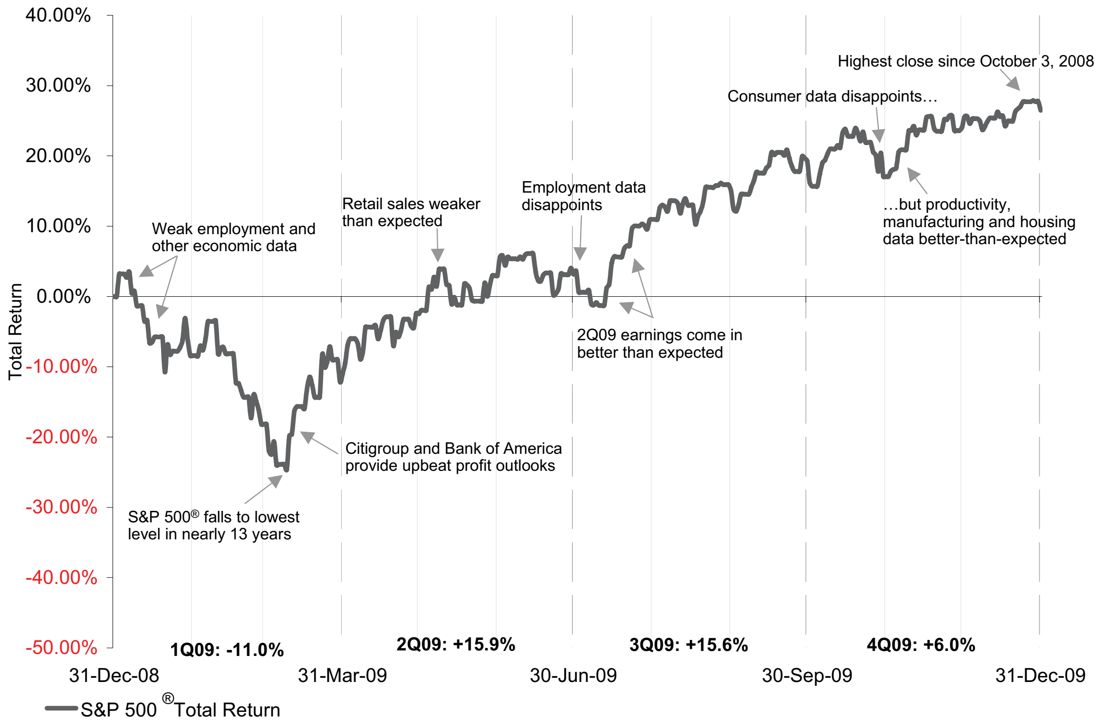
Market **Perspectives**

US Financial Markets Review

Issue One 2010

Chart 1: US Equity Market 2009: On the Rebound



As of 31st December, 2009
Source: Bloomberg, total return shown

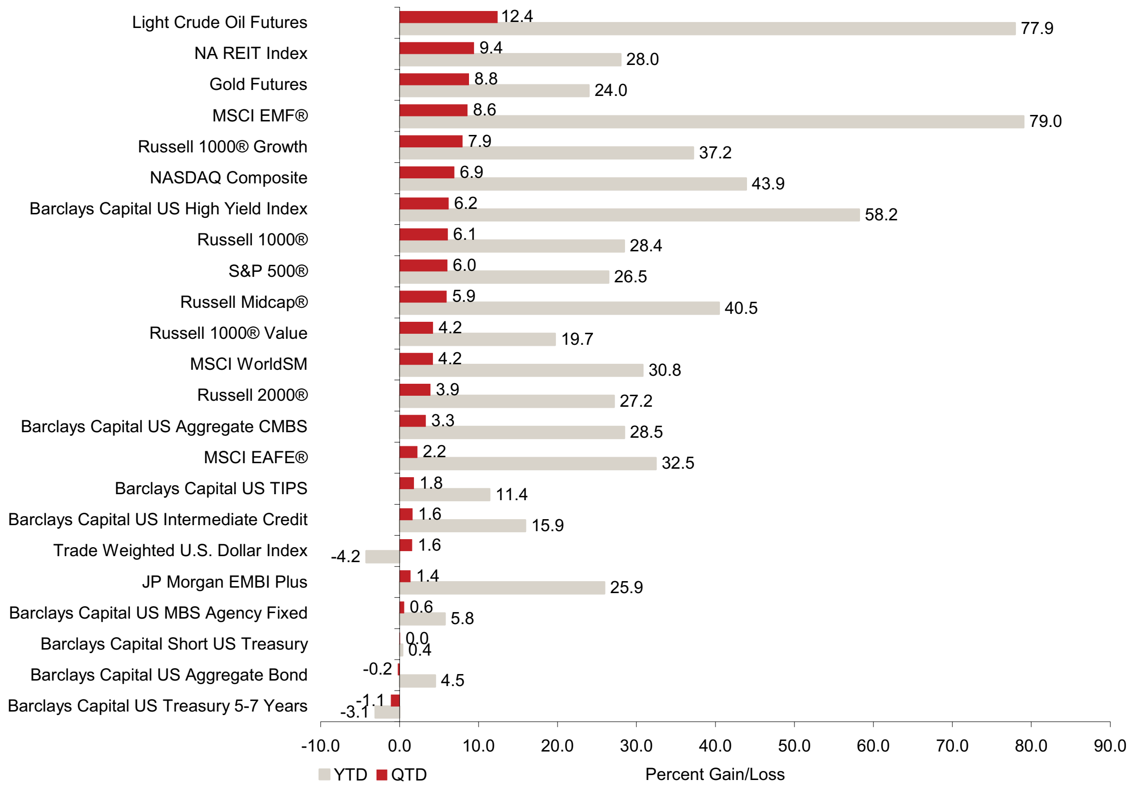
S&P 500® Index finished with a 26.5% gain in 2009

Some equity markets have soared from early March lows.

