JANUS CAPITAL® Group

Spring 2017 Ski Report:
JANUS EQUITY OUTLOOK

Stocks Rally as Confidence Returns

We’re happy to be away from 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.

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

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

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

Equity Outlook

We start with our usual three equity outlook scenarios: The green runs represent our most optimistic case and the easiest path forward for stocks. The most likely and more moderate outlook is reflected in the blue runs. The worst-case and most difficult scenario for equities is represented by the black runs.

With a new administration in the White House, our best-case “green runs” scenario calls for a stronger U.S. economy, improved confidence and the return of risk-taking to the equity market. In turn, active stock selection becomes especially important as stocks are driven more by corporate fundamentals and less by the return of cash to shareholders and other financial engineering.

In our more moderate “blue runs” scenario, political risks continue, especially in Europe, where several countries will hold key elections this year. The U.S. economy improves, but stocks – having priced in reforms that are not yet guaranteed – could experience some bumps. In addition, rising interest rates help boost bank profits but weigh on certain high-yielding equities.

And in our worst-case “black runs” scenario, volatility rises under President Trump, whose prolific tweets and unconventional approach cause short-term sell-offs. Populism in the U.S. and in Europe gains momentum, leading to anti-growth measures, such as trade tariffs and restrictive immigration policies. In addition, an increasingly strong dollar impairs U.S. exports and thwarts the positive effects of growth-oriented reforms.

We see the blue runs as the most likely scenario, followed by the green and then the black runs. U.S. stocks have continued to rally this year, but we do not believe valuations are stretched. On the contrary, today’s price-to-earnings (P/E) ratios look justified in a strengthening economy. If corporate earnings rise along with that growth, the market’s run could last a while longer yet.

The Green Runs

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

> **Flight to safety ends:**
Defensive stocks sell off and risk-taking returns to the market

> **The outlook for the U.S. economy improves:**
The new administration and expectations for additional Federal Reserve (Fed) rate hikes boost confidence

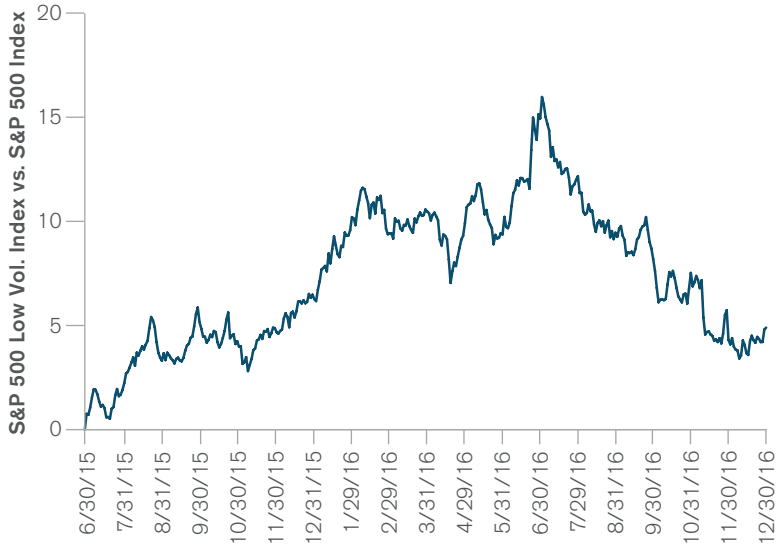
> **Mergers and acquisitions (M&A) continue:**
A good time to own growth stocks

Flight to Safety Ends

Risk-taking returns to the market

- Low-volatility stocks begin to underperform
- ETF flows show a renewed appetite for risk
- The market's equity outlook has changed – and it's for the better

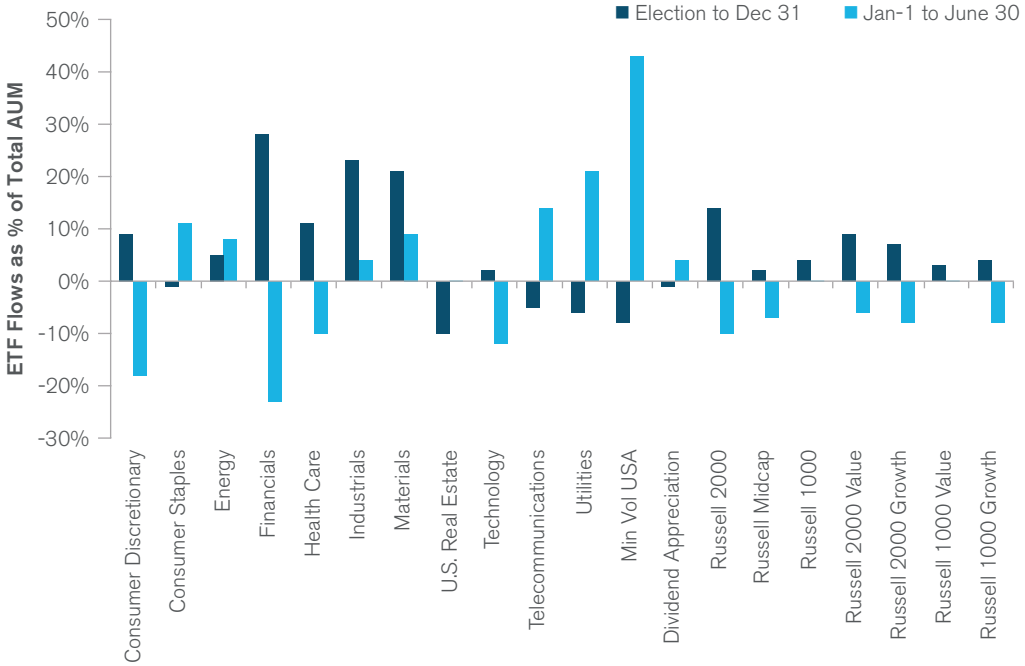
Low Volatility Stocks Underperform



Source: Bloomberg. Data as of 12/30/2016.

