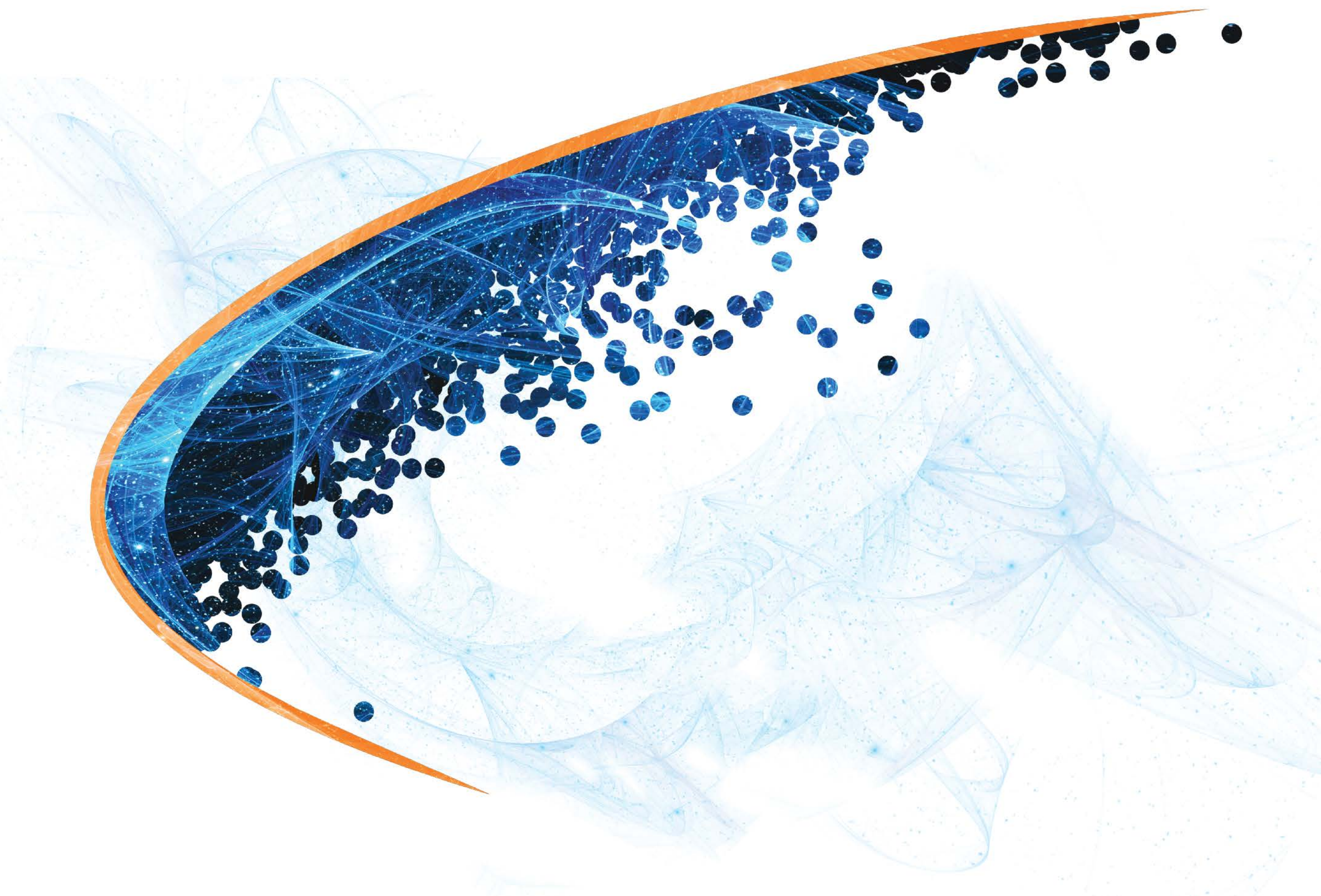
Janus Henderson
INVESTORS



# 2022 TRENDS AND OPPORTUNITIES

## REFLATION AND INFLATION: A SURVIVAL GUIDE FOR AN(OTHER) UNPRECEDENTED YEAR

Portfolio Construction and Strategy

# 2022 TRENDS AND OPPORTUNITIES

## Reflation and Inflation: A Survival Guide for An(other) Unprecedented Year

Memories of the COVID pandemic are not fading as we continue to grapple with new outbreaks, but no longer can we refer to it as "last year's problem." Instead, we now need to make sense of how to interpret last year's outsized economic data and its implications for an ongoing economic recovery. We are two years removed from the unprecedented global economic shutdown and every stage of the recovery creates a new set of questions. What can we expect from the economy as the 2020 base effects roll off? Will the current trends of high inflation and high growth continue or will one, or both, see a reversal? Where do rates go from here? With so many questions, financial professionals can be tempted to adjust their portfolios in preparation for a certain outcome, but we on the Portfolio Construction and Strategy Team believe that having a nimble allocation with the introduction of flexible active management is the key to staying afloat as we discover what economic reality we are facing.

