PLUMMETING OIL PRICES SPARK MARKET JITTERS

JANUS CAPITAL Group

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$50 Oil prices tumbled below $50 a barrel to start the new year.

Global financial markets were spooked as investors pondered what lower prices foretold about global growth expectations, and what a precipitous decline could mean for the once-thriving U.S. shale industry.

Janus energy analyst and sector team leader Kris Kelley explains why more volatility lies ahead for energy stocks, and what it means for investors.

OIL PRICES TO REMAIN LOW IN NEAR TERM; MORE VOLATILITY AHEAD

In the near term, we expect slumping oil prices to remain low. A moderating global economy has softened demand growth for oil and it will take several months for energy and production companies to cut back on resilient supply growth in reaction to the current pricing environment. Additionally, seasonal maintenance to U.S. refineries in early spring will further dislocate the supply-demand balance.

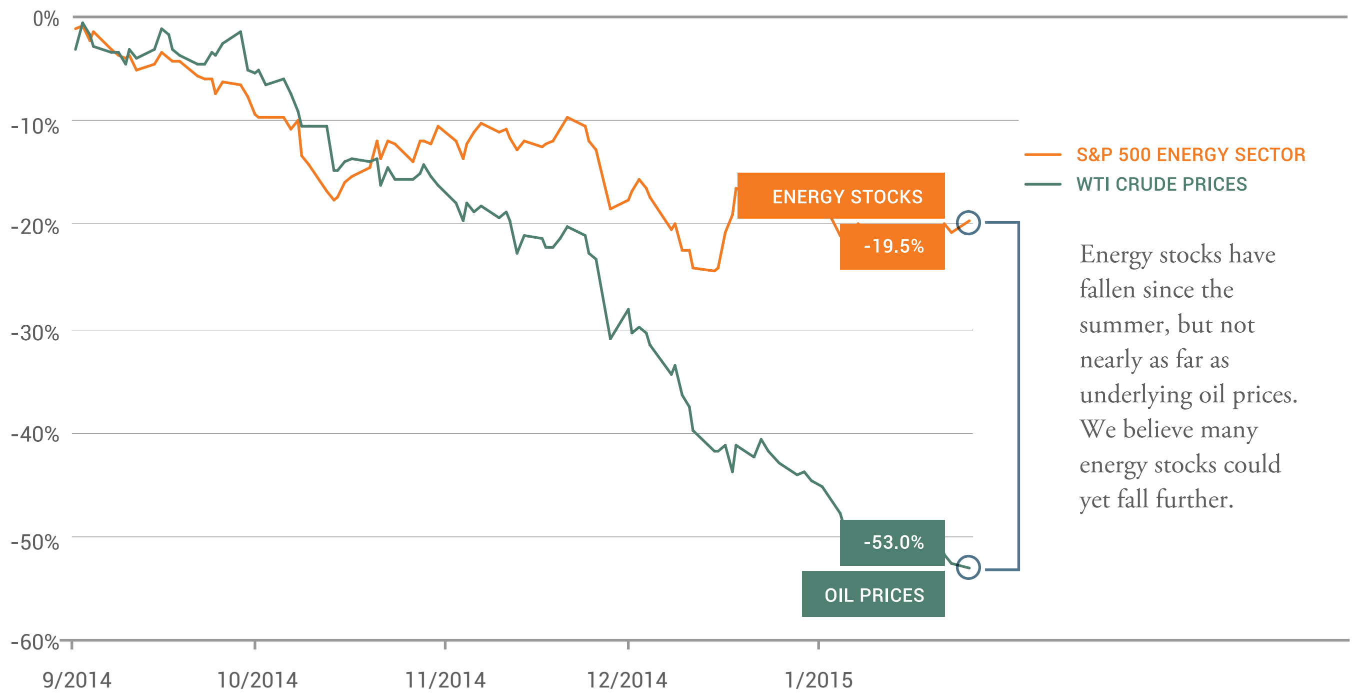
Going forward, we expect oil-related stocks to experience further bouts of volatility. Saudi Arabia has led OPEC members in a decision to keep pumping oil at current volumes, despite lower prices. There are geopolitical incentives for Saudi Arabia to keep prices low. However, the national budgets of other OPEC nations are dependent on producing oil at higher prices. Given the uncertainty over when, or if, OPEC will cut back supply, we would expect more volatility. While energy stocks have already sold off broadly, we think current stock prices imply a sharper, or earlier, recovery in oil markets than we expect. This could heighten volatility if oil prices fall further or remain low for several months.

KRIS KELLEY, CFA
Equity Research Analyst,
Energy Sector Team Leader

"With oil likely to cause more volatility in the future, navigating the energy sector will require a selective approach."

TUMBLING PRICES, FALLING STOCKS

PERCENTAGE DROP IN OIL PRICES AND ENERGY STOCKS



Energy stocks have fallen since the summer, but not nearly as far as underlying oil prices. We believe many energy stocks could yet fall further.

Source: Janus, Bloomberg. As of 1/27/15.

