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INVESTMENT FOCUS

The magazine for investors with Janus Henderson

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Marketing communication
Not for distribution in European Union member countries

Inside: Politics takes centre stage

WELCOME

Sam Mettrick
Head of UK Advisory

Opinions are truly set to count in 2024 as more than half the world's population is set to participate in elections. Markets certainly shifted their views in the final half of 2023. Relatively strong economic news emanating from the US, together with a rising oil price caused markets to expect interest rates to stay higher for longer. Both bond markets and equity markets sold off sharply. From late October, however, the narrative shifted. Economic data, especially in Europe, came in softer and falling inflation allowed the US central bank to shift its tone and signal potential rate cuts in 2024.

With rate cuts back on the agenda, asset classes rallied in the final two months of the year, despite the step-up in geopolitical tension caused by events in the Middle East. Such was the strength of the rally, it more than undid the earlier weakness, allowing most equity and bond markets to deliver positive returns in the final half of 2023.

Cast your votes

This issue, our central feature focuses on politics as we consider the busy electoral calendar. We invited a few of our portfolio managers to highlight a political topic that has resonance for investors and you can see their responses in the article on pages 8-10. Never short of an opinion are our Co-Heads of Global Bonds who on pages 12-13 explain why they think core bond yields could follow one of two likely paths. I know which has my vote. Page 11 contains strident views from European equities manager Tom O'Hara as he discusses key themes shaping industries, while technology manager Alison Porter suggests having a "co-pilot" to navigate an economic soft landing on pages 14-15.

Elsewhere, we open with our regular review of the markets from a multi-asset perspective, explore dividend income from equities, and consider some key sustainable investment themes.

I do hope you find this issue of the magazine interesting. All that remains is for me to thank you for continuing to entrust us with your investments, something which clients have been doing since 1934 – yes, 2024 marks 90 years since we first started investing.

Sam Mettrick
Head of UK Advisory
Janus Henderson Investors

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To reduce our carbon footprint we are looking to encourage a move towards receiving Investment Focus magazine digitally. Currently, we are operating an opt-in to digital but from Summer 2024 we will be asking investors to opt in to print, i.e. if you want to receive a printed version of the magazine you will need to let us know. The Summer 2024 (issue 31) of the magazine will be the last issue that is posted to all investors.

To receive a printed version of the magazine from 2025 onwards you will need to opt in. We will provide details of how to do that in the Summer 2024 issue.

MARKETS LOOK FOR A SOFT LANDING

Oliver Blackbourn looks back at 2023 and the prospects for 2024 as markets seek an economic soft landing.

Oliver Blackbourn
Portfolio Manager,
Multi-Asset

The last few months of 2024 saw strong performance across many asset classes as markets priced in interest rate cuts, seemingly in the context of an expected soft landing. This is where inflation subsides and the economy slows but avoids a recession and a sharp rise in unemployment.

Both government bonds and risk assets, such as equities and corporate bonds, rallied as investors became convinced that we have reached peak interest rates. The rally took 2023 global equity returns, as represented by the MSCI AC World Total Return Index to 22.8% in US dollar terms and 15.9% in sterling terms, as a more dovish outlook for the US Federal Reserve (Fed) weighed on the US dollar. Across corporate debt, credit spreads (the difference in yield between a corporate bond and government bond of equivalent maturity) ended the year lower, with many areas at or close to 12-month lows. The late drop in yields meant that over the course of 2023 as a whole, the US 10-year government bond yield was unchanged at 3.87%, completing a round trip from a high around 5% in October. The UK and German equivalents saw yields decline over the year.

A better-than-expected outcome

Going into 2023, the consensus forecast was for the US economy to shrink slightly but, ultimately, the economy is estimated to have grown by around 2.6% over the year, based on the latest surveys. As the largest economy in the world, the US sets the global tone. The US consumer continued to support growth as the labour market remained resilient. With real wages likely to improve as inflation returns towards the Fed's 2% target rate in 2024, resilient consumer spending remains the key to a soft landing.

Perhaps not out of the woods yet

However, excess savings from the pandemic handouts have been run down and credit card debt has increased. With less money in the bank and tighter access to borrowing, there remain questions about whether spending can continue at the same pace. Similarly, companies have yet to see the full pass-through of prior interest rate increases as many had fixed their debt costs for prolonged periods. Defaults (failing to meet debt repayments) have already started to rise among consumers and corporate borrowers. Debt levels that are lower than a decade ago suggest a crisis is not brewing, but there could be a significant drag on growth. Consensus expectations are for 1.3% growth in the US this year, 0.5% in the Eurozone and only 0.3% in the UK (see chart).

Interest rate cuts coming

Investors have moved to price in very dovish expectations for major developed central banks. At the end of December, the Federal Reserve was expected to make its first reduction in interest rates in March, with 1.5% of cuts implied across 2024 as a whole. A similar level of cuts was forecast for the European Central Bank (ECB) and a little more for the Bank of England (BoE).[1] It is hard to see how markets price in a faster rate of loosening without a significant deterioration in growth expectations. A resilient US economy and continued elevated wage growth in the Eurozone and UK are likely to keep central banks on alert for any stubbornness in inflation and potentially keep interest rates higher for longer.

Corporate bond credit spreads at 12-month lows suggest limited concerns about downside risks, despite the lagged effects of earlier rate hikes still feeding through into borrowing costs. This is likely to present a more immediate problem among lower quality bonds that typically have shorter debt maturities than higher quality bonds and so need to refinance larger proportions of debt. Default rates have already risen meaningfully from the lows and there is no evidence that they have yet peaked.

High expectations

Global equities remain expensive overall but this is predominantly due to the high valuations of US stocks, particularly a small number of large growth stocks. Long-term earnings growth expectations for US companies have risen to very high levels. However, the forecasts dramatically exceed historical growth and look hard to justify without a paradigm shift in productivity growth. More generally, global earnings expectations already price in a substantial rebound in economic activity at a time when economists predict a slowdown in 2024. It is difficult to see how both can be correct simultaneously. However, markets outside of the US remain relatively cheaper and we believe could yet perform well on confirmation of a soft landing.

Outlook

The late 2023 rally left many assets looking somewhat overbought, amid signs of investor exuberance. The path to a soft landing remains a narrow one, with deviation in either direction having the potential to cause significant volatility in markets. Better-than-expected growth outcomes may delay interest rate cuts and weigh on valuations, but weaker data may raise the spectre of a hard landing (recession). We believe investors need to be alert to incoming data and thinking about diversification in their portfolios.