### TAKEAWAYS:

- Longstanding equity portfolio biases leave many investors sorely underallocated to some of the most important exposures in a recovering economy.
- Duration and yield trade-offs in fixed income are exacerbating the worries we have had for years, necessitating a reassessment of where the anchor of a bond allocation should lie.

## U.S. Equity: Mid caps as your new Center of Gravity

Many of the concerns of 2021 – inflation pressures, COVID variants, and shifting monetary policy – will likely continue to dominate client portfolio discussions throughout 2022. While the last two years seem like a blur to most, it is helpful to reflect on the stark contrast of returns between U.S. equity styles. Large-cap growth equities had the upper hand during the 2020 COVID lockdown as demand for technology soared. But once vaccines were announced in late 2020, value and lower cap equities, with greater exposure to cyclical stocks, took over the top spot as the physical economy began to reopen.

### COVID Lockdown Returns (3/20 - 10/20)

| | Value | Blend | Growth |
|---|---|---|---|
| Large | -1.3 | 13.0 | 26.1 |
| Mid | -0.4 | 8.5 | 21.4 |
| Small | -4.9 | 5.2 | 14.1 |

### Post-Vaccine Returns (11/20 - 12/21)

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 39.5 | 39.4 | 39.2 |
| Mid | 44.1 | 38.4 | 28.5 |
| Small | 53.7 | 39.7 | 27.1 |

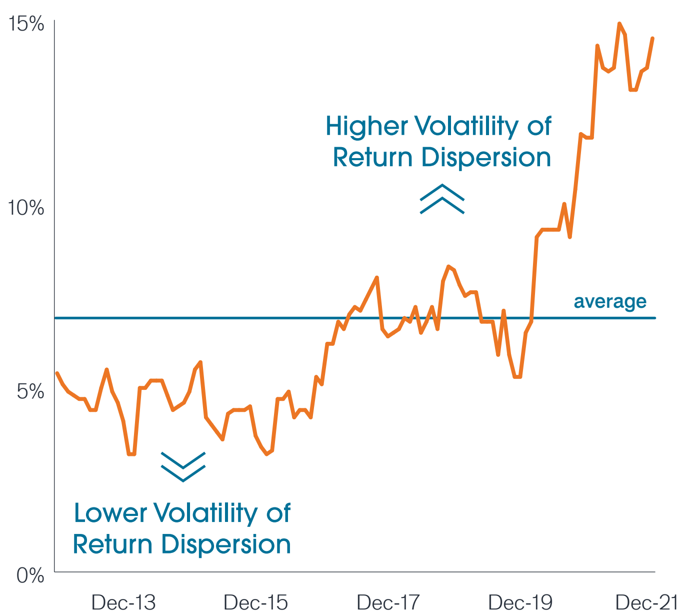
**Past performance is no guarantee of future results.** Source: Morningstar, as of 12/31/21.

The back half of 2021 was a tug-of-war between growth and value, exacerbated by the Delta and Omicron variants and equity market sensitivity to interest rate and inflation headlines. The volatility caused investors to grapple with the thought of another potential lockdown that would put the economic recovery in doubt.

An interesting approach to understanding the unpredictable swings between growth and value is to look at the rolling 1-year tracking error between the Russell 1000® Growth and Russell 1000® Value indices. This is a convenient way to measure the volatility of the return dispersion between the two indices. As seen in the chart below, the tracking error has increased significantly post-pandemic, illustrating the increasingly contentious relationship between growth and value. In short, this is a quantification of the violent leadership changes between growth and value that we've all recently felt.

