

June 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 analyst tenure of nine years at the firm and 17 years of financial industry experience as of 3/31/19
- ▶ 921 stocks covered across market capitalizations, styles and geographies as of 3/31/19
- ▶ 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

## Navigating a Geopolitical-Driven Market

After a brief reprieve, volatility has returned to equity markets. This time, the Federal Reserve (Fed) – which in recent months said it would end monetary tightening and even consider easing – does not appear to be the primary culprit. Rather, an escalation of trade tensions is more likely to blame, beginning with President Trump's decision in May to raise tariffs on \$200 billion worth of Chinese goods and place Chinese telecom giant Huawei on a trade blacklist. The president also threatened tariffs on Mexican imports unless the flow of illegal immigrants to the U.S. was reduced and said tariffs on autos from Europe and Japan could be in the offing, barring new trade agreements.

The escalation in trade hostilities shocked markets, especially after months of what appeared to be progress toward a U.S.-China trade resolution and a revised North American trade deal among the U.S., Mexico and Canada. With the president seemingly favoring tariffs as a means of pushing through his agenda, investors may have to brace for more trade hostilities – and market volatility. In reaction to Huawei's blacklisting, for example, China retaliated by announcing it would do the same to U.S. companies and people who "do not follow market rules." In other words, things could get worse before they get better.

### Geopolitical Tensions: The New Market Driver

Trade is only one part of the geopolitical story. In the months ahead, investors will have to continue digesting news around Brexit, the fallout of European Union elections and the 2020 U.S. presidential campaign. Each has the potential to create unwelcome uncertainty for consumers and businesses, which in turn could crimp global economic growth.

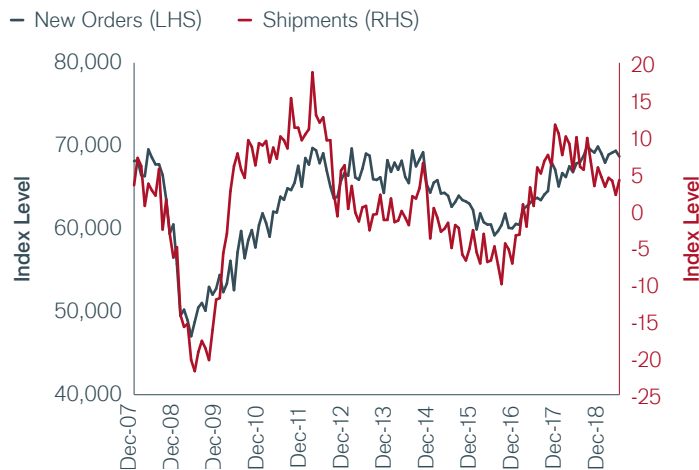
Already, we are seeing some signs of softening. New orders of capital goods, excluding defense and aircraft, declined 0.9% in April from the month prior. Shipments were flat for the same period, and in May the Institute of Supply Management's Purchasing Managers' Index (PMI) came in at 52.1%, still in expansionary territory but down from an average of 56.7% over the past 12 months. Also in May, the Morgan Stanley Composite Capex Plans Index saw a 2.2-point gain, suggesting some continued optimism by businesses, but results were calculated before Trump threatened tariffs on Mexico and demonstrated his willingness to expand trade disputes.

#### Key Takeaways

- ▶ In our opinion, geopolitics has created volatility for equity markets as the combination of escalating trade tensions, tech wars, elections and Brexit could slow global economic growth.
- ▶ Against this backdrop, we believe it is all the more important to take an active investment approach and focus on companies with secular growth drivers.
- ▶ However, we also think long-term growth opportunities exist throughout the market, even among traditionally cyclical sectors.

## Exhibit 1: Early Signs of a Slowdown

New orders and shipments of capital goods have started to ease



Source: U.S. Census Bureau and Bloomberg, as of 4/30/19. Data exclude defense and aircraft spending

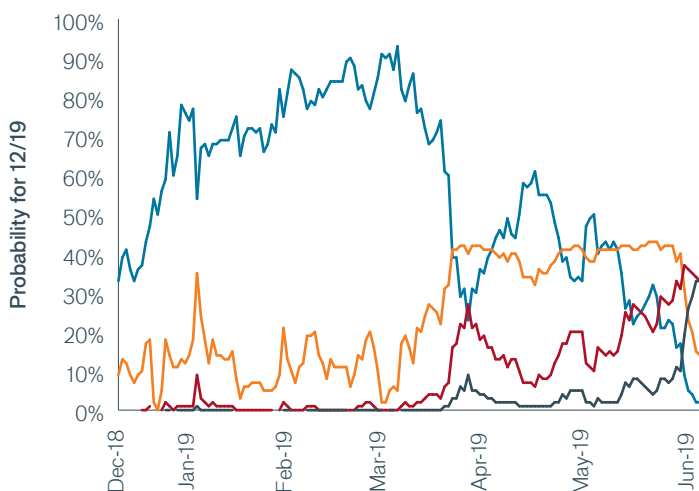
Should this slowdown persist, we'd expect the impact to start manifesting in third-quarter earnings. Already, some companies have suspended forward guidance because of trade unknowns, and equities have come off the market highs hit in early May. The good news: We don't see indications of an imminent or deep recession. U.S. unemployment remains at a nearly 50-year low, banks are well capitalized, companies are reducing debt levels and the Fed has indicated it would cut rates should economic conditions deteriorate.