Investors Embrace Risk After the Election

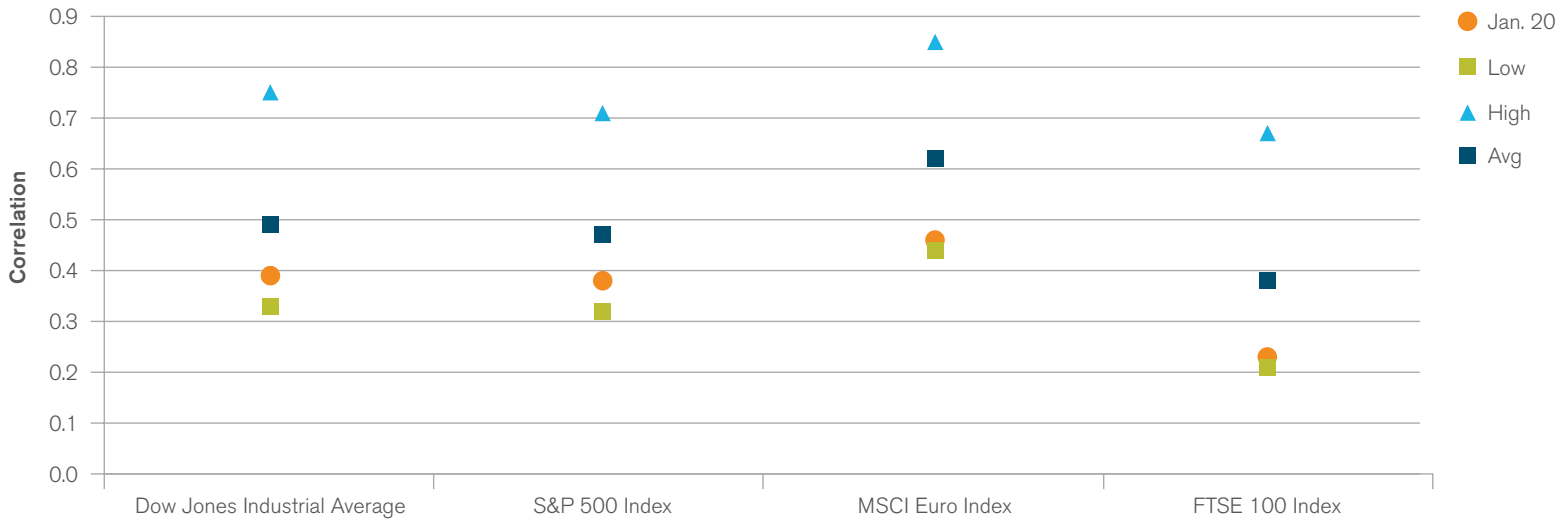
Exchange Traded Fund (ETF) Flows, 2016



Source: Bloomberg.
Notes: Election is 11/8/2016.

Ski Tip: Focus on Fundamentals

Stock Correlations Fall



The Way Down

> Active stock picking has the potential to excel as macroeconomic risks diminish and stocks are propelled by corporate fundamentals. Factors such as volatility, momentum and yield may no longer dominate returns as they did before.

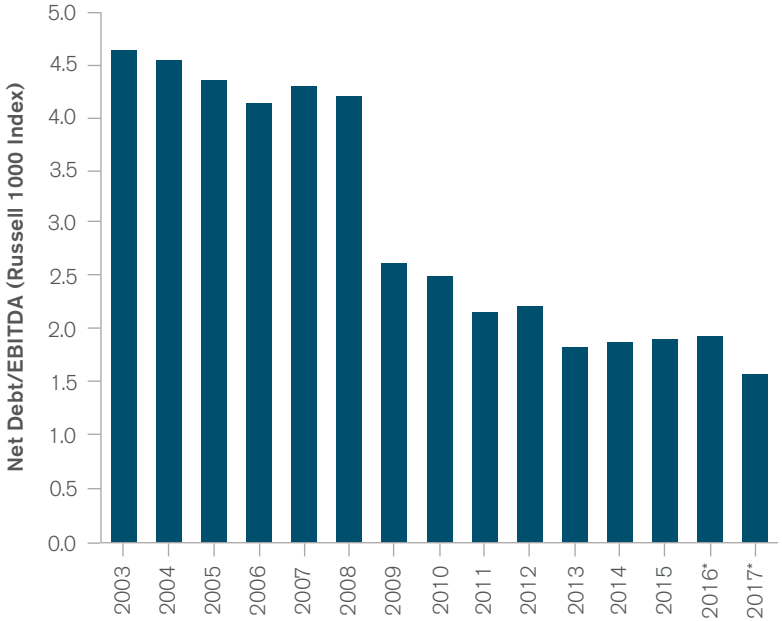
Source: Bloomberg. Data as of 1/20/2017.
Notes: Low, high and average figures are for the last three years. January 20th data reflect last three months.