### An Increasingly Contentious Relationship Between U.S. Growth and U.S. Value...

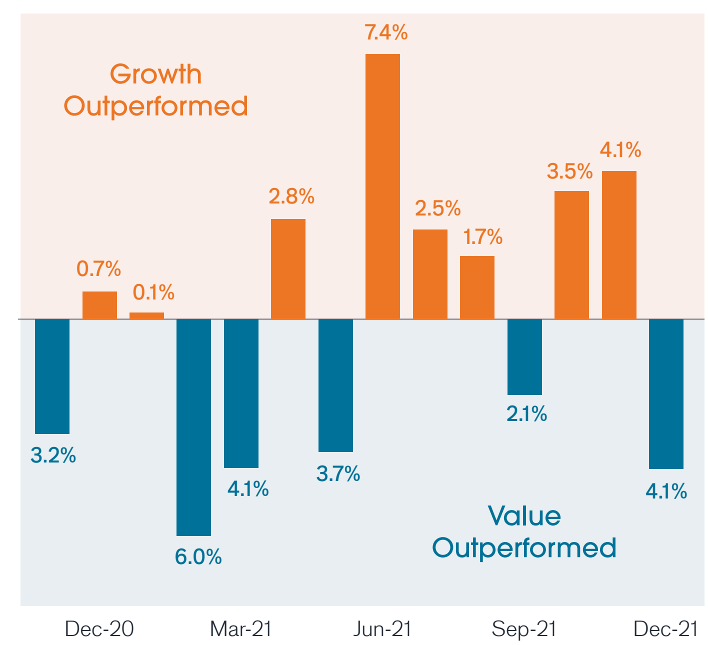
Rolling 1-Year Tracking Error




Source: Morningstar, as of 12/31/21.
Benchmarks: Russell 1000 Growth Index and Russell 1000 Value Index.

### ...Has Recently Escalated

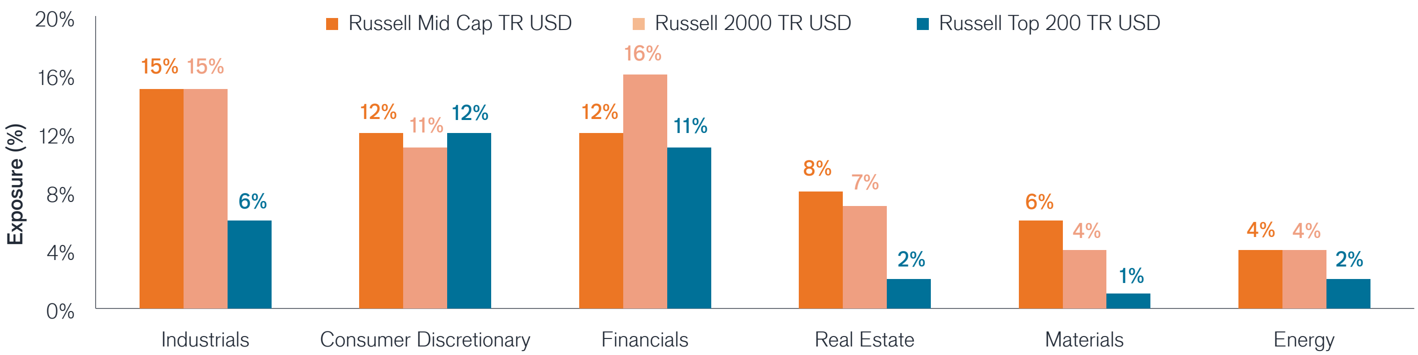
U.S. Growth and Value Relative Monthly Performance (11/20 - 12/21)



The fluctuating nature of the recovery post-pandemic demonstrates the potential benefits of owning more broad-based active equities that could provide investors more versatility within their portfolios. Through our consultations with financial professionals, we often see an overweight to large caps with an inherent tilt toward growth. This implicit (or explicit) growth overweight can in some degree be attributed to the information technology and communication services sectors comprising 40% of the S&P 500 Index. What's more, the largest five stocks represented almost 22% of the index, a level of concentration not seen even in the 2000 dot-com bubble (as of 12/31/21).

Given equity allocations are often top-heavy with an overweight to large caps, we believe there is an opportunity to move down in cap size and create a new, lower center of gravity in U.S. equity portfolios. A broader equity footprint that diversifies the traditional top-heavy, large cap overweight by adding mid- and small-cap equities can potentially provide greater exposure to the reflationary trade via cyclical sectors such as industrials, financials, materials and energy.