Last year was a wild ride for global markets and economies. As recently as nine months ago, the economic situation was being compared to the Great Depression, and the S&P 500's 12-month performance was off nearly 50 percent. Now, some equity markets have soared from the early March lows, and asset classes like global real estate and emerging market equity have actually doubled.

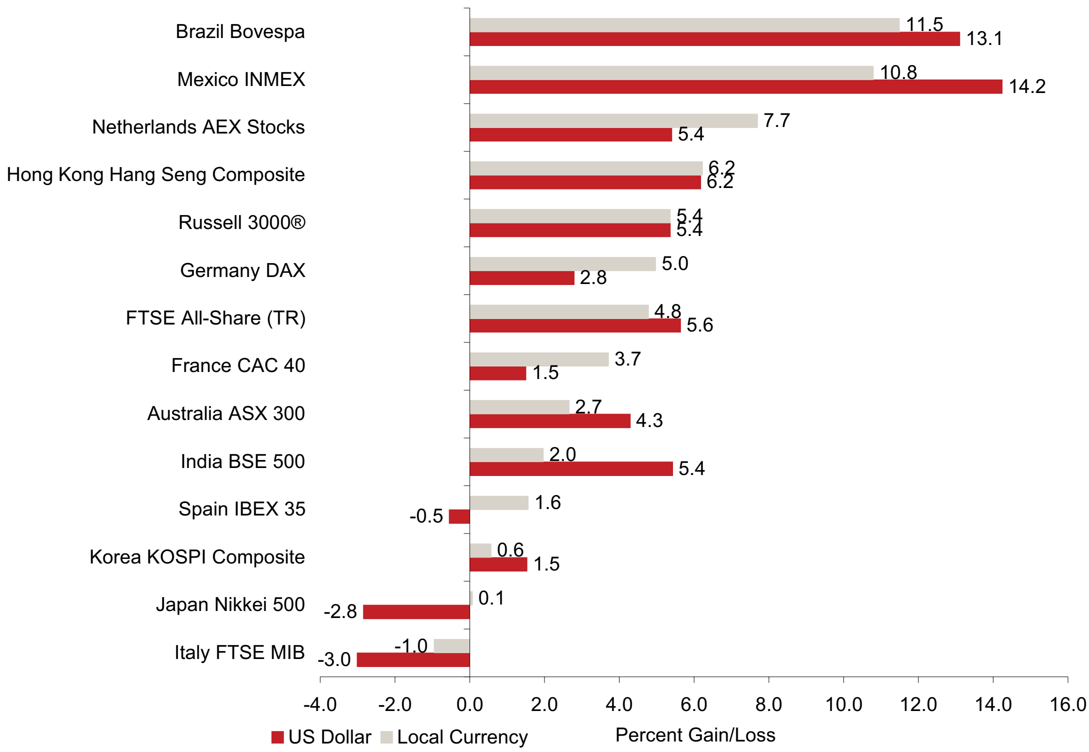
The fourth quarter started with equity markets taking a bit of a breather from the rally (Chart 1), but better than anticipated economic data resurfaced, and the rally resumed in December. However, the real story is what happened over the course of the full year. After hitting an intra-day low of 666 on March 6, the S&P 500 staged an historic rally, rising over sixty percent to close the year up twenty-five percent. The rally was even more pronounced in smaller-cap stocks, as small and mid caps rallied about eighty percent off their lows; other asset classes were up nearly one hundred percent.

Chart 2: Performance of Major Asset Classes: Q4 & 2009



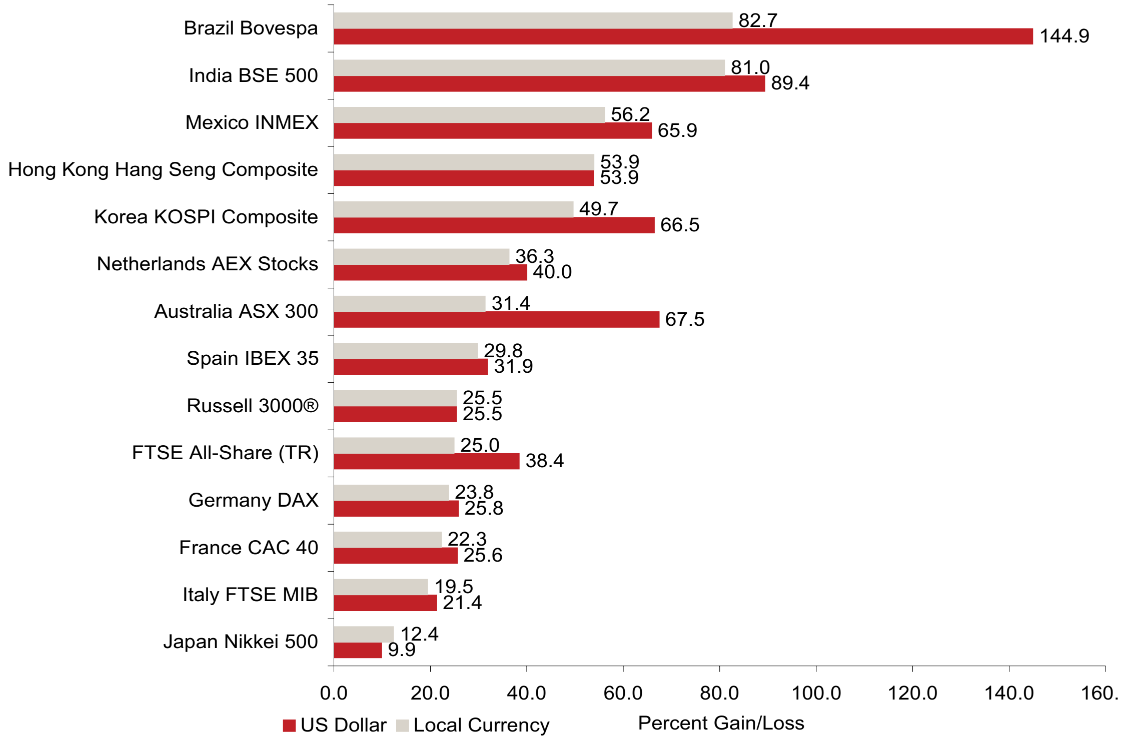
As of 31st December, 2009
Source: Bloomberg, local currency total return performance shown

