Janus Henderson

FIXED INCOME PERSPECTIVES

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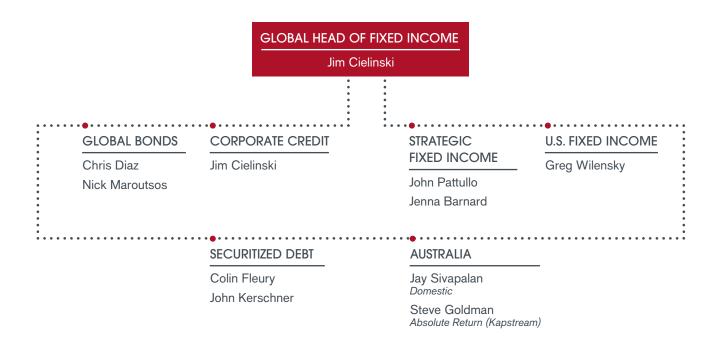
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OUR FIXED INCOME CAPABILITIES

JANUS HENDERSON FIXED INCOME PROVIDES ACTIVE ASSET MANAGEMENT SOLUTIONS TO HELP CLIENTS MEET THEIR INVESTMENT OBJECTIVES.

Over the past four decades, our global investment teams have developed a wide range of product solutions to address clients' varied and evolving needs. From core and multi-sector investing to more focused mandates, we offer innovative and differentiated techniques expressly designed to support our clients as they navigate each unique economic cycle. The capabilities of these teams are available through individual strategies or combined in custom-blended solutions.



While shared knowledge across teams and regions encourages collaboration and the debate of investment ideas, each team retains a defined level of flexibility within a disciplined construct. Our portfolio construction processes are governed by a rigorous risk management framework with the intent of delivering stronger risk-adjusted returns. Further, we believe transparency is the foundation of true client partnerships; we seek to earn and maintain our clients' confidence by delivering robust and repeatable investment processes and by providing firsthand insights from our investment professionals.

A NEGATIVE FED FUNDS RATE: NOT YET WILLING - OR NEEDING - TO GO "THERE"





GLOBAL BONDS

Co-Head of Global Bonds **Nick Maroutsos** states that even without negative interest rates, bond portfolios must work harder to achieve desired results.

Source: Getty Images

KEY TAKEAWAYS

- We believe that the Federal Reserve would seek to exhaust other policy options before resorting to negative interest rates.
- Lower yields in the wake of interest rate cuts and Fed purchases have negatively impacted the risk/return profiles for bonds.
- Shorter-dated, investment-grade corporate credits are, in our view, one of the few pockets of the bond market likely able to provide steady income, capital preservation and low volatility.

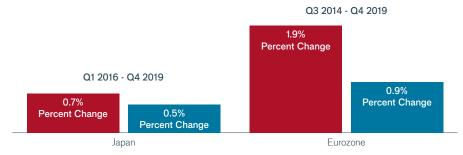
As U.S. monetary policy ventures deeper into uncharted territory, the expectation that the Federal Reserve (Fed) will ultimately resort to negative interest rates has grown. For a brief period in early May, prices on fed funds futures signaled that the benchmark overnight rate could turn negative by early 2021. Fueling these predictions were collapsing employment, consumption and manufacturing data as the COVID-19 pandemic shut down large swaths of the U.S. economy.

We believe that negative rates in the U.S. are not imminent. Shaping our view are comments by none other than Fed Chairman Jerome Powell, who stated that the central bank has plenty of other tools to deploy before resorting to negative rates. He – among others – is also aware that in Japan and the eurozone, two regions that have already gone down the negative rate path, the measure has not been a panacea, failing to ignite growth or inflation. Furthermore, real interest rates – those upon which investment decisions are made – have been negative since early in the year. Given that economic activity tends to lag rate cuts, the Fed may want to assess future data before committing to even more unprecedented policy.

EXHIBIT 1: NEGATIVE RATES NO MAGIC BULLET FOR JAPAN OR EUROZONE

Even after adopting a negative interest rate policy, neither Japan nor the eurozone has been able to spur inflation or economic growth.

- Average Quarterly GDP Growth (Annualized)
- Average Quarterly Inflation (year over year)



Source: Bloomberg, as of 15 May 2020

A NEGATIVE FED FUNDS RATE: NOT YET WILLING - OR NEEDING - TO GO "THERE" (cont.)

AN UNEXPECTEDLY LARGE TOOLKIT

As evidenced by his actions over the past few months, Mr. Powell appears to be a man of his word. The Fed has increased its balance sheet by 66% this year, purchasing Treasuries, mortgage securities, investment-grade and even select high-yield corporate debt. We have little doubt that he has additional levers to pull to support the economy.

In addition to increasing the amount of its purchases, the Fed can continue to expand the breadth of its programs with the aim of aiding the sectors hardest hit by the pandemic as well as those with limited – or no – access to credit markets. Another card up its sleeve may be yield curve control (YCC), a program that seeks to keep certain segments of the yield curve within a defined band. Should the Fed go down this route, we believe YCC would target the front end of the curve, with the aim of maintaining favorable conditions for the large number of corporate borrowers that tend to issue debt in the three -to five-year range.

