



**JANUS CAPITAL<sup>®</sup>**  
Group

# **4Q15 JANUS EQUITY OUTLOOK**

Ski Report | Variable Conditions, Take It Slowly

We're happy to be away from Wall Street and the consensus views of crowds. And on winter weekends, we're happier yet to be in the heart of ski country. In our regular equity outlook, we combine investing and skiing to map the current market terrain. Like a ski day, markets offer a mixture of riskier paths and easier ones. We'll point out the positive and negative themes driving equities, and tips to navigating those themes more effectively.



Black runs are themes that present key risks to equity markets. Be careful and alert before proceeding.



The blue runs highlight issues that are less dangerous, but not without pitfalls. These are attractive runs but proceed with care.



Green runs signal easier paths, but watch for crowds and stay away from the pack.

# The Black Runs



- > China: How big, how bad?
- > Pressure on oil and industrials
- > Volatility: Expect an increase

The impact of China on the global economy is the biggest risk facing equity markets today. We'll look into the issue within our outlook, but while it is a risky run, it is not impossible to traverse. In the U.S. the oil sector and the spillover into industrials is worrisome. Finally, with an uncertain path on interest rates and, of course, with China, we expect volatility to increase in the coming months.

# The Blue Runs



- > Earnings growth leads U.S. markets
- > Japan: Treating shareholders well in slow economy
- > Emerging Markets: China casts shadow on some markets, but not to India

More attractive, but not without problems, is the importance of earnings growth in U.S. markets. A focus on earnings growth should favor fundamental analysis, provided that investors find the right companies that are creating ways to grow. Japan has the appeal of more shareholder focus but a sluggish economy makes the micro of stock selection more important than the economic call. In emerging markets, China is clearly a worry but there are paths in India and even within China that are challenging but rewarding. A blue run is less dangerous than a black, but you have to pay attention and work.



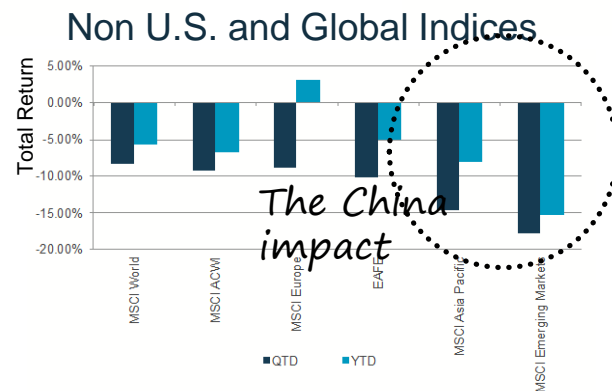
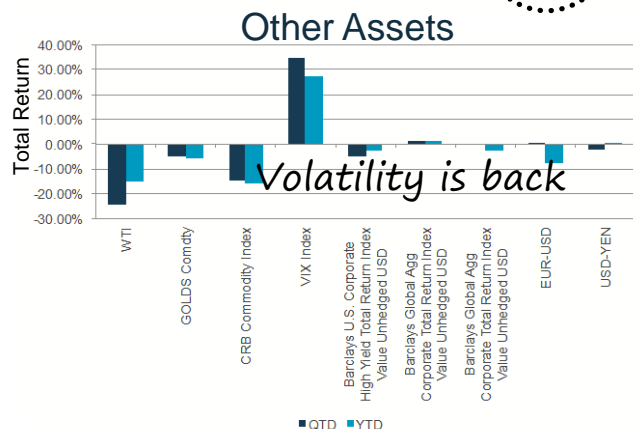
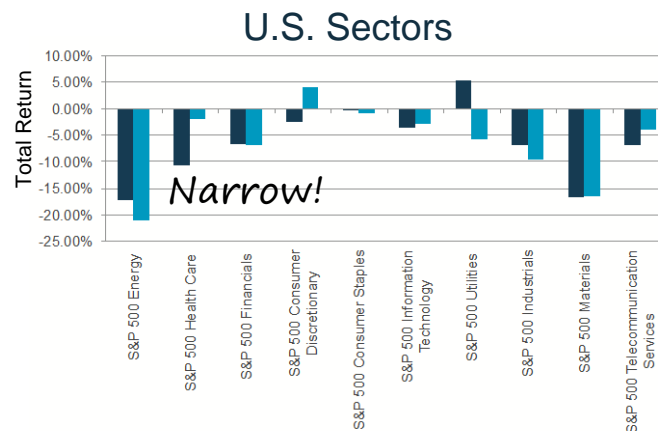
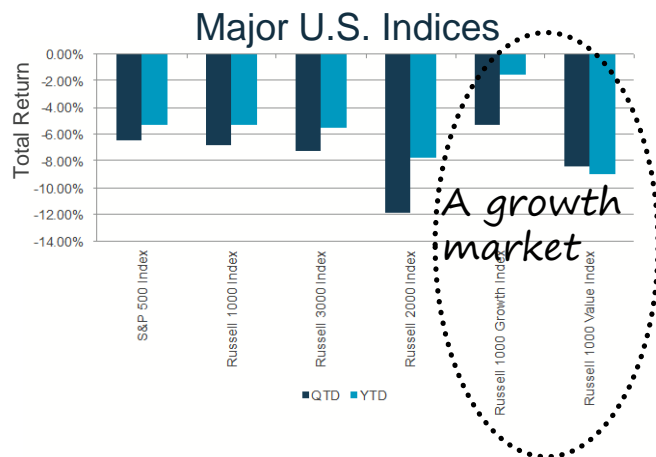
# The Green Runs



- > Europe: Leverage to an improving economy
- > U.S. Consumer: Stronger, smarter and buying
- > Health Care: Innovation makes getting older better
- > Merger and Acquisition: Buy your growth here

Green runs are cruisers, what we see as easier paths – at least compared with the prior themes. Europe's recovery is taking hold. The U.S. consumer is another bright spot. One of our favorite sectors remains health care – and we don't think the government policy will knock us off track. Finally, merger and acquisition (M&A) activity continues to be the visible hand driving investment returns and reshaping industries.

# The Ride So Far



The third quarter was a poor one, making for a poor year so far. A few items stand out: Growth remains in favor over value. And we think that will continue. It is a narrow market: Only two sectors are positive year to date. While energy and industrials are not our favorites, we think other sectors are not disadvantaged and therefore performance could widen. It has been a momentum driven market too, which we think explains the narrowness and the growth bias. If momentum becomes less important, as it naturally should, then the performance of other sectors could improve. Outside the U.S., only Europe is up this year, and China is pulling down Asia and emerging markets overall



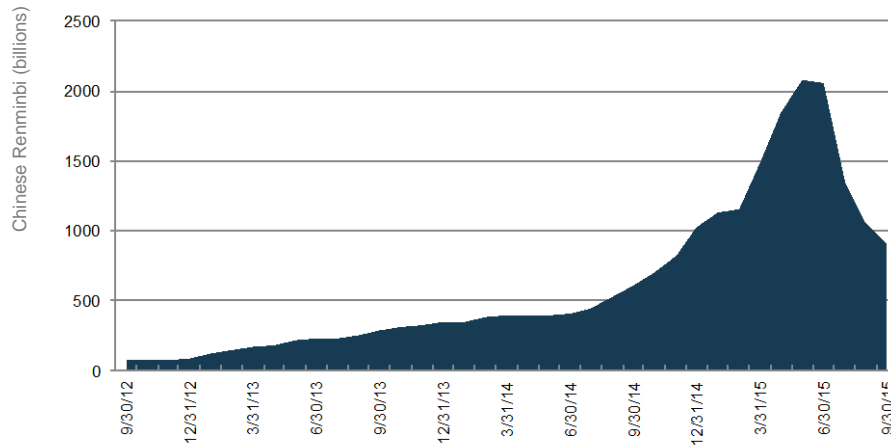
# The Black Runs

Black runs are themes that present key risks to equity markets. Be careful and alert before proceeding.

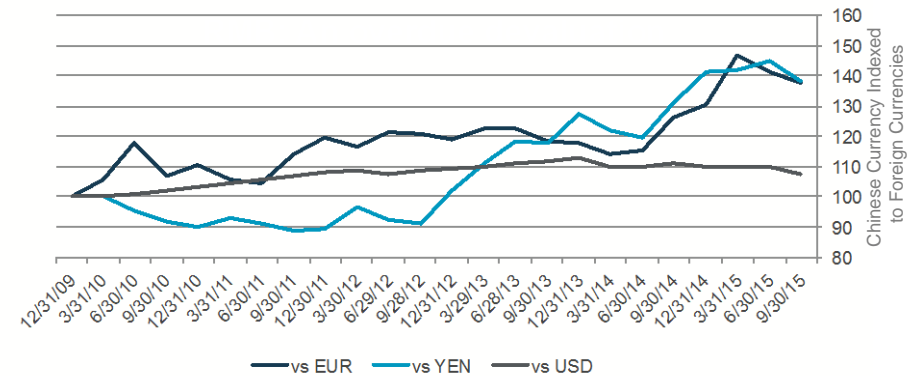
# The China Threat



## Margin Trading in China (by RBM)



## Overdue devaluation



The risks in China are the economy and the currency, which naturally are related. The A-share market fell sharply this summer and that made headlines. We do not, however, view this market as a leading indicator for the economy. It was a bubble, fueled as shown above by margin spending and old fashioned greed. Therefore, we do not think the fall in the market portends a massive economic slowdown.