BEYOND 2015: HIGHER OIL PRICES EXPECTED

While we believe prices will remain lower in the coming months, higher oil prices established over the past decade should be sustainable after 2015. Companies operating in areas that are more expensive to drill are cutting capital expenditures in the range of 30% to 40%, which means there will be a lot less oil supply coming out of the ground next year. Further, rapid depletion rates for most existing drilling sites will mean additional drilling is needed. Higher prices will be needed to encourage new production. Finally, over the long term a growing global economy, particularly in emerging markets, will continue to demand more oil.

ENVIRONMENT CALLS FOR SELECTIVE APPROACH

Stock prices have fallen significantly for many exploration and production companies, but have not fallen as far as the corresponding oil price. At current valuations, we still do not believe it is time to jump in and buy energy stocks broadly. In the coming months, however, we do expect the market to begin to differentiate between individual stocks based on each company's sensitivity to oil prices. Investors need to have a thorough understanding of how an energy-related company will be affected by a lower pricing environment, and whether a production company has the balance sheet strength to withstand current low prices.

The drop in oil prices has big implications for stocks outside the energy sector as well. In the industrials sector, lower oil is shaking out a host of winners who benefit from lower input costs, and losers that serve the energy sector and will experience softer demand. In summary, with oil likely to cause more volatility in the future, navigating equity markets will require a selective approach.

THE BEST OF TIMES, THE WORST OF TIMES

THE DROP IN OIL PRICES ALSO HAS BIG IMPLICATIONS FOR STOCKS OUTSIDE THE ENERGY SECTOR

Falling oil prices should benefit the airline and other transportation industries, but may also be a strong headwind for many U.S. industrial companies serving the energy sector.

− INDUSTRIES THAT ARE GENERALLY HURT BY LOW OIL PRICES

Rails
Shipping less crude by rail

Aerospace
While airlines and other buyers have a bigger budget, low oil prices also mean less demand for more fuel-efficient planes

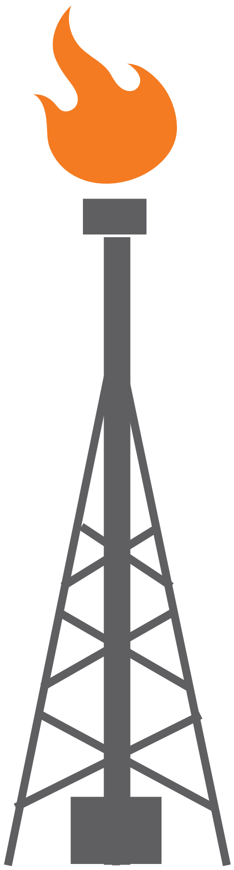
Agricultural Equipment Manufacturers
Cheaper oil means less demand for ethanol, which is made from corn, so there is a knock-on effect of lower agricultural commodity prices

Diversified Industrials
Those companies that supply equipment to the oil and gas industry will experience softer demand

Commodity Producers
Suffer from knock-on effect of other falling commodity prices

Machinery Companies
Machinery companies supplying the oil and gas industry will also experience softer demand

Source: Janus. As of 12/16/2014.



+ INDUSTRIES THAT GENERALLY BENEFIT FROM LOW OIL PRICES

Auto
Cheaper fuel

Trucking
Cheaper fuel

Trucking Equipment Suppliers
Cheaper fuel, larger client budgets

Construction Equipment
A stronger consumer will translate into more construction

Airlines
Fuel is one of the largest input costs

Specialty Chemical Producers
Oil and natural gas are large raw inputs

Housing
Benefits from a stronger consumer

Parcel Carriers
Cheaper fuel, stronger consumer

Tire Manufacturers
Cheaper input costs

PORTFOLIO CONSIDERATIONS

We do not view the recent sell-off as a buying opportunity for energy stocks broadly, as stocks for many oil-related companies could be due for another leg down.

Look for energy companies whose cash flows are less susceptible to a drop in oil prices.
One example is pipeline companies, where the contracts these companies use are not typically tied to the prices of the underlying commodity.

Be mindful of how low oil positively or negatively affects companies outside the energy sector.
Focus on those expected to benefit from cheaper input costs as oil prices fall.

KRIS KELLEY, CFA

Kris Kelley is an equity research analyst, primarily focusing on both the industrials and materials sector, and also the energy and utilities sector, a position he has held since July 2010. Mr. Kelley is also team leader of the energy & utilities sector research team. Mr. Kelley joined Janus in July 2008 as a junior analyst. Previously, he was an equity research analyst intern with Wallace R. Weitz & Co. where he focused primarily on the transportation, financial services and industrial industries. Prior to that, Mr. Kelley worked for Townsend & Associates, Inc. as a senior advisor and investment analyst. Mr. Kelley also served as a Security Forces Staff Sergeant in the United States Air Force from 1998 to 2002.

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Janus Capital Group has a breadth of insights and strategies to help guide clients through 2015 and beyond. Talk to your Janus representative or visit us online for additional insights.

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