The Economic Outlook Improves

A new administration and expectations for additional rate hikes boost confidence

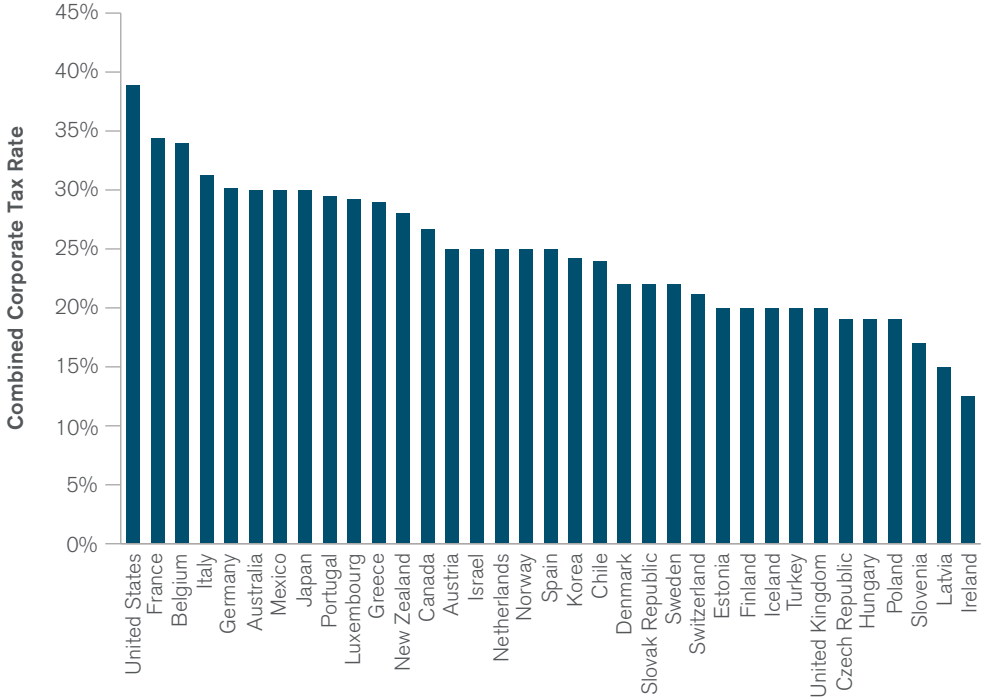
- Markets have shrugged off the political shocks of Brexit, Trump and Italy, showing growing confidence in corporate fundamentals
- Businesses will grow by investing in capital goods, not through financial engineering
- The Fed's outlook has turned positive and corporate tax rates could fall under the new administration

Corporate Leverage



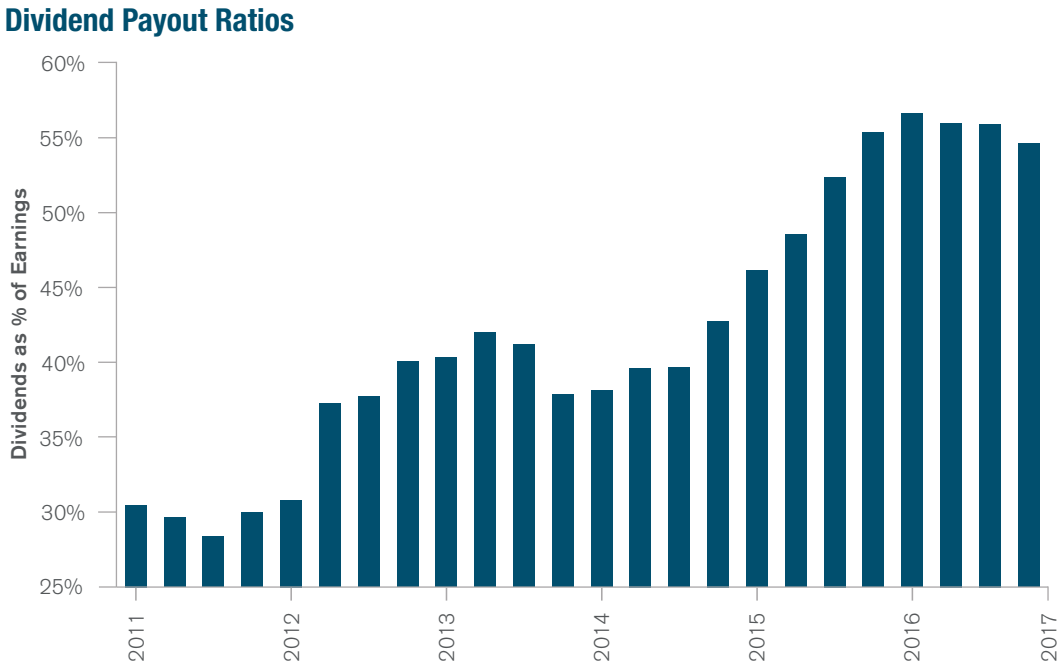
Source: Bloomberg. Data as of 2/21/2017.
Notes: *Estimate. EBITDA stands for earnings before interest, tax, depreciation and amortization.

Corporate Tax Rates By Country



Source: Organization for Economic Co-operation and Development (OECD).