FISCAL SUPPORT PLAYING ITS PART - FOR NOW

For much of the post-Global Financial Crisis (GFC) era, Fed officials have consistently advised that monetary policy cannot go it alone and that governments must do their share by ratcheting up fiscal stimulus. In the wake of the massive programs signed into law as portions of the U.S. economy shut down, it's hard to argue that elected officials have not met the challenge. But we believe that more is likely to be done. Lacking the immediacy of the past few months, additional fiscal measures may take more time to be enacted, but absent certainty on the duration of the pandemic and how consumer and business behavior may permanently change, we believe the government will be forced to take further steps to support fragile businesses and industries.

THE TRAVAILS OF A BOND INVESTOR IN A LOW-YIELDING WORLD

The newest round of quantitative easing and low interest rates create formidable challenges for fixed income investors. With the Fed's open-ended commitment to purchase Treasuries and other assets, a bond investor's core tenet of capital preservation appears intact. The objective of income streams commensurate with the level of risk incurred, however, may prove more elusive, continuing a trend that has lasted for most of the post-GFC era. For example, in the decade through December 2007, a 122 basis point (bps) increase in interest rates would have been required to wipe out the annual yield on the Bloomberg Barclays U.S. Aggregate Bond Index. With yields having tumbled and duration remaining elevated, it would now take only a 24 bps rise in rates to eliminate the year's expected yield.

For investment-grade corporate debt, the bar for eliminating a year's returns is a 33 bps rate increase. While intermediate corporates register a slightly better hurdle of 49 bps², corporate debt in the one- to three-year range has a larger cushion of 82 bps³.

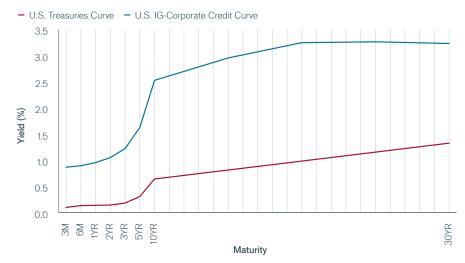
ALL ROADS LEAD TO THE FRONT END

With this in mind, we believe the incremental return one may earn by venturing farther out along the yield curve is not worth the additional risk. Granted, we don't foresee a sell-off in longer-dated securities given low growth, scant inflation and the Fed's commitment to low rates, but the comparable returns on shorter-dated bonds, along with their lower volatility and greater liquidity, create a compelling argument that the front end of the curve is, at present, the natural home for investors seeking the traditional characteristics expected of bonds.

A NEGATIVE FED FUNDS RATE: NOT YET WILLING - OR NEEDING - TO GO "THERE" (cont.)

EXHIBIT 2: U.S. TREASURIES AND INVESTMENT-GRADE CORPORATE CURVES

Shorter-dated debt contains nearly all the yield of longer-dated securities, and corporates have the added benefit of higher yields over Treasuries even as the Fed supports the investment-grade credit market.



Source: Bloomberg, as of 15 May 2020

While investors don't give up much in potential returns by concentrating on the front end of the curve, yields here – especially for Treasuries – are exceptionally low. One can navigate that, however, by focusing on investment-grade corporates, which are now directly supported by Fed purchases. We don't go as far as others by saying "the investment-grade corporate curve is the new Treasuries curve" but with its more pronounced term premium – along with its imbedded risk premium – shorter-dated corporates, in our view, offer some of the most attractive risk/return profiles in today's still-uncertain markets.

A NEGATIVE FED FUNDS RATE: NOT YET WILLING - OR NEEDING - TO GO "THERE"

- ¹ Based on the Bloomberg Barclays U.S. Corporate Bond Index. The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate bond market.
- ² Based on the Bloomberg Barclays U.S. Intermediate Corporate Bond Index. The Bloomberg Barclays U.S. Intermediate Corporate Bond Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate bond market whose maturity ranges between 1 to 9.9999 years.
- ³ Based on the Bloomberg Barclays U.S. Corporate 1-3 Year Index. The Bloomberg Barclays U.S. Corporate 1-3 Year Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate bond market with 1-3 year maturities.

Investment-grade corporate bond A bond typically issued by companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default, such as high-yield bonds.

High-yield corporate bond A bond that has a lower credit rating than an investment grade bond. Sometimes known as a sub-investment grade bond. These bonds carry a higher risk of the issuer defaulting on their payments, so they are typically issued with a higher coupon to compensate for the additional risk.

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.

TAKING HIGHER-QUALITY RISK IN CORE PLUS BOND PORTFOLIOS





U.S. FIXED INCOME

Greg Wilensky, Head of U.S. Fixed Income, discusses the importance of identifying and diversifying risk factors in bond portfolios.

Source: Getty Images

KEY TAKEAWAYS

- ▶ U.S. bond valuations are balanced between an uncertain economic outlook and the explicit support of the U.S. Federal Reserve (Fed).
- ▶ We believe the Fed will continue to intervene in bond markets to ensure liquidity remains sufficient and is likely to act further to support markets if required. Nevertheless, we expect uncertainty and volatility to remain high, amplifying the need for careful security selection.
- We favor identifying areas of the bond markets where the current liquidity premium is high, notably in higher-quality and shorter-dated securities, and likely sufficient to compensate for future liquidity risk.

