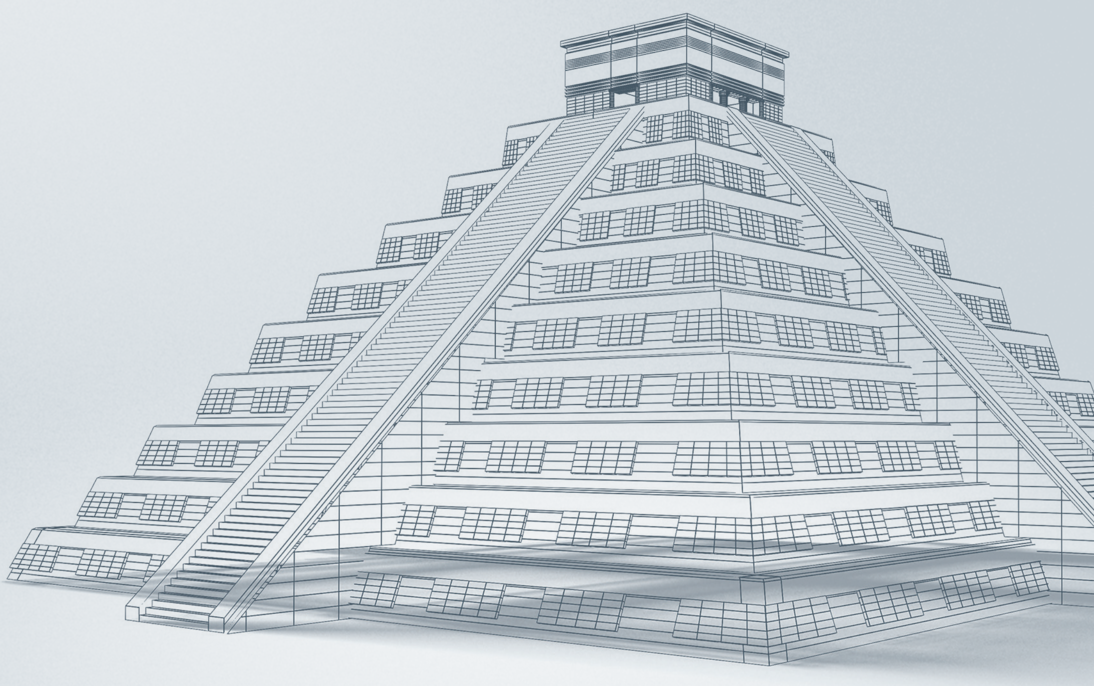
Global Outlook
October 2018

Janus Henderson
INVESTORS

# THOUGHTS AND BONDS

## The Beginning of the End



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>
> **Chris Diaz, CFA, Co-Head of Global Bonds**

## A Word from our Investment Professionals

As we move into the final quarter of 2018, fixed income investors continue to navigate a challenging environment. The Federal Reserve (Fed) is normalizing interest rates and draining liquidity from the system. And with too much money chasing too few risk assets, corporate valuations remain at the expensive ends of their ranges. The credit cycle is in extended innings, and risk in corporate credit is asymmetrically skewed to the downside.

Nonetheless, a sense of complacency prevails. Corporate credit volatility is near 10-year lows, and U.S. risk markets continue onward and upward despite trade war concerns and emerging market stumbles. Near-term U.S. economic strength may be fueling investor exuberance, but we remain concerned with where the chips will fall after the sugar high of fiscal stimulus wears off. We are not yet facing the end of the cycle, but the beginning of the end seems nigh.

Defensive positioning and an emphasis on capital preservation is therefore prudent, in our view. We continue to focus on higher-quality business models, in issuers higher on the quality spectrum. Given rich valuations and limited alpha opportunities, we remain focused on out-carrying, or generating more income than our benchmarks. We favor shorter-dated spread products with minimal interest rate risk and floating rate securities that should perform well as rates continue to climb. This disciplined approach aligns with our core tenets of capital preservation and delivering strong risk-adjusted returns for our clients.

**Darrell Watters**
Head of U.S. Fundamental Fixed Income

**Chris Diaz, CFA**
Co-Head of Global Bonds

**Mayur Saigal**
Portfolio Manager

**Ryan Myerberg**
Portfolio Manager

# RATES

## The Fed Marches On

The Fed is eight hikes into its current tightening cycle, and telegraphing additional increases. With the U.S. economy humming along and no immediate market or economic concerns, tightening will continue, says Portfolio Manager Mayur Saigal, albeit at a gradual pace. We are in the later stages of the economic cycle, and Fed officials want policy tools available for when the cycle inevitably turns. Given that inflation is near the Fed's 2% target and the unemployment rate at 3.9%, we expect another increase in December, three in 2019 and potentially one in 2020 before the Fed's ability to tighten is exhausted. The likely landing spot for the terminal rate is 3.25%, says Mr. Saigal.

