

SPRING 2016

GLOBAL
OUTLOOK



JANUS CAPITAL®
Group

Stronger Banks Weather a Challenging Environment

THOUGHTS AND BONDS: MACRO VIEWS FROM THE JANUS FUNDAMENTAL FIXED INCOME TEAM

Fundamental-Informed Macro Views

Fundamental, independent research has been at the core of the Janus Fixed Income process for over 25 years. While many competitors rely on government statistics to form a top-down view, we focus first on company, issuer and security level fundamentals. We believe this approach differentiates us from our peers and other macroeconomic data providers. Our comprehensive, bottom-up view drives decision making at the macro level, enabling us to make informed sector and risk allocation decisions.

Each quarter we share our global outlook and provide insights on emerging investment opportunities and risks.

ABOUT JANUS FUNDAMENTAL FIXED INCOME

- ▶ **Over 25 years of experience focused on risk-adjusted returns and capital preservation**
- ▶ **Integrated fixed income and equity research**
- ▶ **Quantum Global: proprietary investment research and risk management system**
- ▶ **Highly collaborative, non-siloed team based in Denver and London**
- ▶ **35 fixed income investment professionals**
- ▶ **\$35.6 billion in assets under management as of 12/31/2015**

The opinions expressed are those of the authors as of March 2016 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.

“Our fundamental analysts are paying close attention to developments not only in the financial sector, but also energy – as prices attempt to regain their footing – and sectors that have exhibited an elevated level of shareholder-friendly activity. In aggregate, we see sufficient risks to merit the continuation of our defensive stance, with an emphasis on portfolio liquidity.”



DARRELL WATTERS
HEAD OF U.S. FUNDAMENTAL
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A Word from our Fundamental Fixed Income Team

Global fixed income markets continue to face a convergence of challenges and GDP growth remains stuck in low gear. Recent shifts in monetary policy by major central banks add another layer of uncertainty to an already ambiguous macroeconomic environment. As we near the end of the credit cycle, stretched balance sheets and other shareholder-friendly initiatives, along with low market liquidity, have increased the level of concern among fixed income investors.

These challenges are manifesting within the banking sectors of several regions, as evidenced by the early 2016 sell-off in banking-related fixed income securities and stocks. While banking credits have retraced some of their recent losses, spreads to risk-free benchmarks remain at levels not seen since 2013 in Europe and 2012 in the U.S.

The health of banks is of particular importance to investors, not only due to the sector’s prominent weighting in global credit indices, but also the role these institutions play within the broader economy by allocating

capital to its most efficient use. As such, any hurdles faced by banks – whether it be unfavorable lending conditions or a more restrictive regulatory environment – could inhibit future economic growth.

Our fundamental analysts are paying close attention to developments not only in the financial sector, but also energy – as prices attempt to regain their footing – and sectors that have exhibited an elevated level of shareholder-friendly activity. In aggregate, we see sufficient risks to merit the continuation of our defensive stance, with an emphasis on portfolio liquidity. Such positioning enables us to effectively manage through periods of elevated market volatility and provides us with the ability to transition to more neutral or opportunistic positioning as conditions merit. We believe that our patience will be rewarded. This approach also aligns with our core tenets of capital preservation and delivering attractive risk adjusted outperformance.

! KEY TAKEAWAYS

- ▶ Credit demand from European consumers has been a rare source of economic growth for the region. The baton must now pass to businesses for growth rates to accelerate. The confidence of company managers to increase debt loads will be a major step in achieving this.
- ▶ Banks in both Europe and the U.S. face a challenging environment due to flattening yield curves and increased capital requirements that may disincentivize expanding credit portfolios.
- ▶ Higher capital requirements, on the other hand, have largely served to fortify bank balance sheets.

Healthy Banks: A Key Ingredient for Accelerating Growth

Given European businesses' reliance on loans rather than securities markets for raising capital, the recent pressure experienced by the continent's banks could portend additional difficulty for the region as it seeks to extricate itself from the aftermath of its sovereign debt crisis. While the European Central Bank's (ECB) late entry into the realm of quantitative easing (QE) may have been a necessary step in its fight against deflation, it does no favors for the profitability of the region's banks. Since the beginning of the year – in the wake of the ECB's December policy misfire – the market's expectation for additional easing sent yield curves lower across the eurozone. Lower yields, especially on the longer end of the curve, can be detrimental to net interest margins (NIM) – a key profitability measure for a bank's core lending business.