## Mid and Small Caps Provide Broader Exposure to Cyclical Sectors

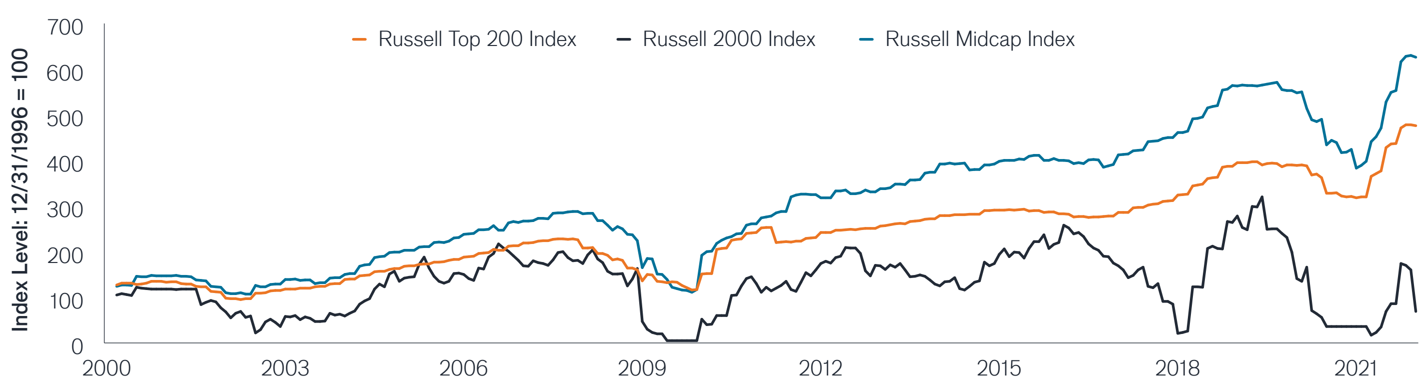



Source: Morningstar, as of 12/31/21.

Specific to mid caps, there is the potential for greater earnings growth relative to large caps. In fact, over the last 20 years, earnings in the Russell Midcap Index have grown at an average annual rate of 5.5%. By comparison, earnings rose by 4.5% annually in the Russell Top 200. Mid caps are more mature business models, which have succeeded in reaching their escape velocity from the small-cap index, proving their viability and ability to be profitable (or on a clear path to profitability). These more proven business models are also generally less volatile than their small cap peers. Also, when compared with large-cap companies, mid caps are often in the prime growth phase of the business life cycle, where they may be experiencing higher cash flow, revenue, and earnings growth rates.

## Earnings Growth in Mid Caps Historically Outpaced Small and Large Caps

Implied EPS for Small-, Mid- and Large-Cap Indices



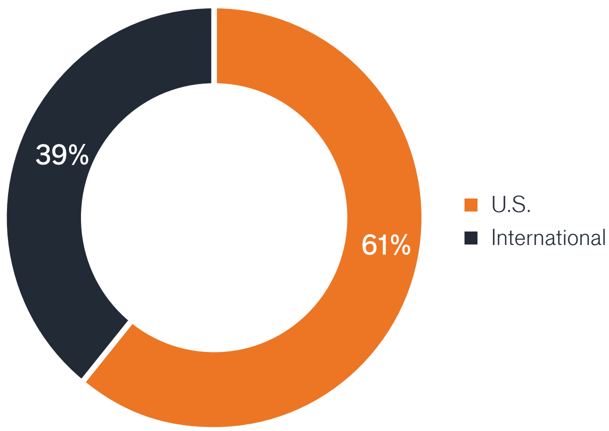

Source: Morningstar, as of 12/31/21. Earnings Per Share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.

Rather than getting stuck in the growth/value analysis paralysis, investors should consider broadening their sights, understanding different risks that may be involved, by looking down in cap size for opportunities and across sectors to access exposure to more cyclicals with current inflation and a continued recovery in mind.

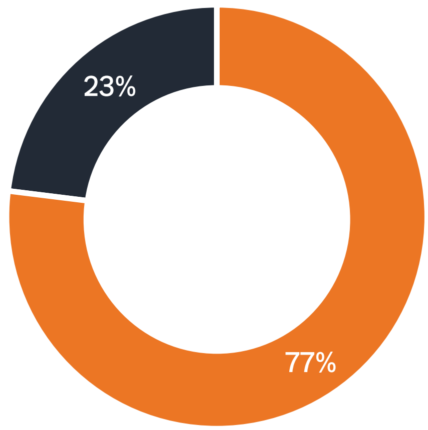
## International Equity: Don't Narrow your Range

Through our team's examination of allocations in our portfolio database, we've long noted that international stocks are underrepresented in U.S.-based portfolios relative to those regions' share of global GDP and market capitalization. Consequently, U.S. investors are typically underexposed to what we would consider the different opportunities associated with international and emerging markets investing. Given this home-country bias, the staggered reopening of the global economy post-pandemic, and recent performance differentials, we believe it could be an opportunity for U.S. investors to reconsider their international allocation to potentially participate in the next stage of the global economic reopening.

