



JANUS CAPITAL®
Group

Investment Outlook

from Bill Gross

March 2016



Sunshine, Lollipops and...

Our Sun – a rather tiny star in the galaxial scheme of things – seems inexhaustible. But 5 billion years from now, it will swallow, instead of nurture the Earth as it burns itself out – first contracting, then expanding like a flaming candle turned firecracker. Not to worry though. We won't be around. It's not that we are beyond worrying; it's that our lives are much shorter and we needn't think much about it. In the nearer term, there is global warming/climate change, and other such down to Earth problems as paying the bills and getting kids into the right colleges. Still – there are presumably inexhaustible things that deserve our attention in the here and now. One of them is finance-based capitalism and our assumption that the risk/reward historically inherent in it will be sufficient to drive economic growth forward. Unlike the Sun, whose fate and lifespan can be scientifically determined, there is little evidence that anything could ever change what has been until now a flawed, yet the best economic system conceivable. Capitalistic initiative married to an ever expanding supply of available credit has facilitated economic prosperity much like the Sun has been the supply center for energy/ food and life's sustenance. But now with quantitative easing and negative interest rates, the concept of nurturing credit seems to have morphed into something destructive as opposed to growth enhancing. Our global, credit based economic system appears to be in the process of devolving from a production oriented model to one which recycles finance for the benefit of financiers. Making money on money seems to be the system's flickering objective. Our global financed-based economy is becoming increasingly dormant, not because people don't want to work or technology isn't producing better things, but because finance itself is burning out like our future Sun.

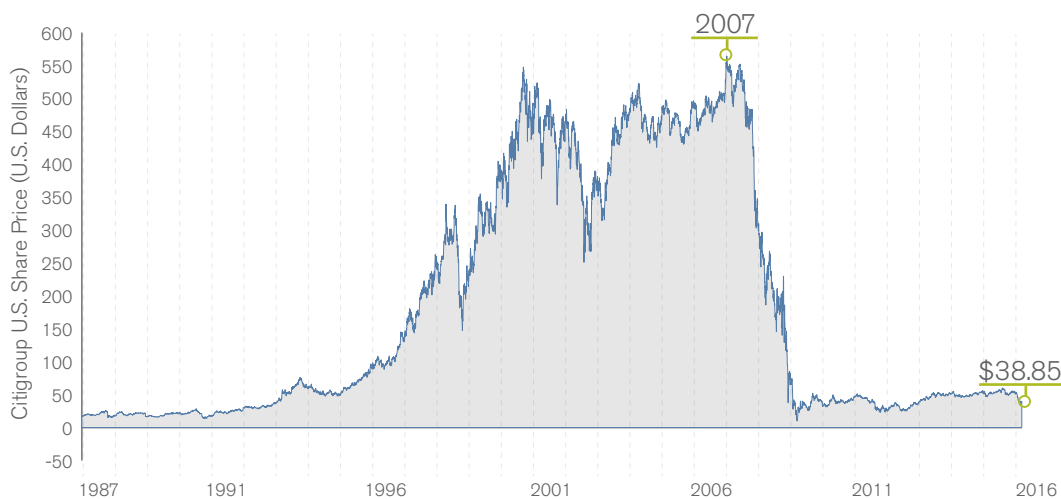
What readers should know is that the global economy has been powered by credit – its expansion in the U.S. alone since the early 1970's has been 58 fold – that is, we now have \$58 trillion of official credit outstanding whereas in 1970 we only had \$1 trillion. Staggering, is it not? But now, this expansion appears to be reaching an ending of sorts, at least in its current form. Private sector savers are growing leery of debt piled upon debt and government regulators have begun to build fences against further rampant creation. In addition, the

return offered on savings/investment whether it be on deposit at a bank, in Treasuries/Bunds, or at extremely low equity risk premiums, is inadequate relative to historical as well as mathematically defined durational risk. The negative interest rates dominating 40% of the Euroland bond market and now migrating to Japan like a Zika like contagion, are an enigma to almost all global investors. Why would someone lend money to a borrower with the certainty of getting less money back at a future date? Several years ago even the most Einsteinian-like economists would not have imagined such a state but now it seems an everyday occurrence, as central banks plumb deeper and deeper depths like drilling rigs expecting to strike oil, if only yields could be lowered another 10, 20, 50 basis points.