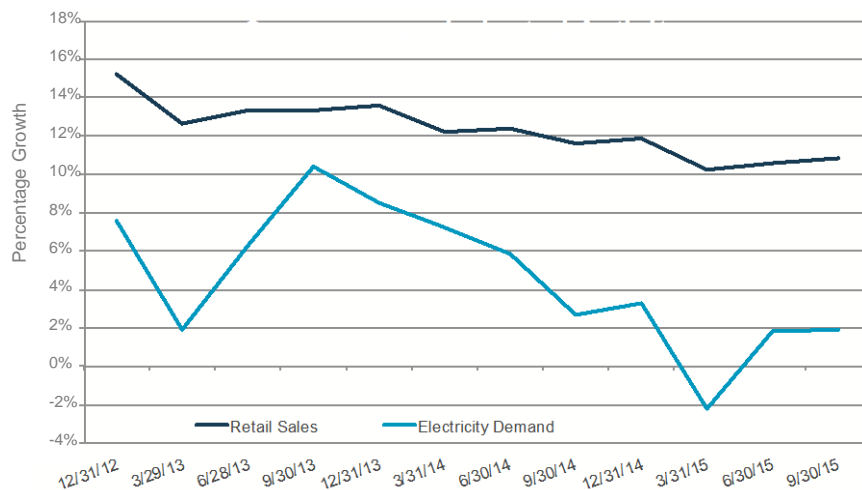
Meanwhile, the devaluation is more meaningful. It reflects a slowing economy but it also is probably overdue considering how the yuan had strengthened against the euro and yen, and, even until recent years, against the dollar. China, which is still an export-oriented economy, was losing competitiveness. The question is where the yuan goes from here. There's a compelling argument that China wants it to weaken further, but it's likely to be a gradual rather than sudden process. If the yuan moves sharply, however, we're afraid the market would see a signal that China's economy is slowing sharply and that the country is pulling out all stops to right the ship. The currency matters because it was the devaluation and not the slowing economy that really spooked the market, in our view. The slowing pace of growth as the country moved toward a consumption-driven economy was clear from looking at industrial measures, such as electricity usage or even the PMI. Against this backdrop, however, we are seeing decent strength with the Chinese consumer. We also think the government has the tools – beyond devaluation – to keep growth in the economy.



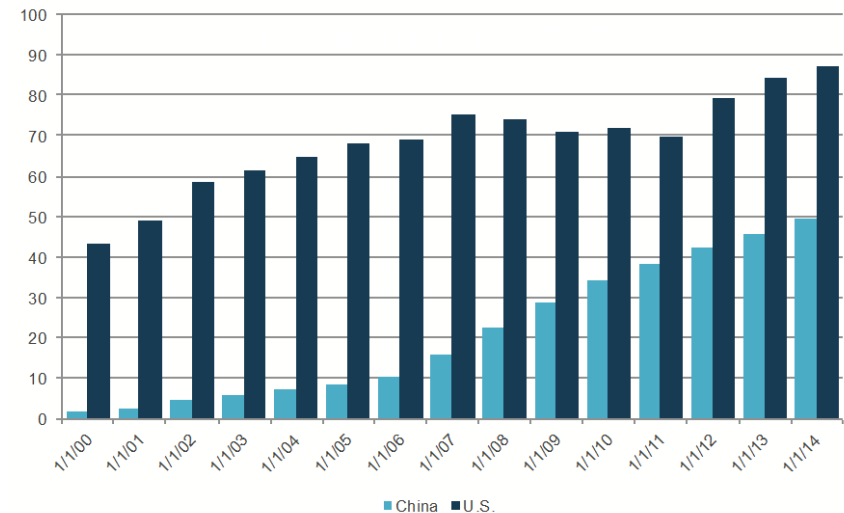
# Ski Tip: Focus on Consumer



## Consumer vs. Industrial Activity



## Internet Users Per 100 People



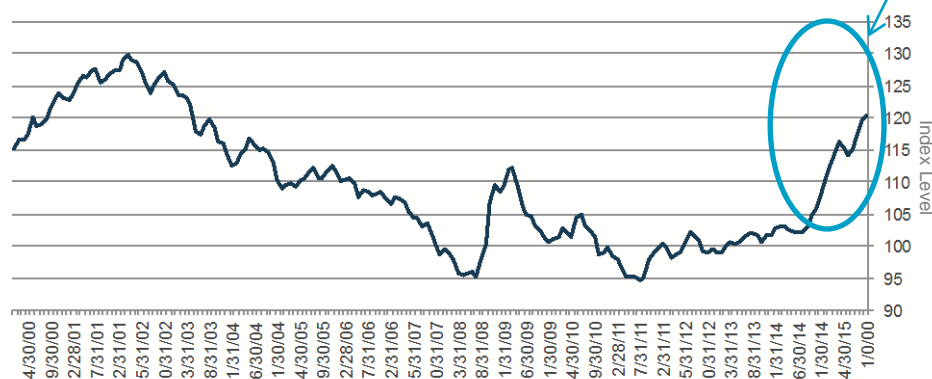
## Way Down

What to do: China is an economy in transition toward the consumer. Despite a slowdown in the industrial and manufacturing sector, the Chinese consumer remains in decent shape. China's labor market remains tight and wages are increasing. Household balance sheets are healthy and retail sales also are holding up. Meanwhile, certain areas such as online services and social media, are robust. Smartphones and tablets are changing consumer habits in China. The point is that while China could be a tough environment for investors and a source of volatility in coming months, it still offers investors some longer term themes where it makes sense to have some exposure.

# Pressure on Oil and U.S. Industrials

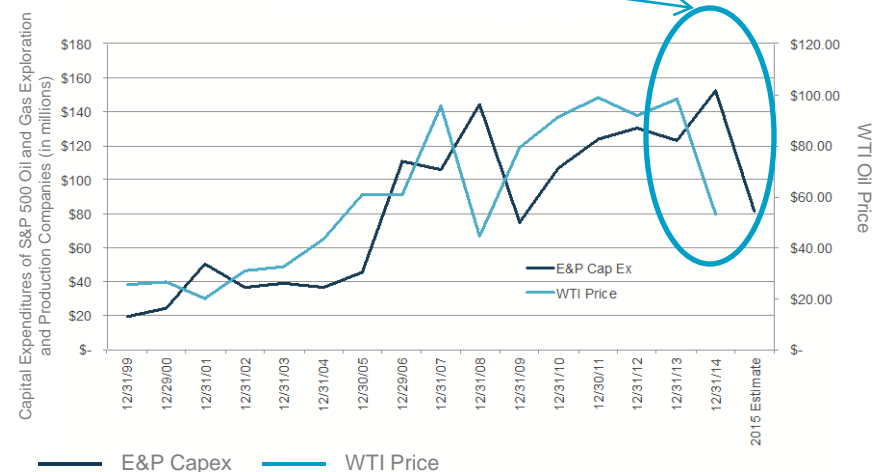


Trade Weighted USD



Steep and difficult

Oil Price and Energy Capex



— U.S. Trade Weighted Broad Dollar Index

— E&P Capex — WTI Price

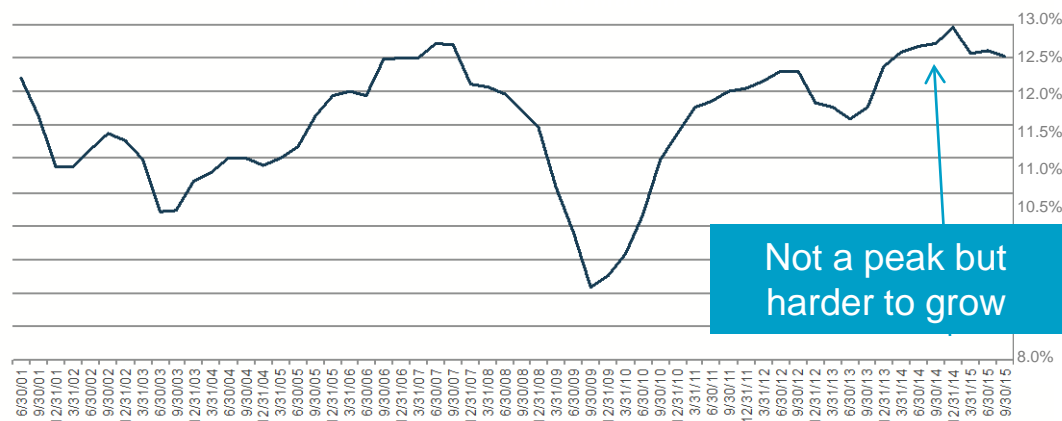
It is tough to get excited about the energy sector or about U.S. industrial companies. U.S. oil producers have reduced expenditures, but the oil market remains oversupplied because of efficiency gains, high-grading and completions of previously drilled wells. Eventually these cuts will be meaningful but it probably won't be until 2016 or even 2017. Furthermore, longer term the world needs U.S. shale production, making companies reluctant to cut dramatically. Capital expenditure (Capex) budgets naturally follow pricing so, while it is not our base case, a short-term speculative price rise could turn supply back on, with longer term negative implications. We see the oil sector as more speculative and volatile as we work through the supply and demand imbalance.

A weak oil industry and the strong dollar are difficult for the industrial sector. Even companies with small direct exposures to oil exploration and production (E&P) companies are feeling pressure as competitors price more aggressively to replace the lost E&P business. Meanwhile, China's manufacturing slowdown directly impacts U.S. industrials. There are glimmers of hope – such as European operations and housing and autos in the US – but these do not outweigh the problems of energy, China and the dollar.

