senior instruments, weighing on returns. As a result, Mr. Aal says, "In this environment, it's important to consider a bond's placement both within the capital structure and along the yield curve, as well as the pace of rate increases."

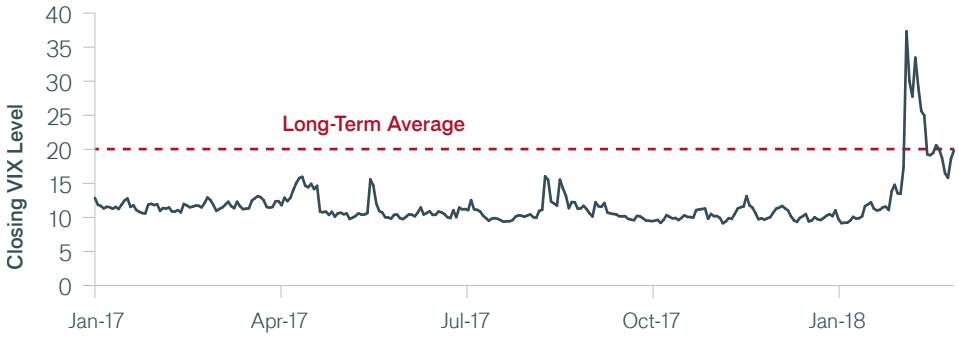
The Return of Volatility

In the meantime, volatility could be another differentiator for financials. Until recently, market volatility has remained well below historical averages. That dynamic changed in February, as yields rose. Higher volatility could be particularly beneficial for firms that earn fees from trading activity, Mr. Jordan says. "There's a hope by market participants that volatility will return to more natural levels, especially as central banks normalize monetary policy," he says. Mr. Aal agrees, noting that many firms are positively levered to market volatility, including investment banks such as Goldman Sachs; retail brokerages such as Charles Schwab, E*TRADE and TD Ameritrade; and exchanges such as Intercontinental Exchange and CME Group.

> "There's a hope by market participants that volatility will return to more natural levels, especially as central banks normalize monetary policy."
>
> **John Jordan, Portfolio Manager and Research Analyst**

The Cboe Volatility Index® (VIX®)

After months of subdued levels, the VIX spiked in February before returning to trade near its long-term average.



Source: Cboe. Data as of 2/28/18
Notes: Long-term average is trailing 10-year period.

Some firms are already starting to see the benefit. In January, the average number of trades per day at TD Ameritrade was up 88% from the previous year, according to company reports. This pattern could continue, so long as volatility does not become too extreme. "If it goes too far, people tend to move to cash and sit on their hands," Mr. McDonald says. "So you want some volatility, but not too much. So far, we're in the good range."

Tax Reform

Tax reform is another potential tailwind. Now that the top corporate tax rate in the U.S. has dropped from 35% to 21%, earnings for many banks with large domestic operations could rise by low double digits or more in 2018, Mr. Jordan says. Additionally, lower tax rates could spur corporate customers to greenlight new capital projects or pursue mergers and acquisitions. In turn, loan growth and investment bank activity could expand, further augmenting bank earnings.

It remains to be seen what financials will do with tax relief. By some estimates, as much as a quarter of the benefit could be funneled into higher wages and new technology. The rest could fall to the bottom line and be available for dividends and share repurchases. One unknown, Mr. Jordan says, is whether dollars get competed away as companies vie for market share. "My expectation is that some of it will over time," he says. However, he notes that institutions with strong franchises and services could retain more and thus deliver comparatively better earnings.

Regulatory Easing

Regulatory changes are also in the offing. The Trump administration took office with promises to ease the regulatory burden imposed on banks after the Global Financial Crisis. These regulations – including higher capital requirements and annual "stress tests" (which measure how banks might cope with an economic and market shock) – went a long way in shoring up bank balance sheets. "From a creditor's standpoint, regulation has generally been positive because it has made the banks safer," Mr. Aal says.

However, a decade after the crisis, some rules may now be unduly burdensome, and lawmakers are trying to change that dynamic. The Trump administration's first steps have been to appoint new regulators, including Randal Quarles, the Fed's new vice chair for supervision, who has called for making stress tests more transparent and revisiting capital requirements. In addition, companies are reporting that interactions with regulators have become more cordial. "There appears to be much more dialogue and awareness that regulation brings both costs and benefits," Mr. Jordan says. As for reform, regulatory changes could take a year or more as proposals must go through a comment and review period and then promulgation. But Mr. Aal is optimistic that rationalization will occur without compromising the soundness of the financial system. He points to penalties the Fed imposed on Wells Fargo in February, which the bank received for deceptive banking practices. "It looks like regulators will still be actively involved in the oversight of these institutions," he says.