Banking/finance seems to be either a screaming sector ready to be bought or a permanently damaged victim of write-offs, tighter regulation and significantly lower future margins. I'll vote for the latter.

There is growing evidence that they cannot. Instead of historically generating economic growth via a wealth effect and its trickle-down effect on the real economy, negative investment rates and the expansion of central bank balance sheets via quantitative easing are creating negative effects that I have warned about for several years now. Negative yields threaten bank profit margins as yield curves flatten worldwide and bank NIM's (net interest rate margins) narrow. The recent collapse in worldwide bank stock prices can be explained not so much by potential defaults in the energy/commodity complex, as by investor recognition that banks are now not only being more tightly regulated, but that future ROE's will be much akin to a utility stock. Observe the collapse in bank stock prices – not just in the last few months but post Lehman. I'll help you: Citibank priced at \$500 in 2007, now \$38 as shown in Chart I. BAC \$50/norw \$12. Credit Suisse \$70/norw \$13. Deutsche \$130/norw \$16. Goldman Sachs \$250/norw \$146. Banking/finance seems to be either a screaming sector ready to be bought or a permanently damaged victim of write-offs, tighter regulation and significantly lower future margins. I'll vote for the latter.

Chart I: The Big C Then and Now



Source: Bloomberg

In addition to banks, business models with long term liabilities that depend on 7-8% future returns from risk assets are themselves at risk – not necessarily of bankruptcy but future profitability. The Met, the PRU, Hartford – all of these insurers whether it be for life, accident, or storm damage, cannot cover claims as conveniently as they could in the past, because they can't earn as much on their bonds and stocks. Same goes for pension funds. Puerto

Rico follows Detroit not just because of overpromised benefits but because they cannot earn enough on their investment portfolios to cover the promises. Low/negative interest rates do that. And the damage extends to all savers; households worldwide that saved/invested money for college, retirement or for medical bills. They have been damaged, and only now are becoming aware of it. Negative interest rates do that.

But central bankers seem ever intent on going lower, ignorant in my view of the harm being done to a classical economic model that has driven prosperity – until it reached a negative interest rate dead end and could drive no more. In addition, government policymakers seem to be setting up future roadblocks for savers. There is a somewhat suspicious uniform attack on high denomination bills of global currencies. Noted economists such as Larry Summers; respected journalists such as the FT's Gillian Tett, central bankers such as Mario Draghi – all seem suddenly concerned that 500 Euro or 10,000 Yen Notes are facilitating drug dealers and terrorists (which they are). But what's an economist/central banker doing opining on law enforcement? It appears that the one remaining escape hatch for ordinary citizens is being closed. Money in a mattress will heretofore be associated with drugs/terror. The cashless society which appears over the horizon may come sooner than the demise of the penny! Give a 500 Euro/take a 500 Euro is in our future I guess. Both that and the lowly penny will be equally scorned.

And that's not the end of it. If negative interest rates fail to generate acceptable nominal growth, then the Milton Friedman/Ben Bernanke concept of helicopter money may be employed. How that could equitably be distributed nationally or worldwide I have no idea, but the opinion columns are mentioning it more and more often, and on Twitter, the "Likes" are increasing in numbers. Can any/all of these policy alternatives save the "system"? We shall find out, but current evidence of the past 7 years' experience would support only a D+ report card grade. Barely passing. As an investor though – and as a citizen in this election year – you should be aware that our finance based economic system which like the Sun has provided life and productive growth for a long, long time – is running out of fuel and that its remaining time span is something less than 5 billion years.