### MSCI ACWI Index Breakdown




### Average Advisor Equity Exposure



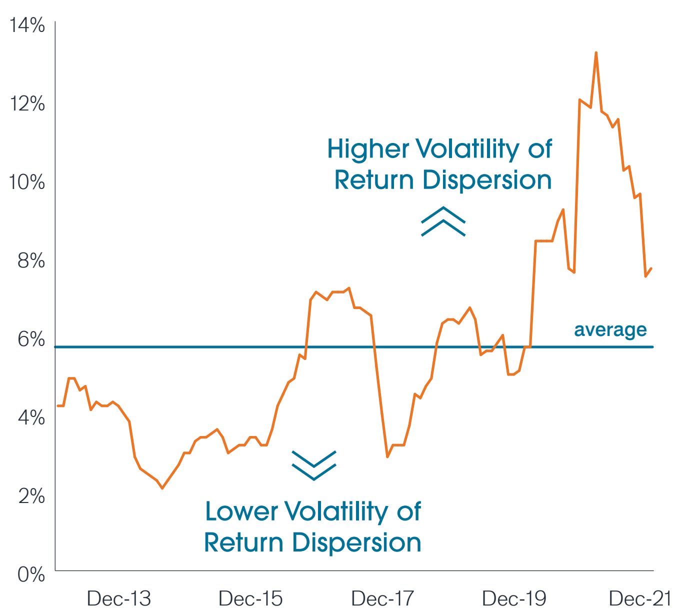

80%

OF CLIENTS WITH AN ALLOCATION TO INTERNATIONAL STOCKS HAVE A GROWTH TILT

Similar to U.S. equities, the disjointed global reopening has caused similar dispersion of returns between ex U.S. value and ex U.S. growth. Within our financial professional Portal database of clients with international stock allocations 80% of them tilt toward growth with no dedicated international value, and almost one-third of clients only allocate to international growth for their exposure abroad. Instead of focusing on a certain style factor, we believe it is prudent to broaden overseas exposure in a way that avoids the growth versus value dance.

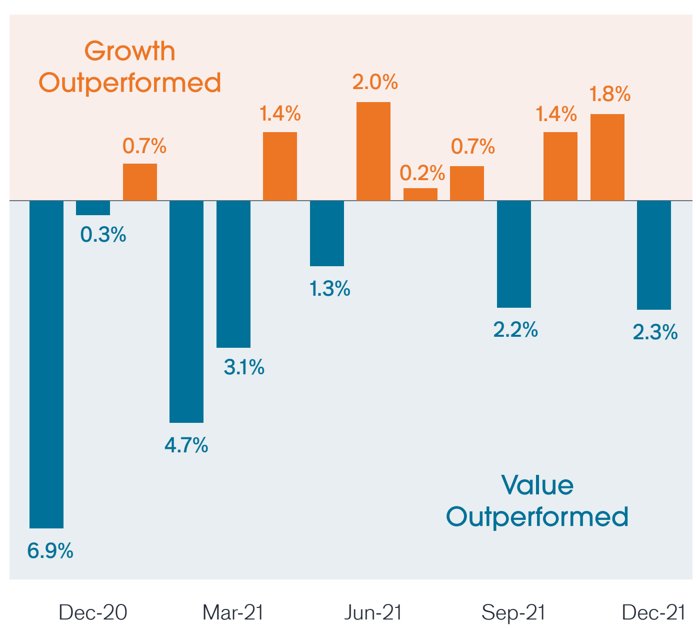
### A Similar Relationship Exists Between Ex U.S. Growth and Ex U.S. Value...

Rolling 1-Year Tracking Error




### ...Highlighted by Recent Performance

Ex U.S. Growth and Value Relative Monthly Performance (11/20-12/21)




Source: Morningstar, as of 12/31/21.
Benchmarks: MSCI ACWI ex USA Growth and MSCI ACWI ex USA Value.

And given the aforementioned home bias, we typically see advisor portfolios underexposed to cyclical sectors and industries that we believe will continue to benefit from the global economic recovery. As illustrated in the chart below, ex U.S. equities are overweight cyclical sectors relative to their U.S. counterpart. Additionally, the ACWI ex U.S. Index is trading at a 20-year high discount relative to the S&P 500 Index, creating a potential opportunity for investors looking to diversify outside the growth-heavy U.S.

## Ex U.S. Equity vs. U.S. Equity Sector Overweights/Underweights

Ex U.S. equities are weighted more heavily toward cyclical sectors and trade at a discount relative to U.S. equities


| Forward P/E (1 year) | 20-Year Average | 10-Year Average | 4Q21 |
|---|---|---|---|
| MSCI ACWI ex U.S. Index | 14.5 | 14.7 | 15.0 |
| S&P 500 Index | 16.8 | 17.9 | 22.7 |
| **Discount (%)** | **13** | **18** | **34** |

Source: Morningstar, Bloomberg, as of 12/31/21.