Italy's **Intesa Sanpaolo** reported that its full-year 2015 net interest income fell 6.5% compared to the previous year, as Italy's sovereign yield curve flattened during the period. The bank's NIM fell to 1.2% in 2015 compared to 1.6% for the prior year. Similarly, Germany's **Deutsche Bank** expects its deposit products to suffer from the low interest rate environment in 2016.

Lower bank profitability is not solely a eurozone phenomenon. While the UK's sovereign curve stayed relatively stable in 2015, it has since flattened considerably, with the yield on 10-year Gilts declining from just below 2% in December to as low as 1.3% in February before nudging back toward 1.5%. With the expectation that Gilt yields will remain low, UK bank **RBS** recently stated that it expects low interest rates to remain a challenge in the short to medium term.

Pressure from rates is likely to be acutely felt by southern European lenders where a large majority of mortgages within the region are "floating rate." This means they periodically reset to lower levels as benchmark rates fall, squeezing bank margins along the way. Such unfavorable conditions may lead some banks to conclude that extending new loans is not worth the balance sheet risk, given more stringent capital requirements. Concern for the health of banks may have been evident in the ECB's decision to launch a new series of targeted longer-term refinancing operations (TLTRO II) aimed at incentivizing banks to lend by providing them with an extremely low cost of funding.

WHERE IS THE GROWTH?

Implicit in the TLTRO program is tepid demand for credit across much of Europe's economy. Company management teams have shown a reticence to borrow in the absence of a durable recovery in demand for their end products. Adding to their caution is the slow pace of structural reforms, especially with regard to labor markets. In his March statement, ECB President Mario Draghi reiterated the limitations of monetary levers in catalyzing growth and implored political leaders to take steps to ease the burden on segments of the economy overly encumbered by regulations.

Also weighing on the prospects for banks is the slowing global economy. Referencing trade as a central driver to German growth, Deutsche Bank stated that external headwinds held back business investment in the country during 2015. It did, however, cite low oil prices, expansionary monetary policy and increasing consumption as reasons for optimism. In fact, the bank expects revenues from credit products to grow on the back of continuing consumption and a selective expansion of its loan book.

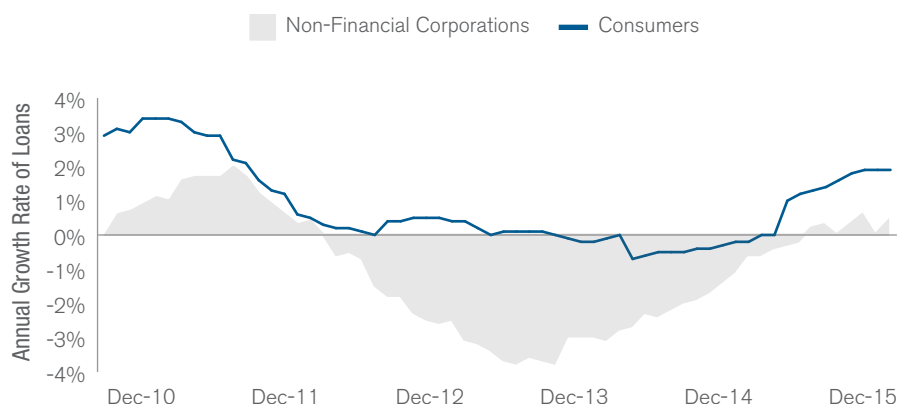
Italian lender **UniCredit** echoes these rising expectations. The company's German

division saw new commercial loans grow by roughly 25% between 2014 and 2015. Although much smaller in absolute terms, UniCredit registered new residential mortgage growth of nearly 50% in Germany during the same period. A more confident consumer is also evident in the Netherlands, where **ABN AMRO** reports an improving residential mortgage business. Mortgage originations within the country rose 28% in 2015. A renewed appetite for mortgages has resulted in home prices having risen 7% off their 2013 low, although they remain 16% below their 2008 peak. The Dutch bank also has the benefit of its home market being dominated by fixed rate mortgages, meaning that – unlike its southern European peers – they are less susceptible to the contracting margins brought on by flattening yield curves. In aggregate, Dutch consumer spending has registered solid improvement since mid-2014, according to ABN.