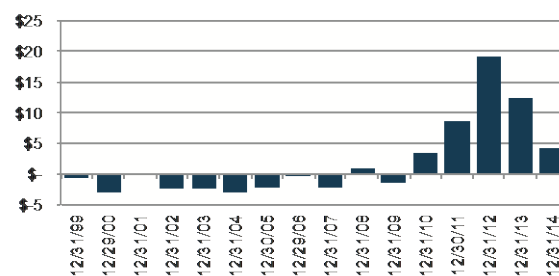
# Ski Tip: Seek Self-Help, Price Insensitivity



## Industrial Operating Margins



## Price Spread Between Brent & WTI Oil



Good for refiners

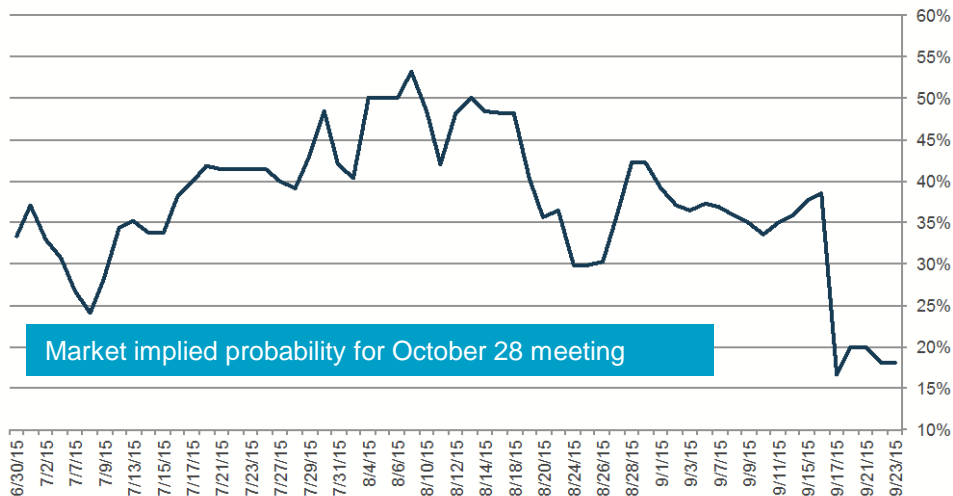
## Way Down

There is a way down, however. For oil, we prefer companies less sensitive to low oil prices, such as refiners, mid-stream companies and master limited partnerships (MLPs) – even with rising rates. If investors take a longer view, some service companies could be attractive because the valuation is compelling and the longer-term competitive prospects are good for select companies as the industry emerges from the slowdown consolidated, and with resumed pricing power. For industrials, without a growth environment, companies need to find their own sources of growth. Margins can still grow in the U.S. but, as we show later, they can grow more sharply in Europe. And some companies still have cost cutting or industry consolidation to help propel earnings.

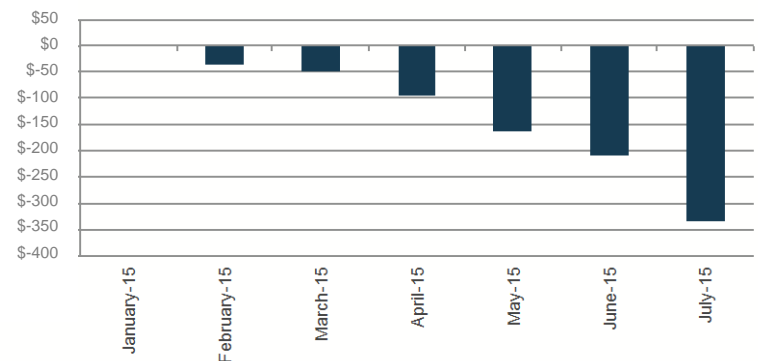
# Volatility on the Rise



## Expectations of 25-50 Basis Point Rate Hike



## Asset Flows Out Of China (in Billions)



Fears about global economic growth and uncertainty about U.S. monetary policy have brought volatility back to the market after a long lull. As the chart shows, the Fed faked out the market and these shifting expectations create instability. Fed Chairwoman Janet Yellen was clearer in a subsequent speech and the market rallied. We don't think a Federal Reserve (Fed) move – as long as it is gradual and data dependent – is a problem for equity markets. It might indeed be a strong positive signal.

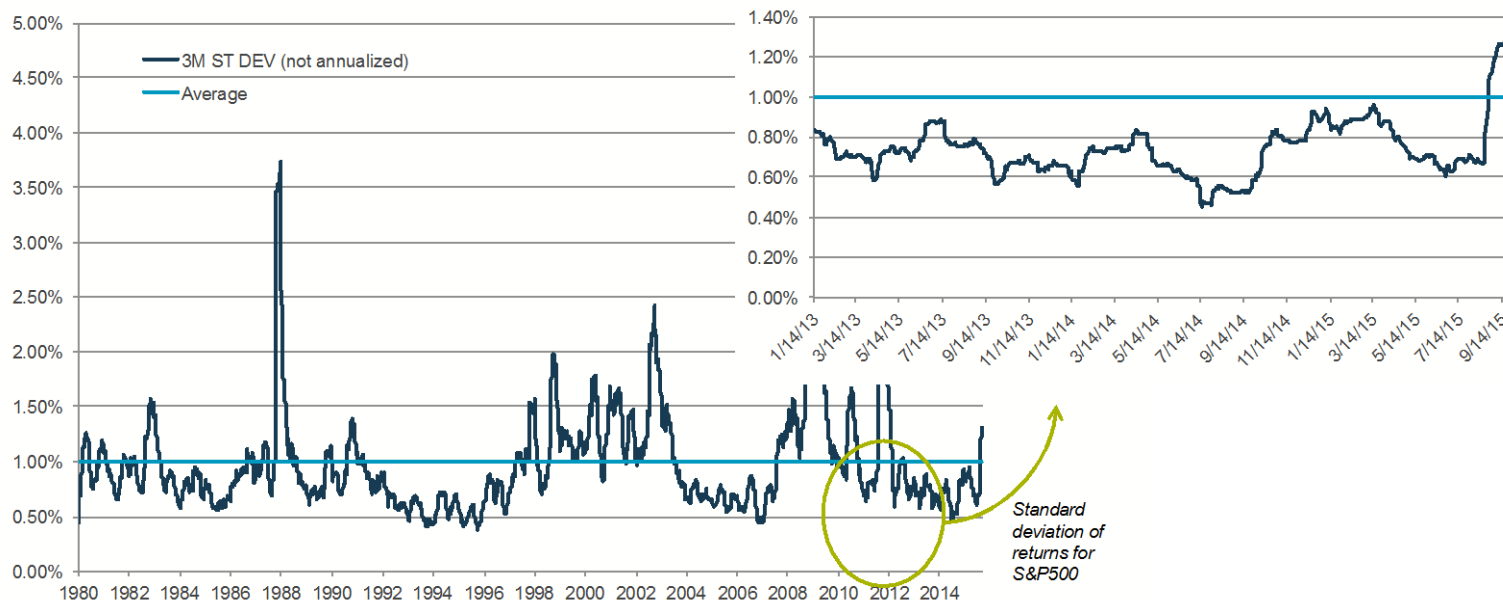
Meanwhile, the volatile market has led to a momentum based market and flow of funds is a factor. The chart on the right shows money pulling out of China, but we saw volatility influence asset allocations and trading strategies too. That may have boosted volatility. Given that China is far from settled and Fed policy undetermined, we would not be surprised to see more volatility, more momentum influence and more disruptions to fundamental investing over the short term.



# Ski Tip: Keep Perspective



Rolling Three-Month Volatility



Past performance is no guarantee of future results.

## Way Down

It is important to keep the volatility in perspective. It remains about average, even including the peaks from the 1987 crash and from the great financial crisis. We show the standard deviations of daily equity returns of the S&P 500 Index, which is the measure of market volatility. While volatility has increased of late, it is actually still in line with or even low relative to historical norms.

In environments of increased volatility, the stocks punished hardest are those where the path to earnings growth is less certain. This is particularly true for small- and mid-cap equities, where market sentiment had been more complacent during a risk-on environment over the last few years. Companies with a more established track record of earnings growth are preferable in a volatile market. Importantly, we believe increased volatility benefits active managers, as they add stocks or increase position sizes in periods when markets sell off.



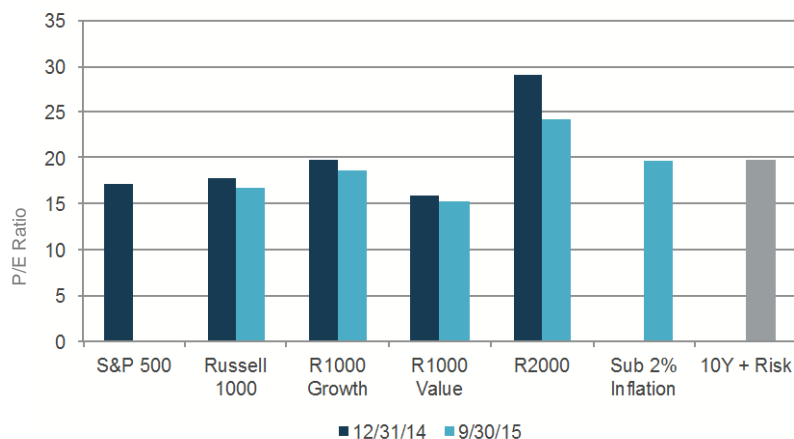
# The Blue Runs

The blue runs highlight issues that are less dangerous, but not without pitfalls. These are attractive runs but proceed with care.