> "It looks like regulators will still be actively involved in the oversight of these institutions."
>
> **Jonathan Aal,**
> **Fixed Income Analyst**

Digitalization

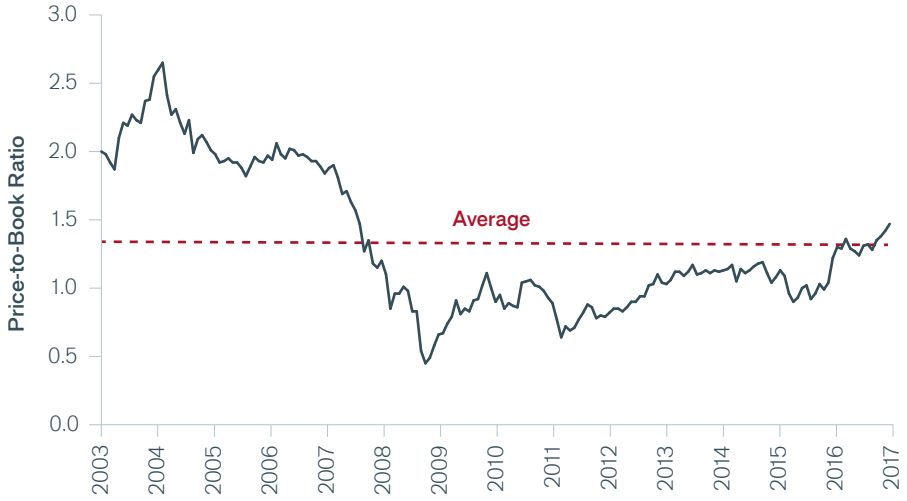
Regulatory relief could help mitigate costs for banks. If expenses come down, companies could use the savings to invest in new technology. Already, the sector is making a big push into digital, migrating from mainframes to the cloud and developing mobile apps and digital payment platforms, among other things. These efforts have accelerated in recent years as mobile devices have proliferated and millennials make up a larger share of depositors. In turn, the number of bank branches in the U.S. is shrinking and could decline another 20% over the next decade, according to one industry report. Meanwhile, companies with robust digital tools are taking market share: JPMorgan Chase and Bank of America now have roughly a fifth of millennial primary checking accounts.

Large banks may have a leg up when it comes to technology, given their scale and ability to aggregate vast sums of consumer data. Regardless of size, though, firms with strong digital toolkits will likely have the advantage in a rising-rate environment, Mr. McDonald says. "Any bank could have low-cost deposits when rates were at zero," he says. "As rates rise, it will become clear which banks have a better digital ecosystem and are engaging customers. Those banks won't have to reprice as fast as others."

Together, these tailwinds are reflected by the sector's rising multiple. Still, the price-to-book ratio of the KBW Index remains below peak levels. At the same time, companies best positioned for today's trends could exceed earnings expectations, further supporting those stocks' valuations. From a credit perspective, spreads have tightened but are attractive relative to other cyclical sectors, such as industrials, says Mr. Aal. In addition, the sector continues to benefit from regulatory oversight, which should help keep bank balance sheets sound. "There's reason to continue liking banks over other credits," he says.

Valuation

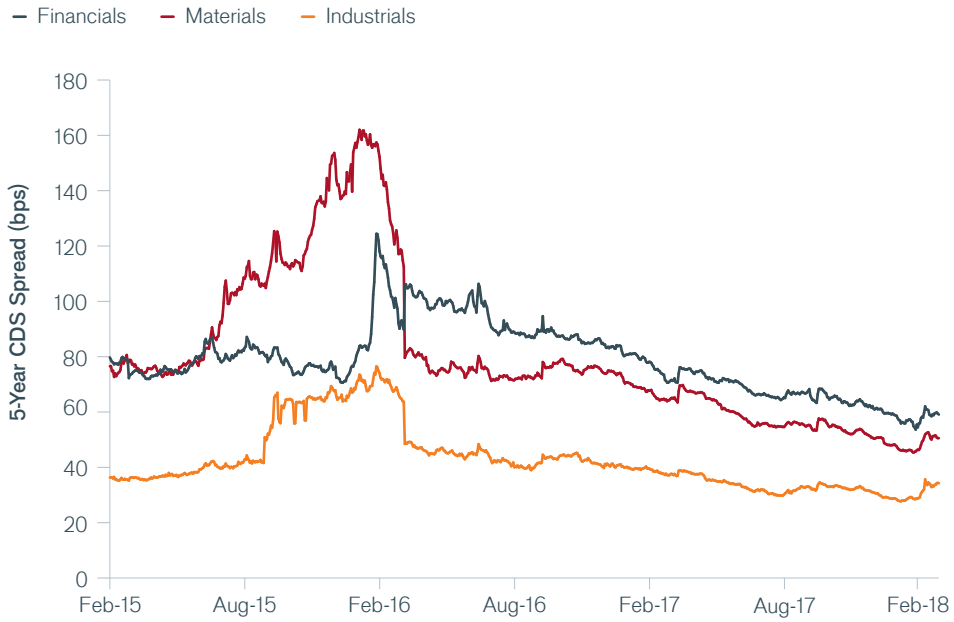
The KBW Nasdaq Bank Index's price-to-book ratio has been rising but is still well below last cycle's peak.