Outside the eurozone, a similar story is unfolding. RBS booked 29% more gross mortgage originations in 2015 versus the prior year. This translated into a 10% gain in its stock of personal and business mortgages to 105 billion British pounds. Yet, as with its continental peers, the bank reports a weaker environment for corporate lending, with growth coming in flat for loans to UK nonfinancial businesses.

Eurozone Loan Growth by Market Segment

Consumers have shown a greater willingness to borrow than have regional businesses.



Source: European Central Bank. As of 01/31/2016.

SIGNS OF LIFE IN SOUTHERN EUROPE

After having endured painful fiscal adjustment and the accompanying contraction of the economy, credit demand is once again showing signs of life in southern Europe. Pointing to a slowly repairing economy is Intesa Sanpaolo, which, in 2015, saw the slowest inflows into nonperforming loans (NPL) since 2007. Overall, the bank's NPL stock declined for the first time since the beginning of the crisis. In Italy as a whole, the bank states that 29,000 businesses have exited NPL status over the past two years. The relevance of this decrease is put into perspective by Intesa's citing of an International Monetary Fund study, which estimates that for every one percentage point a country's NPL ratio exceeds 6%, credit growth falls by 80 basis points (bps) and 20 bps is detracted from GDP.

Intesa expects positive developments to continue. Management believes government reforms have already had a meaningful impact on the economy and that reforms currently in the pipeline may add an additional two percentage points to GDP in five years.

Healthy Banks: A Key Ingredient for Accelerating Growth

CONTINUED

Italian consumer and business surveys reflect this improving sentiment as the former touched a multidecade high earlier this year and the latter reached its highest level in eight years last autumn. More tangibly, lending to businesses and households has reached its highest level since 2012 and, at 1.1%, year-over-year growth in private consumption reached a 4.5-year high in the third quarter of 2015. UniCredit's performance within its home market reinforces improving conditions. Commercial loan growth rose by 21% in 2015, with flows into residential mortgages and mid-size corporate loans climbing 19% and 20%, respectively.

In Spain, which was the epicenter of the continent's real estate excesses, years of austerity and reckoning with falling asset values is starting to show signs of paying off. Spanish bank **BBVA** expects loan loss provisioning and impairments attributable to its real estate portfolio to decline once again in 2016 after having decreased by 24% and 33%, respectively, between 2014 and 2015. As with its Italian peers, BBVA is starting to see loan growth in its home market. Increasing loan demand from consumers, and to a lesser degree businesses, may contribute to banks' growth prospects by increasing volumes and compensating for the low NIMs, which are a consequence of flattening yield curves.

THE COSTS AND BENEFITS OF IMPROVED CAPITALIZATION

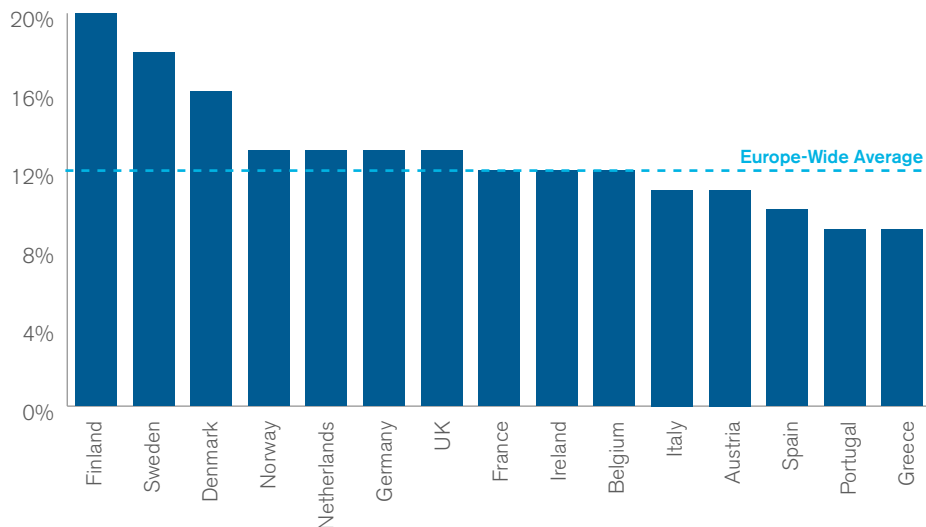
The indiscriminate widening of bank credit spreads over the past several months may not have factored in the small but measurable improving prospects for demand in bank products. They also likely overlooked the sector's more robust capital position. Improvement can be seen in rising common equity tier 1 (CET1) ratios, an important measure of bank capitalization. Since the beginning of 2013, ABN's CET1 ratio rose from just above 10% to 15.5% in the fourth quarter of 2015. RBS saw its CET1 ratio rise from 8.6% in 2013 to 15.5% at the end of last year. Improvement is even being recorded in southern European institutions. UniCredit's CET1 ratio in the fourth quarter was 10.9% compared to 10% at the end of 2014, and BBVA's registered 10.3% with management aiming to increase it to 11% by mid-2017.