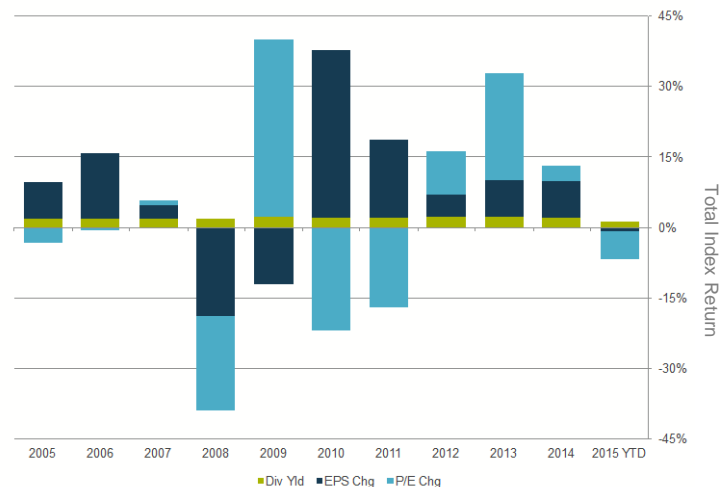
# U.S.: More Reasonable Valuations



## Major Index P/E Ratios



## Decomposition of Returns (Russell 1000 Index)



After the recent sell off, valuations look more attractive compared to where they were at the beginning of the year, with smaller stock multiples contracting the most. The multiples look reasonable against the backdrop of low rates and low inflation. In periods of sub 2% inflation, P/Es have been just above 19x. If you take the 10-year Treasury bond and add a risk premium, it argues for a no growth stock trading near 20. That's not an entirely valid comparison because Fed action is keeping 10-year rates artificially low, but it does say something about the low growth expectations that investors have for stocks in general.

Multiples could expand modestly but the period of expansion is largely behind us, as one can see in the chart that shows contraction in 2010 and 2011 and expansion in the years following. But with growth expectations low, we think growth stocks could be attractive. We expect earnings growth to be a bigger driver of returns going forward, as interest rate uncertainty and economic growth concerns suspend further multiple expansion. And while value stocks are statistically cheaper, there's opportunity in finding companies that are finding ways to grow.

Source: Janus, Bloomberg.

**S&P 500 Index** measures broad U.S. equity performance. **Russell 1000 Index** measures the performance of the 1,000 largest companies in the Russell 3000 Index.

**Russell 1000 Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

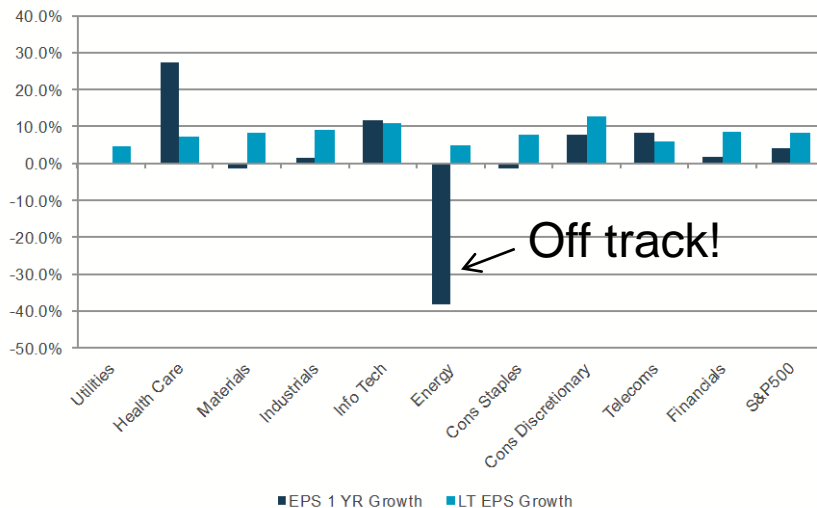
**Russell 1000 Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

**Russell 2000 Index** is an index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

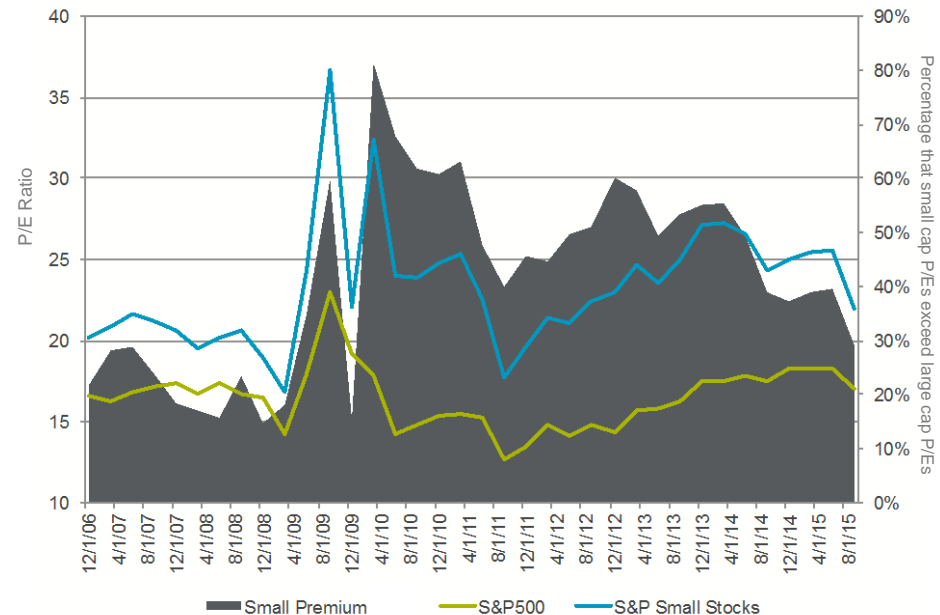
# Ski Tip: Find Earnings Growth



## Earnings Growth by S&P Sector



## Small Cap Premium



## Way Down

Within U.S. equities, investors can find earnings growth. A weak energy sector masks the fact that earnings growth has been strong for other sectors. As earnings growth, rather than multiple expansion, drives returns, investors will need to be selective and find those companies with a clear pathway to growth, or those that are creating value for shareholders by smart capital allocation decisions.

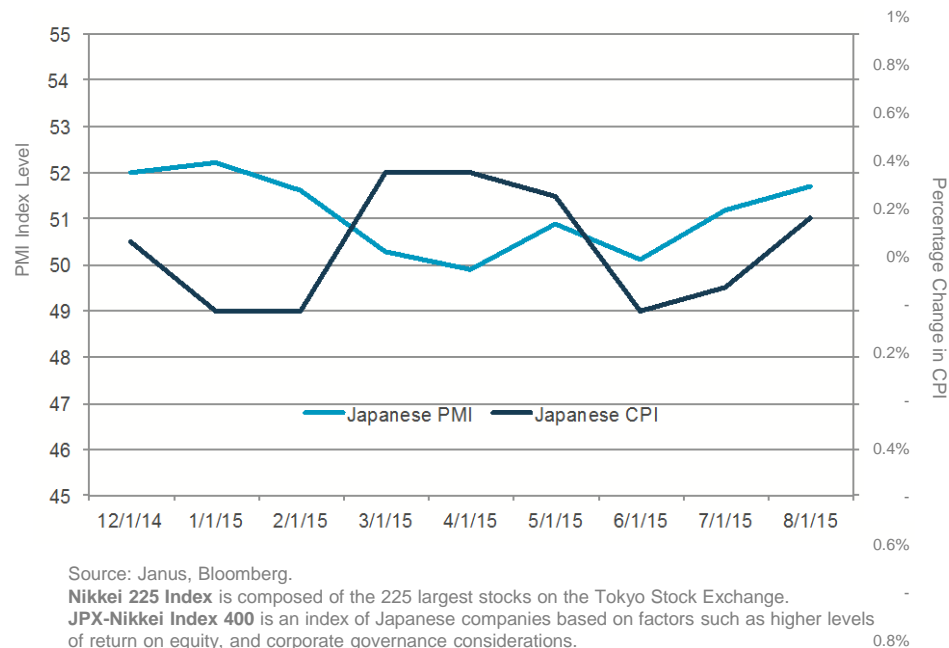
Another important factor within the U.S. equity market backdrop is that the value of positioning a portfolio with a bias toward larger stocks has decreased. In the market sell-off in August, for example, the larger stocks in the index did worse than the smaller stocks, a reversal from prior years. This change has two benefits: It allows managers to add value to an index as they go down in market cap relative to the index. It also opens up the universe and the ability to add differentiated insights through solid research. To be clear, this doesn't mean that smaller cap is more attractive than larger cap. As one can see, there's still a decent small-cap premium. It does mean, however, that being smaller than your index can be beneficial.



