4Q18 Portfolio Commentary

Janus Henderson INVESTORS

Short Duration Income ETF (VNLA)

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Market Environment

Global bond markets started the quarter sluggishly, held down, in part, by weakness in U.S. Treasuries. The one-two punch of U.S. hourly earnings growth eclipsing 3.0% for the first time in the post-financial crisis era and an inference by Federal Reserve (Fed) Chairman Jerome Powell that the central bank was a long way from its estimated neutral interest rate, pushed up U.S. Treasury yields across all tenors. Riskier assets such as stocks and high-yield corporate credits did not absorb the developments well either as evidenced by many U.S. equity indices coming off record closes set in late September. Later in the period, Mr. Powell sought to clarify the Fed's position on rates, stating that the fed funds overnight rate – 2.25% at the time – was just below the neutral rate's range as based on a survey of Fed members. The possibility that a succession of additional hikes was not baked in caused a reversal in Treasury yields, which later accelerated on concerns about slowing global economic growth.

By the time December arrived, market participants were hopeful that the Fed would dramatically lower its projected interest rate path. Those aspirations were dashed at the Fed's December meeting in which their median estimate of roughly one hike in 2019 still exceeded the market's bogey of none. Consequently, riskier pockets of the market continued their slide and purported safe havens, namely Treasuries and gold, rallied. The yield on the 10-year note finished the period at 2.68%, 56 basis points (bps) below its intra-period peak. Given the lower path projected by the Fed, the yield on the 2-year note fell 33 bps over the period to 2.49%. As the market divined where near-term rates would eventually land – and in a rush to safety – points along the front end of the yield curve inverted, historically a signal of impending economic weakness.

Thirty-year Treasuries rallied, as did German Bunds, whose yield dipped to as low as 0.24%. After starting the period relatively tame, spreads between corporate bonds and their risk-free benchmarks widened considerably as fears of a global slowdown grew. While investment-grade credits registered only slight losses – aided by falling Treasury yields – the surge in high-yield spreads resulted in considerable losses. Several broad global and U.S. equity benchmarks slid between 10% and 20% during the quarter and flirted with bear-market territory based on their late-September peaks. Ultimately, major U.S. and global bond benchmarks finished the period with mild gains, fueled by the rally in government debt.

Performance/Positioning

For the period, the Fund underperformed its benchmark, the FTSE 3-Month U.S. Treasury Bill Index. The Fund's core of shorter-duration, investment-grade corporate credits generated positive

Highlights

- Rising market volatility and global growth concerns led to gains in safe-haven government bonds, while riskier assets sold off.
- The Fund underperformed its benchmark, the FTSE 3-Month U.S. Treasury Bill Index.
- The Fund's core of shorter-duration corporate credits generated positive returns while the expense associated with hedges on other parts of the portfolio weighed on performance.

returns for the period. We believe this segment of the market can offer investors a visible stream of income with a lower level of risk than many longer-dated or lower-quality securities. The Fund also can hold derivatives, in part, to hedge overall portfolio risk, including the risk of rising interest rates. During the period, the Fund maintained positions designed to protect the Fund from a potential uptick in rates. Given the cautious environment and accompanying rally in government debt, these hedges detracted from results. While absolute performance remained positive for the quarter, the expense incurred in maintaining interest-rate hedges pushed returns lower than those registered by the benchmark.

As expected, the Fed hiked rates in December, but its forward guidance appeared to indicate a more subdued cadence of expected rate hikes over 2019. The European Central Bank (ECB) also became more cautious, and while it ended its asset purchases in December, it indicated an expectation to keep rates low for a fairly long time. Markets currently anticipate no European rate hikes until at least 2020. Likewise, the Reserve Bank of Australia (RBA) has remained on hold, at 1.5%, since August 2016 with markets predicting little prospect for hikes in 2019.

2018 was a challenging year, given sell-offs in virtually all financial markets. However, we believe there is good value in shorter-dated corporate bonds given higher current yields and spreads. Therefore, we expect to retain a higher level of portfolio risks, believing the sell-off in rates and corporate bond spreads to be largely complete, despite recent market volatility. We have maintained our low cash position given attractive corporate issuance. We still believe the RBA is likely to maintain rates at 1.5% for some time, making Australian rates, in our view, the most attractive globally. We expect to maintain Australian and New Zealand duration in a conservative range.

Over the short run, we expect market stresses to remain elevated as productive progress on Brexit remains fleeting and strains in the European financial sector continue. Investigations of the Trump administration could pose more serious economic damage than expected and severely limit prospects for favorable growth policies.

Our main political concern remains fiscal brinksmanship leading to even more – and possibly longer – government shutdowns (and the requisite back-and-forth finger-pointing) over the debt limit, spending and the budget. The potential for repeated government shutdowns over the next two years will likely keep a cloud over growth prospects. Nonetheless, 2018 payrolls and wage gains reconfirm a solid U.S. economy, consistent with the past few years. Average hourly earnings growth moving above 3.0% raises concern over U.S. inflation, however. We believe the trade war and political uncertainty will remain a negative theme and keep a cap on where rates can go. Fed Chairman Jerome Powell’s and Vice Chairman Richard Clarida’s more recent comments, indicating rates are closer to neutral, support our earlier views of the terminal fed fund rates being below 3.0%. We expect one more rate hike in 2019, closer to current market consensus.