Source for all yields, spreads and returns is LSEG Datastream, unless otherwise stated. **Past performance does not predict future returns. Yields may vary over time and are not guaranteed.**

[1]Source: Bloomberg, implied rate cuts using world interest rate probability projections, as at 31 December 2023. **There is no guarantee that past trends will continue, or forecasts will be realised.**

Glossary:

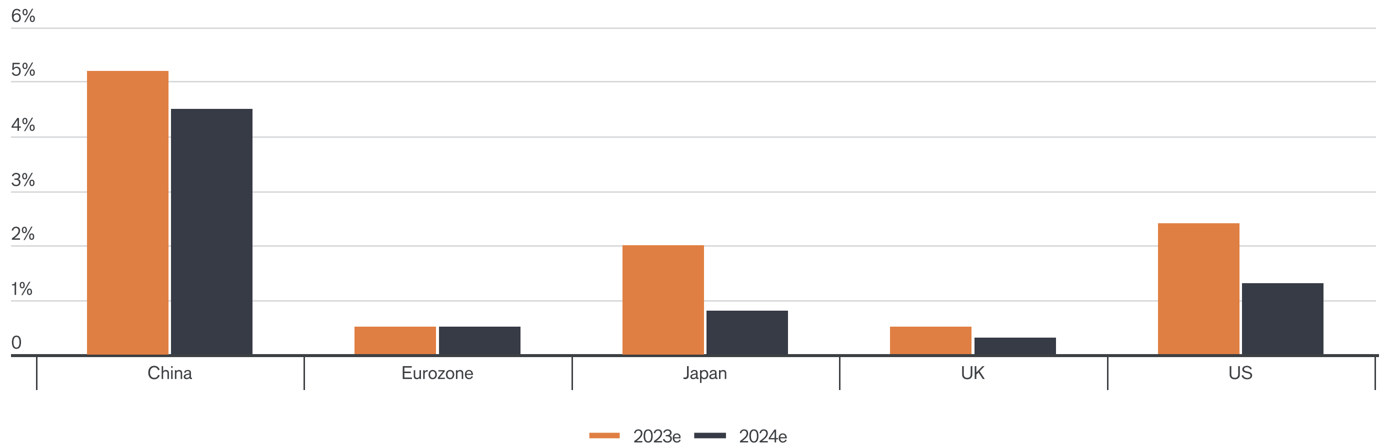
Dovish: A term used to describe policymakers when they loosen policy eg cut interest rates.

Diversification: A way of spreading risk by mixing different types of assets/asset classes in a portfolio, on the assumption that these assets will behave differently in any given scenario.

Inflation: The rate at which the prices of goods and services are rising in an economy.

Volatility: The rate and extent at which the price of a portfolio, security or index, moves up and down.

Economic growth (year-on-year change in GDP) set to be slower in 2024



Source: Bloomberg, consensus economic forecasts, year-on-year change in real (inflation-adjusted) gross domestic product (GDP). GDP is a measure of the size of the economy, reflecting all the finished goods and services produced by a country within a given time period. Figures as at 15 January 2024. e = estimates.**There is no guarantee that past trends will continue, or forecasts will be realised.**

SUSTAINABLE EQUITY: FOCUSING ON COMPOUNDING WEALTH IN UNCERTAIN TIMES

Hamish Chamberlayne
Head of Global Sustainable Equities

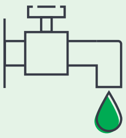
Hamish Chamberlayne, Head of Global Sustainable Equities, presents his outlook for 2024 and outlines the long-term secular growth opportunities for the asset class.

For the past year uncertainty has reigned, with geopolitical discord, inflation and higher interest rates casting a shadow over markets. Returns over this period have been narrow. Outside of artificial intelligence (AI), some of the best equity market returns have been in weight loss drugs, social media, and smart phones – perhaps a sobering reflection of today's society.

In this environment, the good ship Sustainability has hit some rougher seas. The transition to a more sustainable economy requires investment, and higher interest rates are a headwind. Renewable energy projects are being delayed, real estate and construction markets are slowing, and automotive and many industrial markets related to electrification and digitalisation have come under pressure.

Despite the current macroeconomic challenges, our message is to stay the course. Over the next few years, we see a period of value creation in many different sectors, some of which are attractively valued in today's turbulent environment. In uncertain times, where the cost of capital is higher, we believe it is important to be disciplined in terms of company fundamentals and valuation.

We are concentrating on investing in companies with leading franchises in their respective industries, attractive business economics, the ability to generate cash, and strong finances. This approach, in our view, enables us to navigate uncertainty and offers us the best opportunity to compound wealth for investors over the long term.



Transforming water

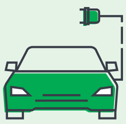
The water industry offers more predictable growth opportunities that are less beholden to the economic environment. Not only does poor quality infrastructure need to be upgraded in many countries but there is growing awareness of the need to invest more in water treatment. PFAS (per- and polyflouroalkly substances) are common chemicals that have useful non-stick, water repellent properties often used in cookware, clothing, and firefighting foam, but are resistant to biodegradation.

In 2023, President Biden's Bipartisan Infrastructure Bill allocated US$2 billion to address emerging contaminants, including PFAS, in drinking water in the US. Independent bodies in the UK and Europe have also called for greater regulation and a phasing out of PFAS, so we expect to see continued momentum in this space.

Decarbonising computing

Artificial intelligence (AI) stands to benefit companies across many different sectors by accelerating innovation and increasing efficiencies. However, the digital transformation of the global economy will require significant processing power, and we therefore believe it is imperative to consider the energy implications.

Graphics processing units (GPUs), such as those made by Nvidia, are used to minimise the significant energy strain of high-performance computing on data centres and are therefore critical to enabling the smarter use of energy in a digitalised world. A recent study showed that using GPU-accelerated systems when running AI programmes globally could save as much as 10 trillion watt-hours of energy per year – equivalent to the amount of energy consumed by 1.4 million homes in a year.[1]



Advancing electric vehicles

The trajectory for electric vehicles (EVs) over the next decade is clear, with government policies and initiatives in place to support development and production.

When we focus on the long-term, the vast amount of capital being invested to transform the industry is telling. This capital will be put to use, for example by increasing battery cell capacity, manufacturing lower-cost EV models, and developing autonomous ride-hail technology. We believe that exposure to this trend – be it through auto suppliers, manufacturers in the battery supply chain or software and system control developers – offer growth opportunities for investors.

