March 2019

Janus Henderson
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GLOBAL SECTOR VIEWS

Quarterly Equity Overview and Sector Highlights

About Janus Henderson U.S.-Based Equity Research

- Six analyst-led sector teams: Consumer, Energy & Utilities, Financials, Health Care, Industrials & Materials, and Technology
- Average tenure of 10 years at the firm and 17 years of financial industry experience as of 12/31/18
- 931 stocks covered across market capitalizations, styles and geographies as of 12/31/18
- Fundamental, independent research that seeks to identify best ideas in each sector
- Stocks with strong-buy or buy ratings considered for inclusion in Janus Henderson equity strategies

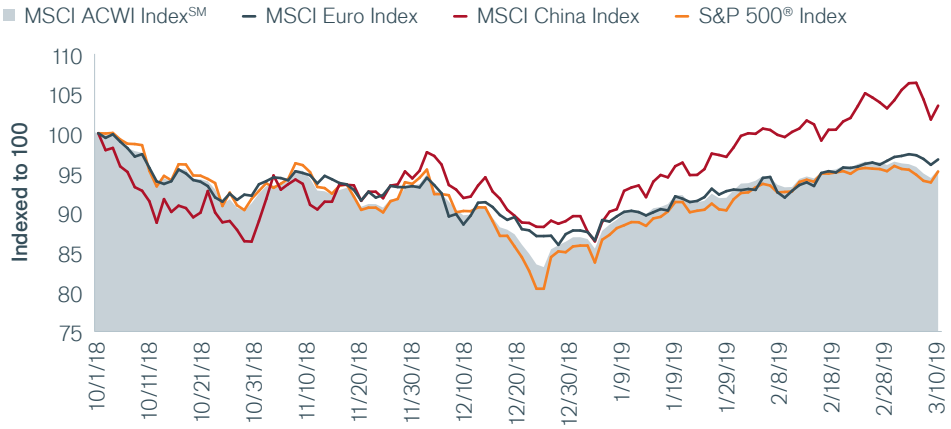
MARKET OVERVIEW

Global Stocks Rebound: What's Next?

The volatility that came to define equity markets at the end of last year has eased significantly, helping stocks to deliver a weeks-long recovery in the early part of 2019. In our opinion, the biggest driver of the rebound was the Federal Reserve's (Fed) decision to slow its pace of rate hikes and potentially end its balance sheet reduction. Other countries have taken a more accommodative stance, too. In China, Beijing is rolling out new stimulus measures to prop up economic growth, including a record $83 billion liquidity injection by the central bank. The European Central Bank recently stated it will maintain the region's ultra-low rates through the end of the year and issue new long-term loans for banks starting in September. And Bank of Japan policymakers have hinted that additional easing could be in the offing in light of a deteriorating outlook for the country's economy.

As such, from the beginning of January through March 11, the MSCI All Country World (ACWI) Index℠ delivered 10.3%, with the previous year's biggest laggards, such as China, enjoying some of the most substantial gains.

Exhibit 1: Global Equities Rally



Source: Bloomberg

Notes: Returns indexed to 100 on 10/1/18. Data as of 10/1/18 to 3/11/19.

Now that central banks look to be stepping back from policy tightening, the next question is whether the global economy can remain in fighting form. In early March, the Organisation for Economic Co-operation and Development (OECD) cut its forecast for global growth in 2019 to 3.3%, down from its previous forecast of 3.5%. The OECD cited policy uncertainty and ongoing trade tensions as reasons for the cut.