## Exhibit 2: The Fed's Next Move: A Rate Cut?

Increasingly, the market expects the U.S. federal funds rate to decline by the end of 2019

### Federal Funds Rate

— 1.50% - 1.75% — 1.75% - 2.00% — 2.00% - 2.25% — 2.25% - 2.50%



Source: World Interest Rate Probability, Bloomberg, as of 6/4/19

## Staying Focused on Fundamentals

Against this backdrop, we believe cyclical equities – stocks whose prices tend to be closely tied to economic expansion and contraction – could face challenges. Even if trade resolutions are reached, we are in the later stages of the business cycle, during which economic activity naturally ebbs.

Consequently, investors might be tempted to shy away from traditionally cyclical sectors, such as financials, consumer discretionary, technology and industrials. However, as our lead research analysts discuss in the *Sector Overview*, we think a better approach is to focus on secular growth stories that are likely to persist regardless of where we are in the economic cycle. Through that lens, we believe compelling, long-term growth opportunities can be found throughout the market's sectors. In technology, for example, the transition to cloud computing persists, driving steady demand for providers of Software as a Service (SaaS) and cloud platforms. In industrials, innovation continues with machine vision systems, which are increasingly being used in logistics and manufacturing. And in financials, digital payments are booming, hitting \$1.9 trillion in global revenues in 2017 and projected to rise by an average of 9% annually through 2022<sup>1</sup>.

Some of these opportunities may be domiciled outside the U.S. in regions where geopolitical uncertainty has helped to make multiples especially attractive. In China, for example, it is possible to find banks that boast strong loan loss reserves and are delivering high returns on equity but that trade at half their book value (compared with one times or more for many U.S. banks). At the same time, we are being cautious about chasing bargains that may be cheap for structural reasons, including in Europe, where a number of companies appear levered to industries that are contracting.

In our opinion, this approach can help investors stay focused on the fundamentals that are likely to outlast the latest trade spat or election and that traditionally have mattered more to returns over the long term.



**Carmel Wellso**  
Director of Research

<sup>1</sup> "Global payments 2018: A dynamic industry continues to break new ground," McKinsey & Company, October 2018

## Consumer

### Tariffs Weigh on Confidence

The backdrop for U.S. consumers continues to be favorable thanks to easy credit standards, low unemployment, moderating home price appreciation and the end of Fed rate hikes. Still, the recent escalation in trade tensions could weigh on sentiment: At the end of May, the University of Michigan's monthly survey of consumer confidence reported a sharp decline following President Trump's decision to raise tariffs on Chinese imports and propose new tariffs on an additional \$325 billion worth of Chinese goods, many of them consumer products. These moves could crimp profit margins or lead to higher prices for consumers, potentially impairing demand.

### Investment Implications

With trade spats continuing, we are focused on finding companies that operate in strong product categories and have market-leading brands. These firms may be better able to pass on price increases without compromising demand. We are also monitoring whether companies with significant sales in China could be impaired should trade tensions lead to anti-American sentiment. In the meantime, a rise in U.S. household formations is helping drive growth in broadband subscriptions for cable operators and boosting sales of home-supply and décor stores. And companies with strong e-commerce capabilities continue to take market share, a trend that's likely to persist and benefit firms that sit on the right side of the digital divide.

## Energy & Utilities

### Oil Demand: A Headwind?

The oil market appears largely balanced, with production cuts by OPEC, Russian pipeline issues, rising tensions in the Persian Gulf and the U.S.'s removal of waivers for Iranian sanctions helping keep supply in check. U.S. production continues to grow, but many exploration and production companies have emphasized their plans for capital discipline in the near term. The demand outlook also looks constructive for now, with more than 1.0 million barrels per day (bpd) of growth expected in 2019, generally the minimum needed for a healthy market. However, worries are mounting that a slowdown in the economy could change that outlook. In June, for example, the International Energy Agency lowered its 2019 forecast for demand growth to 1.2 million bpd, down from 1.4 million bpd earlier in the year.

### Investment Implications

We will continue to monitor the supply-demand balance over the near term. However, should demand hold at 1.0 million bpd and capital discipline continue, we believe West Texas Intermediate (WTI) crude could range from \$50 to \$60 per barrel and Brent, \$60 to \$70. (WTI is a benchmark for U.S.-produced oil, while Brent measures global crude prices.) With U.S. crude production continuing to rise, we think midstream operators, which manage pipelines and transport systems for crude, are well positioned. In addition, market confidence in U.S. producers could improve if these companies stick to capital spending plans in 2019. Meanwhile, integrated oil and gas firms may offer downside protection in a weaker economy thanks to their diversified operations and traditionally high dividend yields.