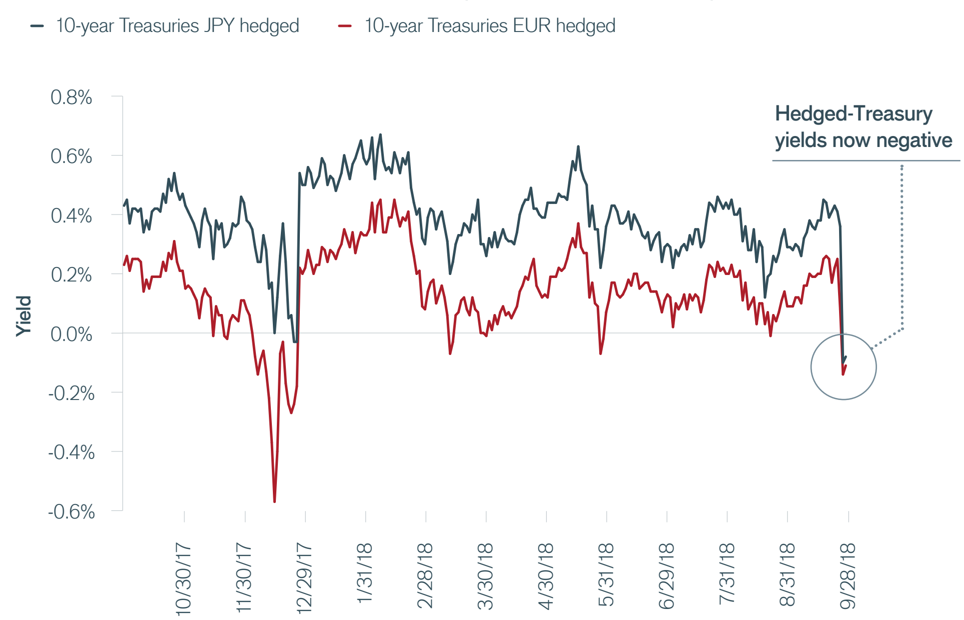
Still, market participants continue to doubt the Fed's longer-term intentions, according to market-implied pricing for the forward path of the federal funds rate. The market is either suggesting a lower neutral rate than the Fed's, or the market doesn't believe that the Fed can reach its long-run target, says Co-Head of Global Bonds Chris Diaz, CFA. In particular, we are watching the yield on the 5-year Treasury note, says Mr. Saigal. Even after the October spike in rates, the market has further to go in order to meet the reality of the Fed, and we expect to see a dramatic repricing in the 5-year when it does.

## Higher and Flatter

We anticipate continued upward pressure on the yield curve, particularly in the front end, as market expectations catch up to the Fed's. Additionally, rising rates are impacting hedging costs and depleting return potential for many non-U.S. investors seeking to put capital to work in the U.S. market. We anticipate foreign buyer demand to decline at a time when Treasury supply will likely increase to compensate for government spending and a shortfall in tax revenues, a scenario that should pressure yields higher, says Mr. Diaz.

### Exhibit 1: Hedged Treasury Yields

Rising rates have led to higher hedging costs and now negative returns for European and Japanese investors buying Treasuries on a hedged basis.




Source: Bloomberg, as of 9/28/18

### Takeaways

- We anticipate a higher but flatter Treasury curve as the Fed continues its measured pace of monetary policy normalization.
- Market participants appear to doubt the Fed's longer-term intentions, and risk remains in the 5-year Treasury note.

Now that we've broken through some key resistance levels, longer-dated yields can continue to climb, says Head of U.S. Fundamental Fixed Income Darrell Watters. Despite the steepening in early October, however, Mr. Diaz expects flattening to resume as a repricing along the shorter end of the curve will likely be more drastic than any further sell-off at the long end. Once the Fed has a few more hikes under its belt, we could even see the yield curve invert. However, that does not mean recession is imminent, in our view.

We are incrementally positive on the U.S. economy, but we do question the sustainability of growth long term, particularly once the impact of tax reform recedes. Given the extremely tight labor market, Portfolio Manager Ryan Myerberg is particularly honed in on whether modest wage gains will begin pressuring inflation higher. A situation in which inflation moves above the Fed's target, forcing the central bank to hike at a faster-than-expected pace, just as the sugar high from fiscal stimulus fades, would be very challenging for fixed income across the board, says Mr. Diaz.