Chart 3: Performance of Global Markets: 4Q2009



As of 31st December, 2009
Source: Bloomberg price performance shown

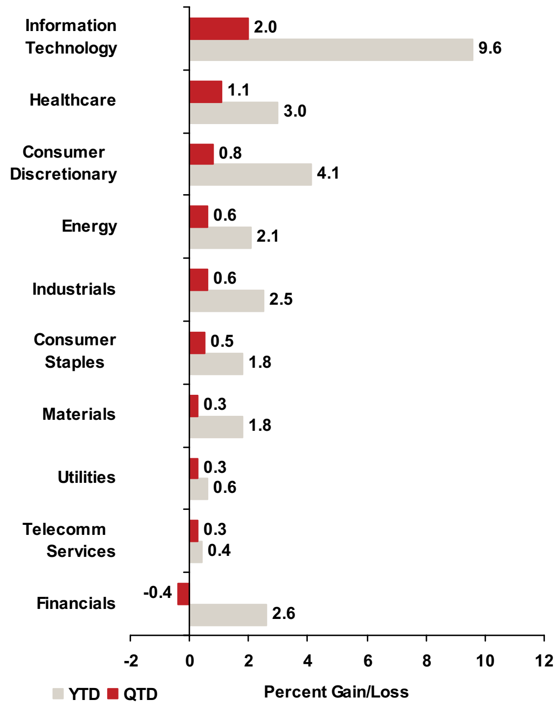
Chart 4: Performance of Global Markets: 2009



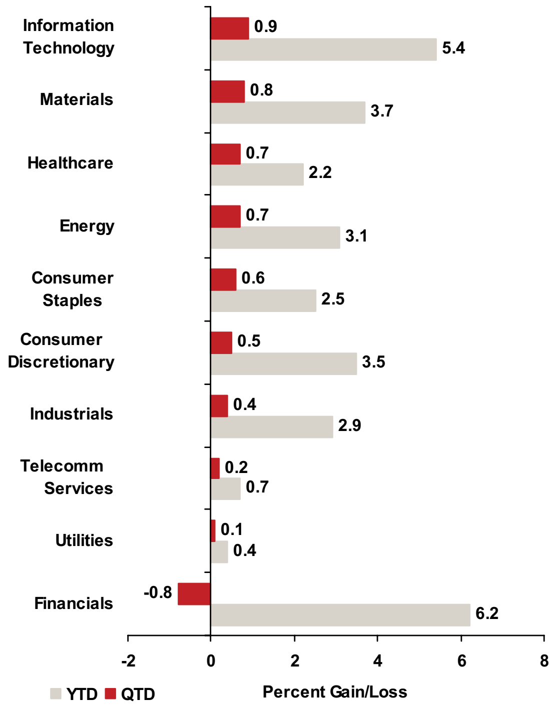
As of 31st December, 2009
Source: Bloomberg, price performance shown

Chart 5: Performance Contribution of Major Sectors

Russell 1000® Contribution by Sector 4Q09 & 2009



MSCI World^{SM} Contribution by Sector 4Q09 & 2009



As of 31st December, 2009 (in US Dollar)
Source: Wilshire Atlas, total return performance shown

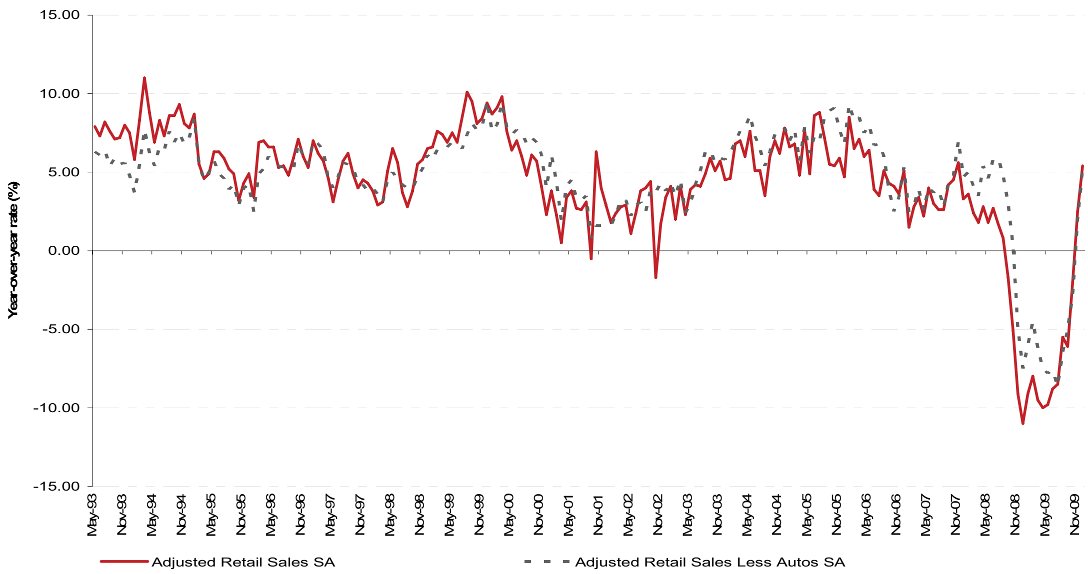
It is clear that the recovery is in place. US GDP growth was at its lowest in March at -6.4% y/y, a significantly negative number. However, the rebound has happened quickly. Q3 GDP rose 2.2% on the year, and recently-released Q4 figures were stronger than expected at 5.7% y/y. This dramatic rebound in growth is the reason for the strong rebound in stocks and corporate bonds.

