Janus Henderson
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What's Inside

As a follow up to our annual Market GPS outlook, we revisit the trends that so far have impacted financial markets and asset classes in 2018. We also look ahead and explore the risks and opportunities that we believe should be key considerations for investors over the remainder of the year.

AN UPDATE ON OUR 2018 OUTLOOK

At the end of 2017, we argued change was on the way for markets. Stocks and bonds had potential to grind higher thanks to a strong global economy, but rising interest rates could trigger the return of market volatility. Additionally, we said innovation would continue to disrupt a range of industries, while sound fundamentals in emerging markets looked set to drive investor demand for those regions' assets.

So far, much of our outlook has proven true – with a few surprises. For one, we did not foresee that data privacy concerns would lead to a sharp pullback in technology stocks. Geopolitical events, including this year's threat of a global trade war, were impossible to predict. Global equities, in turn, have struggled to deliver positive returns. But the major themes from our 2018 Market GPS are playing out: The Federal Reserve (Fed) continues to unwind accommodative monetary policy and the European Central Bank and the Bank of Japan seem primed to follow suit. Market volatility has inched toward historical norms, emerging markets have outperformed developed market peers and innovation continues to disrupt. Recently, we spoke with eight of our portfolio managers to learn whether these trends might persist for the rest of 2018, as well as what new themes have emerged. In short, they argue the global economy is on sound footing, but more change could be on the way – and investors need to be selective.

A Guide to the Midyear Market GPS

Look Back

These questions cover what's happened so far in 2018. In many cases, the forecasts we made last year have materialized, including our outlook for a strong global economy, a gradual pace of monetary policy tightening and the return of market volatility.

Outlook

These questions explore the trends that our portfolio managers are watching for the rest of 2018. Inflation, for example, is expected to remain largely in check, leading to a measured pace of rate increases that can help support markets.

Opportunities

Here, managers highlight the segments of the market they believe are attractive. In fixed income, that includes high-quality, short-duration corporate debt, while select emerging markets are one area where equity managers are finding opportunities.

Ben Lofthouse, CFA

Equities Head of Global Equity Income | Portfolio Manager

"U.S. tax legislation reduces corporate taxes and lowers the barriers to repatriation, both of which could encourage management teams to make bolder dividend decisions."

How have rising rates impacted dividend-paying stocks?

Higher interest rates have caused some dividend stocks to underperform, but in the longer term we expect company fundamentals to be the main driver of returns. Also, many financial services firms' earnings benefit from rate increases, and commodity sectors can be positively correlated to rising rates.

What factors could drive dividend growth in 2018?

Dividends tend to lag earnings growth because management teams like to see improving profits before committing to dividend increases. If today's benign macroeconomic environment continues, 2018 should see good dividend growth. U.S. tax reform and rising commodity prices could also provide a boost.

Where are you finding dividend opportunities now?

We think the market underappreciates the energy sector's improved cash generation. European stocks may also be attractive: Firms in the region are undertaking positive restructuring activities, increasing share buybacks and maintaining low debt levels.

Doug Rao

Equities Portfolio Manager

What's behind the volatility in technology stocks this year?

One driver has been concerns about potential regulation in the wake of the Facebook user data breach. President Trump also railed against Amazon on Twitter for several days. And new privacy rules are taking effect in the European Union (EU), which could impact firms that use customer data for targeted advertising.

Will regulation become a significant headwind for tech?

I don't think so. In the EU, companies could find ways to work around new regulations. In the U.S., I think it will be difficult to define large tech companies as monopolies, per antitrust law, because their products are free to consumers. Meanwhile, revenues for many of the tech sector's leaders continue to grow at double-digit rates.

What innovations are you most excited about for 2018?

I think artificial intelligence (AI) is coming into its own now, but not the cyborg-idea of AI. I'm talking about machine learning: companies using AI to gain customer insights and to drive productivity. These tools are helping businesses today.

"Despite recent volatility, I think the large tech platforms have terrific fundamentals and will benefit from growth in cloud computing and media consumption on the web."

"In the U.S., tax savings is one of the most important drivers of earnings growth, while globally we are continuing to see an acceleration of economic indicators."

Carmel Wellso

Equities Director of Research | Portfolio Manager

What has driven earnings growth so far in 2018?

Generally, earnings have exceeded expectations, and I think the combination of a healthy global economy and U.S. tax reform is the reason. Also, we continue to see strength in China, which benefits markets closely aligned with China's economy.

Do you think this growth can continue in the near term?

It depends. The earnings potential of small- and mid-cap U.S. companies is powerful, thanks to tax reform. Globally, Europe ex-UK appears to be in the middle of its business cycle and, therefore, could have more upside. But I'm negative on consumer stocks. Many of these firms face higher input costs and have zero pricing power due to competition.

Has market volatility made some sectors more attractive?