[1] Nvidia, Blog: What's Up? Watts Down – More Science, Less Energy, May 2023.

References made to individual securities do not constitute a recommendation to buy, sell or hold any security.

GLOBAL EQUITY INCOME:
DIVIDEND GROWTH DRIVERS

Ben Lofthouse
Head of Global Equity Income

Head of Global Equity Income, Ben Lofthouse, discusses companies' ability to pay and grow dividends.

Dividend growth from companies generally remained strong in 2023 across a wide range of sectors and regions, with the exception of commodity-related areas like mining, some energy stocks, and chemicals. We were also pleased to see better quality of dividend growth, with less reliance on one-off special dividends and exchange rate effects that were characteristic of 2022.

In Europe, investor sentiment and company results were much better than analysts forecasted. Banking dividends were the most important driver of European growth, followed by vehicle manufacturers. US dividend growth continued to slow, following exceptional resilience during the pandemic when other regions were cutting payouts. That said, the region remains on track to reach a new record high for 2023.

We had anticipated China's reopening from COVID would be the wild card that could ignite demand in the global economy. While China reopened more quickly than expected, economic momentum in the country fizzled out, as did investor sentiment, dragging down Asia as a region with it. China continues to face challenges in its property and banking sectors, which has prompted the central bank to take action in the latter months of the year by way of rate cuts and other measures to support lending.

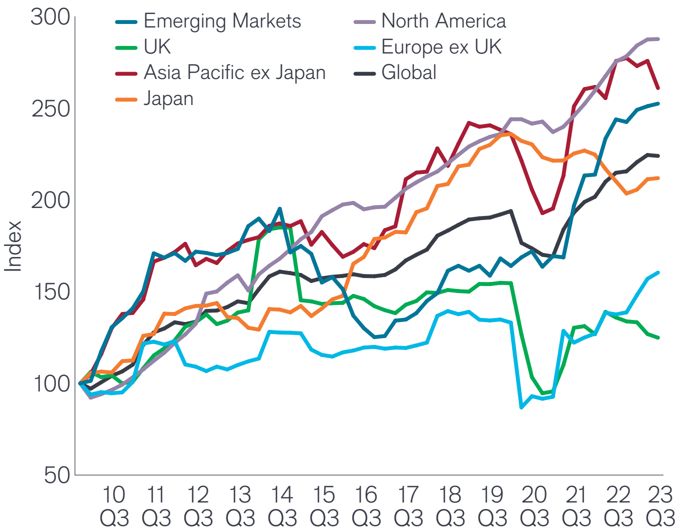
Given the decrease in special dividends reflecting less merger and acquisition (M&A) activity globally and the disappearance of windfall profits in sectors like mining and energy, our headline forecast for total global dividends in 2023 fell slightly from $1.64 trillion to $1.63 trillion, although this still reflects an increase of 4.4% year-on-year.[1]

The outlook for dividends

Looking forward, our view is positive but tempered with some caution. We believe dividends are unlikely to repeat the sharp increases seen post-COVID, as oil prices have moderated. Among financials, banks should benefit from improved margins as a result of the higher interest rate environment. This is because their business model is based on the difference between what they pay for deposits or wholesale funding and the loans they charge to customers.

According to the Janus Henderson Global Dividend Index, in the first three quarters of 2023 more than 85% of companies either increased their dividends or held them steady.[1] That said we have seen some moderation of dividend normalisation – COVID saw some companies cut dividends or cancel them altogether, then reinstate them rapidly during the post-COVID economic recovery. As this effect has now fully worked through the system, what we believe we are seeing is more representative of the underlying earnings growth of companies.

Janus Henderson Global Dividend Index – by region



[1]Source and for chart above, Janus Henderson Global Dividend Index, Q3 2023. Index = 100 at 31 December 2009. **There is no guarantee that past trends will continue, or forecasts will be realised.**

The Janus Henderson Global Dividend Index (JHGDI) is a long-term study into global dividend trends. It measures the progress global firms are making in paying their investors an income on their capital by analysing dividends paid every quarter by the world's largest 1,200 firms by market capitalisation.

CAST YOUR VOTES
ELECTION FEVER IN 2024

In a busy electoral year, three of our portfolio managers look at different topics shaping the political climate and investment markets.

Hamish Chamberlayne
Head of Global Sustainable Equities

Indriatti van Hien
UK Equities Portfolio Manager

Julian McManus
Global Equities Portfolio Manager

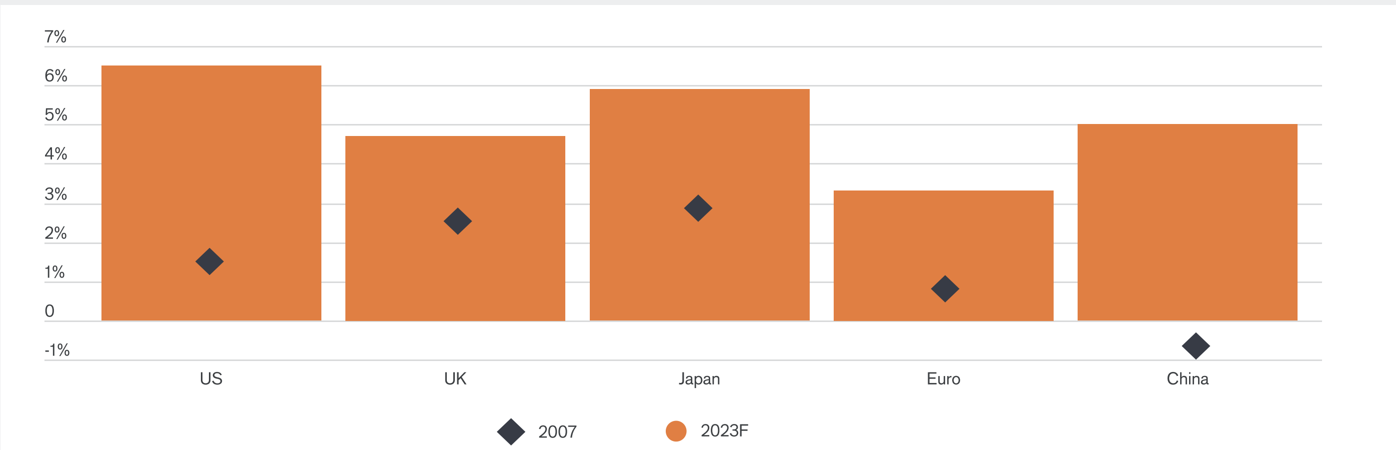
2024 could prove to be the busiest election year on record as eight of the ten most populous countries go to the polls either for national, regional or multilateral elections. Key elections that are likely to keep headline writers busy include India's general election, the European Union parliamentary elections, the US congressional and presidential elections and the high likelihood of a general election in the UK (although the timing of the election could be late as January 2025).