Ski Tip: The End of Financial Engineering



The Way Down

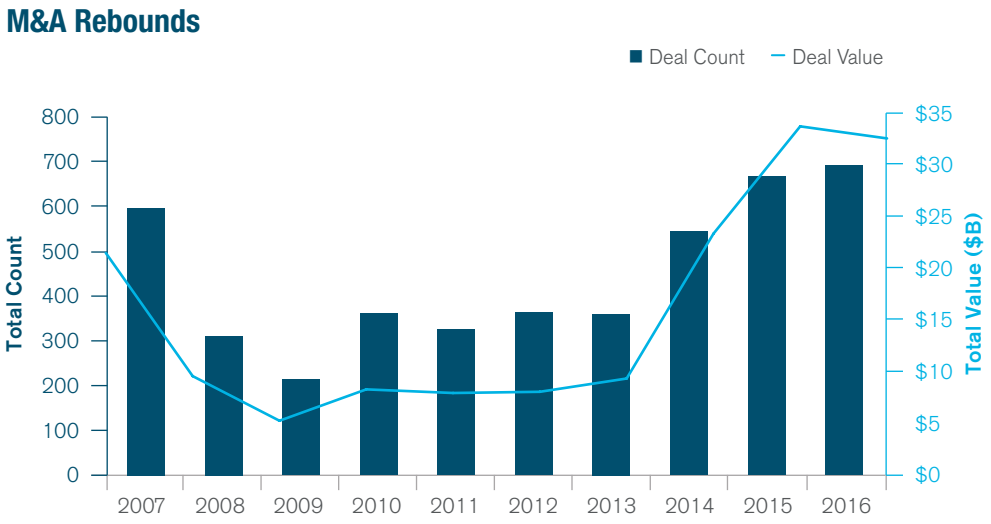
> Pay attention to company fundamentals and be mindful that ETF flows can accentuate broad market moves.

Source: Bloomberg. Data as of 12/30/2016.

M&A Continues

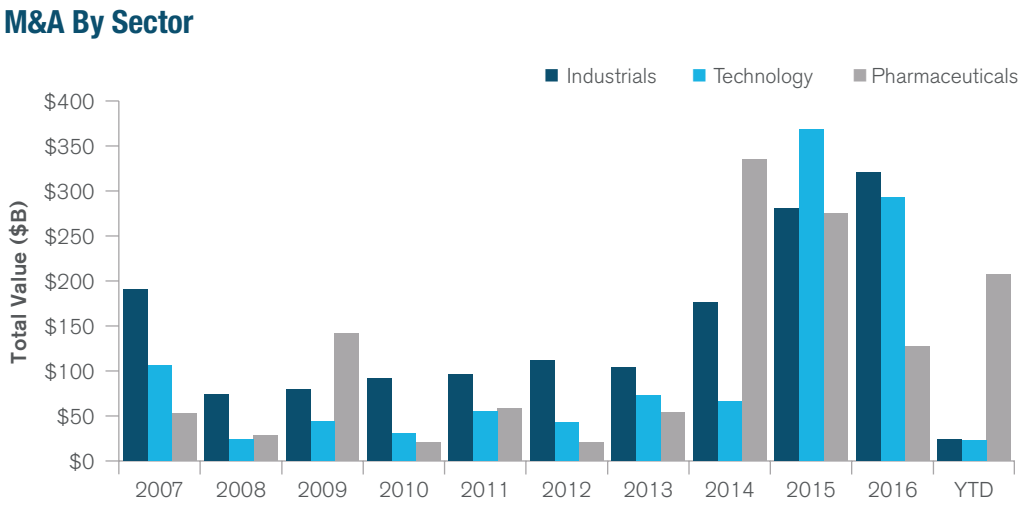
A good time to own growth stocks

- Lower regulatory hurdles and increased corporate spending will fuel M&A activity
- Growing companies make for good acquisitions
- Buy growth, not turnarounds



Source: Bloomberg.

Ski Tip: Look for M&A Across Sectors



The Way Down

> Optimism about the economy is giving more companies confidence to pursue acquisitions. M&A activity in the industrials sector, for example, tends to thrive during periods of economic growth.

Source: Bloomberg. Data as of 2/20/2017.

The Blue Runs

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

> **Financials rebound:**
Bank profits are starting to rise but still face challenges

> **Uncertainty in Europe:**
Corporate balance sheets have improved but political risks remain

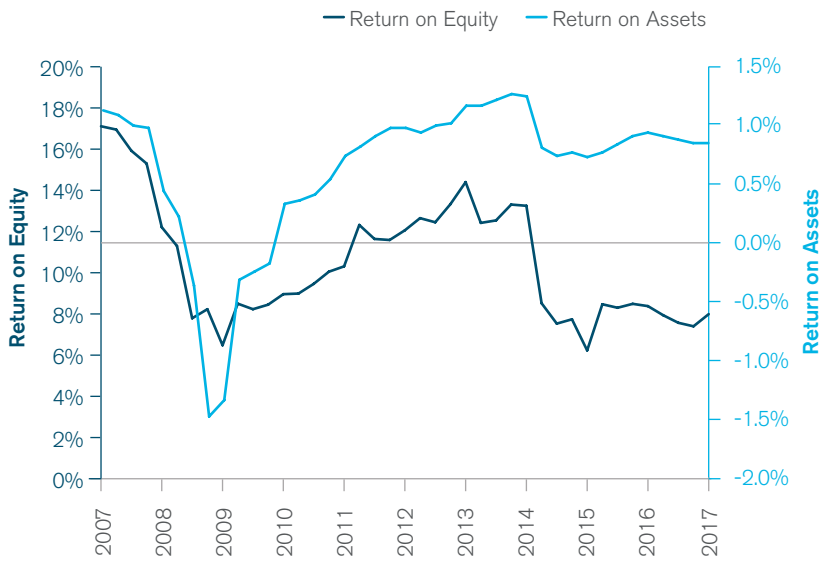
> **Yields rise:**
A stronger economy means challenges for yield-driven investors

