APRIL 2016

GLOBAL
SECTOR VIEW

JANUS CAPITAL® Group

Global Sector Views Report

A sector-by-sector outlook from the Janus Equity Team

For four decades, fundamental, bottom-up research has been at the core of the Janus investment process. Our deep team of analysts covers approximately 1,500 stocks around the globe. Each takes a do-it-yourself, unconstrained approach to research. We believe this differentiates us from our peers and drives results for our clients and the investors they serve.

Every quarter, our seven global sector teams share their bottom-up perspective on key themes in the equity markets and how those themes impact their sectors and areas of coverage.

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The opinions are those of the authors as of April 2015 and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes.

2Q16: Augmented Reality

Put on virtual reality glasses and you can enter another world, slay a dragon, say, or soar over the Grand Canyon. Our tech analyst reported recently about something cooler yet. Augmented reality uses a different set of glasses that allows the user to alter the real world. A doctor may be able to visualize a patient's internal organs by blending X-rays with video images or a shopper can view a couch in her house before buying it.

While the technology is promising, the name itself is intriguing. Augmented reality, it seems to us, helps explain global equity markets. The global economy continues to show signs of slow, consumer-led growth. The skeptical suggest that central bank intervention makes that picture no more real than the flight through the Grand Canyon (but with a true fall when the real world returns). We are more optimistic: Central banks are helping but there is underlying strength too. When we one day take off the glasses, the growth will still be there.

Our optimistic view stems from what we are hearing from our company and industry touch points. While we note caution, we consistently hear reports of decent business conditions. Earning reports generally have not disappointed. Consumer companies are focusing on cost controls and innovation to drive revenue growth or to protect margins. The oil sector may have bottomed as U.S. production declines and inventories of refined products diminish. Many biotech stocks are oversold, reflecting the flow of money out of the sector rather than the potential for life-changing medical breakthroughs.

These outlooks, other opportunities and an acknowledgment of the challenges for each sector are inside.

Certainly, risks remain. Negative rates are troubling. Financial firms in Europe will struggle if they persist. Last quarter we warned that oil and commodities were not signs of an impending market fall. Oil rallied with stocks as the quarter ended. We allow that it doesn't prove our point but we are pleased nevertheless, and suggest that from here markets can and should hold up even with a near-term volatility in oil prices.

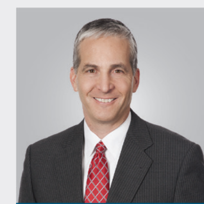
Brexit, the shorthand term for Britain's vote on June 23 on whether to leave the European Union, is likely to bring out volatility. The U.S. election could do the same, especially as Donald Trump progresses with non-specific policy statements. "Win win win" is likely not detailed enough to assuage market jitters. We don't expect a British vote to exit the EU. Polls show the race is close, while the betting lines suggest a defeat. We put our money where the money is. Beyond Brexit, China continues to try its pivot to a consumer-led recovery, and we'll watch how government policy plays out.

The backdrop of modest growth leaves the central bankers at center stage as zero interest rate policies (ZIRP) give way to negative rate policies (NIRP). The ZIRP to NIRP shift startled markets in Europe and Japan and wreaked havoc with financial stocks. Persistent negative rates are problematic for financial firms and for companies overall. With no inflation, companies will find price increases difficult and margins under pressure. Without the power of compounding – Einstein might have been wrong – individuals will need to save more for retirement and spend less. Ultimately, central bank policy is about building confidence so corporates borrow and build things and consumers work and buy things. Low rates only help if confidence follows.

We can see three outcomes. One, China steadies, slowly depreciates its currency and consumer demand holds up, while Europe and the U.S. maintain modest growth. We see this combination as good for equities. Second, the malaise lingers and central banks keep rates low, positive but close to zero. We think equities can hold up here too, although we expect outperformance from companies that are more predictable, higher quality and growing though innovation or capital allocation. Third, China rolls over, negative rates remain in Europe and perhaps come to the U.S., and deflation, and business and consumer activity turns down. The best equity option here is consistent dividend payers offering yield and some defensiveness. Notice how utilities and telecoms held up early this year when markets seriously weighed this scenario and traded down.

The last scenario is possible but not our base case, which leaves us positive on equities. With market valuations, we are not paying a lot for taking these risks, we think. It means that better equity markets for the next few years could be quite real.

Carmel Wellso
Director of Research



Adam Schor, CFA
Director of Global Equity Strategies

COMMUNICATIONS

Mobile search and mobile advertising have reached an inflection point.