Source: Bloomberg. Data as of 12/31/02 to 2/28/18

Credit Default Swap (CDS) Spreads

Although spreads in the financials sector have tightened, they remain attractive relative to other historically cyclical sectors, such as materials and industrials.



Source: Bloomberg. Data as of 2/28/18
Notes: Data aggregated by Bloomberg and consists of U.S. investment-grade CDS.

CONTRIBUTOR PROFILES

Jonathan Aal
Fixed Income Analyst

What is your favored metric for analyzing a bond?
Assessing the credit profile of a bank or any company requires more than a single metric, but one I like to look at is a bank's capital level compared to the minimum level required by regulators and how much the difference between the two is impacted by the Fed's annual stress test. Capital strength and liquidity are two pillars of the safety and soundness of a bank. Looking at these figures gives me an idea of how strong a company's capital position is.

Talk to us about the formative experiences of your career or how you got started in the industry.
The formative experiences of my career started long before my career in finance began. I grew up working on my grandfather and uncle's farm. They literally reaped what they sowed. I try to apply many of those lessons and experiences to what I do today, and strive to vet the market for the best risk-adjusted returns.

What are you passionate about outside the office?
I like spending time with my family and pursuing outdoor adventures that are off the beaten path.

John Jordan
Portfolio Manager and Research Analyst

What is your favored metric for analyzing a stock?
My favorite metric is the price-to-normalized free cash flow ratio, with free cash flow defined as the cash generated by a company after it has invested for growth. "Normalized" adjusts for cyclical and one-time factors. I like this ratio because it represents what is available for shareholders or M&A.

Talk to us about the formative experiences of your career or how you got started in the industry.
My father worked with banks, which probably explains my initial interest in financials. Also, I have always liked math, and in college some of my favorite classes had to do with financial analysis, capital markets, banking and economics. So my first job after college involved working with financial institutions, and I've been analyzing and investing in them ever since.

What are you passionate about outside the office?
I enjoy doing sports and outdoor activities with my family, including skiing and coaching my children in basketball and flag football.

Ian McDonald, CFA

Research Analyst

What is your favored metric for analyzing a stock?
One thing I look for is whether a firm has pricing power. For me, this tends to be the most enduring determinant of long-term and sustainable high returns.

Talk to us about the formative experiences of your career or how you got started in the industry.
I started as a self-taught investor reading Warren Buffett, Peter Lynch, Philip Fisher, Seth Klarman and other investment classics, while sailing with Chevron Corp.'s tankship fleet as a deck officer and navigator. Then, in 1998, I had the opportunity to work for hedge fund pioneer Art Samberg. Art was brilliant and could instantly "triage" an investment pitch (i.e., quickly boil down what was important and what was not), which really helped me refine my investment process. I also had the opportunity to run a mortgage company post-financial crisis that was focused on rehabilitating nonperforming loans. I learned a great deal from that experience, not only about the plumbing and back office of Wall Street but also about management and the power of incentives.

What are you passionate about outside the office?
I live in the foothills of the mountains and love spending time outdoors, particularly rock climbing.

For more information, please visit **janushenderson.com.**

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Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

An index is unmanaged and not available for direct investment.

Price-to-Book (P/B) Ratio measures share price compared to book value per share for a stock or stocks in a portfolio.

Credit Spread is the difference in yield between securities with similar maturity but different credit quality.

Correlation measures the degree to which two variables move in relation to each other. A value of 1.0 implies movement in parallel, -1.0 implies movement in opposite directions, and 0.0 implies no relationship.

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