If necessity is the mother of invention, investment managers have to be creative people. We have a daily necessity to add value for our clients, and a seemingly endless supply of "unexpected" events, even crises, that demand regular reinvention. But investment managers are trained to manage risk, and most managers do it by applying general principles to help tackle each new unknown and its corresponding surge in volatility.

DO YOU TRADE THE ECONOMY OR THE FED?

Consider today's corporate bond market, which is suspended between two competing forces: A highly uncertain macroeconomic outlook and the (almost) limitless support of the U.S. Federal Reserve (Fed). To figure out the fair value of a particular security do you make a macroeconomic call, trusting your forecasts, or rely on the Fed to be a buyer of last resort? In portfolio manager parlance, do you trade the economy or the Fed?

Our answer is: neither, because one of our core principles is that the long-term value is added by understanding investment risk at the security level. A bottom-up approach, if you will. And another core principle is that the closest thing to a free lunch in investment management is the efficiency gained from having a portfolio of risks. Diversifying risk allows the potential to build a portfolio with the same risk as the benchmark, but with a slightly higher return, or the same return as the benchmark, but with slightly less risk. In our view, the choice between trusting the Fed to underwrite the bond market – whatever the macroeconomic data brings – and making a call on what economic havoc the coronavirus could wreak is a false one. Or, more precisely, it is a low-quality question. The higher-quality question is: Given what we do know, can managers create a portfolio of risks that has a greater chance of delivering steady total returns?

TAKING HIGHER-QUALITY RISK IN CORE PLUS BOND PORTFOLIOS (cont.)

SEPARATING THE IMPACT OF ECONOMIC CONTRACTION FROM THAT OF ILLIQUID MARKETS

We believe the answer to that question is: yes. The Fed cannot ensure an economic recovery but it can help ensure that the corporate bond market remains functional. By injecting liquidity into markets, the Fed hopes to keep individual quality (and solvent) companies from failing because they either cannot rollover their existing debt or they cannot raise funds to cover the short-term cash shortfall caused by the pandemic. In sum, the Fed has more control over liquidity, and the corresponding premium companies must pay to borrow in volatile, illiquid markets. We think you can separate the question "what is the price impact of the sharpest economic contraction in a lifetime?" from the question "what is the price impact of an illiquid market?"

Going into March 2020, U.S. corporate bond spreads in both the investment-grade and high-yield sectors were relatively close to their historically tightest levels. The shock to markets from the spread of and attempts to contain COVID-19 that hit in March caused those spreads to widen dramatically. Valuations moved to price in both the deteriorating and highly uncertain economic and fundamental pictures, as well as a collapse in liquidity. Then, the Fed's swift and strong intervention, through a variety of programs, boosted the markets', and our own, confidence. With the Fed's help, credit – particularly the higher-rated segments of the corporate and securitized markets – grew more attractive by late March. But the economic outlook remained far from clear.

TARGETING LIQUIDITY RISK

Adding aggregate credit risk to a core portfolio can be effective, if you are right on the direction of the market. Adding high-yield credit risk in volatile times is a particularly high "beta" version of this approach. But in order to diversify risks, we believe it prudent to look at what sectors and securities underperformed the most "per unit of risk" in a volatile period and what kind of risk was being priced into spreads at the time. This helps us identify the sectors and securities where "illiquidity" is responsible for the largest declines.

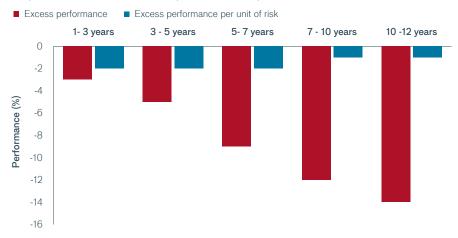
In March, for example, we knew certain securitized sectors where hard hit because of forced unwinds of levered investors in the asset class, even ones predominately invested in Agency mortgage-backed securities (MBS). And, in our analysis, the higher-quality sectors, such as AAA rated securitized products including asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS), as well as A rated corporate bonds looked to have priced in a comparatively high liquidity risk premium. That premium resulted from investors' need to raise cash whether from fund withdrawals or, in the case of levered investors, to meet margin calls.

To help perform our analysis, we looked to the Duration Times Spread (DTS) measure to quantify the risk in different securities. The simple multiplication of a security's duration by its spread creates a metric that accounts for both a security's term risk and its credit risk. What it doesn't account for is liquidity risk. But by dividing a security's DTS by its historical excess return, we can show how it performed "per unit of DTS risk," or how it performed given its unique combination of duration and spread over Treasuries.

TAKING HIGHER-QUALITY RISK IN CORE PLUS BOND PORTFOLIOS (cont.)

EXHIBIT 1: 1Q20 EXCESS PERFORMANCE & EXCESS PERFORMANCE PER UNIT OF RISK FROM U.S. CORPORATE CREDIT TENORS

As performance decreases, performance per unit of risk increases



Source: Bloomberg, Janus Henderson, as of 31 March 2020. Excess returns represent returns above that attributable to falling U.S. Treasury yields of the various maturities of the Bloomberg Barclays U.S. Corporate Bond Index. The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate bond market.