Should investors care about the results? While a common refrain among the electorate is that politicians are all the same, there are some clear dividing lines between parties and presidential candidates. From taxation to trade to environmental policy, the decisions politicians implement can have consequences for corporate revenues and profitability.

Change or stasis?

Most Western countries are running relatively high fiscal deficits despite their economies being near full employment. This means that big changes in spending plans or tax cuts may be hindered by economic realities. Unified governments tend to unlock more transformative policies, with bigger market outcomes, while coalitions or split governments are likely to see more compromise.

Government budget deficits as a % of GDP are much larger than pre-Global Financial Crisis



Source: Bloomberg, Government budget deficit as % of gross domestic product (GDP). 2023F figures represent forecasts representing composite of private contributors on Bloomberg. Latest available figures as at 16 January 2024. **There is no guarantee that past trends will continue, or forecasts will be realised.**

Affordable growth

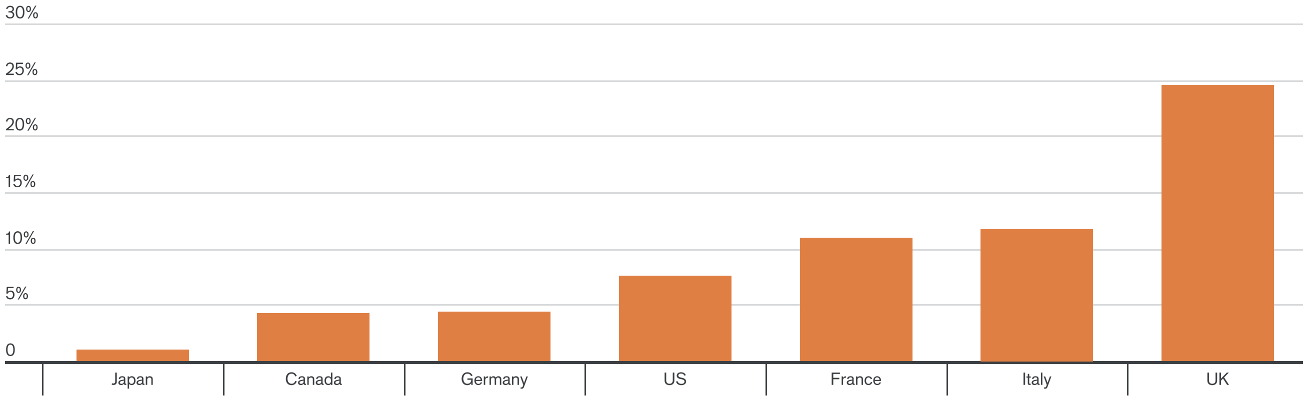
Indriatti van Hien, UK Equities Portfolio Manager

We believe that the unfunded tax cuts to boost growth that were a key part of Prime Minister Truss's short-lived government in late 2022 did more to chain than unchain Britannia by contributing to a sharp rise in UK government bond yields. It laid bare to all those on the right and left of the political spectrum that there were limits to the unilateral approaches one could take with the UK economy. We believe it has softened the approach to Brexit and paved the way for a calmer relationship with Europe.

While a potential Labour government is likely to have more ambitious spending plans for healthcare, education and social care than a Conservative government, they may be hamstrung by the higher interest burden the government needs to fund. Given that 25% of UK government debt is index-linked, nearly 10% (although this number will come down with inflation) of tax revenues is currently being spent on servicing interest. Most initial policies may therefore be focused on targeting growth.

Furthermore, any new government's ability to increase taxes to fund spending will be constrained by the tax burden (tax as a % GDP), which is currently at a post-1940s high of 36.3%.[1] Ultimately, we believe the UK government will be limited to tinkering with how the same amount of tax is ultimately raised i.e. wealth taxes versus income taxes. But again, the government is likely to be wary of increasing any taxes that deter growth and investment.

Percentage of government debt that is index-linked



Source: Bloomberg, Panmure Gordon, as at October 2023.
[1]Source: OBR, forecast for 2023/24 tax year, as at November 2023. **There is no guarantee that forecasts will be realised.**

A sustainable future

Hamish Chamberlayne, Head of Global Sustainable Equities

I have been doing sustainable investing for quite a long time now, and I have seen quite a few political cycles over that time. I vividly remember 2016 when we had Brexit and Donald Trump was elected. At the time, concerns were voiced about the prospects for cleaner energy projects and I remember saying back then that we did not expect a negative impact because the economics for sustainable industries was becoming more compelling.

In election campaigns there is a lot of grandstanding and expressing strong views – and then the reality is often watered down. We think it is important to ignore the rhetoric and instead focus on the underlying investment trends i.e. the projects and capital expenditure being committed in reshoring and towards green industries.

Another interesting dynamic is that a lot of the jobs being created in the US by the Inflation Reduction Act (which helps to foster clean energy and technology) is happening in traditionally Red (Republican) states, despite being championed by a Democratic President. So there is quite strong bipartisan support for government incentives.

It is also worth remembering that sustainable equities suffered a correction in 2022 so a lot of the negative price action has happened. With inflation abating and the prospect for interest rate cuts, I believe the economics for sustainable industries looks set to improve.

US clean energy in numbers

Source: Climate Power, "One year of our clean energy boom", figures relate to period August 2022 to July 2023.