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## Financials

### Navigating Falling Yields

Falling bond yields and competition for deposits have started to pressure net interest margins at some banks. We believe this environment could persist in the near term, especially if the aging business cycle and trade uncertainties lead to slower economic growth. Outside of banking, consolidation is occurring among merchant acquirers. The combined firms are creating cost synergies, new revenue opportunities and, in our opinion, validating global payments as a growing end market. More broadly, we believe the financials sector continues to benefit from structural tailwinds such as the electrification of trading markets, global demand for wealth management services, and data analytics and technology.

### Investment Implications

While pressure on yields may persist, we continue to focus on companies with secular-growth drivers. These include institutions using data analytics and digital tools to create competitive advantages and gain efficiencies. In Europe, slowing economic growth and falling rate expectations are driving negative earnings estimate revisions, making the region less attractive. In emerging markets, uncertainties about trade disputes and the health of the global economy have been headwinds. While some of these risks have been priced into stocks, we remain cautious on those most sensitive to falling rates and weaker capital market activity, instead preferring companies and regions that benefit from lower rates and oil prices and a weaker dollar. In addition, we seek exposure to structural tailwinds, including growing demand for wealth management, banking services and insurance products.

## Health Care

### Political Rhetoric Dominates – For Now

Health care stocks have struggled lately under the weight of political rhetoric, including proposed reform for drug rebates and calls by 2020 U.S. presidential candidates to replace private insurance with a single-payer health care system. While we believe rebate reform could pass – and be a positive, as it would lower out-of-pocket costs for consumers – we think changes to health insurance are less likely. Implementing a single-payer system would cost trillions of dollars and be highly disruptive for the roughly 155 million individuals who have employer-provided commercial coverage.<sup>2</sup> In the meantime, medical breakthroughs continue. In May, the Food and Drug Administration approved a second gene therapy, a treatment for spinal muscular atrophy, the leading genetic cause of infant death. We also continue to see advances in precision medicine and medical devices.

## Investment Implications

We continue to favor the biopharmaceutical and medical device companies developing innovative therapies for high, unmet medical needs. In our opinion, these firms are likely to receive reimbursement regardless of the political backdrop. We also favor plan providers and other industry participants working to improve efficiencies and lower costs in the health care system. Finally, to try to reduce near-term volatility, we are increasingly looking at firms that we think should be less vulnerable to political uncertainty. These include companies in the animal health industry, those that manufacture cash-pay products (such as contact lenses or cosmetic treatments) and those with a strong presence outside the U.S.

## Industrials & Materials

### Focused on “Self-Help” Industrials

Sentiment around industrials has turned more negative as trade tensions flare. So, although capital expenditures and other measures of manufacturing strength remain in positive territory, market participants are increasingly worried that a slowdown is coming. Still, the sector continues to benefit from a number of structural tailwinds, including growth in factory automation, advanced driver-assistance technology, precision agriculture and global travel. In addition, the latest list of proposed tariffs on Chinese exports would impact mostly consumer goods rather than industrials (which were targeted by earlier rounds of tariffs).

### Investment Implications

With trade tensions rising, we are focused on finding companies that do not have to rely on global economic growth to expand operating margins. In our opinion, these “self-help” firms will be better able to increase revenues even if the economy slows. Within automotive, for example, demand continues for the cameras, sensors and LiDAR systems needed for autonomous- and assisted-driving features. In aerospace, a dramatic rise in global travel has resulted in a four- to five-year backlog in aircraft orders. The tech-security war between the U.S. and China, along with other geopolitical conflicts, is likely to provide support for defense companies. And in materials, environmental concerns are driving demand for gasification, technology that turns coal and dirty fuel into cleaner-burning energy sources.

<sup>2</sup> Kaiser Family Foundation, as of 2017.

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## Technology

### Trade Ban Leads to Uncertainty

Stock performance in the technology sector has been bifurcated of late. On the positive side, SaaS and cloud-computing firms have outperformed as more workloads shift from on-premises servers to the cloud. Internet platforms, meanwhile, have experienced volatility due to increased regulatory scrutiny, including potential antitrust investigations by the U.S. Justice Department, the Federal Trade Commission and the House of Representatives. Finally, semiconductor and hardware firms, which had rebounded earlier this year on perceived progress in U.S.-China trade talks, have once again been caught up in the crosshairs of trade disputes. In particular, the Trump administration's decision to place Chinese telecom giant Huawei on a trade blacklist removed a significant source of revenue for the tech supply chain and exacerbated the tech-security rift between China and the U.S.

### Investment Implications

We continue to favor the robust growth prospects of cloud computing and SaaS firms but are also mindful of valuations which, for many stocks, are at the highest end of their historical range. We also believe semiconductor firms could benefit from secular tailwinds such as artificial intelligence and the Internet of Things but that trade disputes have made the short-term outlook uncertain. Conversely, Internet platforms continue to deliver robust earnings results on the back of advertising growth, but long term we believe regulation could become a bigger headwind to growth and innovation. Meanwhile, many domestically oriented software companies offer both growth prospects and protection from tariffs.

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