The chart above shows the excess returns (the returns above that attributable to falling U.S. Treasury yields) of the various maturities of the Bloomberg Barclays U.S. Corporate Bond Index, and their return per unit of risk. As would be expected given heightened uncertainty, the longer the bond, the worse its performance during a particularly weak period for the overall market. But the return per unit of risk was exactly the opposite: The shorter the bond, the worse it performed per unit of risk. Why? Because, in a liquidity crisis, shorter and/or high-quality bonds tend to suffer the most because they are the most liquid instruments at the time. When investors need to raise cash, they sell what they can.

By looking at the difference between a bond's performance and its performance per unit of risk, we can get a sense of just how much liquidity (or lack of it) affected the bond's performance. This allows us to differentiate the premium offered due to illiquidity from the premium offered for macroeconomic risk. In a sense, we are "trading the Fed," but with an important difference: We are isolating the ability of the Fed to provide liquidity, not to cure the macroeconomic ills, or even to be a buyer of last resort for companies struggling to cash capital. Instead, we are focusing on the extra yield offered because securities are illiquid – a problem we believe the Fed addressed in March and will ensure does not return.

The excess yield being offered in most shorter-tenor securities may not be a lot when compared to a high-yield bond, or even the average investment-grade corporate bond. But in our view, the slight yield pickup provided by these relatively short securities offers an attractive risk/reward profile due to the lower probability that issuers will have trouble meeting near-term obligations. Particularly in volatile environments when (as redundant as it may sound) the unknowns are large and the potential impacts are even larger, we think it can make sense to buy more securities with a lower risk profile than adding a lesser amount of securities offering a higher risk profile. When you can isolate the premium being offered for one kind of risk and have confidence that this particular risk will be mitigated by the U.S. Federal Reserve, even better.

TAKING HIGHER-QUALITY RISK IN CORE PLUS BOND PORTFOLIOS (cont.)

LOOKING AHEAD

We do not know the extent of the current recession as its path is dependent on a particularly hard-to-predict set of variables: how well our society bothcontains and treats COVID-19. We believe uncertainty will remain high, keeping volatility relatively elevated (though we do not expect it to return to the highs of March), which should sustain both a liquidity premium and wider dispersion in security pricing. While it would be nice if the economy recovers and spreads compressed quickly, we are happy to earn the excess return generally gained over time.

During periods when volatility is high, we believe bottom-up security analysis is key to identifying higher-quality risks: Finding pockets of securities with, in our view, either mispriced risk or an excessive liquidity premium, or both. And, should a second wave of the virus wash over the markets, we expect higher-quality assets to suffer less on a return basis as well as, with the continued support of the Fed, on a liquidity basis. We believe a commitment to finding the long-term value added by understanding investment risk at the security level and assembling these risks into portfolios that aim to produce lower-volatility, incremental returns should guide us through the unknowns in the months ahead.

TAKING HIGHER-QUALITY RISK IN CORE PLUS BOND PORTFOLIOS

Volatility: The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

Spread: A measure of how much additional yield an issuer offers over comparable "risk-free" U.S. Treasuries. In general, widening spreads indicate deteriorating creditworthiness of corporate borrowers, tightening spreads are a sign of improving creditworthiness.

Beta: Measures the volatility of a security or portfolio relative to an index. Less than one means lower volatility than the index; more than one means greater volatility. Securitized Sectors: Refers to fixed income securities that pool financial assets together to create new securities that can be marketed and sold to investors.

Levered Investors: Refers to an investing technique that seeks higher investment profits by using borrowed money. These profits come from the difference between the investment returns on the borrowed capital and the cost of the associated interest. Leveraged investing exposes an investor to higher risk.

Mortgage-backed security (MBS): A security which is secured (or 'backed') by a collection of mortgages. Investors receive periodic payments derived from the underlying mortgages, similar to coupons. Similar to an asset-backed security.

Asset-backed securities (ABS): A financial security which is 'backed' with assets such as loans, credit card debts or leases. They give investors the opportunity to invest in a wide variety of income-generating assets.

Commercial mortgage-backed securities (CMBS): are fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate.

Liquidity Premium: A premium resulting from investors' needs to raise cash whether from fund withdrawals or, in the case of levered investors, to meet margin calls.

Margin Call: A margin call refers to a broker's demand that an investor deposit money or securities into a margin account (which contains securities bought with

borrowed money) so that the account is brought up to the minimum required value.

Duration Times Spread (DTS): A method for measuring the credit volatility of a corporate bond. Calculated by multiplying a bond's spread-durations and its credit spread.

Duration: Measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice

Excess Return: Indicates the extent to which an investment out- or underperformed an index.

High-yield bond: A bond that has a lower credit rating than an investment grade bond. Sometimes known as a sub-investment grade bond. These bonds carry a higher risk of the issuer defaulting on their payments, so they are typically issued with a higher coupon to compensate for the additional risk.

Investment-grade corporate bond: A bond typically issued by companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default, such as high-yield bonds.

ARE NEAR-TERM DEBT LEVELS A DISTRACTION?