Higher bank capitalization is largely the goal of more stringent regulatory requirements. While these mandates may buttress balance sheets – something important for bond investors – they may disincentivize risk taking, thus impeding credit transmission into the real economy. Both BBVA and Deutsche Bank expect regulatory pressure to continue to influence how the banks approach risk management. The latter organization has characterized 2016 as a year of restructuring, a part of its “Strategy 2020” aimed at simplifying the bank, decreasing risk and improving capitalization. Across the industry, many banks are jettisoning non-core businesses so that their risk profile falls within tighter regulatory parameters.

Some regulatory developments, however, should benefit banks. During the winter, the Italian government took steps to launch an NPL transfer scheme to aid banks still burdened by suspect loans. Should the program be effectively executed, it has the potential to not only spur lending, but also lead to much-needed industry consolidation. At present, the fragmented nature of Italy's banking sector is the opposite of the Netherlands, where it is dominated by a few players that have the scale to navigate the low-margin lending environment and the increasing cost of regulatory compliance.

Common Equity Tier 1 Ratios of Select European Countries

Southern European banks lag their northern peers in strengthening capital ratios.



Source: European Banking Authority. As of 09/30/2015.

U.S. BANKS: MISPLACED CONCERNS

Banking sector credit spreads have also widened in the U.S., though for different reason than in Europe. Recent pressure on these credits, however, may not fully reflect the sector's condition. As with other segments of financial markets, a recent driver has been the collapse in oil prices. While many energy producers face potential defaults, much of their funding was sourced through debt capital markets rather than loans. Where banks do have credit exposure to energy, the risks appear manageable.

Energy accounts for only 6% of **Zions Bancorp's** loan portfolio. While expecting to incur energy losses during 2016 and even beyond, management expects these to be controlled and its reserve level toward these loans sufficient. Indirectly, energy may impact Zion's business via its commercial real estate (CRE) exposure in Texas. In Houston, specifically, CRE loan growth has seen a dramatic drop-off. As with its energy portfolio, Zions expects to safely navigate this development, namely due to strong collateral, cash flow support and risk hurdles put in place when originating such loans.

Citigroup has also taken steps to buttress itself against weak energy prices. The bank has increased the loan loss reserves of its energy portfolio. Should crude prices stay above \$30 per barrel, Citigroup is comfortable with the level of its reserves. Also aiding the company is its energy exposure being concentrated in multinational companies and a majority of its borrowers having an investment-grade credit rating.

Similar to their European counterparts, U.S. banks have also improved their capital positions over the past several years. Contrary to some of the tailwinds invigorating the sector in Europe, U.S. banks may be developing a more cautious stance. A strengthening dollar has negative implications for export-oriented borrowers and commercial real estate in gateway cities. Another risk is that while consumption has been a solid contributor to growth, the lack of other sources and doggedly weak wage gains may cause bankers to determine that it may not be prudent to further expand their loan portfolios.