Where do we go from here? US GDP is comprised roughly of two-thirds consumer and one-third business. From the consumer side, retail sales (chart 6) have shown a significant uptick, beginning in mid-2009. That shows an increase in consumption, and therefore an increase in consumer confidence. This has formed the backbone of the recovery.

However, there are still a few negatives. Personal income, which is tied closely to the job market, has not kept pace. Housing, while it has improved dramatically from the lows, has hit a plateau. While there has been significant government intervention which helped the entry-level portion of the housing market, it remains to be seen whether the improvement will also affect higher-income housing.

Chart 6: The Consumer Sector

U.S. Seasonally Adjusted Retail Sales Yearly Change



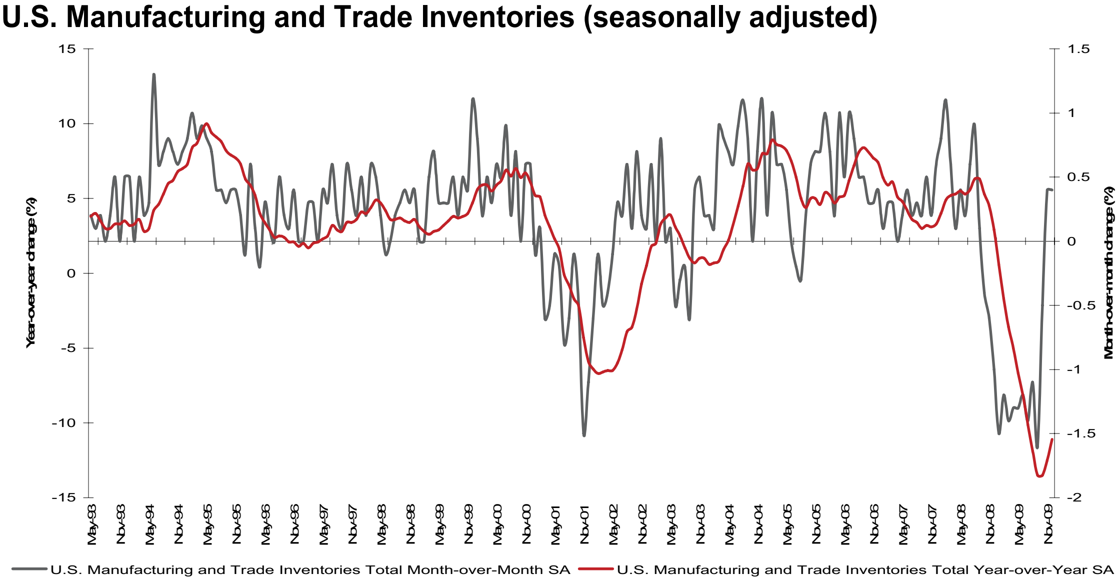
Significant uptick in retail sales from mid-2009

As of December 31, 2009.
Source: U.S. Census Bureau, Bloomberg

On the business front, a key positive has been the rebuilding of inventories (chart 7). This is one of the necessary conditions to transitioning from a consumer-led rally to a business rally. If we see consumer demand sustained to the point where businesses need to rebuild their inventories, then they will also eventually need to hire new workers. That will be the key to an improving employment picture (chart 8) – the final piece of the recovery puzzle. Capacity utilisation is another important variable, and we have finally begin to see improvements here, which will be important to the inflation debate. In addition, the ISM survey has now rebounded. On the downside, industrial production has been rising for five months after eight months of steady decline, but the y/y number is still negative, at -5.1%.

Chart 7: Inventory rebuilding

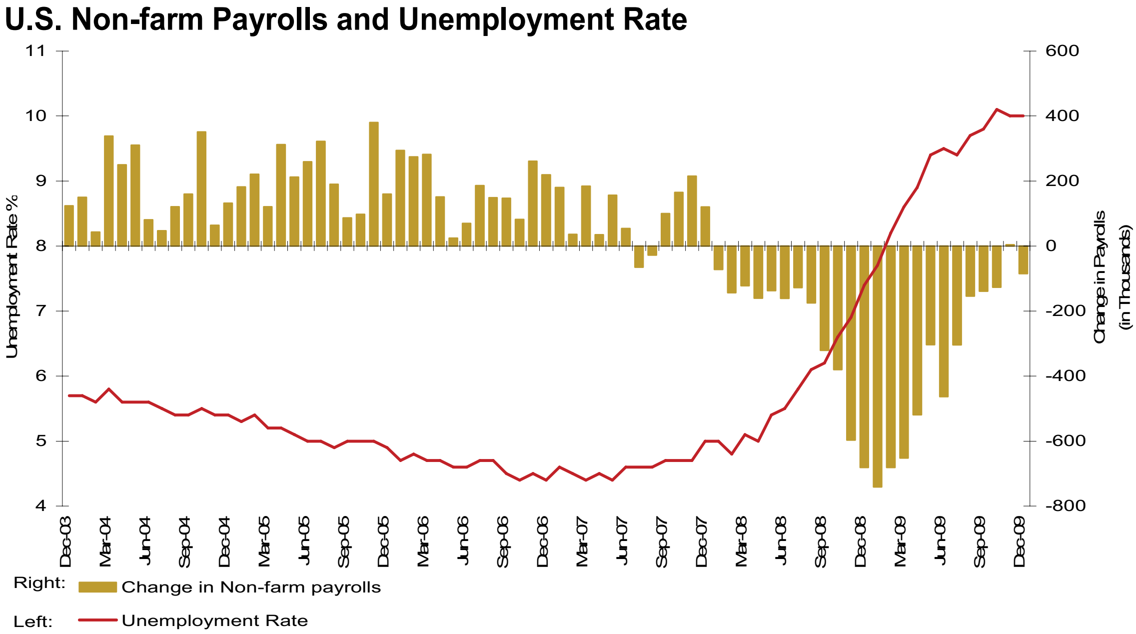
Looking for sustained inventory rebuilding...