CORPORATE CREDIT

Credit portfolio managers **John Lloyd** and **Tim Winstone** argue that markets are fixated with the near-term expansion in debt levels when a deeper look at credit fundamentals shows a more nuanced picture.

Source: Getty Images

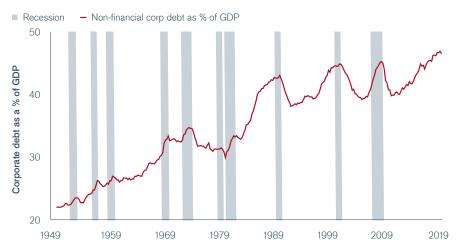
KEY TAKEAWAYS

- ► The non-financial sector went into this crisis with record levels of borrowing and much of the central bank largesse, while welcome, will inflate this further.
- Yet corporates are adapting and refinancing their debt, which could help to reduce bankruptcy/default risk.
- We can expect an acceleration of structural disruption and differences in corporate responses, underscoring the need for discrimination in lending.

A cursory glance at the chart below and investors might be forgiven for thinking corporates have a debt problem.

EXHIBIT 1: US NON-FINANCIAL CORPORATE DEBT AS A % OF US GDPS

This has reached record levels as interest rates have trended down.



Source: FRED, Federal Reserve Bank of St Louis. Q4 1949 to Q4 2019, data as at 30 May 2020. GDP = gross domestic product.

Since the Global Financial Crisis, financials have been deleveraging but non-financial corporates have been leveraging up since 2011. In fact, as a percentage of gross domestic product US corporate borrowing reached a record high last year. Much of this is understandable: the downward trend in interest rates incentivises companies to use debt as a cheap source of financing.

ARE NEAR-TERM DEBT LEVELS A DISTRACTION? (cont.)

DEBT LOAD IS NOT UNIFORM

The coronavirus crisis will raise leverage levels further as lost revenues are substituted by corporate borrowings to allow them to bridge the revenue valley caused by economic lockdowns and social distancing measures. Yet it may also lead to some positive longer-term outcomes. In Exhibit 1 there is a noticeable downward trend in borrowing after each recession event. We can probably expect something similar to occur post the COVID-19 crisis as companies scarred by the crisis seek to re-strengthen balance sheets.

This is where analysis of credit fundamentals come into play. We know 2020 aggregate leverage will rise. The leverage ratio of Net debt/EBITDA will see an expansion of the numerator as companies borrow more and a shrinking of the denominator as earnings fall.

Yet much of the recent issuance has been to refinance existing debt or to provide a liquidity cushion in case things get worse. Refinanced debt does not increase the total debt burden and actually reduces the near-term risk of restructuring/bankruptcy. For companies that are raising excess liquidity to protect in a downside scenario, this should not be considered a long-term increase in the debt burden as they will likely look to reduce debt once the economic environment normalises. And if the borrowing simply sits as cash on the balance sheet, then net debt is unchanged.

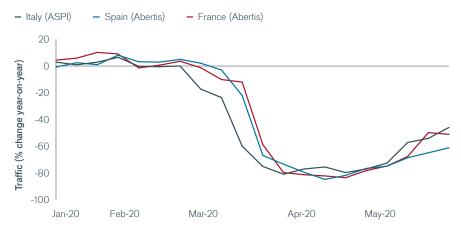
Of course, some companies are raising debt to fund negative free cash flow. This clearly increases the debt burden and it is where credit fundamentals matter the most. How long will companies burn through cash? Do these companies have the ability to support the increased debt burden? What might be the expected default rates?

We can establish which sectors and areas of fixed income are most likely to be hardest hit and which may come through this in even better shape. For example, in Europe, estimated earnings growth for 2020 sees sectors such as pharmaceuticals, technology and food retail experiencing positive single digit earnings growth. In contrast, consumer discretionary sectors are hardest hit, with year-on-year earnings declining more than 50% for sectors such as autos, energy and transport. The numbers appear stark, but we need to remember that 2021 figures are likely to show a significant bounce-back as economies recover.

Yet taking one sector as a whole masks differences within that sector. The transport sector is a case in point. Companies within it are better placed than others for a re-opening of the economy. Social distancing is likely to present ongoing challenges for airlines and airport operators where passenger volume was a key element in driving revenues and cash flow. Some airline operators are expecting only to have 30% of their normal capacity in what would traditionally be the peak summer period. In contrast, toll roads could see a swifter return to normal given that social distancing here is not an issue and private vehicle use could potentially rise if people are reluctant to use public transport. Road traffic within Europe has quickly begun to recover as Exhibit 2 shows, even before lockdowns are fully eased.

ARE NEAR-TERM DEBT LEVELS A DISTRACTION? (cont.)