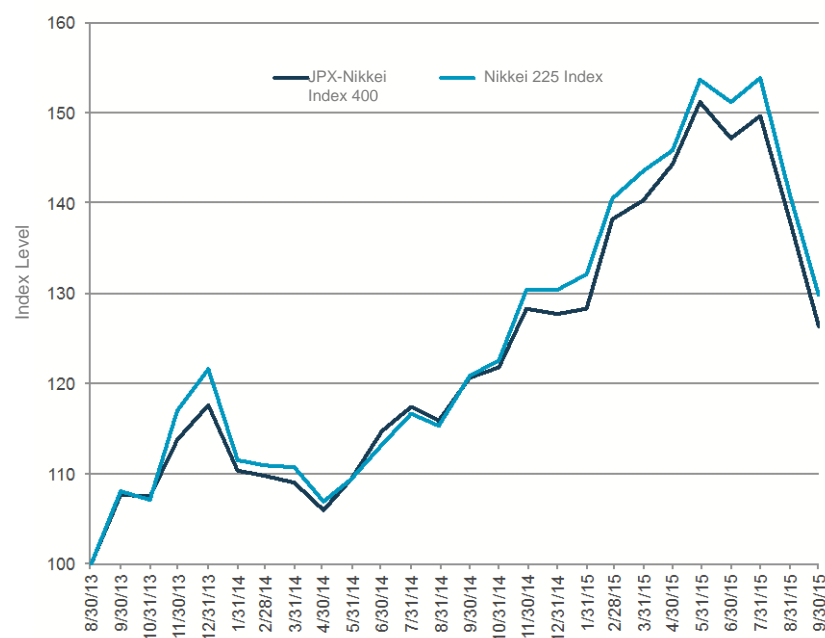
# Japan: Slow Growth, but a Better Investor Experience



## Japanese Economic Indicators



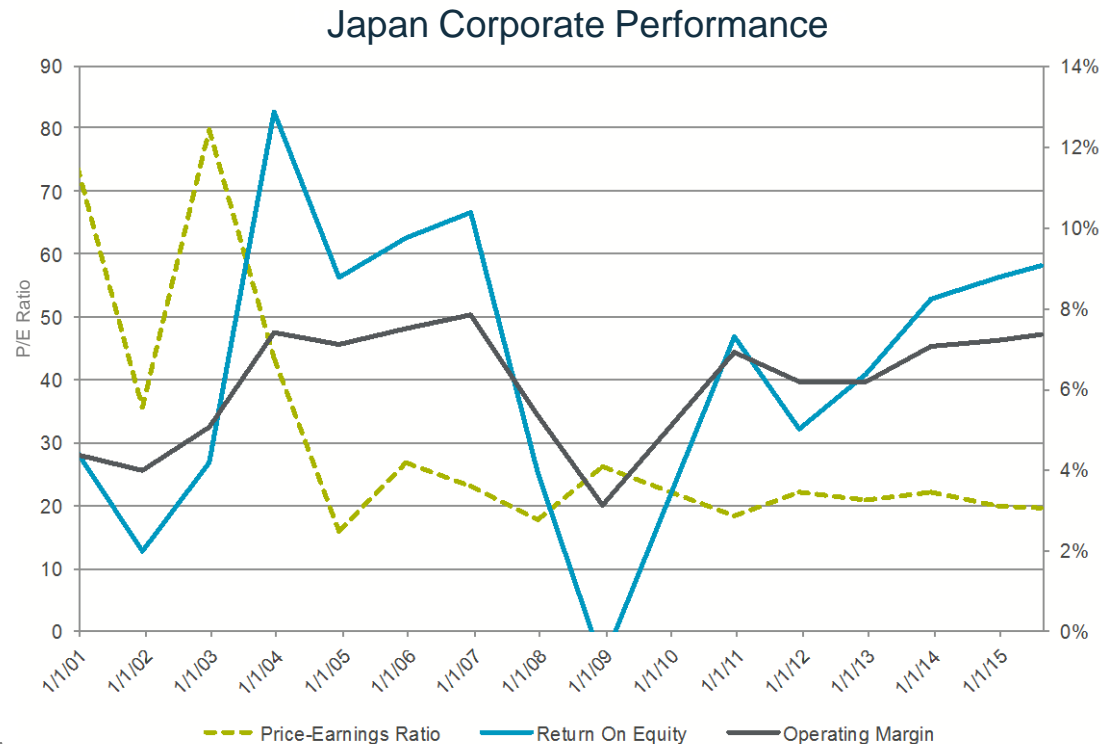
## Corporate Governance Inspired Index



Another intermediate run is Japan, where the economy is showing modest growth but corporations are improving their shareholder focus. Of major developed markets, Japan and Australia are probably the most sensitive to China's economy, and that is worrisome. The slow progress of structural reforms, promised as Abe's third arrow, is also problematic. The government is likely to experiment with some of these key economic reforms, such as labor market liberalization or incentives for capex spending, in specific regions before a broader introduction.

But what is promising is the new stewardship code in Japan that is driving companies to increase return on equity and to improve treatment of shareholders. There's a new index – seen here in dark blue – that selects companies based on factors such as return on equity (ROE), operating profits and corporate governance. It is interesting that the index has so far lagged the broader index but we think that partly reflects rapid stock revaluations with the sharply weakening yen. It stands to reason that, over a longer period, better run companies should perform better than average.

# Ski Tip: Focus on the Micro



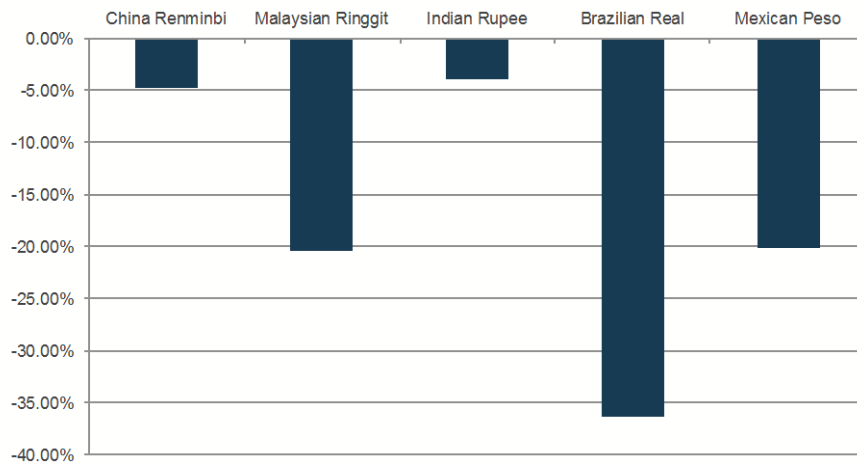
## Way Down

Given the backdrop of a weaker economy but positive corporate reform, we are suggesting that investors in Japan focus on individual companies rather than macro factors. In past years, we have seen Japanese companies improve operating performance as multiples have shrunk. We expect more improvements as companies focus more on shareholder benefits and better use of their balance sheets. Even in a low-growth environment, a company that is boosting margins and ROEs can be a good investment. The key is to find them.

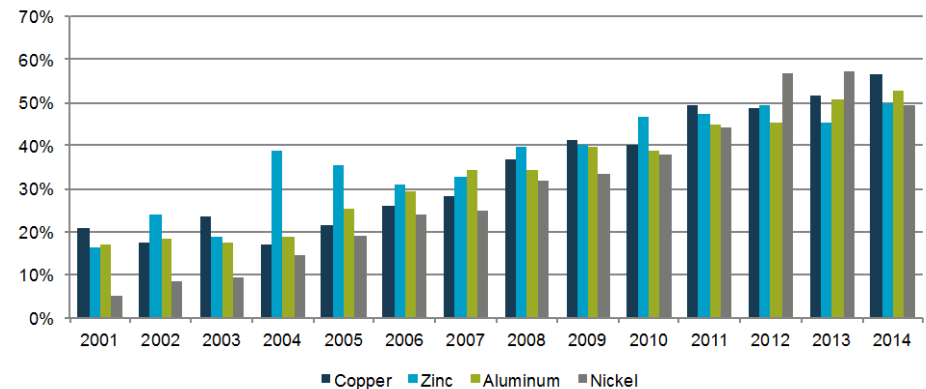
# Emerging Markets: The China Shadow



## Currency Depreciation since 12/31/13



## China's Portion of Global Commodity Consumption

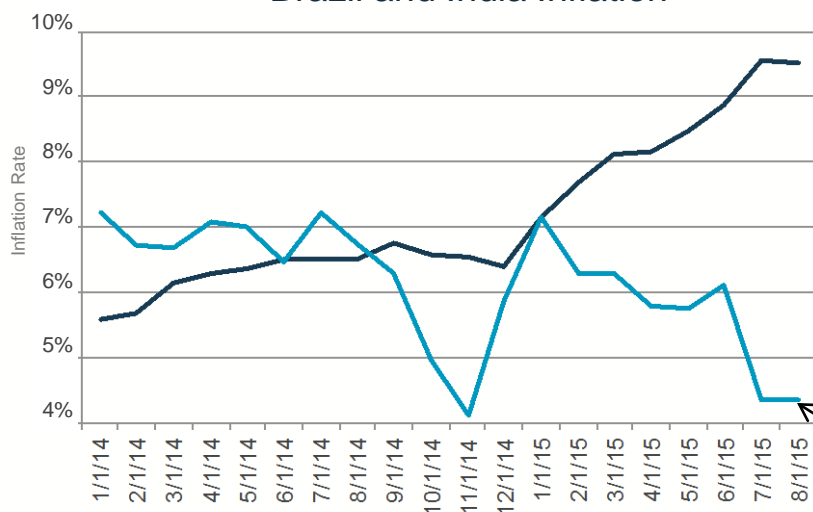


China, weak commodities demand, a stronger dollar and the potential for rising rates in the U.S. are difficult for emerging market economies. The outlook is particularly troubling for Brazil, where weak commodity prices, political upheaval and spiraling inflation have thrown the economy into turmoil. Clearly the currency markets are worried about Brazil. While Brazil has its own internal problems, the chart on the right shows how important China is to commodity demand and, by extension, how important China is to emerging markets. Chinese demand for many key commodities is now close to 50% of total demand, about three times its share of global GDP.