Financials Rebound

Bank profits are starting to rise but still face challenges

- Although the Dodd-Frank Act is likely not going away, some rules are being rolled back
- Higher interest rates help bank profits, but competition for cash deposits could weigh on net interest margins
- As the economy improves, increased capital expenditure could fuel demand for bank loans

U.S. Bank Profitability

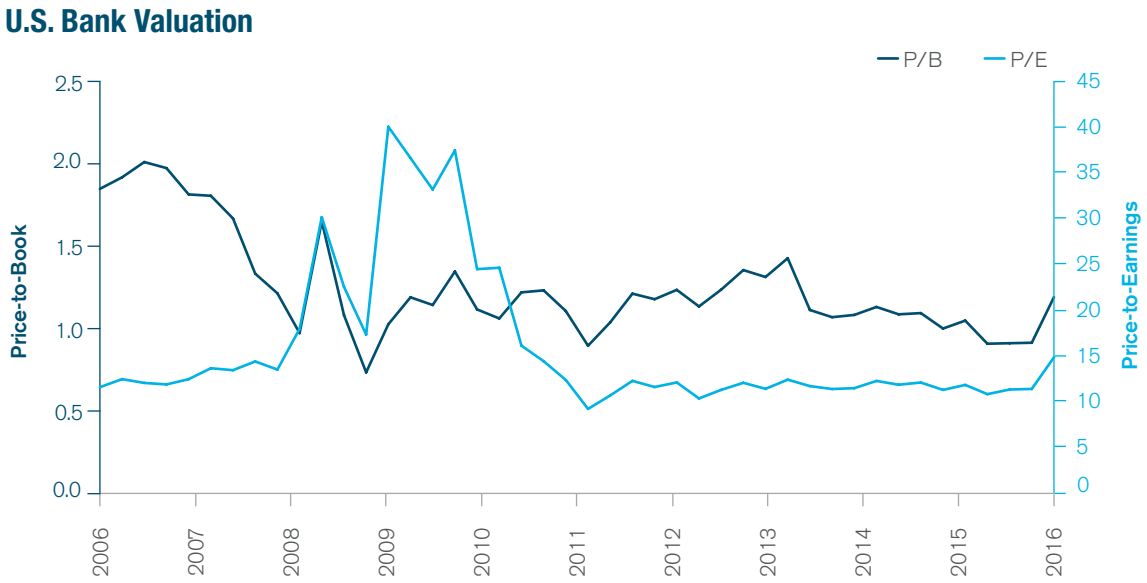


Source: Bloomberg. Data as of 12/30/2016.
Notes: Data based on MSCI U.S. Banks Index.

Yield Curve Spread

Source: Bloomberg. Data as of 1/31/2017.
Notes: Spread reflects the difference between the 10-year Treasury and the federal funds rate.

Ski Tip: Focus on Valuation



The Way Down

> Multiples for financial stocks now assume that net interest margins and return on equity (ROE) will climb this year. The multiples also assume additional Fed rate hikes in 2017. All are plausible but not guaranteed.

Source: Bloomberg. Data as of 12/30/2016.
Notes: Data based on MSCI U.S. Banks Index.

Uncertainty in Europe

Corporate balance sheets have improved but political risks remain

- Corporations are operationally healthy and consumer confidence has improved
- But Brexit details are unknown and populist sentiment could sway key elections in 2017
- A weak euro and accommodative European Central Bank (ECB) help, but how will the market react when easy-money policies are scaled back?

On the Horizon

Key Political and Other Events in Europe, 2017

March	Possible UK trigger of Article 50, the start of negotiations for Britain's exit from the European Union 15th: General elections in the Netherlands
April	23rd: Earliest date for 1st round French presidential elections
May	7th: Earliest date for 2nd round French presidential elections German regional elections
July	Greece faces large repayments of International Monetary Fund (IMF) and ECB debt
September	24th: German federal election

Source: Janus.

Ski Tip: Consider Key Growth Metrics

European Operating Margins

Consumer Confidence in Europe Improves

The Way Down

> Key metrics in Europe include increased business investment, rising exports (thanks to a weak euro) and higher inflation. If these cause interest rates to climb, the European economy and financial sector will benefit.

Source: Bloomberg. Data as of 12/30/2016.
Notes: Data based on MSCI Euro Index.
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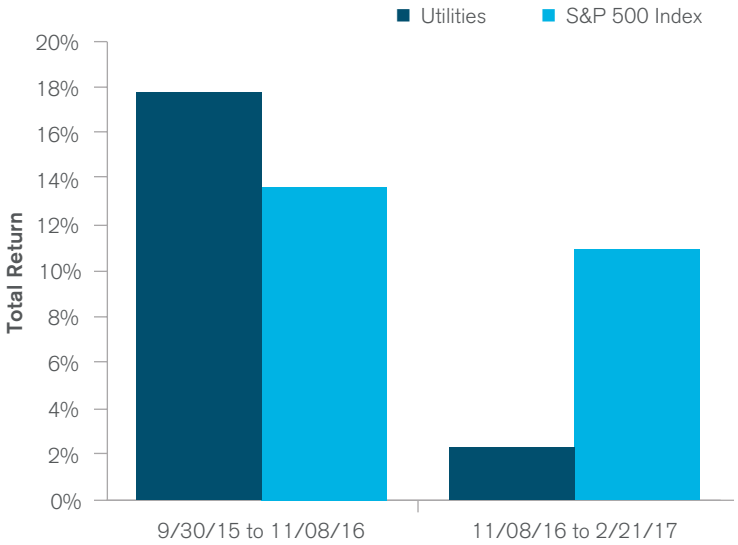
Source: Bloomberg. Data as of 12/30/2016.
Notes: Data based on the European Commission Consumer Confidence Indicator, which measures consumer confidence in the eurozone. Negative values indicate lack of confidence, zero is a neutral opinion and positive values indicate confidence.