Probing the Outer Reaches of Accommodative Monetary Policy

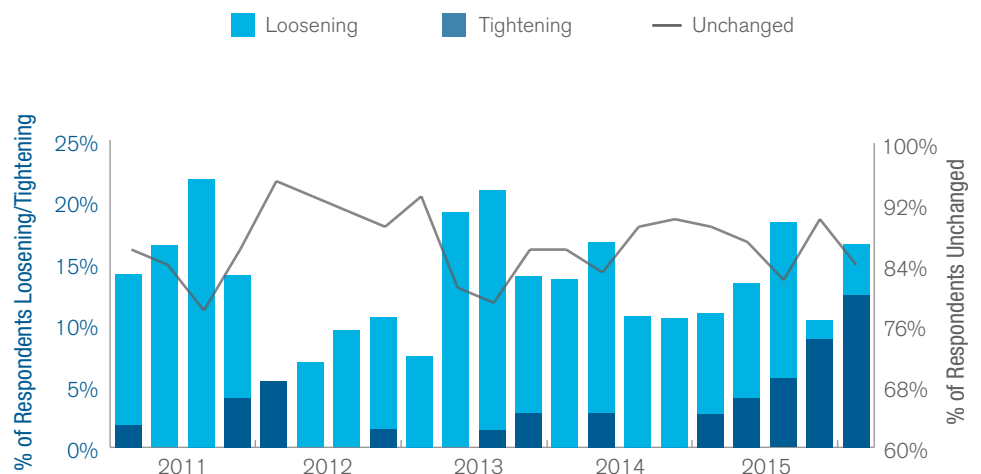
UNITED STATES

The March meeting of the Federal Reserve (Fed) may have been a seminal moment in clarifying the trajectory of the U.S. economy over the next several quarters. Prior to the meeting, the Fed's outlook for GDP growth, inflation expectations and interest rate hikes exceeded that of the market. By lowering its forecasts to more closely align with market consensus, the Fed admitted its disappointment with sluggish wage growth and concern for a continued slowdown of the global economy. While the Fed chose not to raise interest rates at this meeting, the fact that it did so in December may imply its recognition that market-based inflation expectations – with five-year breakevens roughly 1.3% at the time – could be the maximum amount of inflation it expects the U.S. economy to generate. Otherwise, raising rates with inflation still well below its 2% target would seem to contradict the Fed's posture of being data driven.

Even with the expectation of only two rate hikes in 2016, the U.S. remains one of the higher yielding countries among its developed market peers. As an attractive destination for capital, U.S. Treasury yields may be capped for the near term. Another implication of the country's positive relative value may be continued upward pressure on the U.S. dollar. This continues the trend that began in mid-2014, a period in which the dollar has appreciated by more than 20% as measured against a basket of developed market currencies. As a result, a post-crisis competitive advantage – a weak currency – has turned into an impediment. Heavy equipment producer **Caterpillar** highlighted the stronger dollar when discussing the challenges it faces when competing with firms based in countries with weakening currencies.

Federal Reserve Senior Loan Survey Hints at Rising Caution

Since early 2015, a greater number of banks have begun tightening lending standards to businesses.



Source: Federal Reserve, Bloomberg. As of 01/31/2016.

Within the U.S., growth remains low by historical standards. As a result, management teams have undertaken a series of initiatives to boost earnings and share prices. Last year set a record for merger and acquisition activity. The duration of this shareholder-friendly activity leads us to believe that we are in the later stages of a credit cycle. We believe it plausible that credit agencies are behind the curve in recognizing deteriorating balances sheets, and not just within the hard-hit energy and mining sectors. While those sectors have been the source of widening spreads of high-yield credits, the rise in investment-grade credit spreads that began last summer has been, in our view, the result of a large amount of new issuance, which topped \$1.3 trillion during 2015.

DEVELOPED MARKETS

Growth rates among developed markets remain narrow and, for the most part, the upper boundary of such growth continues to decline. Both the European Union and Japan are combatting disinflation, with the aim of escaping a debt-deflation downward spiral. The extraordinary measures recently undertaken by the ECB and Bank of Japan (BOJ) highlight the importance of spurring a sufficient level of inflation to grow out of their debt overhang. The suppressed demand caused by disinflation would magnify the demographic headwinds both economies face.

Fortunately, European consumers have shown an increasing appetite to spend. Still, more help is needed. So far, Mario Draghi's appeals for structural reform and fiscal stimulus have fallen upon deaf ears. He soon, however, may gain allies in this quest. Political parties running on anti-austerity platforms made gains in recent elections. As countries such as Spain, in which these parties are active, have already improved their fiscal position, they may be able to implement a certain degree of stimulative fiscal policy, which has the potential to enable the business sector to join the consumer in driving growth.