# Ski Tip: India Stands Out

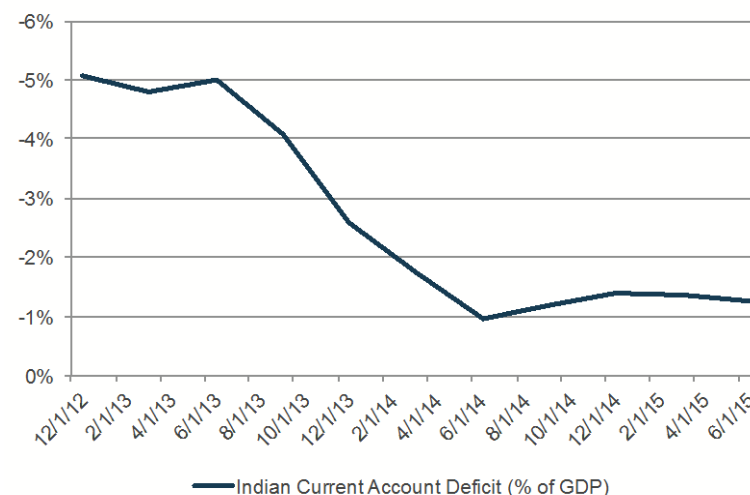


## Brazil and India Inflation



The  
easier  
route

## Indian Current Account Deficit



### Way Down

— Brazil — India

While Brazil struggles, India's economic outlook is more favorable. Slowly, we are seeing the benefits of a new government and signs of sustained economic growth. China does provide a challenge and the Indian government lowered rates late in the quarter. But inflation is falling and economic growth is still in the 6% to 8% range. The country is better equipped for a U.S. rate rise, too. A few years ago, India was part of the so-called "Fragile Five" that suffered when markets feared a U.S. rate hike. Since then, the current account balance – a general measure of vulnerability to capital flows – has come down dramatically.

So emerging market investing leads us away from Brazil, into India, especially some of the banks, and into consumer-related companies in China.





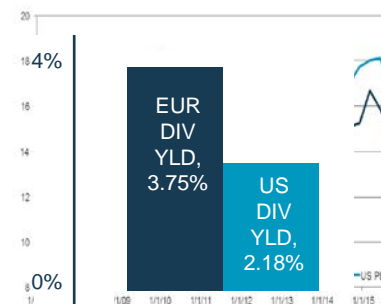
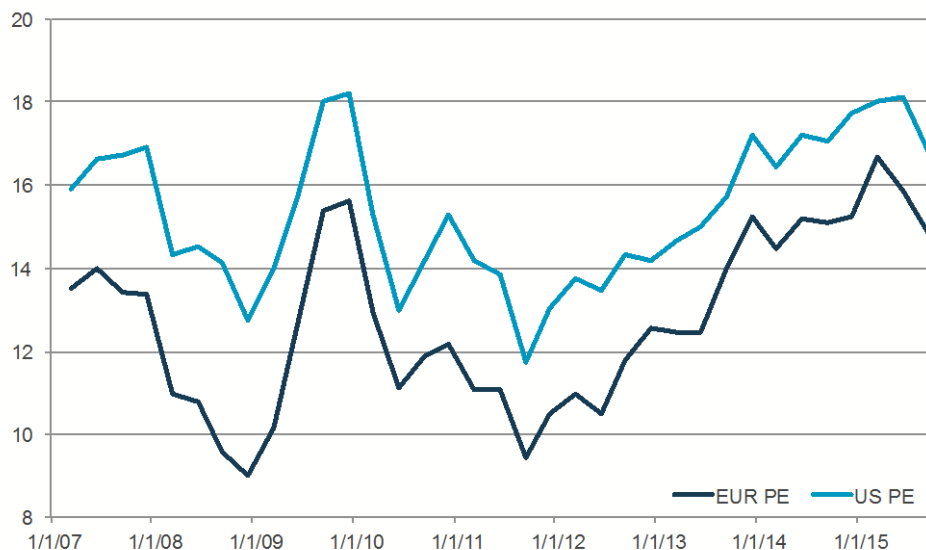
# The Green Runs

Green runs signal easier paths. But watch for crowds and stay away from the pack.

# Europe: Riding the Improving Economy



U.S. and European Equity P/E Ratios

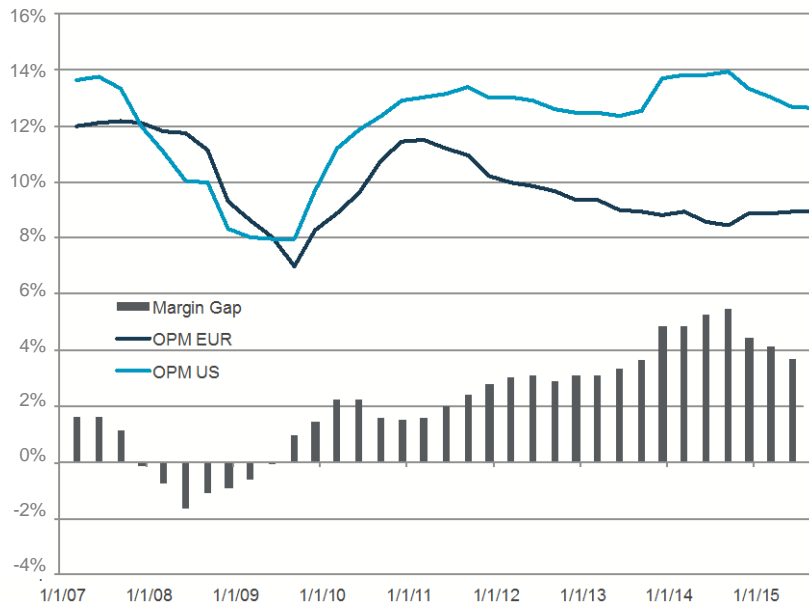


Now, the easy runs, where we think the path is easier for investors. We see Europe benefiting from a valuation discount to the U.S. — in terms of P/E and dividend yield — and also benefiting from an improving outlook. We know growth isn't robust, and the migration crisis and, to a lesser extent, Volkswagen are problematic. But Europe's quantitative easing program is gaining traction. Peripheral countries, with the notable exception of Greece, are improving. We also think earnings growth can far outpace economic growth, as we see operating leverage kick in.

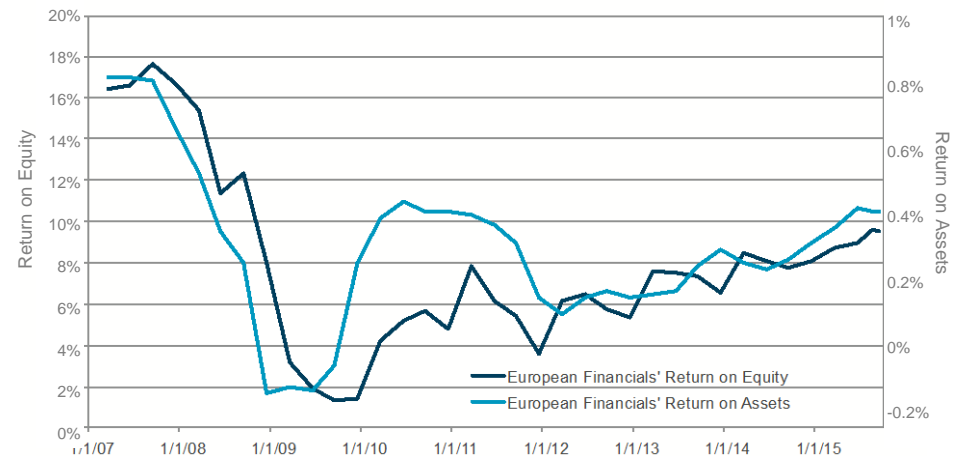
# Ski Tip: Look for Operating Leverage or Economic Sensitivity



## Europe vs. U.S. Operating Margins



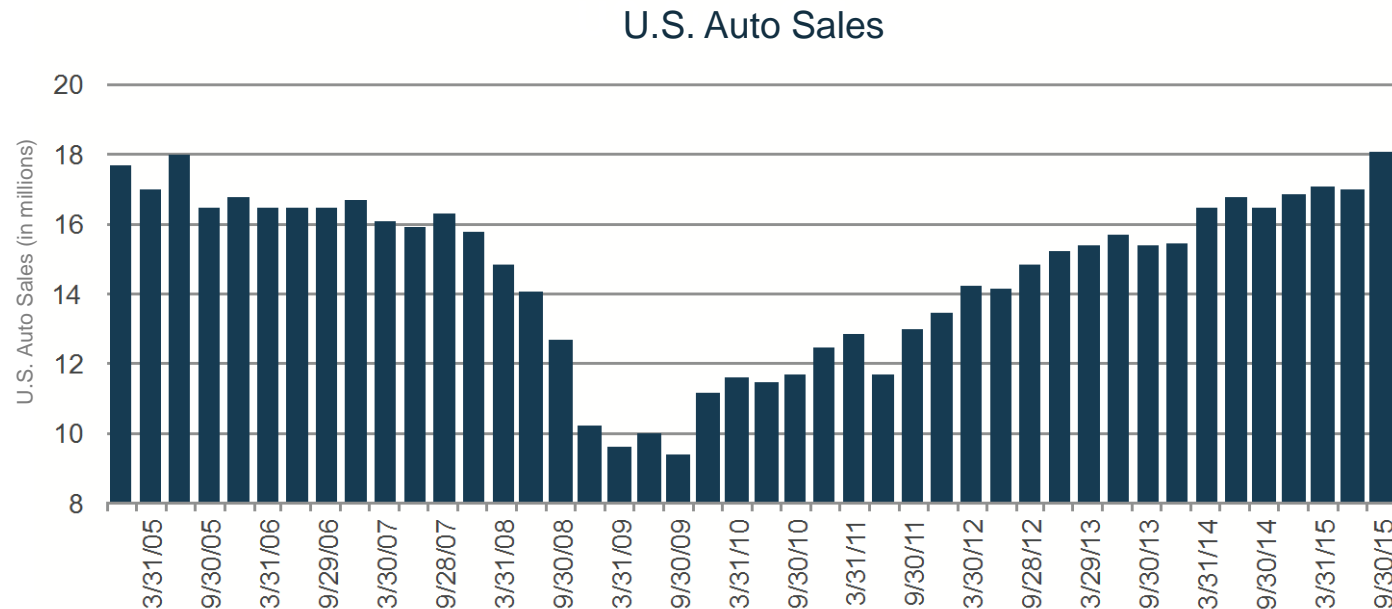
## European Financials Return Ratios



## Way Down

Industrial companies, which restructured later and more slowly than their U.S. counterparts, can use export growth to lift operating margins. The Volkswagen scandal potentially hurts Germany, which has a lot of jobs and activity tied to the auto sector, but the longer-term trend of improving financial performance still holds. Banks in particular look better as they face improved property prices, greater regulatory clarity and improved balance sheets. We see a continued move to higher returns, and, in connection higher dividends, for investors.