For now, however, inflation appears contained, and the Fed is likely to retreat in the event of a material downturn in risk markets or a significant backup in the cost of capital, says Mr. Watters. We saw evidence of this in 2016 when the Fed held steady through tumultuous markets early in the year. Until inflation forces the Fed's hand, the central bank should provide a reassuring backstop, he adds.

## Catching Up Will be Hard to Do

Developed world rates seem destined to go higher, says Mr. Myerberg, but while other central banks may normalize, it will not be at the same pace as the Fed. The divergence in policy rates is not for lack of wanting. The European Central Bank (ECB), for instance, needs to get on with policy normalization to bring the deposit rate back into positive territory, says Mr. Myerberg, and that will be challenging to do once the Fed reaches its final resting spot. However, euro-area growth has slowed in recent quarters and core inflation still remains well below the central bank's target. The ECB has already made clear its intent to hold its policy rate steady until fall of 2019. The growing gap between the U.S. and other markets is creating opportunities to take interest rate risk in regions normalizing at a slower pace, says Mr. Myerberg.

## A Breakdown in Currency Pairs

While core European rates are pinned, central banks in a number of smaller European economies are positioning to tighten ahead of the ECB, due to strong growth and inflationary pressures. In particular, we are watching economic growth in Scandinavia and tight labor markets in Eastern Europe. These interest rate differentials would normally lead to accretive relative value currency opportunities. In recent months, however, we've seen a general breakdown between fundamentals and currency trends, says Mr. Diaz. Despite their central banks' hawkish tilts, currencies in these regions are trending downward versus the euro in reaction to broader risk sentiment, challenges in emerging markets and tariff concerns. We anticipate this disconnect to abate in coming months and for currency pairs to once again trade in line with interest rate differentials, says Mr. Diaz.

### Takeaways

- While the yield curve could invert in 2019, we do not believe that means recession is imminent.
- The Fed is normalizing faster than the rest of the developed world, which will perpetuate the divergence in policy rates and present attractive duration opportunities.
- We expect the breakdown in fundamentals and currency trends to abate in the coming months and for currency pairs to once again respond to interest rate differentials.

# CORPORATE CREDIT

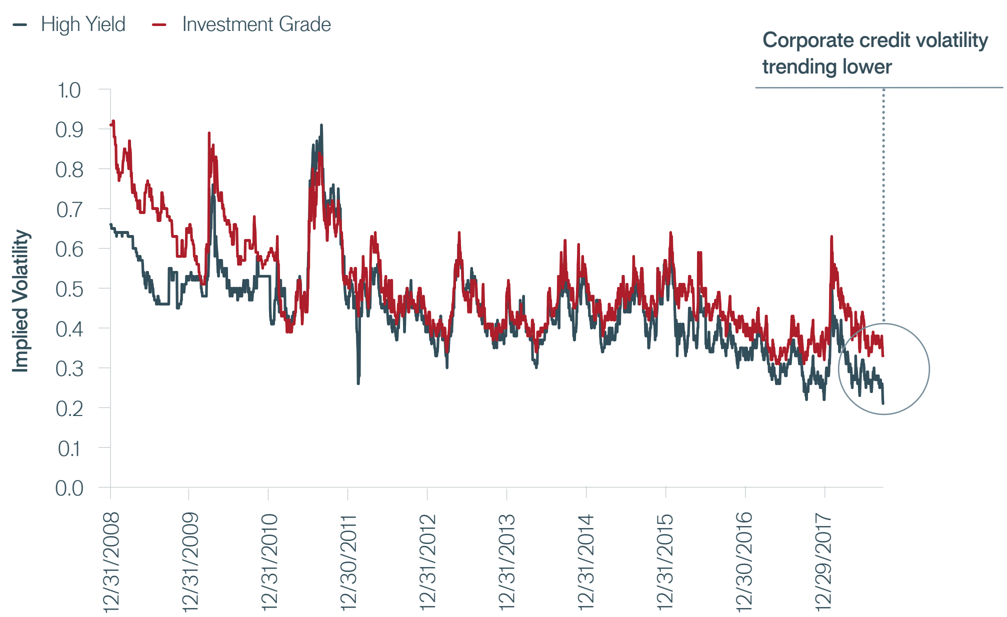
## Exuberance Remains

After corporate credit spreads reached the tightest levels of this credit cycle in February, they generally widened until bouncing back in the third quarter of 2018. Regulatory restrictions caused a number of large mergers and acquisitions to fall through, says Mr. Watters, and the unexpected dearth in supply has supported investment-grade spread tightening. U.S. companies, in particular, also continue to benefit from tax reform, strong earnings and healthy growth outlooks.