Key Takeaways

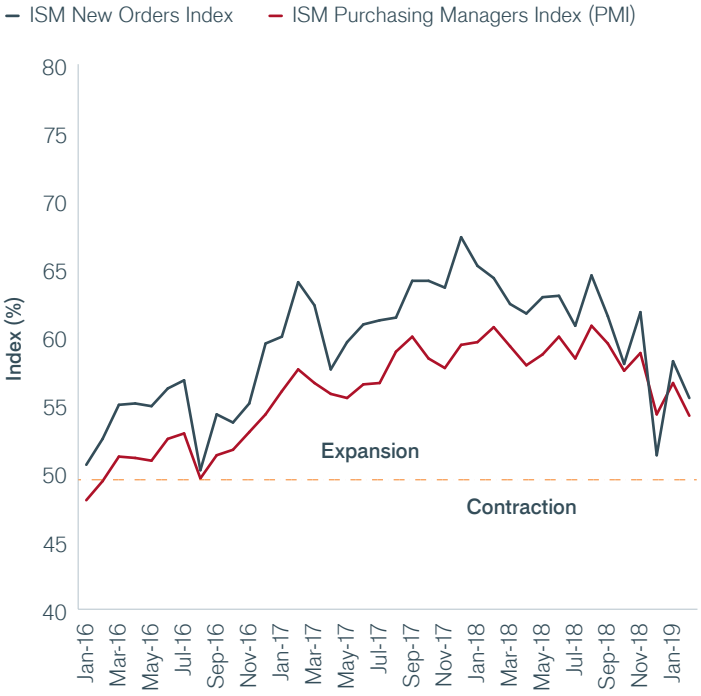
- In our opinion, global stocks' strong performance in early 2019 was largely due to the Federal Reserve's decision to slow the pace of monetary tightening.
- With rate hikes now on hold in the U.S. and many other countries, we think conditions are supportive of equities – so long as the global economy can remain on solid footing.
- Based on discussions with corporate management teams, progress made on U.S.-China trade negotiations and signals from macroeconomic indicators, we believe growth could moderate in 2019, but still be positive.

Global Economy: Stronger than it Looks?

We agree that these issues could present headwinds to economic growth. And yet, most companies we speak with are not seeing evidence of a slowdown. In February, the Institute for Supply Management (ISM®) New Orders Index, a leading indicator of business sentiment, came in at 55.5%, which indicates positive demand. In addition, though profit growth in the S&P 500® Index could be negative during the first quarter, earnings growth is projected to accelerate toward the end of 2019, according to FactSet (as of March 8). Merger and acquisition activity has been surprisingly strong, and a number of companies are expected to file initial public offerings this year, including Uber, Lyft, Pinterest and Peloton.

Exhibit 2: Manufacturing Continues to Grow

Despite a slowdown in recent months, growth in manufacturing – including new orders – remains in expansionary territory.



Source: Bloomberg. Data from 1/31/16 to 2/28/19.

That's not to say volatility is a thing of the past. Geopolitical concerns, including Brexit, U.S.-China trade negotiations and the 2020 election cycle in the U.S., are likely to cause short-term market moves. It has also been nearly a decade since the end of the last recession. As business cycles age, growth typically moderates.

Seeking Durable Growth

Therefore, we continue to invest on the assumption that economic growth remains positive but are focused on finding companies that we think have secular tailwinds, capable management teams and other high-quality attributes that can help sustain revenue growth over the long term. In our opinion, examples include biotech companies developing groundbreaking medicines, global payments firms facilitating the move from cash to digital payments and cloud service providers enabling workloads to move from on-premises servers to the cloud. We are also focused on companies that may thrive in the latter part of the business cycle, such as suppliers of agriculture equipment, as farmers may no longer be able to put off upgrading aging tractors and combines.

And we are monitoring pockets where economic weakness is evident. In Japan, for example, manufacturing activity recently fell to its lowest level in more than two years. In Australia and Canada, falling home prices, high household debt levels and worries about potential headwinds to exports (caused by a slowdown in emerging markets growth) could weigh on those countries' respective economies.

> "Most companies we speak with are not seeing evidence of a slowdown."

In the *Sector Overview*, our lead sector analysts go into more detail about how they are navigating the current environment. But by taking an active approach and focusing on companies with the high-quality attributes described above, we believe investors may be able to root out durable growth no matter how the global economy fares over the next year.