Trends & Opportunities

> **A convergence of advertising and commerce simplified the purchasing process on mobile phones.** "Buy buttons" within advertisements and services such as Apple and Android Pay ease mobile transactions. Bigger screens and better apps for mobile use also encourage mobile shopping.

> **Mobile shopping is becoming mainstream, and we hit an inflection point where mobile search and advertising revenues are key drivers of aggregate income growth for some Internet service companies.**

> **Bandwidth demand is growing in a "content anywhere" environment.**

> **Consumers view more content than ever, but viewing habits are shifting.** An increasing amount of content is viewed on demand. Younger audiences are gravitating toward short-form, digital native content. These trends have positive and negative ramifications within the sector.

Risks & Headwinds

> **A tougher macroeconomic environment would be a near-term headwind for any company with advertising-based revenue models.** So far, television and online advertising spending has held up well.

> **The choices for entertainment content have widened.** Skinnier content packages and Internet services such as Netflix and Hulu threaten the traditional cable bundle package.

> **The shift in television viewing is happening faster than distributors and content companies can develop advertising and measurement models around it.** Future advertising revenues for content companies are harder to predict.

Investment Implications

> **We like the opportunity for Internet service companies offering digital advertising platforms.** Large platforms benefit from a positive feedback loop. The scale of their platforms creates enriched customer data that creates more value for the consumer and the advertiser seeking information about them.

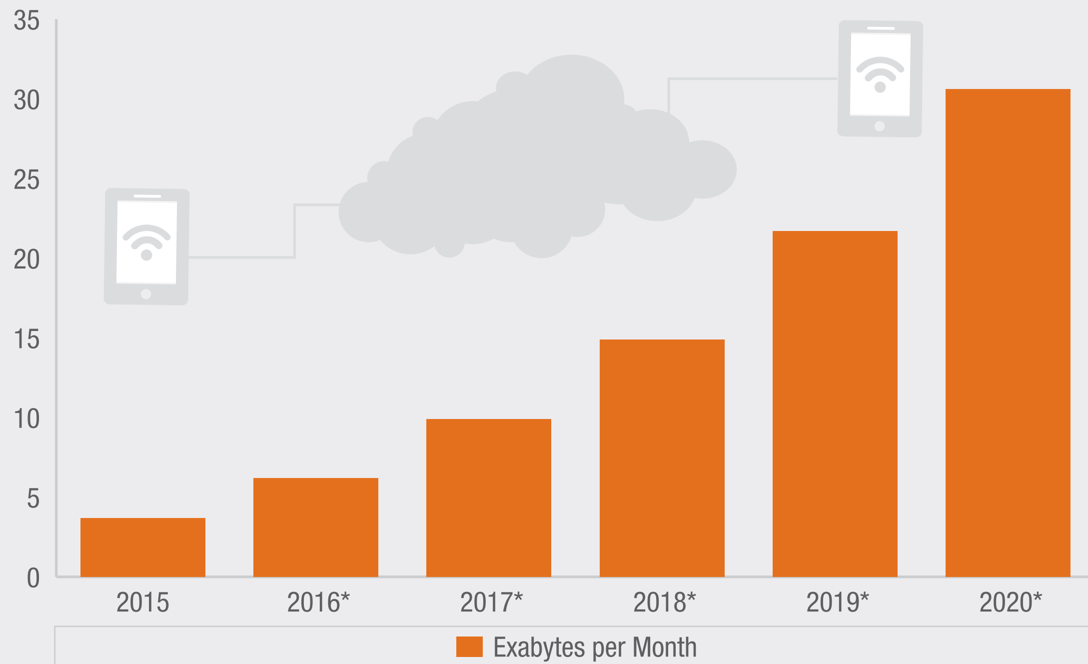
> **We see less upside for traditional media companies.** Changing television advertising models and alternative content packages outside of the cable bundles also make revenue streams for these companies harder to predict. Any cyclical downturn in advertising spending will also hit these companies harder than those focused on digital advertising.

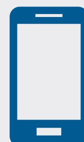
> **We are investing in mobile tower companies.** Such companies provide the infrastructure that allows more video viewing on smartphones and tablets.

> **Among pay-TV distributors, we prefer companies that bundle video services with robust broadband offerings.** These companies are more insulated from the risk of substitute video services because those services require strong broadband capabilities.

Bandwidth Needed

Global Mobile Data Traffic, 2015 to 2020





The growth in mobile data traffic is creating heavy demands for the infrastructure that supports it.