We've had a pretty big pullback in a number of natural resources stocks and commodity prices, and these could rebound along with economic growth. Also, the flat yield curve has weighed on bank stocks. But bank earnings still tend to be strong during such periods, creating potential upside.

Nick Maroutsos

Fixed Income Co-Head of Global Bonds | Portfolio Manager

How would you assess global central banks' path toward policy normalization?

We believe that most central banks are reactive, rather than proactive. This patient approach is merited as the global economy is more fragile than it seems and we consider inflation concerns exaggerated.

Where might markets and central banks diverge on their views of the economy?

In growth environments, investors tend to jump on the bandwagon of expecting rate hikes and favoring risk assets. We, however, believe the Fed won't meet its rate target for this year or next. The jury is out on the benefits of tax reform, and trade is another threat. Central banks won't risk policy error by hiking too quickly.

How can bond investors position themselves in a less-accommodative environment?

Investors would be well served to pursue attractive opportunities – with respect to geography and duration – regardless of benchmarks. Today's environment appears favorable for an absolute-return mindset as different countries operate in different economic cycles.

"Bond strategies that have chased returns down the cap structure belie the defensive nature of fixed income and will likely provide little protection in a risk-off environment."

"The real fear for investors is not how high rates go, but how they get there. A chaotic path should be cause for significant concern, but we expect a measured, controlled path."

Ashwin Alankar, Ph.D.

Multi-Asset Head of Global Asset Allocation | Portfolio Manager

What is driving the return of market volatility?

Rising Treasury rates. Higher yields lure investors seeking income away from selling volatility, a strategy that has muted price swings in stocks in recent years.

What risks are investors potentially overlooking?

A bond sell-off led by real rates. Inflation is getting all the attention despite bonds already pricing in near-normalized levels. Real rates are still very low, with much of the developed world yielding less than 0%. Inflation was the first step on the path to normalization; real rates are the second – potentially more painful – step as they impact all asset classes.

Where is the options market signaling opportunities?

Emerging market stocks appear attractive despite a potentially stronger U.S. dollar, as many countries have shifted to funding debt in local currencies. A stronger dollar stands to lift exporters' competitiveness, especially if U.S. consumption remains healthy.

Glen Finegan

Equities Head of Global Emerging Market Equities | Portfolio Manager

What has been the impact of economic reform in China?

We still see limited opportunities in China due to the presence of state-controlled enterprises, which raises concerns about alignment with investor interests. Also, Beijing's focus on debt reduction could force cash-rich private companies to perform "national service," rather than focus on sustainable growth and the return of profits to shareholders.

What are your expectations for emerging markets broadly?

Lately, we've seen enthusiasm for risky assets such as emerging markets, and think investors could be overly optimistic. But we are positive about the long-term investment opportunities based on rising living standards in parts of the developing world.

Where are you finding exciting opportunities?

Significant changes are underway in South Africa: A rising middle class is demanding less corruption and improved living standards. Corporate confidence has also lifted after Cyril Ramaphosa's election as president, and we expect to see private investment pick up. As a result, we think South Africa offers fertile ground for long-term investors.

"We believe investors in EM are currently at risk of being overly optimistic, so we think it is important to not compromise on quality, to apply a strict valuation discipline and take a long-term view."

Why did both fixed income and equity assets sell off in early 2018?

The primary factor was the unwind of stimulus by central banks in Japan, Europe and the U.S. "As the market had been on a tear, it's natural for asset prices to adjust down as the pool of money shrinks," Darrell W. Watters says. Adds Marc Pinto, "The Fed's perception as being overly hawkish also caused concerns that it might inadvertently put the brakes on the economic expansion."

Marc Pinto, CFA

Multi-Asset Portfolio Manager

What could help push U.S. equities higher this year?

I expect that sustained economic growth, along with continued strength in corporate earnings, will continue to boost stocks. Corporate tax reform should also aid cash flow, which could allow companies to enact aggressive capital return plans.

How is disruption creating investment opportunities?

The disintermediation of traditional industries is creating many opportunities. For example, the shift from traditional retail to e-commerce may allow us to capitalize on consumers' changing habits. Similarly, continued adoption of cloud technology, which helps companies run more efficiently, offers attractive opportunities.

Darrell W. Watters

Multi-Asset Head of U.S. Fundamental Fixed Income | Portfolio Manager

Could we see a breakout in inflation later in 2018?

While inflation can go higher, a breakout is unlikely. Technological advances, especially, should help keep inflation in check as they help companies navigate labor shortages and higher employee costs. Other factors that could support higher inflation – like strengthening crude oil or wages – are unlikely to have outsized impacts.

Where do you see opportunities amid rising rates?

Our first question is if a security can deliver a reasonably positive return as rates go higher, so investors should consider avoiding excessive duration risk. We think investors should focus on companies with strong asset bases, management teams and balance sheets.

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