Geopolitical tension

Julian McManus, Global Equities Portfolio Manager

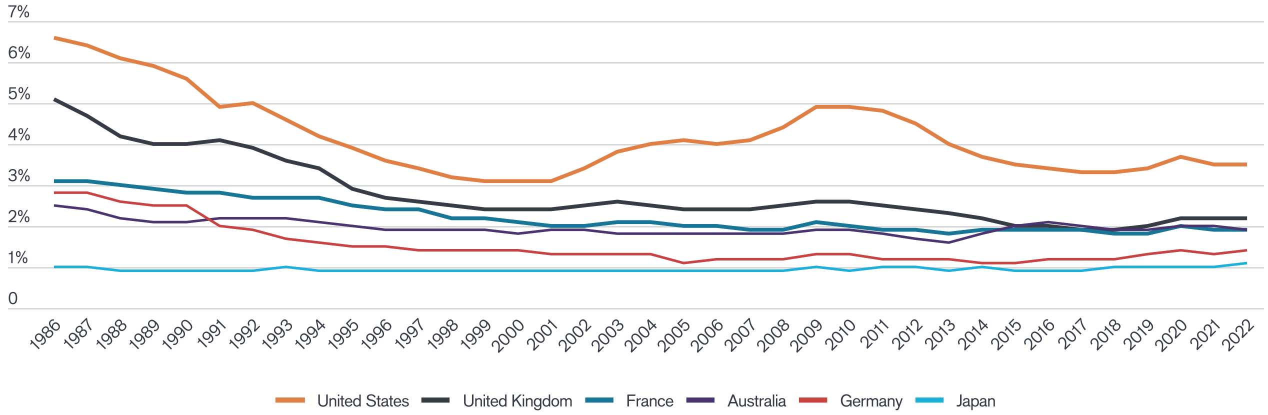
In the US election in November, the race for the White House is once again too close to call. But under Trump, the Republicans could be expected to lead with an "America First" policy. Even if the Democrats win the White House, we will likely see more of these isolationist policies from them than in the past.

The forces responsible for this are largely geopolitical. Guided by "Xi Jinping Thought", the Chinese Communist Party's economic policies are increasingly alienating trading partners such as the US and Europe. As a result, viewing China, not to mention Russia, as a threat, rather than a partner, is now gaining support across both sides of the aisle in Washington. This is likely to affect several sectors in a way that is under-appreciated by markets today. Chief among these is the defence industry.

The US will likely have to divert military spending from Europe to the Pacific region. As a result, certain allies in Europe, Japan and Australia will have to expand their own defence spending, which has lagged commitments for decades. Japan's Kishida administration has taken the first steps to reverse the accumulated under-spending on defence (doubling its spending commitment by 2027), but several European countries still have a way to go.

The conflict in the Middle East and vital sea lanes coming under attack add urgency to this predicament. Expect the next US administration to force other allied countries to increase their own defence budgets. This implies years of above trend order growth for major defence companies, regardless of who wins the election.

Defence expenditure as a % of GDP



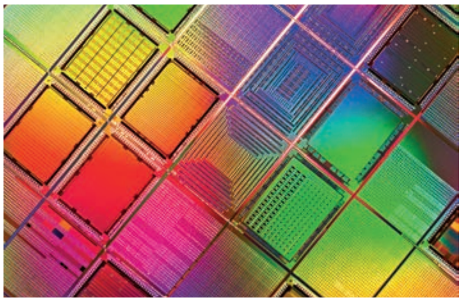
Source: Bloomberg, World Bank, military expenditure as a % of gross domestic product, 1986 to 2022.

PLAYING GLOBAL THEMES THROUGH EUROPE

Tom O'Hara
Portfolio Manager, European Equities

Tom O'Hara, European Equities Portfolio Manager, discusses his outlook for the asset class.





What themes will influence European equities most in 2024?

We can expect more paranoia, more volatility, and more erratic behaviour in markets as everybody obsesses over recession, inflation, and whether interest rates have peaked. I don't mind that. I can use it as an opportunity to buy companies that I think will succeed not only in 2024, but for the next decade ideally.

The amount of money being spent on building factories in the US right now has reached almost 0.6% of GDP – a level of expenditure on building manufacturing capacity not seen since 1990, before the World Trade Organisation was established.[1]

I view that as significant. We are entering a new era. We had over 30 years of ever-increasing globalisation – sending manufacturing to Asia. But that is now in a period of reversal. Even if it is only a partial reversal, it can be very powerful in terms of where capital expenditure will be deployed and which companies will benefit.

Where are the most compelling opportunities in Europe?

The opportunity-set includes companies that are listed in or born in Europe, but are often global in their reach and leaders in their fields. Many participate in the major shifts in the world right now, think re-shoring of manufacturing, artificial intelligence, and cloud computing. I see this as a capex 'supercycle', and it offers a great opportunity to invest in leading European companies.

Aerospace is a resilient, high growth industry and Europe has global champions, including one of the two major builders of aircraft as well as aeroengine makers. These businesses have multi-year order books.

Then there are businesses that thrive in an environment with a higher cost of capital. Higher interest rates bring discipline back to industries. Take the brewing industry. Some of the small breweries, many of which appeared over the last 10 to 15 years during the low interest rate environment are going bust. The brewing industry is re-consolidating into the hands of the powerful incumbents, many of which are European.

Finally, it is about accessing the picks and shovels of this capex supercycle. It might be the heavy materials companies that do the groundworks or the roads. Or the capital goods companies that provide the hardware and the software that automates manufacturing facilities. Or the semiconductor capital equipment companies, at which Europe excels, that provide the machinery needed to produce the microchips that we will need in abundance in the years ahead.

What is the most important takeaway for an investor in Europe?

European equities allow investors to access global leaders at reasonable prices, often at discounts to their richly-valued US peers.

European companies are good at making and doing things. They can therefore play a key role in reshoring manufacturing back to the Western world, automating those factories, building the data centres, or reinvesting in infrastructure such as roads, railways and bridges. We have the companies here in Europe that are not just a play on Europe – they offer access to global themes.

[1]Source: US Bureau of Economic Analysis, US Census Bureau, Q3 2023.

Capital expenditure (capex): Money invested to acquire or upgrade fixed assets such as buildings, machinery, equipment or vehicles in order to maintain or improve operations and foster future growth. A capex supercycle represents a long period of above-average expenditure.

Re-shoring: Bringing manufacturing back to the country a company is based in or near to where its products are sold.

Volatility: The rate and extent at which the price of a portfolio, security or index, moves up and down.

DO ALL ROADS LEAD TO LOWER BOND YIELDS IN 2024?

John Pattullo
Co-Head of Global Bonds

Jenna Barnard
Co-Head of Global Bonds

Jenna Barnard and John Pattullo, Co-Heads of Global Bonds, consider the outlook for bonds in 2024, positing that different routes are likely to lead to the same destination.

2023 was supposed to be the year of the bond – and while returns have been positive, broadly reflecting income from the bonds, a strong capital uplift from a decline in yields was less forthcoming. So, with interest rates arguably peaking, what caused the delay and where do yields go from here?