As of December 31, 2009.
Source: U.S. Census Bureau, Bloomberg

Chart 8: The Labour market

...which would lead to a better employment outlook



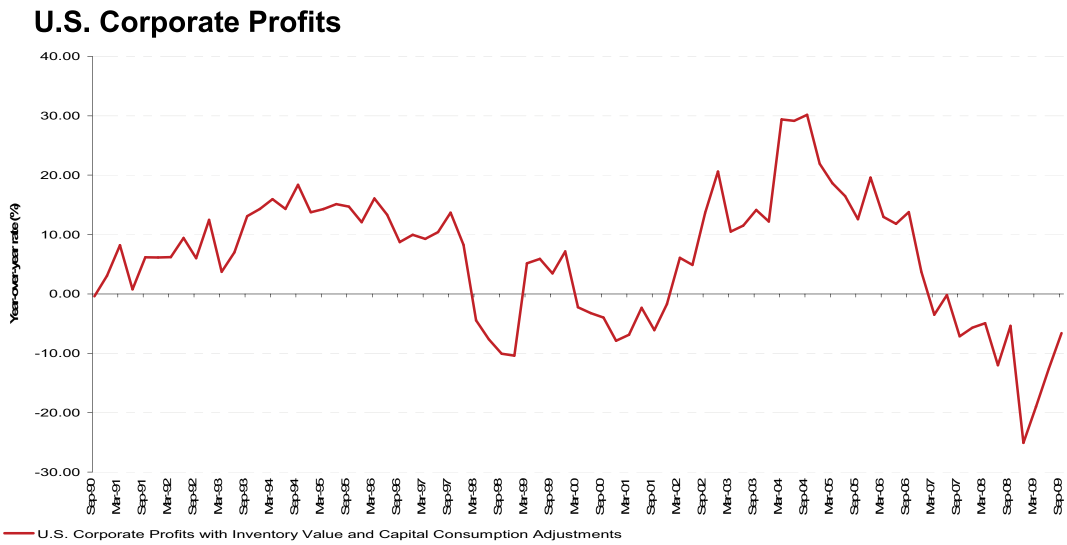
As of 31st December, 2009. *Subject to revisions
Source: US Bureau of Labor Statistics

Here at Janus, of course, our main focus is on companies. If we begin to see inventory rebuild and rising employment, what would the impact be in the corporate world? Chart 9 shows US corporate profits, which had already begun to spike upward through the middle of last year. That movement continued in the third quarter with profits up 10.6%. Companies are in the process now of reporting Q4 earnings, and we are seeing them reach expectations, for the most part. However, improvements in corporate profits are still mainly due to margin improvements and cost cutting. We hope to see top line revenue growth in the next leg of the rally, and rising employment would clearly have a positive impact.

Another hot topic at the moment is inflation. While we do not take macro views here at Janus, inflation remains a hotly debated topic within the investment team. On the one hand, there are some that believe inflation is under control with some deflationary forces at work, while there are others who believe that the excess liquidity in the system could create a significant amount of inflation in the future.

Corporate profitability improvements still due mainly to margin improvements and cost cutting.

Chart 9: Small improvement in corporate profitability

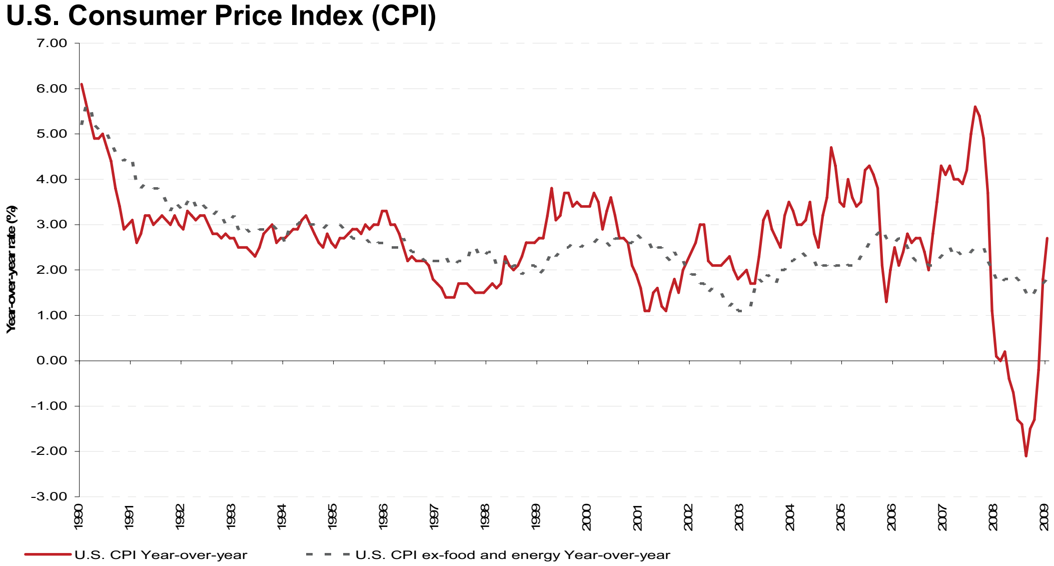


As of 31st December, 2009.
Source: Bloomberg

The first camp point to core inflation (chart 10), which has been very steady over the past five years. Looking at industrial inflation, for example, in some markets we are actually seeing deflation. This is also true on the fixed income side, particularly for grocery stores and food and beverages. This points to a lack of persistent core inflation which would be a clear concern.