* Estimated
Source: Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update. As of 02/03/2016.

CONSUMER

U.S. home improvement spending continues to grow at a strong pace.

Trends & Opportunities

> **Consumer wallet share has shifted in recent years toward experiences and away from physical goods.** The change happens as social media enriches experiences by facilitating greater sharing with friends and family.

> **U.S. home improvement spending continues to grow at a strong pace.** Rising home values are encouraging households to invest in home improvement projects they delayed after the 2008 Great Financial Crisis.

> **Preference for natural and organic foods continues to increase.** As natural and organic foods become mainstream, specialty organic retailers are losing share to traditional grocers with private label organic products. Organic private label goods are higher margin products for traditional grocers.

> **Product innovation and the desire to be "camera-ready" amid increased social media use drive higher demand for beauty and cosmetic products.**

Risks & Headwinds

> **Revenue growth for packaged food companies remains low, or nonexistent.** Margin expansion helped companies grow earnings in the near term, but we are concerned about topline trends.

> **We see signs of increased promotional activity among consumer staples companies.** We would rather see companies redeploy savings from falling commodity prices to shareholders, rather than increase promotional activity.

> **The strong dollar remains a headwind for U.S.-based consumer staples companies.** Weaker emerging market currencies are particularly damaging for consumer staples companies, as those markets were the predominant source of revenue growth in recent years.

> **The shift toward e-commerce sales is accelerating.** Foot traffic in malls is steadily declining. The price transparency from mobile and online shopping hurts a number of apparel and retail companies. These companies need to make large investments to improve the multi-channel shopping experience, which will damage margins.

Investment Implications

> **Among consumer staples, we favor cosmetics and beverage companies.** Innovation underpins strong sales for these industries. Beauty and beverage products are also avoiding destructive promotional activity.

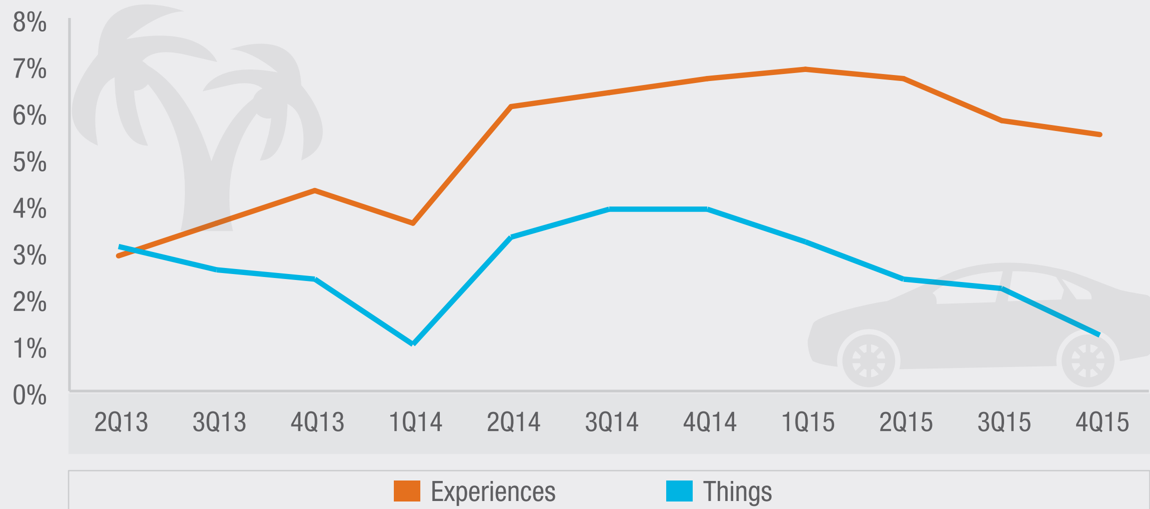
> **We prefer consumer discretionary companies that are less impacted by the migration toward online and mobile sales.** Many of our companies sell products that require a consultative sale, or are too large to ship.

> **We continue to invest in home improvement retailers.**

> **We are investing more heavily in restaurants, select hotels and other leisure and entertainment companies.** Such companies benefit from the gravitation toward spending on experiences.

Shared Experiences

Quarterly Personal Consumption Expenditures (PCE) Changes in Things vs. Experiences



Aided by the ability to share through social media, consumer spending has shifted in recent years toward paid experiences and away from physical goods.

Source: Bureau of Economic Analysis, Janus.

The oil market is moving closer to an upward correction.