A bump in the road

Back in early October 2023 we discussed the phenomenon of a 'bond bear steepener' that was taking place. This is where yields on longer-term bonds rise more than the rise on shorter-dated bonds. It is called a steepener because the yield curve that plots yields of bonds of the same quality but different time to maturity is normally upward-sloping from bottom-left to top-right. So, if yields on longer-dated bonds rise faster than on shorter-dated bonds this would cause the yield curve to steepen. We explained that a bond bear steepener was a very rare occurrence and when it took place when yield curves were inverted – as was the case in 2023 – it typically led to 1) a fall from peak yields and 2) the onset of a recession.

As if on cue, yields began to fall throughout November and December, undoing much of the rise in yields during 2023, but not far enough to deliver the capital gains we had expected. But that was 2023. Can yields decline further in 2024 and will the second part of the historical pattern hold, i.e. will a recession take place?

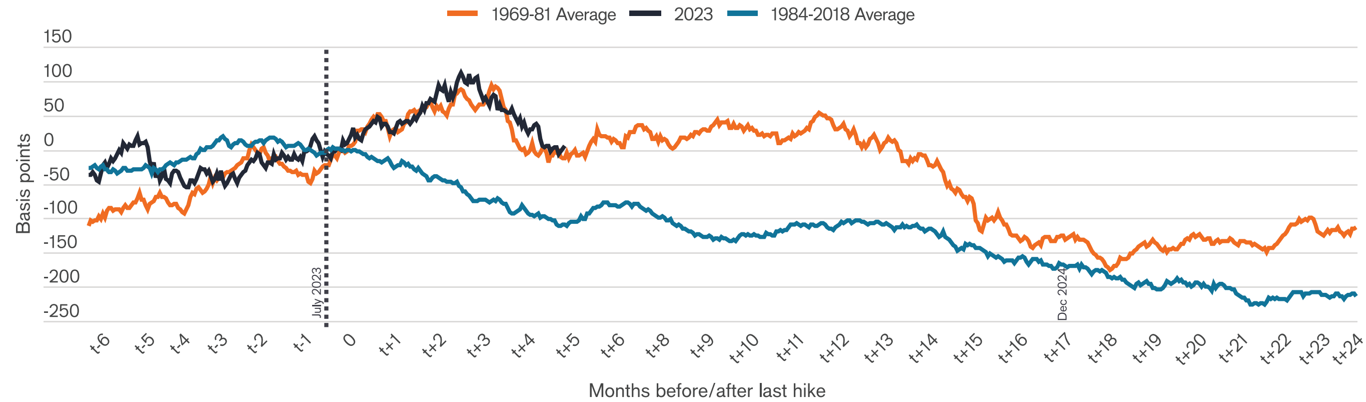
Different route, same destination

History may offer a valuable lesson. First, let's agree that the July 2023 hike by the US Federal Reserve (Fed) was the final hike in the current rate cycle. This seems a reasonable assumption given the remarkable decline in the pace of inflation. We can then plot the change in the US 10-year Treasury yield before and after the last hike (see Figure 1), with 0 representing the point of the last hike. Recall that a rise in yields leads to a fall in bond prices and vice versa, so a declining line would indicate falling yields and rising bond prices. We compare this with how yields responded on average every time the Fed finished hiking rates in the 1969-81 period (characterised by rising and high inflation) and the 1984-2018 period (characterised by declining or low inflation). Overlaying the most recent 2023 episode shows that yields have followed the 1969-81 behaviour rather than 1984-2018 average.

This is interesting because it sets up potentially strong returns for bonds over the next 12-18 months regardless of which path is followed. Yet the outcome over the next six months or so could be very different:

- **Frustrating near-term bond bear market:** Yields follow the orange 1969-81 path. This would see them range bound for a part of 2024 – anything that reignites inflationary concerns or a temporary re-acceleration of growth that leads to central banks

Figure 1: Change in US 10-year Treasury yield after last rate hike



Source: Bloomberg, Janus Henderson calculations, 31 December 2023. Basis point (bp) equals 1/100 of a percentage point, 1bp = 0.01%.
Past performance does not predict future returns.

pushing back rate cuts might cause this. The longer spell of high interest rates contributes to economic weakness in the second half of 2024, inflation fears subside and rate cuts loom large, prompting a sharp decline in bond yields later in 2024.

- **Steady bond bull market:** Yields reconnect with the blue 1984-2018 path and bond yields steadily decline. This could happen if it becomes clear that inflation is firmly defeated. Central banks embark on rate cuts to prevent real rates (interest rates minus the inflation rate) becoming too restrictive.

Of course, bond yields may take an entirely new path that resembles neither of the above. While that may be the case, we reckon the general direction for yields in 2024 is lower. In our view, it seems unfeasible that the lags from earlier monetary tightening do not weigh on economic growth. We still see a high probability of a US downturn in 2024 and some European countries are already flirting with recession. Remember that even if central banks start the process of cutting rates, most companies or households that are refinancing debt or mortgages will be paying a higher rate of interest than was the case a few years ago. Policy will still be restrictive and if inflation is lower it means real (adjusted for inflation) rates are more punitive.

That is why when the Fed starts to cut, it tends to do so quickly. Interest rates rarely plateau for long. In fact, over the last 70 years the average plateau was six months. So, were a cut to occur in March 2024 – a plateau of eight months since the July 2023 hike – this would be broadly in line with the average cycle.

Synchronised easing

The hiking cycle among developed market central banks was synchronised, with most banks raising interest rates within a few months of each other. We expect the same to happen with cuts. We therefore think that 2024 should potentially offer the returns we expected in 2023, with a combination of income and capital gain from government bonds as yields decline.

Glossary

Bear market/Bull market: A bear market A bear market is one in which the prices of securities are falling in a prolonged or significant manner. A bull market is one in which the prices of securities are rising, especially over a long time.