We recognize that only a handful of countries, including Spain, Portugal and Ireland, have made headway in fiscal adjustment and structural reform. This was largely due to them having been forced to under conditions of rescue packages. Larger countries in need of reform, such as Italy and France, have done little to liberalize their economies.

We continue to be mindful of the political risks permeating Europe. Of greater potential consequence than the recent Scottish secession vote is the so-called "Brexit" referendum slated for this summer, in which the UK will vote on whether it wishes to remain a member of the European Union. Additionally, the rise of not only anti-austerity parties but also populist parties harboring anti-immigration sentiment weighs on Europe's political future.

Japan faces a daunting task of spurring growth. Even by the standard of two decades of accommodative policy, recent initiatives have been impressive in scale. By extending the maturity of government bonds the BOJ is buying, the central bank has been able to materially flatten the sovereign yield curve. Despite such monetary initiatives, the necessary complements of structural reforms have been lacking. After much promise, key tenets of so-called "Abenomics," named after Prime Minister Shinzo Abe, have yet to make headway against entrenched economic interest.

! KEY TAKEAWAYS

- ▶ The Fed's March decision to lower expectations around its interest rate hike trajectory may take some steam out of a strengthened U.S. dollar, which has acted as an impediment to corporate growth over the past several quarters.
- ▶ ECB President Mario Draghi, while extending his organization's asset-purchase program, has stayed on message about the need for structural reform within the eurozone to create an environment conducive for durable growth.
- ▶ Slower-than-expected Chinese growth has had an indirect impact on global fixed income markets as levered commodities exporters have seen their growth prospects and debt coverage ratios deteriorate.

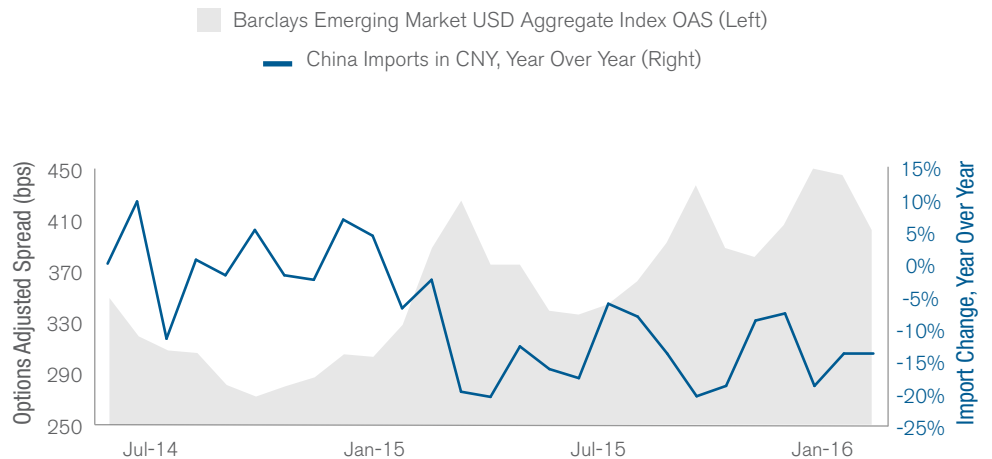
EMERGING MARKETS

Given the role emerging markets played as the marginal source for global growth in the post-crisis years, any material slowdown merits our attention. This is especially the case as developed market growth trajectories remain underwhelming. China's slide toward sub-7% GDP must be put in perspective; while not in the elevated range registered during the investment-led, post-crisis years, the country's growth rate still far outpaces those of other major economies. We believe the country's transition to a consumer-led economy will continue, though not without hiccups. Last year's yuan devaluation and recent weakness in the currency may hint that officials may, in the short term, continue to rely upon an export-led model. We are mindful of the increased leverage in China's system, especially among the provinces and state-supported enterprises. While local debt markets are largely closed to international investors, a debt crisis could have a significant impact on the country's finances and growth prospects.

The weak commodities price environment has created a bifurcated universe among emerging markets. Net importers of raw materials, including China, India and Turkey, have been beneficiaries. Major commodities exporters such as Russia and Brazil have seen their exports, currencies and foreign reserves punished. The situation is magnified with not only companies, but also countries, that have recently relied upon leveraged business models.