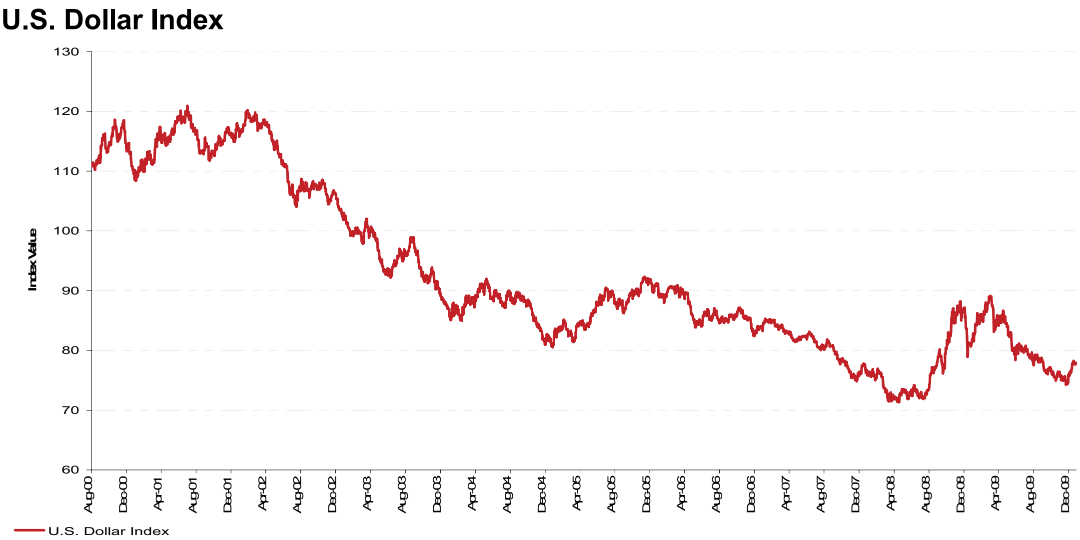
On the other hand, the flood of liquidity in the system could begin to gain traction (i.e. if the velocity of money begins to increase), and this could cause inflation. The headline inflation figure has increased slightly of late, due to the rise in commodities prices, although the latter remain relatively unconcerning as they are still below the level of a year and a half ago.

Chart 10: Inflationary Pressures



As of 31st December, 2009
Source: Bloomberg

Chart 11: A stabilising dollar



As of 31st December, 2009
Source: Federal Reserve

A near-term bottom in the US dollar

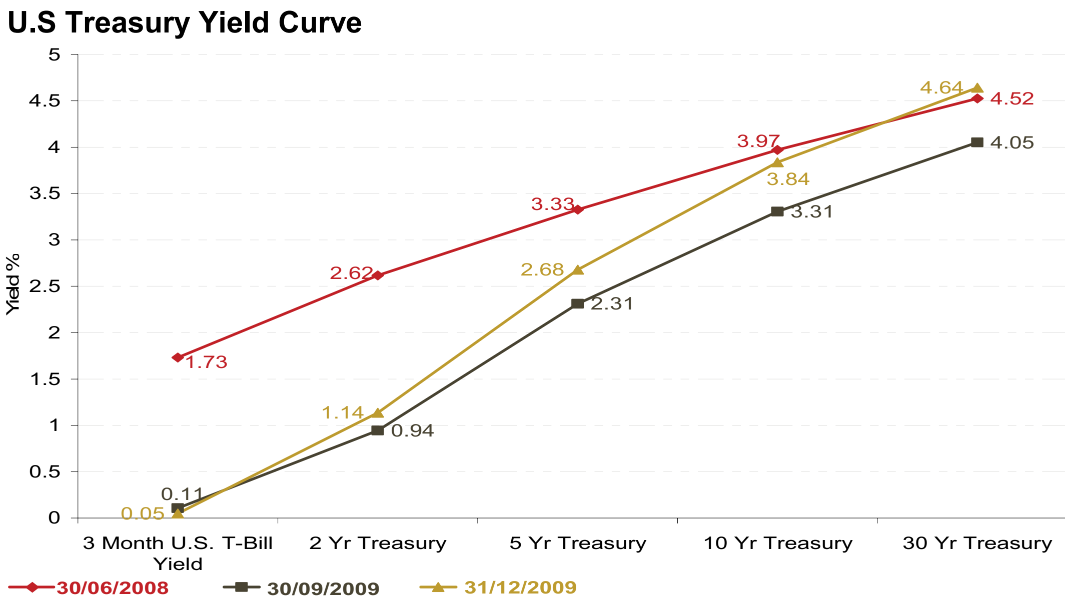
As for the dollar (chart 11), we seem to have reached at least a near-term bottom as the US economy has begun to recover, and perhaps also to have done so faster than expected, particularly with respect to some of the other industrialised countries across the globe (e.g. Europe and Japan). In the future, we will be looking at the dollar with respect to the emerging markets currencies. Here, the rules of the game are somewhat different, and we expect more volatility.

How will all of this impact interest rates (chart 12)? In terms of the yield curve, there is currently quite a lot of risk priced in. In June of 2008, before the crisis, the difference in yield between the two-year and the 30-year was 2%, compared to around 3.5% now. That means market participants have demanded an extra 150 basis points to compensate them for the risk embedded in the US market.

The main fears driving this move are inflation and increased debt issuance. On the second point, Chart 13 shows the dramatic increase in US debt issuance between 2007, and then between 2008 and 2009. We believe that the reason the yield curve is currently so steep is due to the expected issuance in 10 and 30-year Treasuries. On the other hand, if inflation really begins to rise, that would push up the two-year yield from its current 94 basis points, and that could be a driver of change to the yield curve. The current situation is very beneficial for banks, since they make money essentially by borrowing at the short end and lending long.

Chart 12: Interest Rates

Yield curve steepening due to rising expected issuance.