Trends & Opportunities

> **We believe we are in the early innings of an upward correction for the oil market.** Inventories will build for the next few months, but U.S. production companies have slashed production budgets. The drop in supply from the U.S. and other non-OPEC producers could go a long way to balancing the market if demand holds.

> **We envision oil prices in the $50 to $60 range by the end of the year.** We are looking for inventories to begin drawing down in the fourth quarter.

Risks & Headwinds

> **Midstream companies may experience reduced volume through their pipelines as U.S. production declines through the remainder of this year.**

> **If prices do trend upward and U.S. production is profitable for more companies, service companies will have a difficult time meeting service demand.** Smaller service companies are struggling to stay in business and are not maintaining equipment to cut near-term costs. Service companies also cut staff levels drastically.

Investment Implications

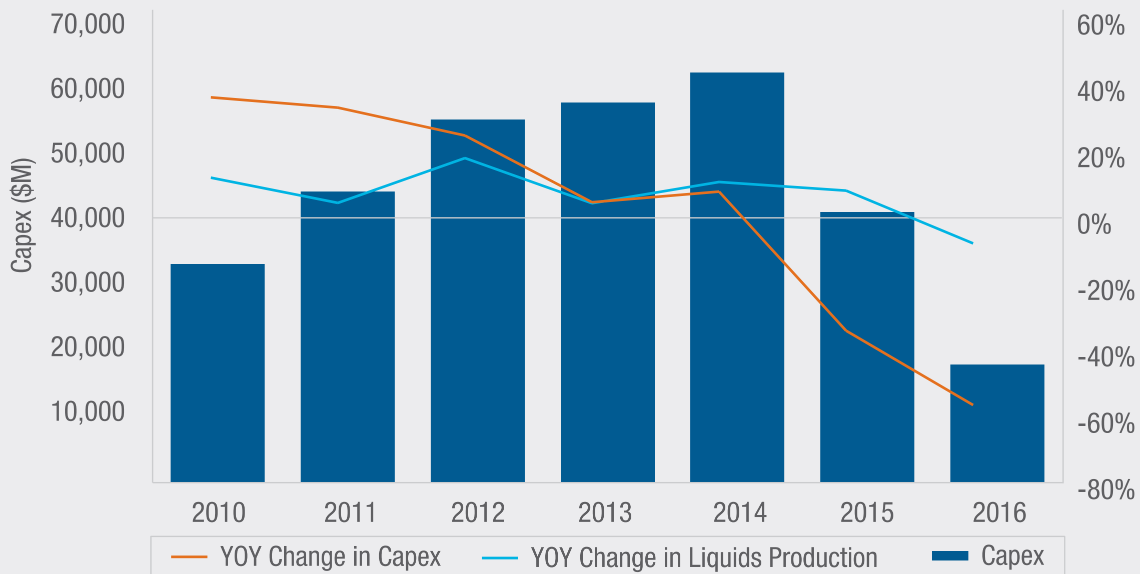
> **We see opportunity in dominant service companies.** When prices recover producers will gravitate toward the larger service companies that can respond faster and with better equipment. We think such companies could have meaningful pricing power in 2017 and beyond.

> **We remain selective with exploration and production companies.** Valuations for many companies already reflect higher oil prices. Our holdings are limited to a few companies that wisely managed capital allocation for shareholders during the downturn. These companies did not dilute shareholders by issuing new equity when prices fell, and are likely to pay down debt when oil prices rise again, rather than putting all cash flow back into drilling.

> **We see opportunity in some pipeline companies.** We have avoided exposure to midstream companies with counterparty risk from lower-quality exploration and production companies. We seek pipeline companies that can maintain steady cash flow in the current low pricing environment due to the minimum volume commitments and take-or-pay associated with their contracts.

Belt Tightening

Projected Cuts to Capital Expenditures by U.S. Production Companies



Low oil prices led U.S. producers to slash capital expenditures in the last two years. Capex cuts don't perfectly correlate to a drop in production levels, but paring back expenditures should still reduce production this year.

Source: Energy Information Administration. As of 9/30/2015.

The migration from cash to credit cards, debit cards and electronic payment remains a strong secular growth trend.

Trends & Opportunities

> **The migration from cash to credit cards, debit cards and electronic payment remains one of the strongest long-term secular growth trends within the sector.**

> **More corporations look to outsource real estate management of their properties.**

> **Demand for insurance products continues to grow in Asia as consumers seek to preserve newfound household wealth.**

> **Financial services companies are finding ways to do more with the data they collect.** Exchanges and index and financial data companies are delivering more and better data and analytics that is in high demand for trading, execution, risk management and compliance purposes.