# U.S. Consumer: Smarter Spending

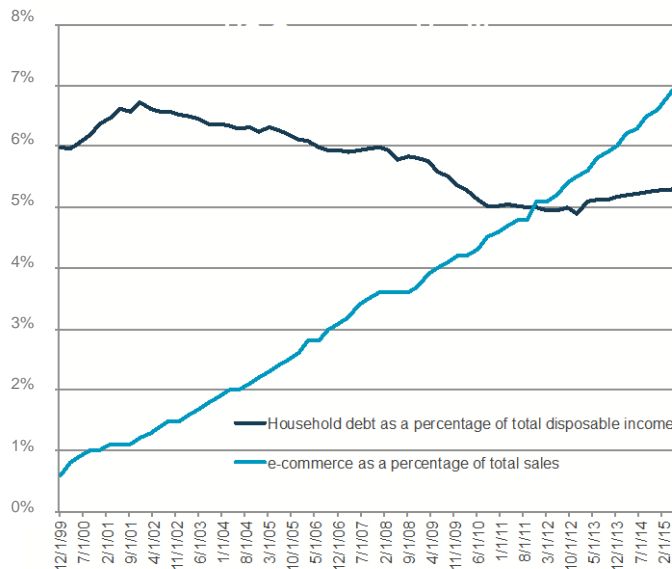


Auto sales are just one indicator of a stronger U.S. consumer. Improving employment, rising home values, lower gasoline prices, early signs of rising wages, lower household debt and a stronger dollar are all favorable for U.S. consumers. China's weaker currency is also helpful as it has the potential to lower the cost of imported goods. For example, Walmart recently told some of its Chinese suppliers that it will expect some price cuts after the Yuan weakened.

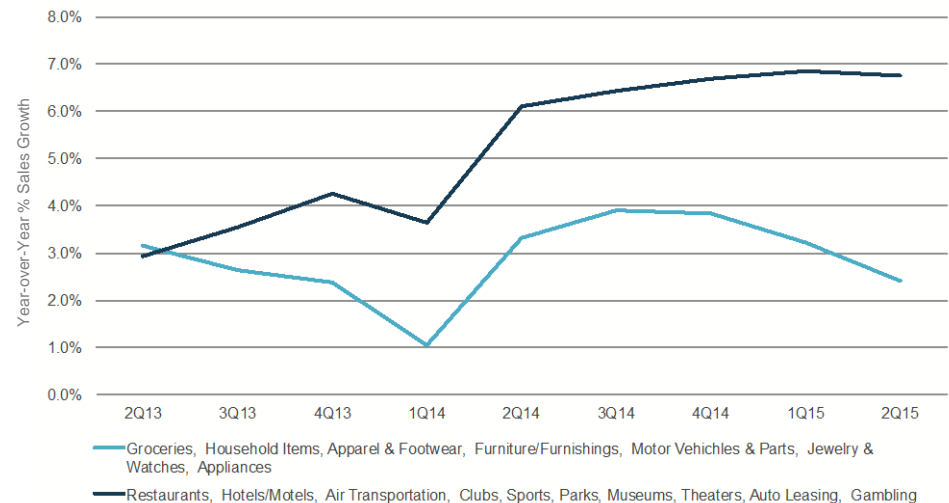
# Ski Tip: Think About Consumer Behavior



## U.S. Consumer Health



## U.S. Consumer Behavior: Things vs. Experiences



## Way Down

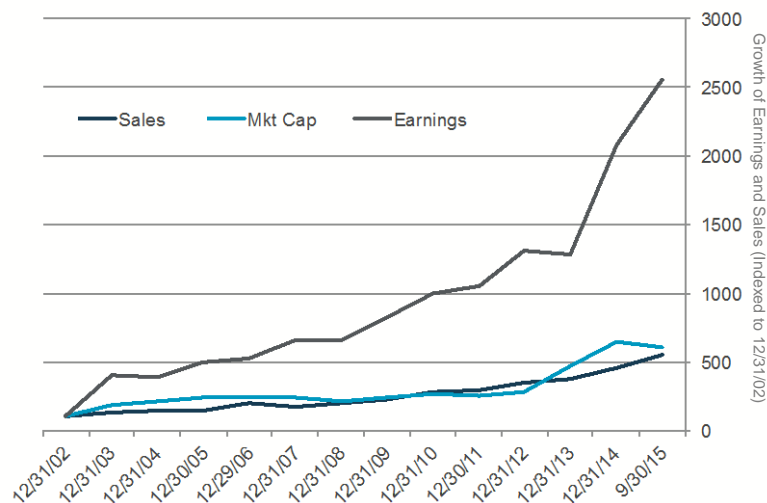
Wage increases and lower gas prices have a greater impact on those with lower incomes and, as we said earlier, China's problems help U.S. consumers. While the consumer is spending and strong, it is still important to understand the sector trends. Companies must be able to benefit, or at least stay relevant, as consumers shift purchasing more to online shopping. Another growing trend is that consumers are shifting from physical goods to experiences that they can share on social media. Travel and restaurant spending grows more quickly than furniture or jewelry, for example.



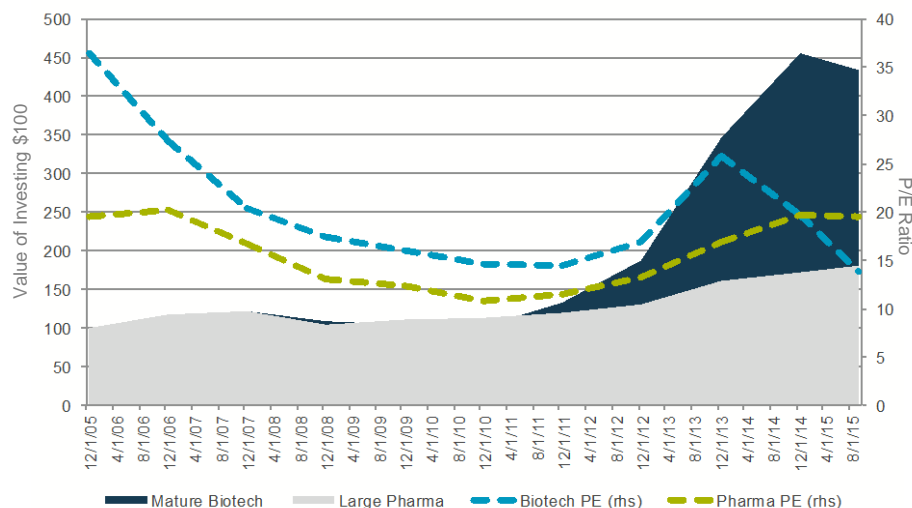
# Health Care: We Don't Believe the Run is Over



## NASDAQ Biotech Stats



## Mature Biotech vs. Large Pharma



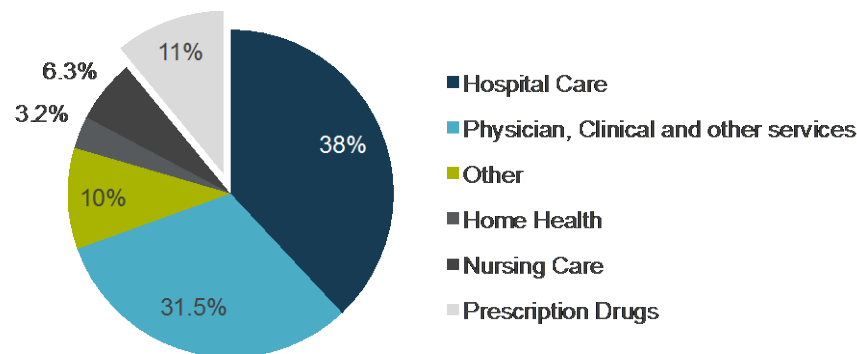
While headlines and politicians are taking air out of the biotech sector, we remain excited about the future. The last month of the quarter made us more positive as valuations came back to more reasonable levels for many health care stocks. The long-term view is unchanged: We see the valuable confluence of a growing population over 65 and a wave of scientific innovation that makes drugs far more effective. We are seeing major progress on Alzheimer's, cancer, cardiac disease and a host of other diseases, which often are far more prevalent in the elderly. We are in the early stages of a multi-year trend but many biotech breakthroughs are out there already. The chart on the left shows that while the biotech sector has soared more than 500% since 2002, earnings has far outpaced that growth. Unlike Internet companies during the tech bubble, for biotech companies the translation of sales to profits is clear and powerful.

The chart on the right shows how the biotech sector has changed. It is more than speculative, clinical stage companies at high valuations. Mature biotech companies actually trade at a discount to big pharma. It doesn't mean that biotech is cheap across the board. It means that not all biotech exposure is equal and there's a blurring of lines between biotech and big pharma in many cases.