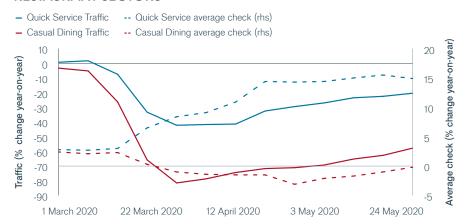
EXHIBIT 2: TOLL ROAD TRAFFIC



Source: Goldman Sachs, company data, 12 January 2020 to 24 May 2020, data as at 28 May 2020

Similarly, in the US restaurant sector, we are seeing a dichotomy between quick service restaurants (QSR or fast food) and casual dining (more lingering at seat service). The former has traditionally carried higher leverage because cash flow tends to be more predictable and during recessions revenues have historically been firmer. This was certainly true during the Global Financial Crisis and looking at Exhibit 3 we can see this to be the case so far during the COVID-19 crisis, with traffic (footfall) declining far less in QSR. More efficient drive-thru only operations and consumers' greater comfortability with off-premise oriented dining is helping QSRs to outperform casual dining. Structurally, QSRs are more likely to be national chains rather than independents and so are in a stronger position to benefit from enhanced scale and resources or to access capital markets to weather the pandemic.

EXHIBIT 3: TRAFFIC AND AVERAGE CHECK IN US RESTAURANT SECTORS



Source: Jeffries, Miller Pulse, 1 June 2020

ARE NEAR-TERM DEBT LEVELS A DISTRACTION? (cont.)

Casual dining has also seen declines in average check (cost of meal) as patrons look to trim expenditure on a higher ticket meal. For QSRs, however, average checks have risen around 15% in recent weeks as they are offering more family meals and restaurant traffic has shifted to dinner (breakfast and lunch traffic have waned due to soaring unemployment and the shift to working from home), which is a higher ticket.

STRUCTURAL CHANGE

The changes visible in the restaurant industry may be only temporary, more permanent is the acceleration in structural change. Technology companies are likely to be the winners as online retailing becomes more embedded, video-conferencing reduces the need for face-to-face meetings and streamed entertainment proliferates. Shifts in behaviour tend to become permanent when adopted by a majority and many people have (forcibly) begun to normalise a more digital world.

Equally potent is how individual corporates respond. The crisis is likely to bring forward internal structural change, with companies bringing in more technology and cutting costs. The pace of recovery will ultimately determine the default rate: a prolonged downturn or W-shaped recovery will erode cash reserves and challenge liquidity among more vulnerable and cyclical companies.

POLICY RESPONSE - THIS TIME IT'S DIFFERENT

In that regard, it is worth highlighting the strength of the policy response, both in terms of its size and its speed. A trifecta of stimulus is available – low interest rates, quantitative easing and fiscal support. Moreover, monetary and fiscal policy are working in unison, unlike following the Global Financial Crisis when government austerity undid monetary easing.

The figures are impressive. By late May, central banks globally had announced nearly US\$9 trillion of supportive measures, including a US\$4.5 trillion expansion of their balance sheets since the end of February alone. Coupled with this is more than US\$3 trillion of fiscal stimulus (not counting the automatic stabilisers of normal welfare) from governments and a further US\$6 trillion of below-the-line fiscal measures such as guarantees, loans and capital injections.²

This is meaningful to both interest rate risk and credit risk. Central bank accommodation is facilitating bond issuance and expectations for low interest rates reduce duration risk. The fiscal support should directly and indirectly make its way into supporting corporates, lowering credit risk. Taken together, they help explain why credit spreads have snapped back significantly from their widest levels in March.

Ultimately, therefore, a near-term rise in debt levels may be both manageable in an environment where rates are held low and temporary as companies use the expected recovery to repair their balance sheets. Differentiating between those companies where this is true and those for which the crisis is an insurmountable obstacle will be key.

ARE NEAR-TERM DEBT LEVELS A DISTRACTION?

- ¹ Source: MSCI, IBES, FactSet Estimates, Morgan Stanley Research, 22 May 2020.
- ² Source: Deutsche Bank, Covid-19: Policy responses by G20 economies, 21 May 2020.

Leverage ratio: Any one of several financial measurements that look at how much capital comes in the form of debt (loans) or assesses the ability of a company to meet its financial obligations.

Net debt: Total debt minus cash and cash equivalents.

EBITDA: Earnings before interest, tax, depreciation and amortisation. A metric used to measure a company's operating performance that excludes how the company's capital is structured (in terms of debt financing, depreciation, and taxes).

Credit Spread: The difference in yield between securities with similar maturity but different credit quality. In general, widening spreads indicate deteriorating creditworthiness of corporate borrowers, narrowing spreads are a sign of improving creditworthiness.

THE LONG-TERM OPPORTUNITY IN STRUCTURED SECURITIES





SECURITIZED DEBT

The Securitized Debt team discusses its positive long-term outlook for U.S. structured securities in higher-quality, seasoned and shorter-dated exposures.

Source: Getty Images

KEY TAKEAWAYS

- ▶ Many structured securities have lagged corporate bonds in their recovery from the lows of March as the latter received more explicit support from the Federal Reserve (Fed). But the ability to earn higher income for credit similarly rated to the U.S. government is, in our view, compelling.
- Given the large opportunity set in the securitized market, we believe that in-depth research can reveal mispriced securities with an attractive risk/ reward outlook.
- We broadly favor higherquality, seasoned and shorterduration exposures as we maintain our view that these characteristics offer investors attractive risk-adjusted returns in uncertain, volatile and lowyielding times.