Carmel Wellso
Director of Research

SECTOR OVERVIEW

Consumer

Sentiment Improves

After turning negative last year, housing fundamentals are showing signs of improvement. Notably, 30-year mortgage rates recently hit 12-month lows, according to Freddie Mac, and home price inflation is beginning to move more in line with wage growth, all of which could help boost home sales. At the same time, consumer sentiment appears to be rebounding from the unease caused by the partial government shutdown in December and January. The Federal Reserve's (Fed) decision to slow its pace of rate increases was also a positive. Despite worries that the Tax Cuts and Jobs Act of 2017 could mean higher tax bills for households this year, as of March 1, the average refund was up slightly (0.7%) from last year, according to the Internal Revenue Service.

Investment Implications

Although homebuilder stocks have come off recent lows, we believe other housing-related companies offer more sustainable growth. Examples include high-quality paint manufacturers and online home décor retailers. Meanwhile, performance in the consumer sector is being concentrated in an ever-shrinking number of names, requiring a selective investment approach, in our opinion. Digital platforms, for one, continue to take market share across multiple categories, including media and retail. Among consumer staples, name-brand foods that once dominated supermarket shelves now face increasing pressures from rising costs and private label competitors, while consumers' growing preference for premium beers and spirits is creating growth for industry leaders, which have wide-scale (and hard-to-replicate) distribution channels.

Energy & Utilities

A Stabilizing Oil Market

Oil prices have come off their December lows, thanks to supply outages in key regions such as Venezuela and Nigeria and production cuts by the Organization of the Petroleum Exporting Countries. At the same time, oil demand is expected to be 1.2 million barrels per day (bpd) in 2019, according to consensus estimates. That forecast represents a decline from 2018, but anything above 1.0 million bpd typically indicates a healthy oil market. As such, we believe the outlook for oil remains constructive despite worries over a slowing global economy and continued production growth in U.S. shale. In the near term, our outlook for West Texas Intermediate (WTI) crude is $55 to $65 per barrel and $60 to $70 for Brent. (WTI is a benchmark for U.S.-produced oil, while Brent measures global crude prices.)

Investment Implications

We believe exploration and production firms with low costs and a diverse geographic footprint are well positioned for today's market. In our opinion, these companies have the flexibility to direct capital away from oil basins where logistical bottlenecks have driven up production costs, helping support free cash flow. U.S. shale growth is expected to continue in 2019, a trend that should benefit midstream operators managing pipelines and transport systems for crude. We also think refiners with a diverse geographic footprint are attractive as these firms can more easily take advantage of potential price differentials in crude. New standards for global shipping fuel, taking effect in 2020, could also prove a tailwind for refiners able to meet the new guidelines.

Financials

Focused on Structural Growth

The backdrop for financials has changed modestly from last quarter, with the Fed taking a more dovish tone and market volatility diminishing. Consequently, expectations for net interest margins have eased while year-over-year growth in trading volumes (and subsequent revenues) could be flat or negative during the first quarter. Still, despite these near-term challenges, we think the sector continues to benefit from a number of long-term growth drivers. These include the rapid growth of digital payments, the electronification of trading markets, global demand for wealth management services and data analytics and technology.

Investment Implications

We favor large franchise banks with the scale to invest in new technology and attract low-cost deposits. We also continue to look for institutions using data analytics and digital tools to create competitive advantages and gain efficiencies. In our opinion, such opportunities exist across the sector, from digital payments and insurance providers to exchanges and credit card firms. Meanwhile, in Europe, slowing economic growth, tighter regulation and allegations of money laundering have weighed on financials there. However, we think these risks are now increasingly priced into stocks, adding to the appeal of companies with exposure to structural growth drivers, such as cyber insurance. Similarly, in emerging markets, valuations have contracted as a result of last year's equity market sell-off. However, we continue to find long-term growth opportunities, including rising demand for wealth management and banking services in greater China, Singapore and Indonesia.