Risks & Headwinds

> **Earnings expectations for banks retreated in response to a weaker global economic outlook, negative rates in Europe and Japan and expectations of a "lower for longer" rate environment in the U.S.**

> **Weaker capital markets activity should continue to weigh on investment banks.**

> **Many banks' loan exposure to energy companies should negatively impact earnings over the next couple of quarters.** While energy defaults are a headwind, we do not believe they will significantly impair most banks' balance sheets. U.S. banks are already building up reserves to offset those defaults.

Investment Implications

> **We continue to like the theme of growing credit card, debit card and electronic payments.** Payments companies remain some of our largest holdings. We also added companies that benefit from growth in private label cards. Customer loyalty and customer data associated with such cards provide a strong value proposition for businesses to issue specialized cards to their customers.

> **We are investing in large real estate service providers.** Large real estate service providers are gaining market share because of the expertise and breadth of services they offer clients.

> **A sell-off in banking stocks provided selective opportunities in Europe.** Now that stocks have re-priced to reflect a tougher backdrop for banks, we see opportunity in a few high-quality lenders with near-term capital return potential.

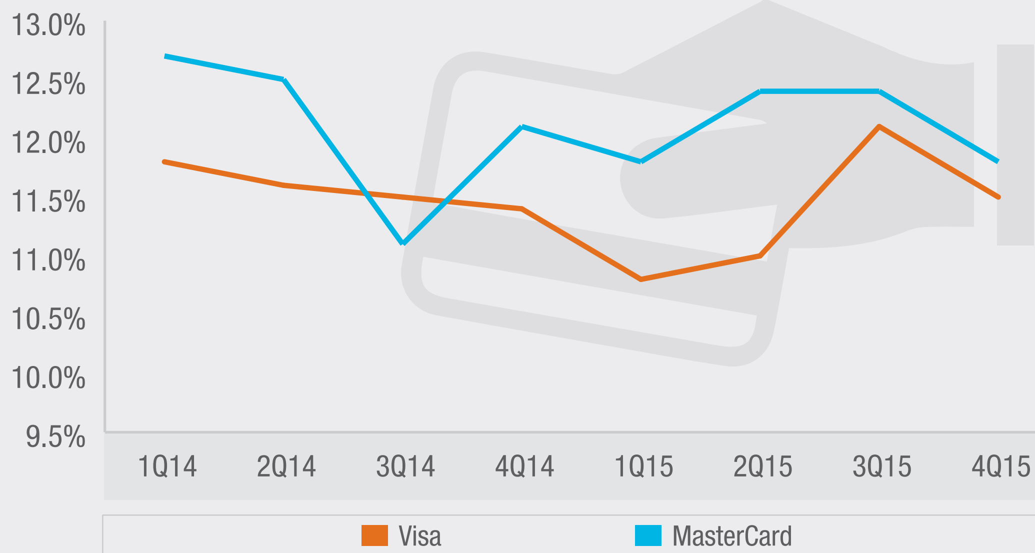
> **U.S. bank holdings we like are focused on banks with good management teams and earning higher or improving returns.**

> **We are investing in global insurance companies with a large presence in Asia.** Brand recognition should help these companies capture market share from smaller, local competitors as demand for insurance grows.

> **We see opportunity in select exchanges, index and financial data providers.** Such companies are improving the data and analytics they create and deliver to clients.

Payments Growth

Year-over-Year Purchase Volume Growth for MasterCard and Visa



Growth trends for the payments industry have remained steady, and well above nominal GDP growth.

Source: Visa, MasterCard. As of 12/31/2015.

Innovation in the sector remains high, and the regulatory environment is supportive.

Trends & Opportunities

> **Innovation leads to promising drug pipelines for biotech and pharmaceutical companies.** New therapies may offer functional cures for many cancers. We also like the potential of new cardiovascular treatments and gene therapies that could address many monogenetic diseases.

> **The regulatory environment for health care companies remains favorable.** Drug approval rates remain above historical norms. Last year saw the highest number of novel drugs approved by the FDA in nearly 20 years. The regulatory review process for medical devices is also speeding up.

> **After a pause in deal activity, merger and acquisition activity should pick up again this year.** Larger companies look to fill pipelines by acquiring innovative therapies. However, target companies may need some time to adjust to the reality of lower valuations after the recent sell-off in biotechnology and pharmaceutical stocks.