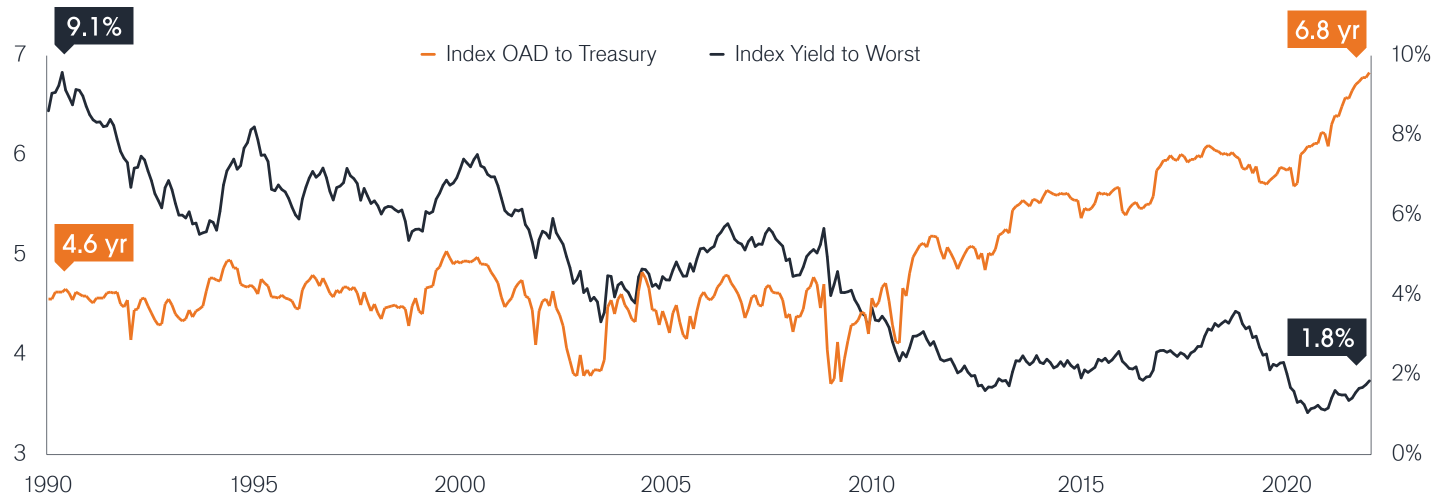
As investors revisit their global equity allocations, rebalancing into international equities could fulfill a broad mandate – geographic and sector diversification within portfolios, as well as more cyclical sensitivity to a global economic recovery.

## Fixed Income: Anchor with Flexibility

For a long time, the Bloomberg U.S. Aggregate Bond Index served as a productive core allocation for a fixed income portfolio, providing a generous yield/duration trade-off. We've watched that benefit slip away, and today the index has taken on more duration for much less yield. This is, of course, not a new trend, but worries have grown louder given YoY inflation is sitting at 7.0%[1] and the market is expecting the Federal Reserve will raise interest rates at least three times in 2022. In order to survive this market, we want to bring you back to our goals-based framework. High inflation and rate hikes do make the outlook for core bonds less attractive, but they still play an important role for portfolios. Where is the solution?

### Traditional Fixed Income's Dilemma

Bloomberg U.S. Aggregate Bond Index (1/1/1990 - 12/31/2021)




Source: Bloomberg, as of 12/31/2021

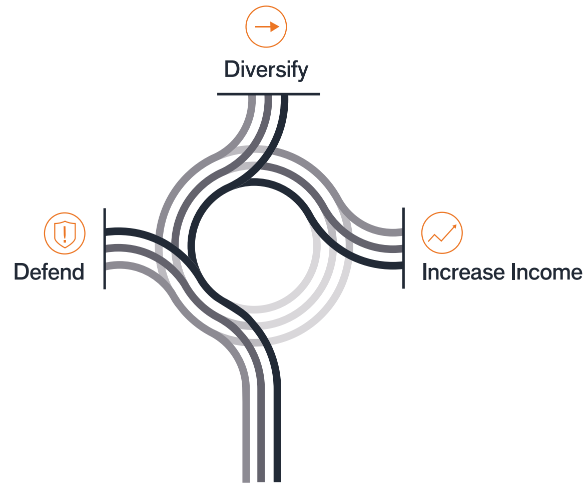
We think a solution lies at the intersection of duration, yield, and risk. Referring to the chart on the following page, first start with duration by shifting your focus to empirical duration: theoretical duration, which is commonly found on a strategy's fact sheet, often overstates real-life interest rate sensitivity; empirical duration estimates a bond's reaction to Treasury yield changes by incorporating real-life market risks (e.g., credit spreads). The gap between expected theoretical duration and the actual experienced, or empirical, duration is a valuable tool to capture real-life results and how they can be dramatically different than a simple calculation. Strategies with lower empirical duration have the ability to weather a period of rising rates better those with more duration sensitivity.