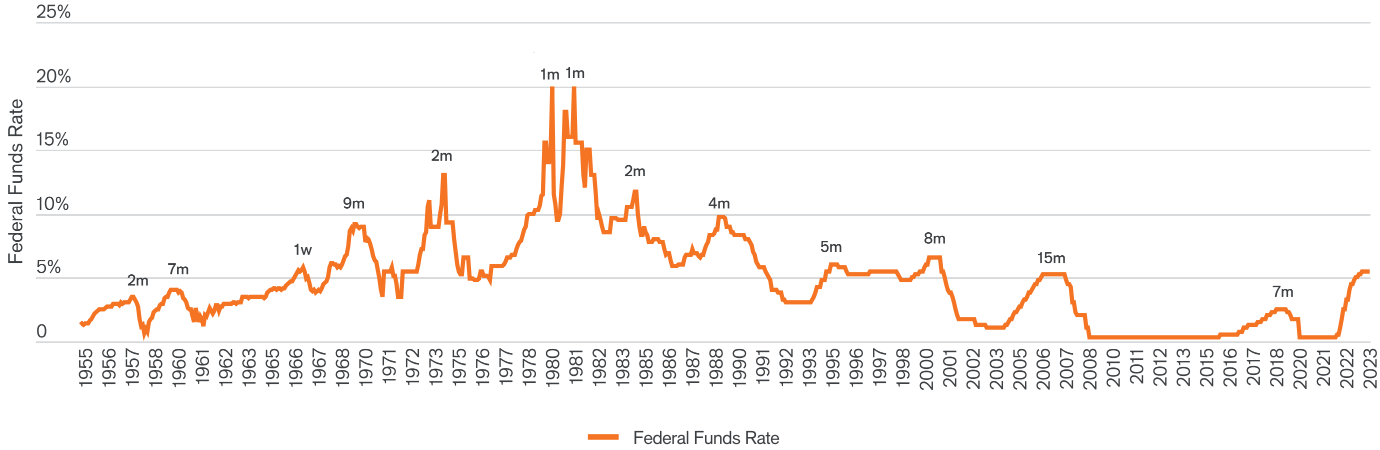
Inflation: The rate at which prices of goods and services are rising in the economy.

Maturity: The maturity date of a bond is the date when the principal investment (and any final coupon) is paid to investors. Shorter-dated bonds generally mature within 5 years, medium-term bonds within 5 to 10 years, and longer-dated bonds after 10+ years.

Yield: The level of income on a security over a set period, typically expressed as a percentage rate. For a bond, at its most simple, this is calculated as the coupon payment divided by the current bond price.

Yield curve: This plots the yields (interest rate) of bonds with equal credit quality but differing maturity dates. Typically bonds with longer maturities have higher yields. An inverted yield curve occurs when short-term yields are higher than long-term yields.

Figure 2: Rate peaks are typically short-lived and cuts proceed quickly



Source: Janus Henderson, Piper Sandler, December 1954 to 31 December 2023. Fed funds rate reflects either effective rate or upper bound of target rate. m = month, w = week; these indicate the length of time for which interest rates plateau at the peak. **Past performance does not predict future returns.**

TO NAVIGATE A SOFT LANDING AND THE TECH SECTOR, YOU NEED A "CO-PILOT"

Alison Porter
Portfolio Manager

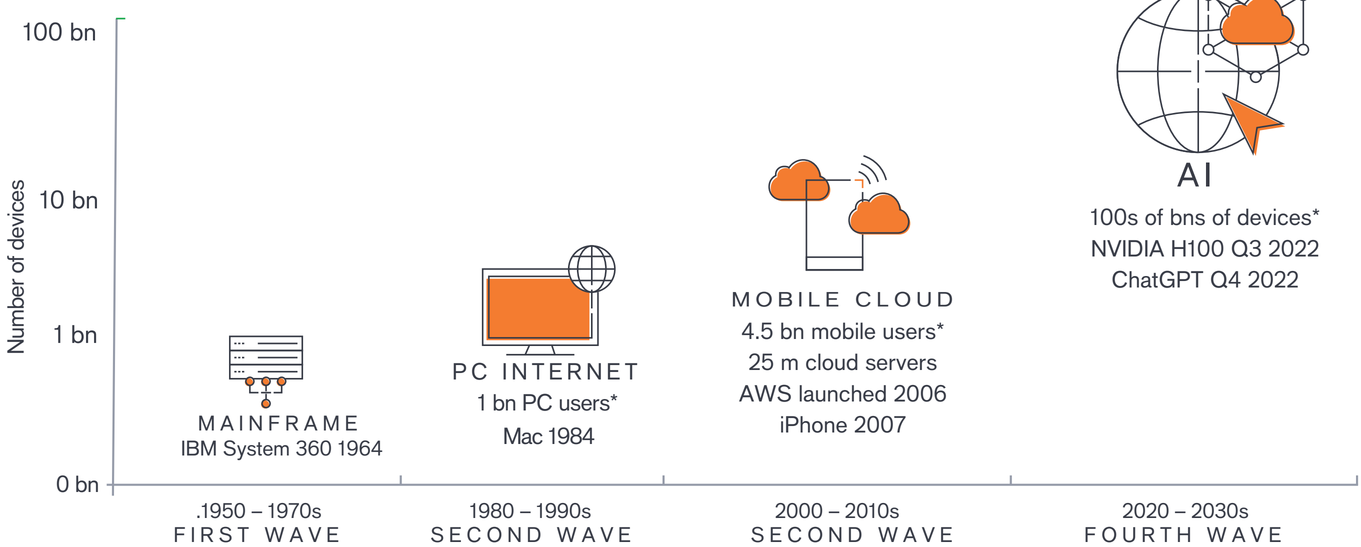
Technology equities portfolio manager Alison Porter discusses the team's outlook for 2024, highlighting the importance of navigating the return of the cost of capital and hype surrounding AI.

With the US Federal Reserve (Fed) currently on pause in terms of rate moves, investors are bracing for the lagged effect of higher interest rates on company earnings – a so-called "hard" or "soft" landing for the economy. While the Fed Chairman is undoubtedly the "main pilot", as tech specialists we think investors need to be cognisant of artificial intelligence's (AI) role as the "co-pilot" of the economy in terms of improving productivity. There is also a need for an experienced "investment co-pilot" to help navigate the return of the cost of capital following a prolonged period of low interest rates and the hype cycle that may emerge around AI.

AI is not just a theme

We view AI as the fourth wave of compute rather than just a theme. We are currently evolving from machine learning to generative AI (ability to create new content) and then, over the long term, to what is known as artificial general intelligence (AGI) when software and compute can replicate human thinking. Compute waves happen only every 10-15 years (Figure 1). Each wave has tended to be bigger and more disruptive, bringing new and compelling opportunities while disrupting incumbent business models in the old economy. The personal computer (PC) internet era evolved throughout the Savings and Loans crisis in the US, while the iPhone in the midst of the Global Financial Crisis heralded a new wave of disruption from mobile cloud compute. We are at a critical juncture in the global economy. The coming of AI, combined with the strongest balance sheets in equities,[1] we believe puts the technology sector in a relatively strong position to continue its long-term history of equity outperformance.[2]

Figure 1: The fourth wave of compute



Source: Janus Henderson Investors. Note: *Citi Research, as at 30 December 2016.