A sense of exuberance remains in U.S. risk markets, says Mr. Saigal. New issues have been oversubscribed in recent weeks, and options markets show implied credit volatility near 10-year lows. Mr. Myerberg agrees that a sense of fatigue, or general comfort, has set in despite trade wars, Fed tightening and emerging market challenges.

### Exhibit 2: Corporate Credit Volatility

Complacency is back, as exhibited by high-yield volatility reaching its lowest level in 10 years and investment-grade volatility encroaching on 2017 lows.




Source: Barclays Live, as of 9/28/18

Note: Graph depicts 3-month implied volatility based on credit default swap index (CDX) options.

## The Beginning of the End

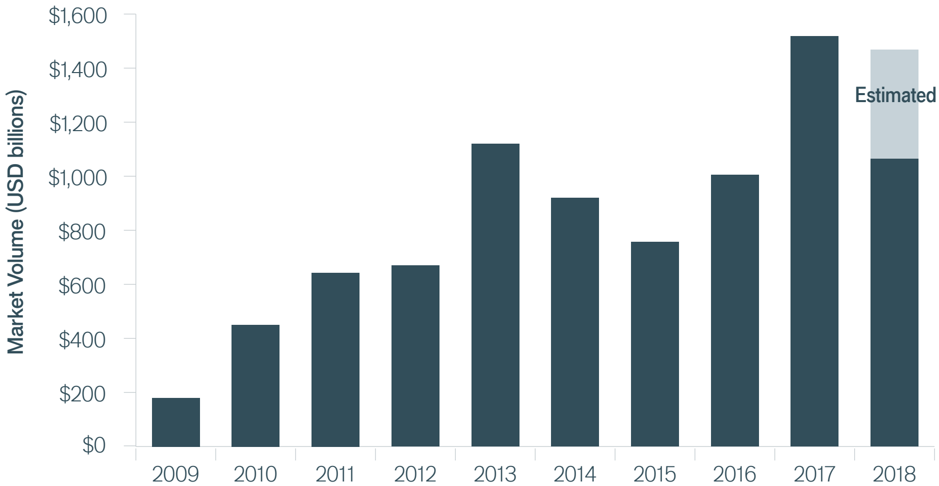
We acknowledge that U.S. corporate fundamentals are strong, tax reform is beneficial and economic growth is decent, all of which can extend the credit cycle, but we still find reason to be cautious. The credit cycle is in its later stages, and while the end is not yet here, this is likely the beginning of the end.

Valuations are rich and leverage is trending higher among investment-grade issuers. We are particularly concerned with the BBB segment of the market, where issuance has been substantial and leverage continues to climb, says Mr. Saigal. A number of larger, outdated business models are borrowing to combat technology-driven industry disruption.

We are also monitoring the levered loan market. As a result of regulation that impacted banks' ability to underwrite high-yield bonds, many high-yield issuers are raising capital via leveraged loan issuance. We believe the pace at which the loan market is growing is something to keep an eye on, says Mr. Diaz.

### Exhibit 3: U.S. Leveraged Loan Issuance

Loan issuance has trended higher in recent years as many corporate issuers have choosen to issue loans instead of fixed-rate bonds.




Source: Bloomberg, Janus Henderson, as of 10/5/18

In our view, the ability to add alpha through corporate credit is generally diminishing as the tailwinds of low rates, quantitative easing and tax reform fade, says Mr. Watters. Further, with valuations at the expensive ends of their ranges, risk grows more asymmetric against us every day, says Mr. Myerberg. Given the inherent challenges in calling the catalyst that will drive a risk-off event – and its timing – we believe it is prudent to emphasize defensive positioning in liquid, high-quality business models that generate consistent free cash flow. The ability to out-carry the index, will be a primary source of return in coming months.

That is not to say that dislocations in credit don't exist, says Mr. Watters, but the ability to identify companies with sound business models, disciplined management teams and bonds that are structured to withstand rising short-term rates will be key to navigating the last few months of the year. ■

### Takeaways

- U.S. corporate credit volatility is back near 10-year lows, despite a number of existing risk-off catalysts.
- While tax reform, steady growth and strong corporate fundamentals can extend the credit cycle, we still find reason to be cautious in these later innings.
- We are growing concerned with increasing leverage in both BBBs and levered loans.