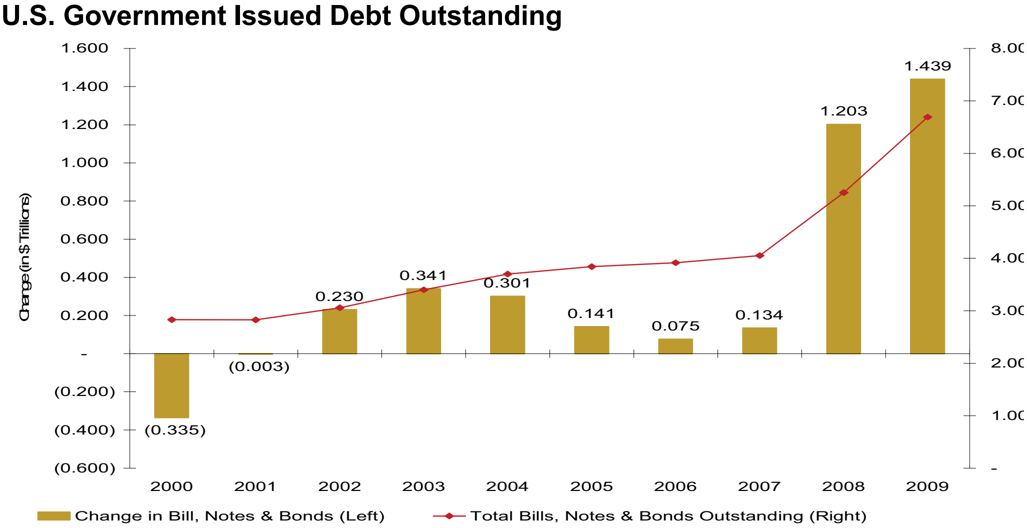
Source:Bloomberg

For fixed income, there are two main themes for 2010. The first is that credit still matters. We believe that when you look at all the different options within the fixed income markets, particularly in the US, the only place to get yield in a risk-adjusted way is in the corporate credit market. Our portfolios had been significantly overweighted credit for the majority of 2009, and that has not changed. Although credit spreads are at long-term averages, they will continue to tighten, driven by fundamentals such as rising demand and the reduction in debt at the U.S. company level.

The other theme for 2010 is concern over interest rates. Clearly, if the long end continues to underperform, portfolios will be impacted. We are working diligently to protect the Janus portfolios against this by, for example, shortening futures in the long end. Meanwhile, mortgages are still at a zero weight in our portfolios.

Dramatic increase in US issuance

Chart 13: Treasury Issuance



As of 31st December, 2009.
Source: US Treasury

Sector Outlook

As always, our emphasis is on stock picking, and on distinguishing winning business models from losing business models, while being very cautious not to overpay.

Technology

Our longer-term view is that technology spending, particularly at the corporate level, is entering a multi-year period where it is going to grow more slowly than corporate revenues. This year, however, we could see a bounce due to some of the deferred projects from 2009, when spending was very tight. We also believe that Windows 7 will create a disruption in the longer-term pattern of the extension of the PC replacement cycle, although this does not change our long-term view. We remain cautious on the prospects for some of the companies around the PC space.

We expect to see spending this year in the build-out for telecommunications networks, as increased use of hand sets (smart phones) or demand for cloud computing increases data needs. The increased spending will likely favour companies that offer a wide range of products. For example a company such as Cisco may not be the best in each category, but has the ability to offer an integrated solution. This will be increasingly appealing to customers.

Smart phones remain an important exposure for us in several portfolios. We like the secular growth, and we like the importance that software has reached in this area, as opposed to just the form factor of the phone. It allows us to identify a few key winners, but it also means we need to watch very closely the threats to these operating systems, and especially what will happen with Google Android phones[1].

Financials

In the U.S., we are seeing credit issues peaking or coming close to a peak, and we are not certain that this normalisation of credit trends is priced into stocks, especially in the large cap names. Banks are generally well capitalised. They have collectively raised tens of billions of dollars to pay back TARP funds over the last year, in the process increasing their common equity ratios, which is an important metric for them.

We are seeing a recovery in real estate in terms of less distressed sales, increased access to finance, etc. That, in turn, will help banks, which are already benefiting from the steep yield curve environment as we mentioned earlier.

The evidence shows that there is less risk priced into the financial sector – show for example in the credit default swaps on banks. One concern is regulation. It is a key issue in the news right now, and has moved the markets. Here at Janus, we do not expect extensive reform, particularly with a dwindling mandate for Obama. Policy makers will be conscious of the fact that overly aggressive reforms could hurt loan growth, and probably also the long-term competitiveness of US financial firms in an increasingly global market. For the coming 11 months, until the next elections, we expect a lot of populist noise in the financial sector, but ultimately we expect the reform bark to be worse than the bite.

Financials outside of the US are seeing profit recoveries, and are reflecting this in valuations, so we are somewhat less positive on European financials. The credit cycle is also becoming more favourable, and we expect to see increased profitability, particularly if banks are tougher on compensation. However, we remain cautious, and we believe there are longer-term pressures on the sector and their ability to generate good returns.

The story is better in Asia. China is making great efforts to cut loan growth, but we still see strong numbers coming out of China, and we are not yet concerned about non-performing loans, or loan losses. Beyond China, we are looking at banks in other parts of Asia where the valuations are more attractive. That said, one problem banks have in Asia is that there is a lot of money coming in, i.e. a lot of liquidity, which in many cases is not offset by loan demand. That has resulted in some fat balance sheets, which will hurt long-term returns.

One area where we are seeing opportunities in Asia is in life insurance. Some of our exposures in the portfolios are to emerging markets or with exposure to emerging markets in life insurance. That is a growing sector, as these economies mature and still do not have the traditional safety nets that are common in developed markets.

[1] For more information on this topic, please see the January 2010 Janus Analyst Viewpoint with Alan Bezoza – please contact your usual Janus representative for a copy.

Energy

In the medium term, we believe oil prices will move higher, based on our analysis of supply and demand. There may be some shorter-term pressure as higher gasoline prices during difficult economic times sap demand, but over the longer term, our broader view is unchanged.

We see some pricing pressure in the service and equipment areas, so we are a little more favourable toward the integrated and the EMP companies. Natural gas remains at a discount to oil and coal on a BTU equivalent basis. We are closely watching liquid natural gas imports and rig counts.

Communications

The advertising recovery, both in volume and rates, we have talked about in the past is now happening. Our surveys and our contacts in the industry were right, and the market is pricing in some of that. Therefore, what we are focusing on now, more than ever, is stock selection. We are not just trying to anticipate/participate in the general cyclical recovery, but are trying to look at companies that have either valuable properties, new revenue streams, or can generate increased margins through cost-cutting.