Risks & Headwinds

> **Drug prices have drawn scrutiny in an election year.** Increased attention to pricing means companies will self-regulate and avoid aggressive price increases on newly acquired drugs. Over the long term, we expect market mechanisms, not government intervention, to govern drug prices.

> **Drug payers are delaying access to drugs for some subsets of patients.** A consolidated number of drug payers (pharmacy benefit managers and insurers) are delaying access to some drugs for select subsets of patients. Delayed access does not hurt every company. We believe access issues will affect those companies whose drugs are not differentiated from competing treatments. Payers will still make available (without significant restrictions) drugs providing a material advantage over current standards of care.

Investment Implications

> **We own many biotech and pharmaceutical companies developing innovative therapies.** We closely evaluate the science behind therapies to determine their likelihood of clinical success, while conducting our own analysis to determine the potential market size of new drugs. We feel these are matters the market frequently gets wrong.

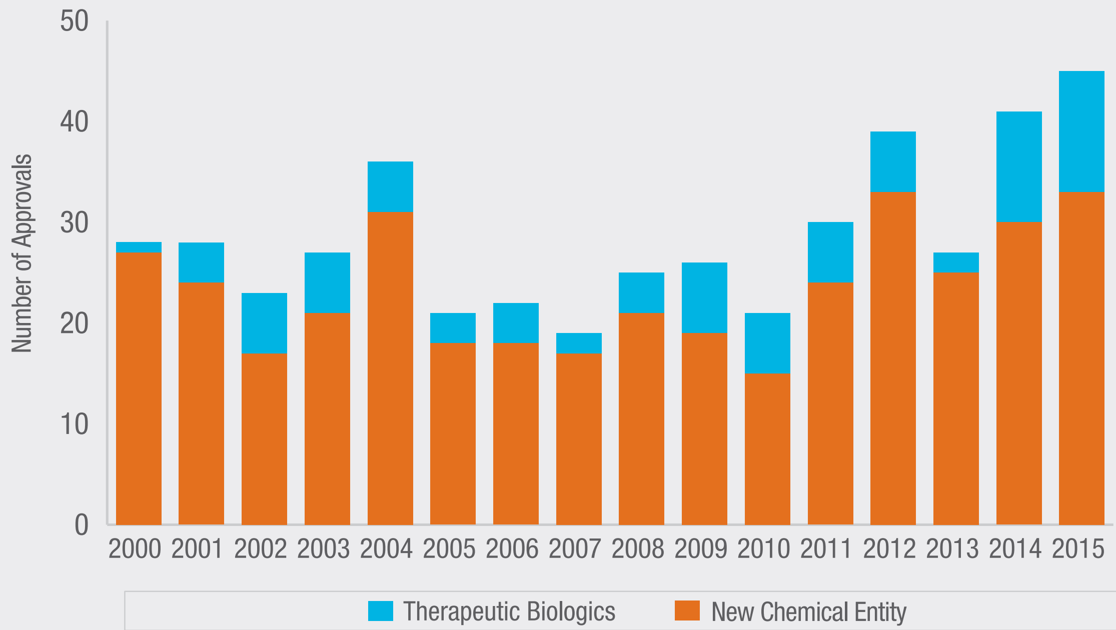
> **Political rhetoric around drug prices does not change our outlook for our biotech and pharmaceutical holdings.** We expected a more moderate pricing environment for some time. Companies with innovative therapies will experience earnings growth primarily from volume increases, not aggressive pricing.

> **We see limited potential for many insurance companies.** We have limited our holdings to select companies that have the most exposure to highly profitable and fast-growing end markets.

> **We are investing in medical device companies using advanced technology to create differentiated, life-saving products.**

Innovation Continues

Novel FDA Drug Approvals by Year



Innovation in the biotech and pharmaceutical industries is leading to the devlopment of many new therapies, as evidenced by the high rate of novel drug approvals over the last few years.

Source: Washington Analysis. As of 12/25/2015.

For multinational industrial companies, headwinds in Europe are abating.

Trends & Opportunities

> **For multinational industrial companies, headwinds in Europe are abating.** Companies report slow demand growth in Western Europe. The stabilization of the euro also removes another headwind to earnings for U.S.-based multinationals.

> **In the U.S., a period of inventory destocking is closing.** Monthly sales growth for U.S. industrial distributors turned positive. This is a good indicator of future industrial demand.

> **Merger and acquisition activity remains high.** Muted growth prospects and more reasonable valuations underpin M&A interest.

Risks & Headwinds

> **In China, fixed asset investment is decelerating.** The outlook remains healthy for industrial companies tied to Chinese consumers.