Investment implications? Do not reach for the tantalizing apple of high yield or the low price/book ratio of bank stocks. Those prices are where they are because of low/negative interest rates. And too, do not reach for the seemingly momentum driven higher prices of Bunds and Treasuries that negative yields have produced. A 30 year Treasury at 2.5% can wipe out your annual income in one day with a 10 basis point increase. And no, you can't go to a bank and demand your cash for a fear of being labeled a terrorist. Seems like you're cornered, doesn't it? Well not quite. The secret in a negative interest rate world that poses extraordinary duration risk for AAA sovereign bonds is to (1) keep bond maturities short and (2) borrow at those attractive yields in a mildly levered form that provides a yield (and expected return) of 5-6%. Janus unconstrained portfolios attempt to do that and are inching to the head of its asset universe day by day. No guarantees. The advice about borrowing at low yields above obviously has to be matched with investments that are less volatile and least affected by the evolving changes of our monetary system. But it can be done. Closed end funds at deep discounts, highly certain acquisition arbitrage stocks, as well as volatility sales at tails are general examples.

The Sun still comes up every morning but at different times according to the season. Summer, for our credit based financial system, is past and a shorter winter-like solstice is in our future. Be prepared for change.

You should be aware that our finance based economic system which like the Sun has provided life and productive growth for a long, long time – is running out of fuel and that its remaining time span is something less than 5 billion years.

About Janus Fixed Income

Janus has been helping fixed income investors reach their financial goals for more than 25 years. Our team of investment experts is committed to delivering the stability our clients expect, with an unwavering focus on risk-adjusted returns and capital preservation. Today, we serve investors across a variety of markets by offering a diverse suite of fixed income strategies with highly complementary and distinctly separate investment approaches: a bottom-up, fundamental process led by CIO Gibson Smith, and a top-down, global macro process managed by Bill Gross.



JANUS CAPITAL[®]
Group

 **Follow Bill Gross on Twitter for his latest global macro insights: [Twitter.com/JanusCapital](https://twitter.com/JanusCapital)**

Investing involves risk, including the possible loss of principal and fluctuation of value.

Returns quoted are past performance and do not guarantee future results; current performance may be lower or higher.

The views expressed are those of the author, Bill Gross, and do not necessarily reflect the views of Janus. They are subject to change, and no forecasts can be guaranteed. The comments may not be relied upon as recommendations, investment advice or an indication of trading intent.

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

In preparing this document, Janus has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Investing in derivatives entails specific risks relating to liquidity, leverage and credit and may reduce returns and/or increase volatility.

Statements in this piece that reflect projections or expectations of future financial or economic performance of the markets in general are forward-looking statements. Actual results or events may differ materially from those projected, estimated, assumed or anticipated in any such forward-looking statements. Important factors that could result in such differences, in addition to the other factors noted with such forward-looking statements, include general economic conditions such as inflation, recession and interest rates.

Janus makes no representation as to whether any illustration/example mentioned in this document is now or was ever held in any Janus portfolio. Illustrations are only for the limited purpose of analyzing general market or economic conditions and demonstrating the Janus research process. References to specific securities should not be construed as recommendations to buy or sell a security, or as an indication of holdings.

This material may not be reproduced in whole or in part in any form, or referred to in any other publication, without express written permission. Send email requests to mediarequests@csg-pr.com. Janus is a registered trademark and New Natural is a trademark of Janus International Holding LLC.

© Janus International Holding LLC.

Investment products offered are:

NOT FDIC-INSURED	MAY LOSE VALUE	NO BANK GUARANTEE
------------------	----------------	-------------------

FOR MORE INFORMATION CONTACT JANUS

151 Detroit Street, Denver, CO 80206 | 800.668.0434 | www.janus.com

C-0316-109439 03-30-17

188-15-32803 03-16