Why have many structured securities broadly lagged corporate bonds in their recovery from the lows of March? The primary cause, in our view, was the Federal Reserve's (Fed) explicit support for corporate bonds. In contrast to its direct support to both the investment-grade and high-yield corporate bond markets, in terms of structured securities, the Fed is only buying Agency mortgage-backed securities (MBS), albeit in historic amounts. To the rest of the securitized market, the Fed offered only a variant on the Term Asset-Backed Securities Loan Facility (TALF) and limited it to AAA rated commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS). The effect, predictably, has prolonged the illiquidity of the securitized market generally, delaying its recovery. But this unusual situation could create a unique opportunity for investors with in-depth fundamental research capabilities – and patience.

WHAT WILL SPARK THE SECURITIZED MARKET TO RISE?

2020 is not 2008. While the downturn in 2008 was caused primarily by excess leverage in the financial sector generally and structured securities specifically, the 2020 crisis has been the result of a sudden, swift, economic shutdown with no more cause attributable to the securitized market than the investment-grade corporate bond market. In fact, many of the fundamental variables were stronger for securitized sectors in early 2020 – consumer leverage was relatively low compared to corporate leverage and aggregate asset qualities (which underly the securities) were relatively high.

We do not know the breadth or depth of the current recession and (outside of Agency MBS) expect caution and lower liquidity to prevail across the securitized market until the economic outlook is clearer. However, current yields broadly reflect this, remaining well above their pre-crisis levels while U.S. government bond yields are at historic lows (and remarkably close to zero). The additional income available for structured securities that carry the same AAA rating as the government, or better, may warrant a closer look.

THE LONG-TERM OPPORTUNITY IN STRUCTURED SECURITIES (cont.)

EXHIBIT 1: YEAR-TO-DATE YIELDS FOR CORPORATE AND STRUCTURED SECURITIES



Source: Bloomberg, as of 30 April 2020. CMBS: Bloomberg Barclays U.S. Commercial Mortgage Backed Securities Index. MBS: Bloomberg Barclays U.S. MBS Index. Investment-Grade Corporates: Bloomberg Barclays U.S. Corporate Bond Index. ABS: Bloomberg Barclays U.S. Aggregate Asset Backed Securities Index. High-Yield Corporates: Bloomberg Barclays U.S. Corporate High Yield Bond Index.

Where illiquidity caused a security to be marked lower than the economic outlook may have warranted, we expect it will gradually reprice as the fundamental data becomes clearer and risks can be better priced; uncertainty requires an additional premium, as insurance against the worst case happening. Like corporate credit, we expect there will be defaults and permanent credit impairment. But the opportunity set is very large in the securitized market, and we believe that in-depth research can reveal mispriced securities with an attractive risk/reward outlook.

OPPORTUNITIES IN MBS

Forbearance requests in MBS have risen sharply, but approximately 40% of those requesting a reduction or postponement in payments are still paying their full mortgage. Regardless, both the interest and the principal on Agency MBS is guaranteed to investors by the Agencies, so the risk of capital impairment on Agency MBS is equivalent to the risk that the U.S. government chooses to relinquish their backing of the Agencies. And, as forbearance and/or delinquency prohibits refinancing, the risk of prepayments that would normally accompany such a swift drop in U.S. Treasury yields has greatly diminished – a positive for holders of Agency MBS.

At the security level, the current climate should lead to significant dispersion in the pre-payment characteristics of different offerings, creating opportunities. How will borrowers cure their forbearance? When? As different bonds are more or less sensitive to the possible outcomes, relative-value opportunities abound and are likely to persist as the impact of the recession evolves. As active managers specializing in security-by-security analysis, we see this as an opportunity to add value. Individual credit-risk-transfer (CRT) securities, for example, have different terms, with some having explicit language protecting investors from forbearance while others may have language protecting investors from hurricanes. While we would hope that hurricanes will not be added to the list of struggles the American homeowner faces, close analysis of individual securities can reveal critical differences in the risks, and those differences deserve significantly different pricing.

THE LONG-TERM OPPORTUNITY IN STRUCTURED SECURITIES (cont.)

OPPORTUNITIES IN CMBS

Index-eligible super senior AAA CMBS, if issued prior to March 23, are TALF eligible and thus relatively more liquid and higher priced at the date of writing. We think the non-TALF eligible securities, particularly those collateralized by a single asset or sponsored by a single borrower, are more interesting. In our view, CMBS securities collateralized by higher-quality, marquee, real estate holdings or with significant institutional sponsorship – large insurance companies with deep pockets that will be less reluctant to write off an asset – deserve to be priced based on these characteristics. Yields currently available in many sectors and securities appear attractive, insofar as they carry a premium for illiquidity and – in today's market – simply the fact that they are not TALF eligible, and thus take a little more work to price accurately.

Data relevant to CMBS so far is showing to be stronger in many aspects than the market anticipated. For example, rent collection among certain property types such as multifamily, industrial and office, have been higher than expected, with the apartment sector a beneficiary of the various stimulus packages and economic impact payments. In general, we think securities with lower retail or hotel exposure and higher exposure to more stable real estate subsectors offer more attractive risk/reward, particularly those with relatively low leverage and a high percentage of institutional or well-capitalized sponsors.