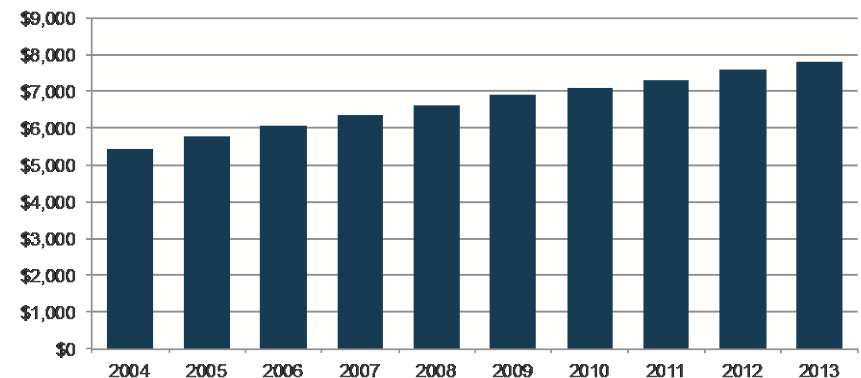
# Ski Tip: Innovation trumps regulation



Prescriptive Drug Spending



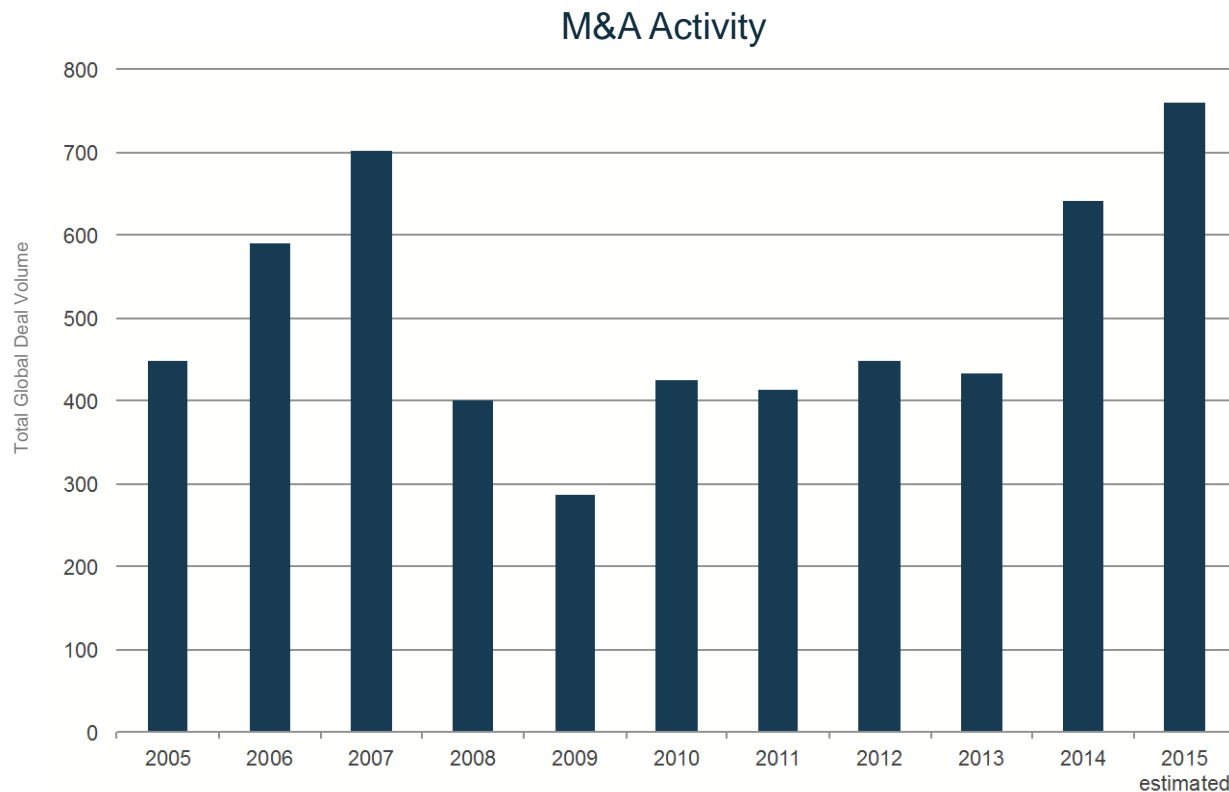
Health Care Spending Per Capita



## Way Down

While we are positive on the health care sector, there are a few keys to bear in mind. First, follow the science to find those companies that can turn innovation into profits. The second key is that drug prices are under attack but still represent just over 10% of total health care spending. As the chart on the right shows, spending is still rising. It doesn't mean that all drugs will see price increases. It means that companies with strong therapeutic benefits that ultimately help reduce costs to the system still have pricing power. The competition for pricing requires a focus on companies with treatments addressing high, unmet needs. Also, valuation matters. Don't worry about P/E's on average because earnings can ramp up quickly but do worry about over-hype. A lot of money is coming into the sector passively. Passive investors are buying hype in many cases, not science.

# Mergers & Acquisitions Continue

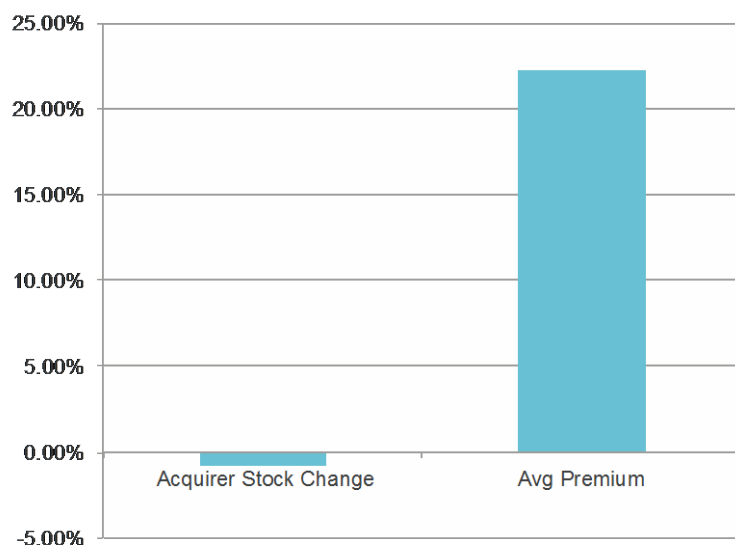


M&A is another good run that we believe is not over yet. The deal flow is picking up and we do not think it is dependent on low rates. We recognize liquidity issues in the bond market could be problematic but, nevertheless, we think companies in a low-growth and low interest rate environment could use strong balance sheets and a desire to improve competitive positions to enhance growth. Therefore, while there are synergies that occur, we think a great number of the acquisitions are fueled by strong business cases rather than opportunistic buyers of turnaround situations.

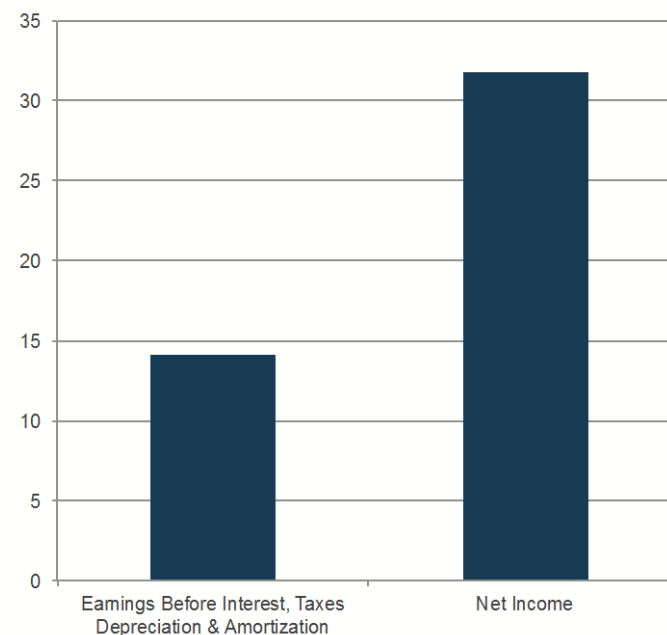
# Ski Tip: Quality growers or industry consolidators



M&A Market Reaction



Average Multiples Paid By Acquirer



## Way Down

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# Off piste: Items on the edge to consider

## Possible Future Headwinds

- > Europe refugee crisis leads to nationalistic political parties
- > The Fed raises too fast for U.S. economy
- > Wages and job growth slow in China and lead to unrest
- > Bureaucracy wins in India
- > A strong dollar and weak China squeezes the U.S. market

## Potential Future Tailwinds

- > European growth surprises and markets revalue
- > Rising rates signal a strong U.S. economy; housing and wage growth continue
- > China is more inventory correction than sustained slowdown
- > Market again prefers cash flow and valuation to momentum



# Key Takeaways

- > **China:** A consuming story
- > **Europe:** Earnings growth can exceed economic growth
- > **U.S.:** The healthy consumer and the appeal of health care
- > **Overall:** Today, investment fundamentals matter

We hope the previous slides help in navigating the equity terrain. As a few key takeaways to remember, realize that while a slowing Chinese economy will likely create more volatility, there are a number of secular growth stories tied to the Chinese consumer that we believe offer long-term opportunities. In Europe, the economy is improving, albeit slowly. The economic improvement comes at the same time many companies have made major costs cuts that will further drive earnings growth in the coming quarters. In the U.S., we still see opportunity in companies tied to the U.S. consumer and also in the health care sector, where a number of promising therapies have launched or are under development.

In each of these markets, individual stock selection matters. Investing behind a strong Chinese or U.S. consumer also requires knowledge of how consumer purchasing habits are changing. In Europe, some cost cuts and restructuring efforts are more impactful than others and will have a greater impact on the bottom line. In the U.S., there is innovation among some drug companies, but hype surrounding others. We believe an understanding of the science behind each therapy, and the potential market size a new therapy will address, is critical to success.

# Disclosures

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