BBVA has experienced a slowdown in its Chilean and Peruvian divisions. It views Mexico as more resilient, though it slightly downgraded its forecasts for that county on account of potential weakness in exports to the U.S. **Citigroup**, on the other hand, still regards Mexico as a bright spot within emerging markets, as it does India. The bank has also wound down its commercial portfolio in Brazil, given that country's stagnating economy. Outside of financials, **Fiat** and **Caterpillar** expect a material slowdown in Brazil.

Emerging Market Bond Spreads and Chinese Imports Drifting Apart While known for exports, China's softer appetite for imports is hurting finances of emerging market commodities producers.



Source: Bloomberg, Barclays, National Bureau of Statistics of China. As of 03/24/16.

Defensively Positioned



PORTFOLIO POSITIONING: DEFENSIVE

- ▶ Conditions in fixed income markets continue to merit defensive positioning. Shareholder-friendly initiatives and an increase in credit downgrades indicate the later stages of the credit cycle. Low market liquidity, disjointed energy market fundamentals, and the uncertain path of global economic growth also present concerns. Given these risks, we maintain an active approach to duration and yield curve positioning with a focus on capital preservation. Our focus remains on higher-quality corporate issuers with strong fundamentals.



SECURITIZED

- ▶ We utilize agency MBS as portfolio ballast, seeking spread over Treasuries while maintaining similar risk levels. We focus on generic agency pass-throughs with high coupons, high loan-to-value (LTV), and pre-payment resistance.
- ▶ We are opportunistically investing in ABS and CMBS, focusing on those that we believe have strong underlying assets, cash flow stability and favorable optionality. In our view, single-asset, single-borrower deals provide more attractive relative value opportunities than conduit (i.e., multi-loan) deals.



DEVELOPED & EMERGING MARKET SOVEREIGN CREDIT

- ▶ We maintain exposure to the sovereign debt of the peripheral European countries that have shown a commitment to structural reform. The recent rise of anti-austerity parties on the continent merit concern as backsliding on reform could impede future economic growth.
- ▶ We have minimal exposure to emerging market debt, but recognize that a material slowdown in Chinese economic growth would have profound effects on its trading partners, especially those that supply the country with raw materials. A weakening yuan may provide an ephemeral boost to Chinese growth, but would also complicate the accommodative monetary policy of global central banks by adding to disinflationary pressure.



TREASURY

- ▶ We believe Treasuries can act as "insurance" to spread products, especially when we find credit risk/return profiles unattractive. Treasuries are also utilized to adjust portfolio duration. In the current market environment, we favor longer-dated Treasuries to hedge the risk of our shorter-dated corporate exposure. We view short-duration Treasuries as a source of liquidity, potentially enabling us to take advantage of strong risk-adjusted opportunities presented by price dislocations.



CORPORATE CREDIT

- ▶ Historically low interest rates have prompted a flurry of shareholder-friendly activity, financial engineering and increased leverage. Favorable borrowing terms have enticed management teams across many sectors. In many cases, this increased debt has become problematic as global growth falls short of expectations. Resource companies that issued bonds when commodity prices were high and debt was cheap are now struggling to meet their obligations, resulting in an increase in ratings downgrades.
- ▶ We are concentrating our holdings in what we believe to be higher-quality companies with solid free cash flow and management teams demonstrating balance sheet discipline. Our energy exposure is focused on issuers that can withstand lower oil prices. Security avoidance remains an important tool.
- ▶ We are navigating low market liquidity by seeking higher-quality credits with shorter- and intermediate-term maturities. Our shorter-term Treasury positions provide a source of liquidity, helping us to potentially take advantage of opportunities in fundamentally sound corporates presented by potential price dislocations.



YIELD CURVE / DURATION*

- ▶ Sluggish global growth and global deflationary concerns will likely result in lower rates for longer. While the Fed has recently lowered its expected trajectory of rate hikes to better align with market consensus, we still foresee additional bouts of volatility over the course of the year.
- ▶ Given the heightened volatility, our focus remains on defensive positioning. Our corporate credit duration remains skewed to the short- and intermediate-segments of the curve, reflecting our concerns over liquidity and continued volatility among lower-rated issuers.
- ▶ We are largely keeping duration in line with the benchmark. Our level of duration contribution is reflective of our defensive stance.

* Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to interest rates, all else being equal.

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There is no assurance that the investment process will consistently lead to successful investing.

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