Yields Rise

A stronger economy means challenges for yield-driven investors

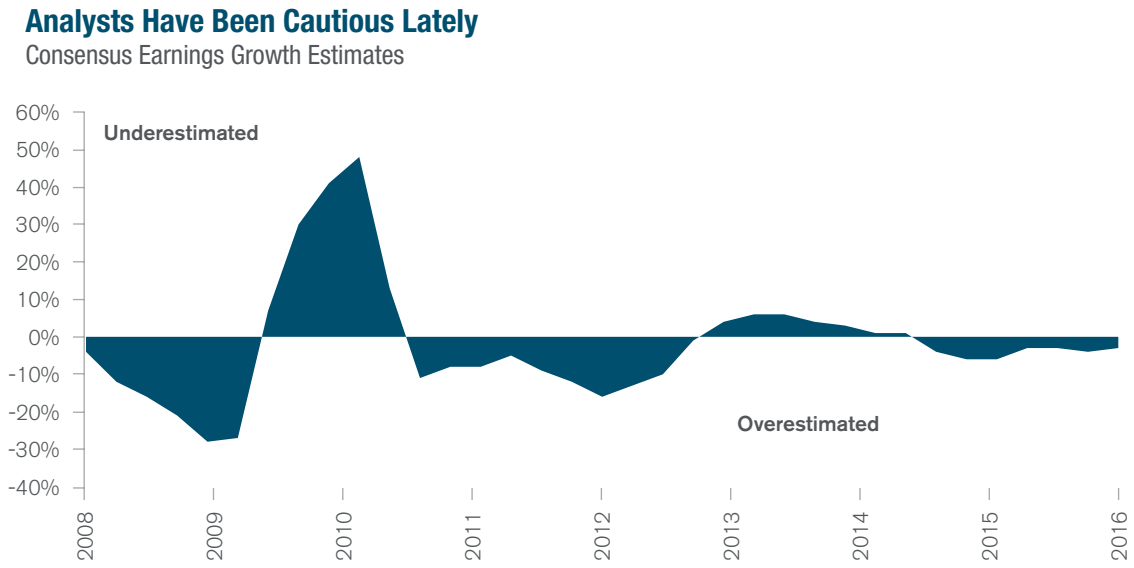
- The yield trade in equities is over. Now what?
- The Fed is signaling a stronger economy and markets are pivoting
- Not all yield is bad. Some dividend payers can grow in a strong economy

High-Yielding Stocks Underperform



Source: Bloomberg.
Notes: Utilities reflect the utilities sector in the S&P 500 Index. The period up to 11/08/16 reflects market performance before the November election. The period from 11/08/16 onward reflects performance after the election.

Ski Tip: Watch for Earnings Revisions



The Way Down

> Although P/E ratios have risen, they do not look stretched, given low interest rates. Earnings also may be understated. If the economy strengthens, earnings estimates could start to rise.

Source: Bloomberg. Data as of 9/30/2016.
Notes: Consensus earnings growth estimates for the next 12 months in the Russell 1000 Index compared with actual earnings growth.

The Black Runs

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

> **Market noise escalates:**
Uncertainty under the new administration

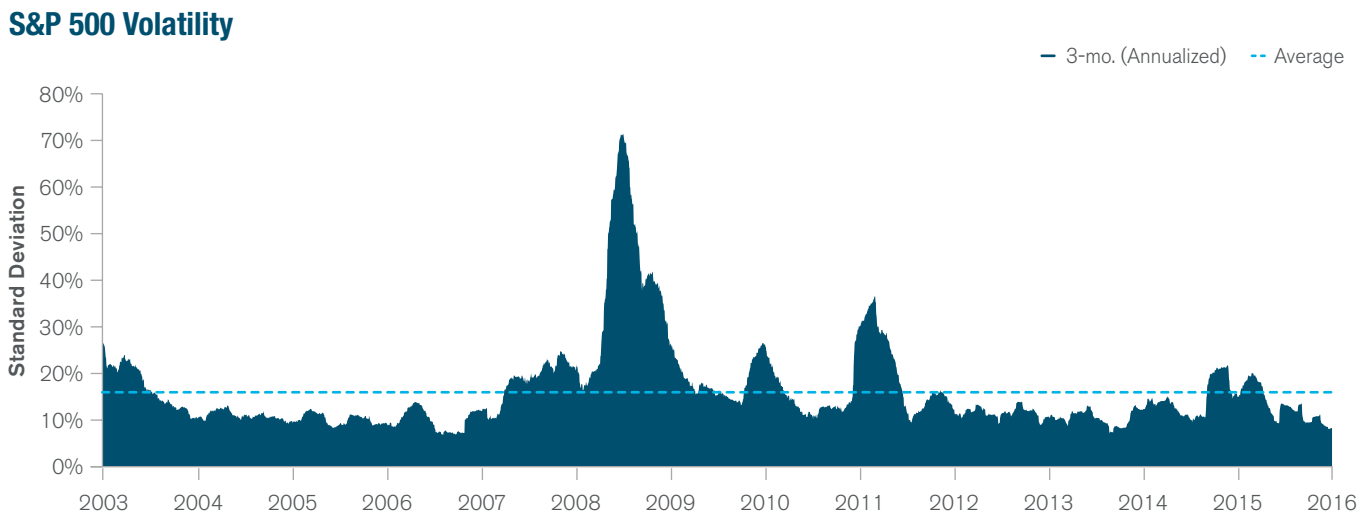
> **The dollar rises:**
The challenge of an increasingly strong greenback