Another magnificent year for tech

In 2023, the outperformance of the technology sector was driven not only by the excitement over AI, but also by a combination of cautious positioning and low earnings expectations. The sector's outperformance was narrow – focused on the "Magnificent 7" (Microsoft, Apple, NVIDIA, Alphabet, Meta, Amazon, and Tesla). Yet it was not irrational in our view, given the companies' balance sheet strength, focus on margin improvement, and the fact these stocks were among the few actual beneficiaries of AI spend in this early stage of evolution.

We expect there will continue to be volatility in sales growth but we believe that earnings growth for the sector will prove resilient given the focus on headcount reduction and the deployment of AI to drive profit margins. Overall, the tech sector's valuation sits above its average but is within the historical 25-year trading range.[3] We continue to avoid hyped technology stocks with no visible profitability. Given the fact that the pace of innovation is accelerating amid a higher cost of capital, predicting company cash flows beyond the next five years is proving more challenging than it has been in the last ten years.

We urge investors not to think of the Magnificent 7 as a monolith to be judged against the rest of the tech sector or broader equities. As was the case in prior compute waves, we expect the number of beneficiaries from AI to broaden gradually over the next three years with many of these companies key to enabling that wider adoption. Within the Magnificent 7, valuations and growth vary widely between companies. History tells us that uniformly strong performance from these seven names is not the norm – and we are positioned as such with a highly active stance.

Corporations are being forced to take a more holistic view of their future operating expenditure, which we believe will drive incremental spending towards our long-term secular themes of Next Generation Infrastructure, Automation & Productivity, Internet 3.0, Electrification and Fintech (technology-enabled financial innovation). For Next Generation Infrastructure we expect AI demand for large language models (LLMs) to enhance the role for cloud infrastructure, and a need for AI at the edge, where AI computation is done near the user, close to the data source – right to the device level. Sustainability considerations also necessitate a focus on power efficiency to limit cost and carbon intensity. The demand for clean energy tech solutions is rising, with hardware and semiconductor companies well positioned to be key beneficiaries. Fintech is a theme that has not been in focus in 2023, but is an area where we continue to see a rich vein of quality companies.

A favourable environment for active stock pickers ahead

AI can deliver significant productivity gains to the economy and to companies, driving lower inflation and profit growth. But it may take years rather than months for this to be demonstrable and investors must be mindful of the hype cycle (Figure 2). The winners of AI development will broaden out but at a gradual pace; in the meantime investors should be wary of extrapolating early adoption in a parabolic manner.

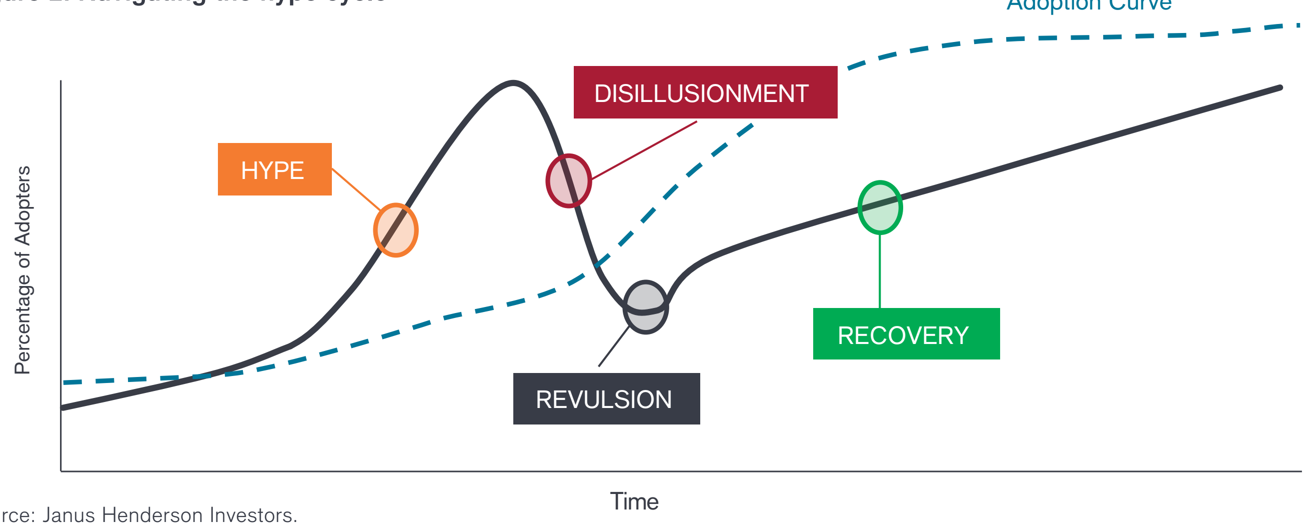
Similar to how we have navigated prior compute waves, we continue to be focused on sustainable barriers to entry, incorporate environmental, social and governance (ESG) insights, and rely on our valuation discipline to guide us in identifying those companies that will become or will remain global technology leaders. The technology sector benefits from one of the strongest tailwinds in the equity market, but with macro turbulence ahead, experienced "investment co-pilots" with proven navigation skills are needed to help chart a smoother path to achieve investors' risk and return objectives.

[1]Janus Henderson Investors, Bloomberg consensus estimates, Bloomberg net debt and net cash data, as at 7 September 2023.

[2]Janus Henderson Investors, Morningstar. MSCI ACWI Information Technology + Communication Services vs MSCI ACWI total returns in USD, 31 December 1995 to 30 September 2023. **Past performance does not predict future returns.**

[3]Janus Henderson Investors, Bernstein. MSCI ACWI Information Technology + ACWI Communication Services price-to-forward earnings relative to MSCI ACWI, September 2000 to September 2023

Figure 2: Navigating the hype cycle



Source: Janus Henderson Investors.

Artificial intelligence: A term for a range of algorithm-based technologies that solve complex tasks by carrying out functions that previously required human thinking or action.
Cloud computing: The provision of IT services remotely by specialised service providers over the internet.
Hype cycle: A representation of the different stages in the development of a technology from conception to widespread adoption, with investor sentiment being a key driver of valuations of that technology and related stocks during the cycle.
Large language model (LLM): A specialised type of artificial intelligence that has been trained on vast amounts of text to understand existing content and generate original content.

References made to individual securities do not constitute a recommendation to buy, sell or hold any security.

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