> **Demand from the energy sector could be due for another leg down.** The completion of projects started before prices turned negative helped sustain some demand from the energy sector. The backdrop for some industrial companies will weaken further as energy companies slash capital expenditures.

> **Emerging market currency weakness continues to negatively impact multinationals.** It is worth noting, however, that Europe is a much bigger market for U.S. large-cap multinationals than emerging markets. As noted above, currency headwinds from Europe are abating.

Investment Implications

> **In China, we see limited potential for machinery companies.** Our holdings in China are limited to industries tied to consumer demand. Examples include companies serving the auto and aerospace industries.

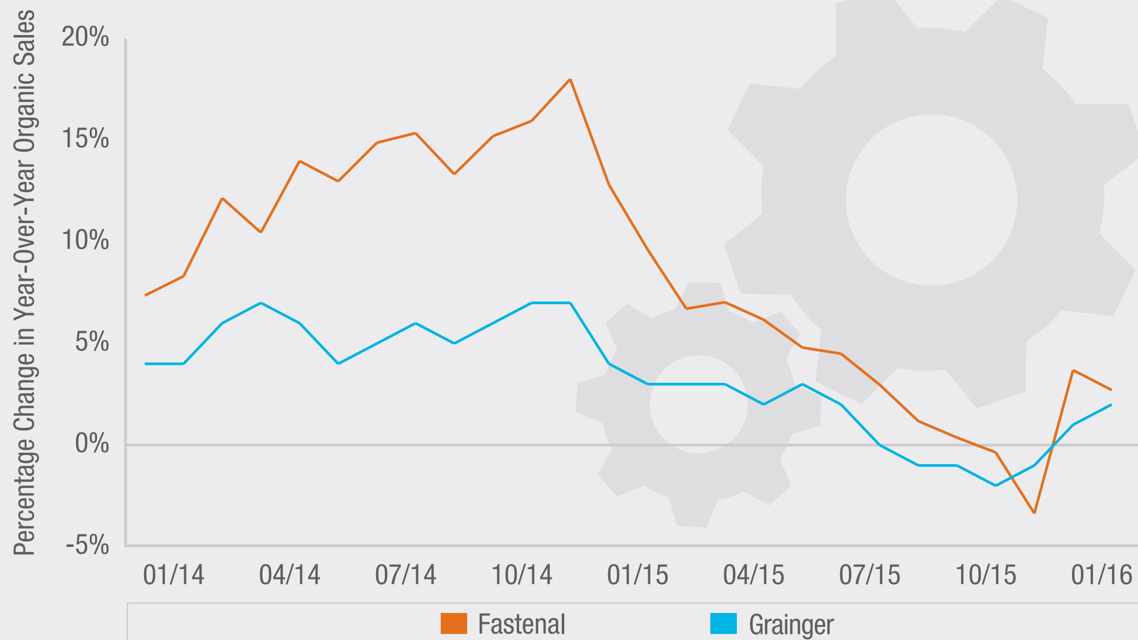
> **We are investing in auto suppliers more than automakers.** Many auto suppliers have higher margins, less competition and more product differentiation than automakers. Auto suppliers benefit from both strong vehicle demand and the spread of high-tech applications within the car.

> **Our exposure to the energy sector is limited to industrials serving midstream and downstream companies.** Midstream and downstream companies do not need high oil prices to maintain projects.

> **Within the materials sector, we see limited potential for metals and mining companies and other companies heavily exposed to commodity prices.** Instead, we favor materials companies serving industries such as aerospace, where the demand cycle is much longer.

U.S. Industrials Reach Bottom

Change in Year-Over-Year Sales for U.S. Industrial Distributors Grainger and Fastenal



Sales are ticking up for industrial distributors, a sign that demand from industrial companies has troughed.

Source: Janus.

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TECHNOLOGY

Several factors are speeding companies' transition to the cloud.

Trends & Opportunities

> **Businesses are quickly transitioning hardware, servers and on-premises data centers to the cloud.** Security concerns about on-premises data centers, the favorable economics of software-as-a-service (SaaS) models and the quick adoption of Microsoft Office 365, which is critical to many business functions, are hastening this transition.

> **Companies with SaaS-based solutions are establishing themselves as the platform of choice for different business verticals.** IT spending is shifting from broad IT departments to individual business units. As the same time, cloud-based companies are creating an array of solutions to meet the various needs of a specific business department such as marketing, sales or finance.