> **Populism:**
Not popular with every sector

Market Noise Escalates

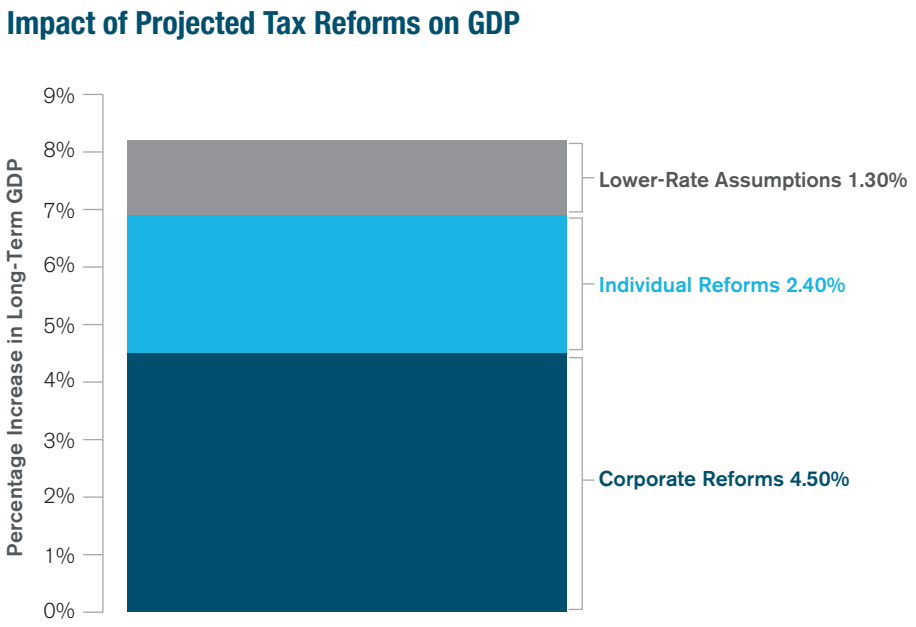
Uncertainty under the new administration

- Expect volatile days as markets react to new policies
- Pro-business minds could prevail
- Volatility is moderate, which is good for stocks if correlations stay low



Source: Bloomberg. Data as of 1/31/2017.

Ski Tip: Consider Risks to Growth



The Way Down

> Equity returns now depend on stock selection, not sector positioning. The Trump administration has a pro-growth agenda but details are far from certain. Also, the market is overlooking the long-term risk that proposed reductions in corporate tax rates and increased government spending meaningfully expand the federal debt.

Source: Tax Foundation.

The Dollar Rises

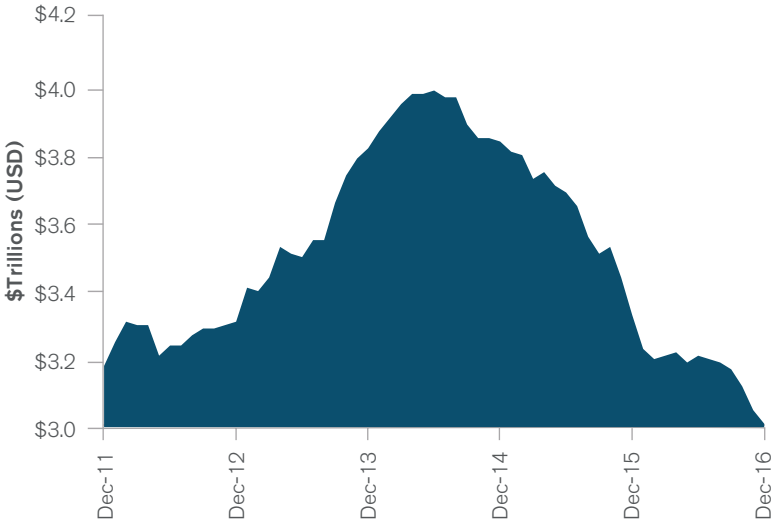
The challenge of an increasingly strong greenback

- Expect the dollar to continue rising, a trend that eventually could get in the way of Trump policies
- Trade barriers and inflation fears could undermine currency policy
- China's currency policy in 2017 is important, but Brexit and Europe's path also matter