OPPORTUNITIES IN ABS

Newly issued AAA rated ABS are eligible for the TALF program, effectively putting a floor on the assets' prices, and current spreads largely reflect that support. Like the other securitized markets, the most interesting opportunities remain highly sector and security specific.

Liquidity in aircraft-related ABS remains poor as few investors are willing to speculate on how the aviation sector will perform in the coming months. But some of the more esoteric industries, such as cell towers or litigation financing, have held up remarkably well. The largest ABS sector, Auto ABS, also has performed better than expected. The sudden shutdown closed many of the resale outlets, causing used car prices to fall sharply. But used car prices have rebounded as some liquidity has returned. And, looking ahead, near-zero government rates should help demand for new cars, as could the reluctance of consumers to take public transit or taxis in the interest of social distancing.

The subprime auto market is particularly interesting to us given the prevalent assumption that subprime means greater risk. On the contrary, there is a rating spectrum for both prime and subprime autos, so it is possible that an investment-grade rated prime auto bond is riskier than a AAA rated subprime auto bond. After the volatility in March, prime auto securities were the first to recover. But, in our view, subprime auto may perform equally well or even better in the months ahead, because people rely on their vehicles to get to work, to gather essentials, etc. Indeed, a number of subprime issuers are seeing collections better than they were pre-crisis.

Tenor also matters. A lot of the more seasoned Auto ABS securities are, at this point in their life cycle, overcollateralized. As payments are made on the underlying loans, the principal and interest go toward reducing the ABS debt balance, improving credit enhancement or the debt balance as a percentage of the total collateral. At some point, even the recovery value of the underlying assets can exceed the amount owed.

THE LONG-TERM OPPORTUNITY IN STRUCTURED SECURITIES (cont.)

OPPORTUNITIES IN WHOLE BUSINESS SECURITIZATIONS (WBS)

The bulk of WBS is in the fast-food sector, which has performed relatively well through the crisis. Roughly 75% of the quick-service restaurant sector was off-premises (e.g., delivery or carryout) or drive-through before the crisis, which compares favorably to the restaurant sector as a whole. Nevertheless, they generally offer a premium yield over comparable high-yield or investment-grade corporate bonds from the same issuer. And, corporate bond debt is generally unsecured, while WBS is typically secured by the entity's income-producing assets and/or their intellectual property. Ultimately, we view the excess yield available in WBS as more than sufficient compensation for lower liquidity resulting from the market's smaller size and unique properties. As security-selection specialists, we relish (no pun intended) the opportunity to fully understand the credit and thus more efficiently monetize the liquidity premium.

LOOKING AHEAD

In the current environment, patience is required for successful investment in structured securities. But we believe that the illiquidity relative to corporate bonds offers a sufficient premium, and we see opportunities in the wide range of sectors, structures and individual securities available. In times of crisis, many securities are marked well below "fair value" given the high degree of uncertainty. As such, price movement can often be skewed to the upside, reducing volatility. Put differently, we consider the crisis-to-date performance to imply securitized assets have more relative upside, and less relative downside, compared to corporate credit. The ability to earn higher income for credit similarly rated to the U.S. government (while also, in the case of Agency MBS or TALF-eligible securities, having its explicit support) is, in our view, compelling. Nevertheless, we continue to broadly favor higher-quality, seasoned and shorter-duration exposures as we believe these characteristics offer investors better risk-adjusted returns in uncertain, volatile and low-yielding times.

THE LONG-TERM OPPORTUNITY IN STRUCTURED SECURITIES

Duration: Duration is a measure of a bond price's sensitivity to changes in interest rates.

Term Asset-Backed Securities Loan Facility (TALF): Created by the Fed in November 2008 and reinstated in 2020 to boost consumer spending in order to help jump-start the economy. The program seeks to broadly enhance market conditions for primary ABS and secondary CMBS and support the credit needs of consumers and businesses.

Credit Risk Transfer Securities (CRT): Pioneered by Freddie Mac in 2013, Credit Risk Transfer programs structure mortgage credit risk into securities and insurance offerings, allowing the transfer of mortgage credit risk exposure to investors.

Bloomberg Barclays U.S. Commercial Mortgage Backed Securities (CMBS) Index measures the investment-grade market of U.S. Agency and U.S. non-agency CMBS securities

Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks the performance of U.S. fixed-rate agency mortgage backed pass-through securities.

Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate bond market.

Bloomberg Barclays U.S. Aggregate Asset Backed Securities (ABS) Index measures the investment-grade market of U.S. ABS.

Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the US dollar-denominated, high yield, fixed-rate corporate bond market.

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Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. The principal on mortgage- or asset-backed securities may normally be prepaid at any time, which will reduce the yield and market value of these securities. Investing in derivatives entails specific risks relating to liquidity, leverage and credit and may reduce returns and/or increase volatility.

Credit quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

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Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Mortgage-backed securities (MBS) may be more sensitive to interest rate changes. They are subject to extension risk, where borrowers extend the duration of their mortgages as interest rates rise, and prepayment risk, where borrowers pay off their mortgages earlier as interest rates fall. These risks may reduce returns.

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