> **The bubble that popped in the private sector benefits public technology companies.** As the private market dries up, the M&A market for public companies is opening. Concerns about private market funding have also led to less spending and hiring by private companies, and taken wage pressure and competition for talent off public companies.

Risks & Headwinds

> **PC, tablet and smartphone markets have matured.** This has led to weaker demand for a number of semiconductor companies and other suppliers.

> **We believe the market continues to underestimate risks for legacy tech companies.** Many companies tied to desktop computing or enterprise hardware trade at high valuations due to the perceived safety of large cash reserves or high dividend payments. However, profit pools for these companies are eroding and we believe there is a limit to how long financial engineering can hold up valuations.

Investment Implications

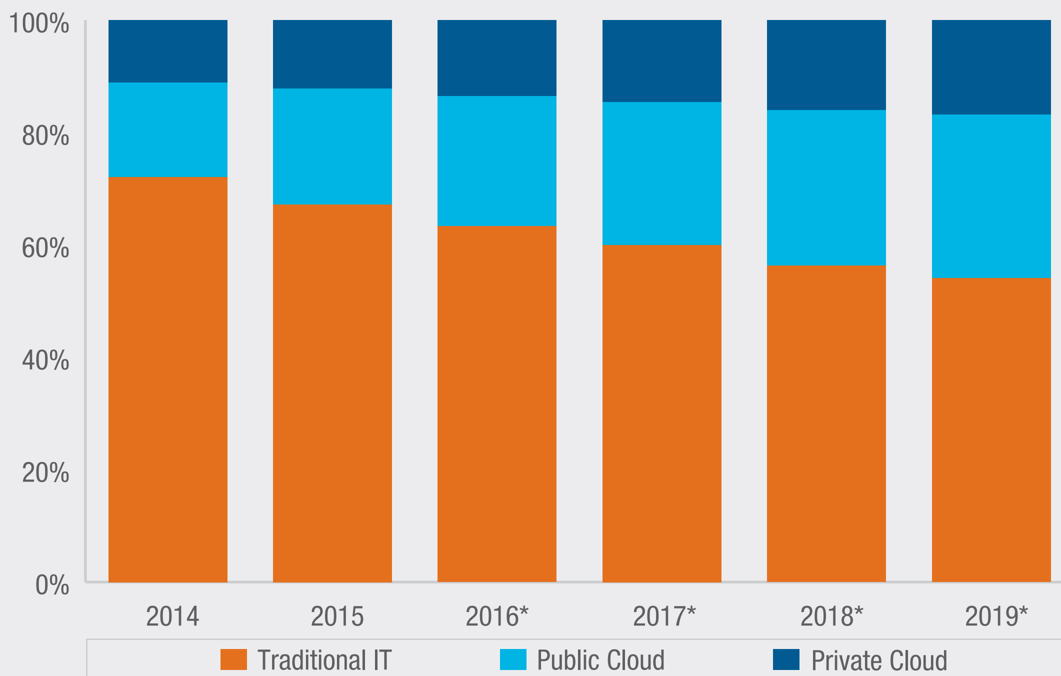
> **We used weakness in cloud and SaaS stocks as an opportunity to invest more in these companies.** High-growth companies with low current-period earnings sold off in tandem during February, but the fundamentals for these companies remained unchanged. We believe some truly disruptive – and attractive – companies overcorrected.

> **We are investing in semiconductor manufacturers that are less dependent on smartphone growth.** Smartphones make up a portion of revenues for nearly every semiconductor company, but the companies we hold serve growing end-markets such as health care, communications or autos.

> **We have largely avoided large, legacy technology companies.** We believe risk for these companies is underpriced.

Cloud Rising

Worldwide Cloud IT Infrastructure Market Forecast by Deployment Type, 2014-2019



Businesses are quickly migrating to the cloud from on-premises data centers.

** Indicates estimated data.*

Source: IDC Worldwide Quarterly Cloud IT Infrastructure Tracker Q2 2015.

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- Invest with our clients' interests first.
- Develop a deep understanding of the companies we research.
- Employ a strong valuation discipline focused on quality growth.
- Develop independent and differentiated views on our companies, supported by in-depth primary research.
- Spend as much time thinking about what could go wrong as about what could go right.
- Take a long-term view.
- Seek to anticipate change, don't just analyze it.
- Attract the best and brightest analysts in the business, and foster an environment in which they can succeed on behalf of our investors.

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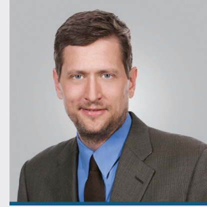

TECHNOLOGY
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