# ROAD MAP

## Portfolio Positioning

- Corporate valuations remain rich, and we are in the extended stages of the credit cycle. We remain cautious on corporate credit but intend to maintain our opportunistic approach. Given the asymmetric risk profile of credit investing at this point of the cycle, security avoidance is as important as security selection.
- We anticipate a higher but flatter Treasury curve as the Fed continues its measured pace of monetary policy normalization. We will continue to actively manage yield curve positioning with a focus on capital preservation.

## U.S. Corporate Credit

- Tax reform provided a near-term boost for corporate credit, and we are opportunistically adding risk when we identify dislocations in excess of what we believe is warranted by company fundamentals. Still, our overall tone is cautious. Valuations remain stretched and the credit cycle is in extended innings.
- Within high yield, valuations are rich, but the asset class continues to benefit from a waning supply technical. Our analysts are seeking transformational balance sheet stories and ratings upgrade candidates that we believe can perform well, regardless of the broader market environment.
- As rates rise, front-end spread products offer more attractive risk-adjusted carry opportunities with less interest rate risk than longer duration credit.
- While we are monitoring growing excesses in levered loans, their senior, more defensive position in the capital structure, shorter-dated nature and LIBOR base rate that has moved higher with recent increases in the fed funds rate are attractive given the current environment.

## Yield Curve/Duration

- We anticipate five more Fed hikes by 2020 and view 3.25% as the likely landing spot for the terminal rate.
- The curve could invert in 2019, but we do not think that means recession is imminent.
- Near term, we expect a higher but flatter curve as market expectations catch up to the Fed's and foreign demand is negatively impacted by higher hedging costs. We expect moves on the front end to be more dramatic than any further sell-off in long-term rates.
- Risks to both the upward trajectory of the U.S. economy and the exuberance in risk markets remain in play, which could pause the Fed if they were to pan out. We intend to maintain duration modestly below that of the benchmark, but will continue in our tactical approach to yield curve positioning.
- Our spread product duration remains skewed to short- and intermediate-dated issues. Long-end Treasuries balance our spread product exposure.

## Securitized

- Fed balance sheet normalization is underway and banks and international buyers have scaled back purchases, leading to a modest widening in spreads on mortgage-backed securities (MBS) and creating attractive entry points.
- We utilize MBS as ballast for our core portfolios, to act as a diversifier when volatility rises. We emphasize securities with higher expected certainty of cash flows and seek to optimize carry per unit of convexity.
- When identifying commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS), we seek opportunities with favorable optionality, liquidity and upgrade potential. We invest only when we hold a constructive fundamental view on the underlying assets. Our analysts seek to avoid those securities highly correlated to rate volatility while taking advantage of shorter-dated, more credit-intensive securities where risk is more likely to be mispriced.

## Developed Markets

- Monetary policy in much of the developed world remains on hold. Developed rates are ultimately destined to rise, but meanwhile, the gap between the U.S. and other markets is creating attractive relative value opportunities.
- In core Europe, longer-dated rates should rise in sympathy with the U.S. and as quantitative easing ends. The front end should remain pinned by the ECB's decision to hold rates steady well into 2019.
- Due to the unknowns surrounding Brexit, and a general lack of clarity from the Bank of England, sterling, gilts and UK corporate credit generally remain unattractive, in our view.
- As the Bank of Japan slows its pace of asset purchases and the yield curve steepens, we are closely monitoring any follow-on impact in other developed market curves.

## Emerging Markets

- The asset class has struggled amid higher U.S. rates, a stronger dollar and idiosyncratic challenges in Turkey and Argentina. Given the asymmetric risk profile of the asset class should we experience a major risk-off event, we remain cautious but opportunistic. We favor countries with improving economic and political backdrops, and seek to avoid countries with large current account deficits that require significant outside funding.
- Relative value currency trades in countries where central banks are positioning to hike ahead of the ECB remain attractive.
- We also are identifying opportunities in issuers poised to benefit from increased demand for commodities.

# About Janus Henderson Fixed Income

- 30+ years of experience emphasizing risk-adjusted returns and capital preservation
- Fundamental, independent research focus
- Quantum Global: proprietary research and risk management system
- Integrated fixed income and equity research effort
- Highly collaborative investment team based in Denver and London
- 111 fixed income professionals, portfolio managers, analysts and traders as of 6/30/18
- $76.5 billion in assets under management as of 6/30/18

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

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