Next, factor in yield. Strategies with relatively lower (<3) empirical duration and higher (>3%) yield are positioned to perform better in high inflationary environments. This leads the reader to the top left quadrant of the chart.

Finally, incorporate risk. High Yield, Emerging Markets, and Bank Loans are largely non-investment grade, benchmark-constrained categories (red dots, "Increase Income") but the Multisector category (orange, "Diversify") is the one solution in this quadrant that has the flexibility to invest in the spectrum of sectors across the entirety of the following chart. This flexibility comes in many shapes and forms so manager due diligence in the space is critical.

### A GOALS-BASED APPROACH[2]

- Have a forward-looking mindset
- Reduce the universe of fixed income managers into three distinct objectives
- Allocate across these objectives according to one's goals

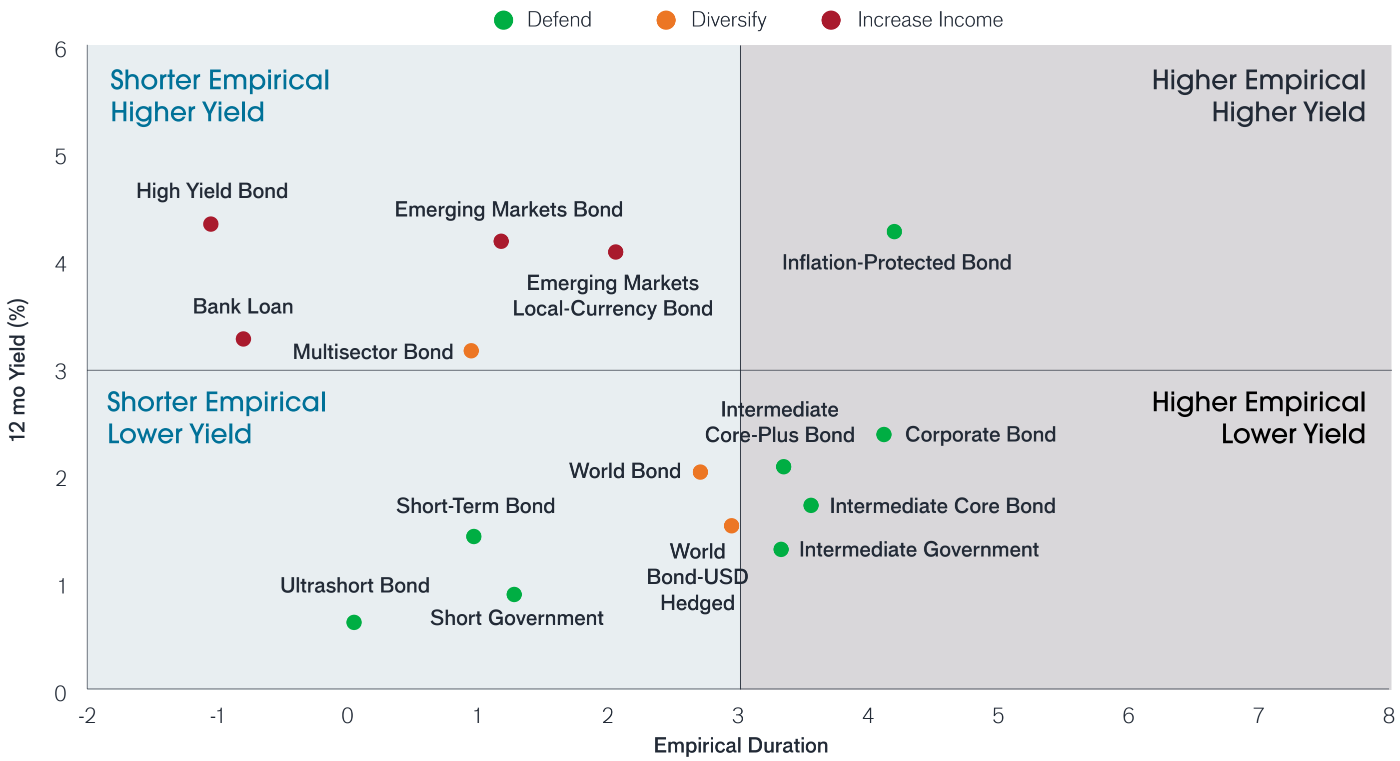



[1] YoY CPI for December, 2021

[2] For more information on our Fixed Income Framework refer to our article **Shifting Gears**