Health Care

M&A and Innovation

Following a pullback in health care stocks late last year, merger and acquisition (M&A) activity has picked up, with six major deals announced through early March. The acquisitions are being made at premiums ranging from 50% to more than 100%, suggesting that valuations within the sector remain broadly attractive. As such, more M&A could be in the offing, especially as the top 20 biopharmaceutical companies – which now generate a total of $150 billion in free cash flow each year – look to add innovative medicines and drug platforms to their portfolios. The biotech industry is delivering ample choice. Last year, the U.S. Food and Drug Administration approved 59 novel drugs, setting an all-time calendar-year record. In 2019, more results from landmark studies for cancer-fighting immunotherapies and novel gene therapies are expected. Medtech companies also continue to make strides, especially with robotic- and augmented reality-assisted surgeries.

Politically, scrutiny of health care costs continues, and we are wary that the 2020 election cycle could create more volatility for the sector over the next 18 months.

Investment Implications

Last quarter, we noted that attractive valuations in biotech could lead to more M&A activity, an outlook that is starting to bear fruit. As such, we continue to favor companies focused on developing innovative medicines or improving efficiencies within the health care system. We believe these firms could see long-term growth by addressing new markets and potentially generating strategic interest. Although medtech valuations remain elevated, we think many of these firms continue to have strong organic growth and pricing power. We also believe companies with a global sales reach or exposure to markets with less regulatory scrutiny, such as animal health companies, could be well positioned.

Industrials & Materials

Trade Worries Ease

Factors that were headwinds for industrials at the end of last year – a strong dollar, trade tensions and rising input costs – have started to ease, helping the sector outperform the broad equity market in 2019 (as of March 11). Although global growth may be slowing, many economic indicators still remain positive. In the U.S., the Institute for Supply Management's Purchasing Managers Index (PMI®), a measure of manufacturing health, was 54.2 in February. That was down from the previous month, when PMI was 56.6, but still solidly in expansionary territory (anything above 50). In China, government stimulus and the easing of U.S.-China trade tensions could help boost consumer and business sentiment. And in Europe, Brexit uncertainties, a recession in Italy and stricter auto regulations are weighing on growth, but forecasts still call for the region's gross domestic product to be positive in 2019.

Investment Implications

We continue to look for areas within industrials that we think have secular growth opportunities or that are well positioned for the latter part of the business cycle. In agriculture, farmers may finally be ready to update aging equipment and invest in new precision-agriculture technology. The thawing of U.S.-China trade tensions could also give farmers more confidence to spend, as China is a major importer of soybeans. In autos, global sales show signs of slowing, but the number of advanced driver-assistance systems per vehicle is on the rise, potentially benefiting suppliers of the technology. In addition, some automakers are paring costs while investing in long-term growth opportunities, an attractive combination, in our opinion.

Technology

Cloud, SaaS and Internet Platforms Dominate

Broadly, technology stocks have rebounded this year due, in part, to progress made on U.S.-China trade negotiations. Although regulatory scrutiny of big Internet platforms persists, recent company earnings show that user engagement continues to be robust, driving impressive growth for the platforms. Consumers have proven more fickle when it comes to video games, lowering expectations of video publishers' ability to predictably monetize gaming activity. Meanwhile, semiconductors have entered the third quarter of their worst down-cycle since the Great Financial Crisis as a result of trade disputes and excess chip inventory.

Investment Implications

We continue to favor secular themes in technology, such as the shift to cloud computing and Software as a Service (SaaS), both of which appear to have long runways of growth. Semiconductor companies exposed to autos, industrials and 5G appear well positioned, in our opinion, as these areas have rising demand for semi content. They would also benefit from a resolution to trade disputes and the replenishment of chip inventories, which we expect to occur later this year. We are monitoring the regulatory oversight of Internet platforms, but believe these companies have built enduring networks as evidenced by recent earnings. However, we are less optimistic about the supply chain for smartphones, as many end markets are now saturated with units. We also believe the investment thesis for video game publishers has become challenged in light of consumers' lack of engagement.

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