While we foresee eventual increases in service-sector inflation, goods inflation, in our view, should remain well contained, being less linked to decreasing U.S. unemployment. Global spare capacity should continue to make cheap imports a viable alternative to domestic products, although the continuing trade war acting as a de-facto tax on consumers may limit otherwise cheaper imports’ effects. Payroll gains corroborate the last eight years of stable and steady jobs growth, but inflation risks are limited. We expect unemployment to remain close to the current sub-4.0% level, which is a 50-year low. Wage pressures remain a concern, with average hourly earnings growth above 3.0% and the ratio of job seekers to number of available jobs moving from 9:1 toward 1:1. While core inflation may slightly increase given increasing wage pressures, we expect it to remain well contained in the 2.0% to 2.5% range over the next few years.

In global bond markets we continue to favor Australian rates versus the rest of the world, given our expectation for the RBA to remain on hold for all of 2019. Housing and labor markets should remain key factors in future growth and inflation expectations, and we expect the RBA to await further data before acting. The latest jobs data reconfirm the continuation of last year’s strong employment environment when 400,000 jobs were added, with 75% of them being full time. However, employment slack remains, with businesses more recently focused on part-time hiring and remaining reluctant to increase wages.

We believe Chinese growth will remain key for Australia and we remain optimistic despite a deceleration in credit provisions and an ongoing trade war. Gross Domestic Product remaining near 6.5%, in line with targets, remains our base case, despite heightened trade rhetoric. We expect continuation of an agenda supporting the addition of 10 million people per year into the urban labor force as a central economic policy theme while financial sector reforms should remain an important, yet secondary, policy goal.

The need for Australia to become more competitive in a global world with technological change and weaker labor bargaining power will likely continue to keep downward pressure on wages. The impact of macro-prudential policy changes have yet to filter through the economy, but we believe inflation risks will remain to the downside, again supporting the theme of the RBA remaining on hold through 2019.

We continue to hold a positive view on investment-grade credit in Australia, largely due to attractive real yields, healthiness of issuers compared to other developed markets, and wider yield spreads versus comparable U.S., European and Japanese issuers. Therefore, the Fund continues to have material exposure to Australia. Favored sectors remain the banking sector due to attractive yields and greater liquidity, and infrastructure such as airports and toll roads, which tend to offer attractive yields and solid cash flows and are typically monopolistic businesses with high regulation and quality underlying collateral, and are also of systemic importance. While Australian banks have come under pressure with the revelation of a new bank tax, rating agency downgrades of second-tier banks and first-tier hybrids, and disclosures in the Royal Banking Commission, we remain bullish on Australian senior bank debt given what we view as conservative business models, strong profitability and implicit government support. We have more recently moved out of "Big Four" issuers into second-tier financials, including regional banks and credit unions in order to generate additional yield.

Elsewhere, we like systemically important, highly rated Asian issuers such as government-related energy, telecom and banking entities and the U.S. “too big to fail” banks, whose bonds should be supported by a robust regulatory environment focused on less risk taking and higher capital requirements.

We remain less supportive of European bond opportunities. While in the nearer-term, growth has improved, aided by increased consumer spending and improving employment, we see little inflationary pressure. Stresses in the eurozone have increased, particularly with the Italian coalition government focused on decreasing taxes and increasing spending with little concern over growing deficits. With Italian risks increasing, we believe it will be difficult for the ECB to end quantitative easing (QE) permanently. We expect European growth and inflation to continue to underperform expectations amid structural rigidities in labor and product markets, particularly in peripheral regions. Low to negative bond yields already reflect this scenario.

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OBJECTIVE: Janus Henderson Short Duration Income ETF (VNLA) seeks to provide a steady income stream with capital preservation across various market cycles. The Fund seeks to consistently outperform the FTSE 3-Month U.S. Treasury Bill Index by a moderate amount through various market cycles while at the same time providing low volatility.

Investing involves risk, including the possible loss of principal and fluctuation of value. There is no assurance the stated objective(s) will be met.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Derivatives can be highly volatile and more sensitive to changes in economic or market conditions than other investments. This could result in losses that exceed the original investment and may be magnified by leverage.

The Fund is not a money market fund and does not attempt to maintain a stable net asset value.

Holding a meaningful portion of assets in cash or cash equivalents may negatively affect performance.

Actively managed portfolios may fail to produce the intended results. No investment strategy can ensure a profit or eliminate the risk of loss.

ETF shares are not individually redeemable and owners of the shares may acquire those shares from the Fund and tender those shares for redemption to the Fund in Creation Units only.

FTSE 3-Month U.S. Treasury Bill Index tracks the performance of short-term U.S. government debt securities.

Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment.

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