### Seeking a More Flexible Anchor

Empirical Duration vs. Yield

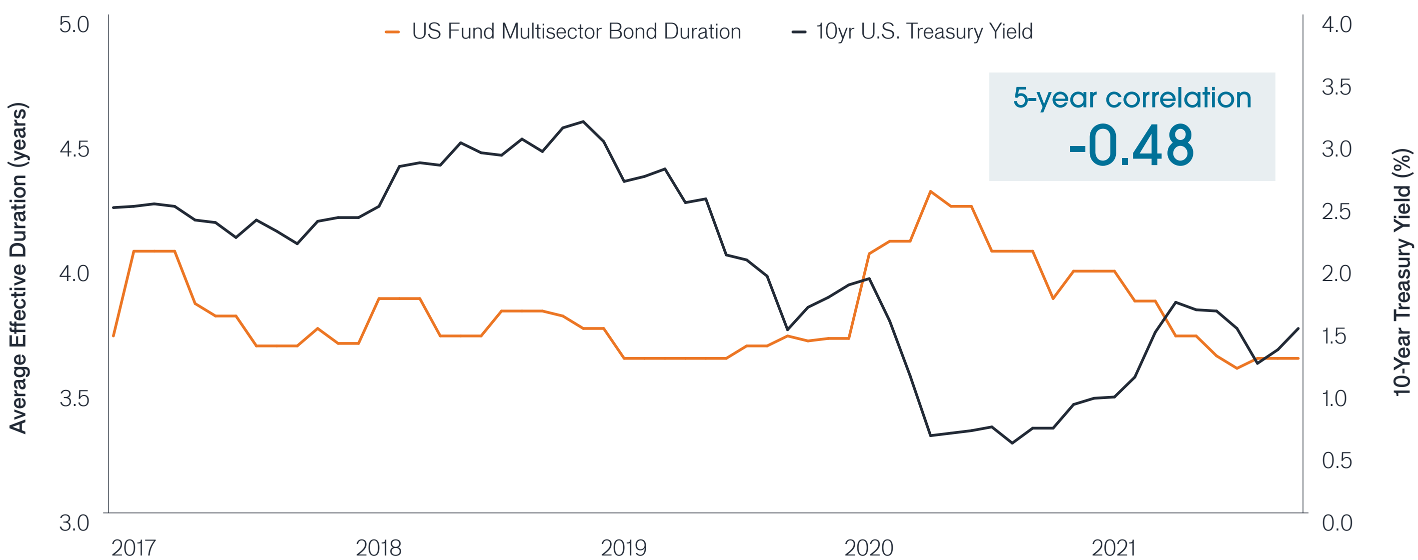



Source: Janus Henderson. Median empirical OAD for the labeled bond categories calculated from 5-year period from 11/18/2016 - 11/17/2021 using 3M rolling weekly returns. 12-month yield of the respective category as of 12/31/2021.

Additionally, the looser benchmark constraints of the Multisector space generally allow for more active duration and credit management on top of sector selection. One example of the risk-mitigating potential of this flexibility is the category's duration management. In fact, the 5-year correlation of the category's duration to the 10-year yield is -0.48, meaning as rates rise the category has shown finesse to lower its duration to combat negative returns.

Going forward we believe this flexibility is paramount as investors continue to recalibrate fixed income portfolios in the face of a new phase of duration, inflation, and credit risks. Fixed income remains a portfolio's most important anchor, and we believe this environment means it needs to be more flexible than the rigid passive fixed income anchors of the past.

### Multisector Bond Category Duration Management




Source: Morningstar, as of 12/31/2021. Orange line indicates yield and black indicates duration

## CONCLUSION

To prepare for a year in which markets will continue to be closely tied to the recovery, it can be almost impossible to predict where we'll end up after previous years' unprecedented stimulus and reopening. Throughout portfolios, mindfully balance allocations to both a cyclical recovery as well as a defensive risk-off mentality. Be active, be flexible and be nimble. Please feel free to reach out to our team as a resource to assess your allocation and make sure you have balance to survive yet another unprecedented year.

## ABOUT THE PORTFOLIO CONSTRUCTION AND STRATEGY TEAM

The PCS Team performs customized analyses on investment portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

FOR MORE INFORMATION, PLEASE VISIT **JANUSHENDERSON.COM**

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**Tracking Error** is the divergence between the price behavior of an investment and an index. **Volatility** is a statistical measure of the dispersion of returns for a given security or market index. **Reflation** is a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. **Effective duration** is a duration calculation for bonds that have embedded options. **Yield to worst** is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.



FOR MORE INFORMATION CONTACT JANUS HENDERSON INVESTORS

151 Detroit Street, Denver, CO 80206 | www.janushenderson.com