A Rising Dollar

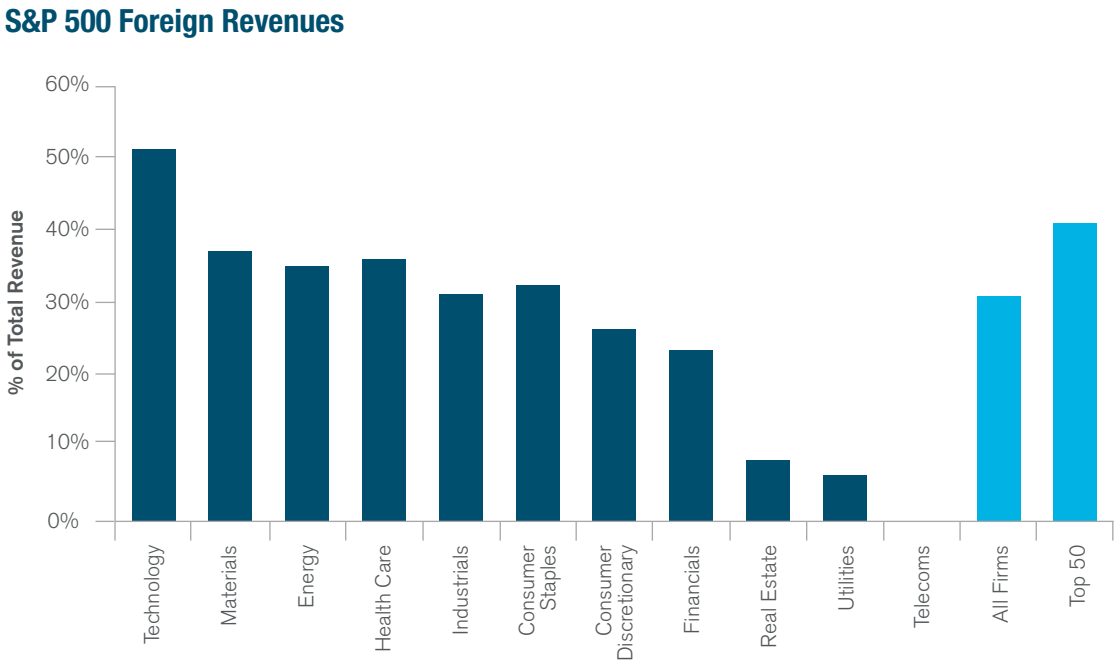
Source: Federal Reserve Bank of St. Louis. Data as of 1/31/2017.

China's Falling Currency Reserves



Source: Bloomberg. Data as of 12/31/2016.

Ski Tip: Look Beyond the Headlines



The Way Down

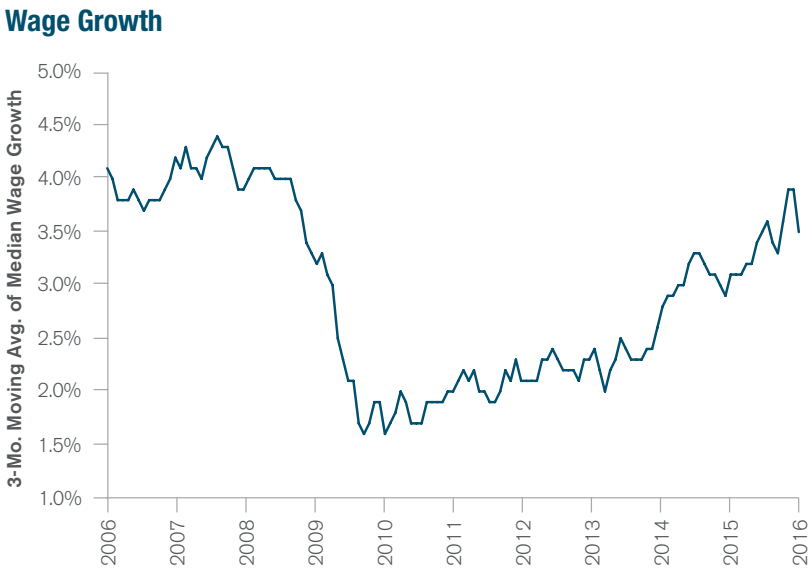
> The technology sector has the highest foreign-revenue exposure, but the sector – as well as other exporters – could benefit from earnings repatriation. Also, remember cost structures. What is lost in accounting translation may not hurt long-term competitive positioning.

Source: Bloomberg. Data as of 2/21/2017.
Notes: Data based on 324 firms reporting. Top 50 determined by market capitalization.

Populism

Not popular with every sector

- Although good for workers, rising wages cut into operating margins
- Tax reform could hurt companies that import goods or services for resale in the U.S.
- Lower-margin businesses with high labor costs would feel the biggest impact



Source: Federal Reserve Bank of Atlanta. Data as of 12/31/2016.

Ski Tip: Rising Costs Could Be a Headwind

The Impact of Potential Tax Reform on Imports

	Current Tax Code 100% U.S.-Sourced COGS	As Proposed, 100% U.S.-Sourced COGS	As Proposed, 100% Imported COGS
Sales	$1,000	$1,000	$1,000
COGS	($600)	($600)	($600)
Gross Profit	$400	$400	$400
Gross Margin Rate	40%	40%	40%
SG&A	$200	$200	$200
Taxable Income	$200	$200	$800
Taxes	$70	$40	$160
Tax Rate	35%	20%	20%
Net Income	$130	$160	$40
Shares	$100	$100	$100
Earnings Per Share	$1.30	$1.60	$0.40

The Way Down

> Wage pressure may create inflation, which could help equities. But companies with high wage costs would suffer. In addition, tax reform targeting imported goods would offset the benefit of lower corporate tax rates for some firms.

Source: Bloomberg, Janus.
Notes: COGS is Cost of Goods Sold; SG&A is Selling, General and Administrative Expenses.

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Russell 2000® Growth Index measures the performance of those Russell 2000® companies with higher price-to-book ratios and higher forecasted growth values.

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C-0317-7976 03-15-18

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