Sometimes these aspects come in one package, such as in some media properties, for example. The so-called "old media" such as newspapers, are looking more interesting as they find new ways to add revenue. For example, by charging for online content, they are participating in some of the advertising growth. Therefore, we believe that old media is not necessarily dying, while new media (such as some Internet sites) aren't in completely calm waters. The latter companies are also facing some structural charges. For example, travel sites that allow customers to look for the best hotel rate will soon be facing changes. We believe that these kinds of sites will soon lose their core functions to general searches, and they will therefore become replaceable by other online services.

Finally, another old media source – television – remains a powerful way to reach consumers when combined with search and other Internet ads. Advertisers are increasingly finding that television ads shown at certain periods of the day can sharply increase search activity at the same time – that means there is a significant need for more display ads in traditional media.

Consumer

Focusing on the retail sector, we are most positive on high-end retailers, with activity there strongest. However, retail sales are still below 2006 levels. Same-store sales were positive across the board in the fourth quarter of 2009, and we expect low, single digits for this indicator in 2010. While that is positive, it is still below 2006 levels in retail sales. Consistent with other sectors, and perhaps with economies in general, US growth might be weak for some time, so same store sales growth could remain in single digits for the foreseeable future.

We believe that the US is "over-retailed", particularly in shopping malls, and for that reason we expect square footage to shrink. However, that may be good for retailers, as they can get out of money-losing stores and in that way increase their earnings. Putting this all together, we believe that growth in retailers will only be achieved through a more efficient store base, market share gains or overseas expansion. These are the things we are looking for, and the need to understand and identify these trends makes stock picking and research even more important.

Industrials and Materials

The Industrial materials sector is seeing some reasonable growth in profits, and we expect that to continue in 2010. At the same time, valuations are beginning to reflect this, so stock picking once again is important.

At Janus, we are looking at areas where we see structural as well as cyclical change, including autos, airlines, and transportation stocks. Airlines and autos are relatively new sectors for Janus, but may appear in more portfolios in future. Importantly, we own these because we feel there is tremendous structural change in the industry. While transportation companies are clearly tied to economic activity, there are other attractive features, such as low inventory levels. Transports need inventory restocking, which means more production, and some job growth, at least in this sector.

The Janus industrials analyst had a good example of this. Winnebago, which makes campers (RVs – recreational vehicles), last year sold 5,000 units, but they only produced 2,000 units. The rest came from inventory. The order book this year is for another 5,000, and the company is scrambling to hire back workers and to boost production. While that is an extreme example, our contacts and our surveys are telling us that similar trends scenarios are happening at Caterpillar, Deere, and other industrials.

Importantly, with Chinese competition growing, excess capacity and material costs falling, we are seeing fewer companies with traditional pricing power. We believe that is an important observation to include in any discussion about the inflation outlook, and it is equally important to understand when analyzing companies. China is becoming an increasingly important competitor, and that puts pressure on us to really know where the competitive barriers are and whether a company can build differentiated and competitive products.

Healthcare

Health care has been very much in the news. We have felt for some time that the proposed health care reform was not going to be as bad as feared, or certainly not as bad as it was priced in the market. And therefore, the sector, for some time, had looked attractive to us – increasingly so as we approached what we thought were the final stages of the reform process. Now that the electoral scenario has changed with the election of Scott Brown in Massachusetts, the outlook for the sector has become even more favourable.

We believe there are a variety of scenarios. The best, or most likely scenario is a watered-down bill, with more focus on insurance reform and less on cost control. That will still put pressure on managed care and on insurance companies, but by and large, should be even better for the sector than we would have thought before the 19th January election.

Non-US

Europe still suffers from sluggish growth and faces the pressure of weaker EU members, especially Greece, but also maybe Spain, Italy and Portugal. The UK is not as strong as the other parts of Europe, and London remains very dependent on the financial sector, which is neither thriving nor is it pleased with new regulations/taxes on bonuses.

Japan remains burdened by the structural issues we have talked about for some time, but we are becoming a bit more hopeful there, and our hope lies on the prospect of change. There is a new finance minister that we believe could start on the path of reform at the Bank of Japan, meaning, perhaps, that quantitative easing could become more aggressive which would ultimately boost the economy (and weaken the yen). All would be generally good things for Japan.

The emerging market outlook remains positive, but we are wary of valuations. China seems to be keeping inflation under control, while still growing. The Chinese have some concerns about the slower economies in the West, and, therefore, feel the need to keep their stimulus programme in place.

Brazil, with a stabilising economy and massive oilfields continues to look promising and interesting. Emerging markets soared last year, and while we do not expect a similar performance this year, at the same time we do not see cracks in the foundations of any of these economies. In addition, we are noticing increasing analyst activity in some of the smaller emerging markets, both in terms of PM or analyst visits or purchases. We have had one or the other recently in Malaysia, Indonesia, Sri Lanka and Mongolia.

Small and Mid-Cap (SMID)

SMID stocks performed very well over the course of 2009, but that is not the whole story. While both small and mid-cap stocks rallied 80% off the 9 March lows, that was still not enough to overcome the loss that we have experienced since October of 2007. Small and mid-cap stocks are still off 40 percent from the highs they reached just over two years ago.

The rally among small-cap companies has been indiscriminate, and there has been very little regard for fundamental quality. Currently, there are plenty of overvalued small and mid-cap stocks that have been driven by the momentum of the market rally. Built into these valuations are expectations of a return to economic growth as we saw earlier in the decade. Given our uncertainty about that outcome, we think the risk/reward of these names is not in our favour. We believe that the most important thing in investing in the small and mid-cap space is avoiding the losers, and picking the winners. For that reason, we believe that companies whose share price valuations have been driven up significantly by momentum and indiscriminate buying are important to avoid.

On the other hand, we believe that there will always be tremendous opportunities in the small and mid-cap space for those world class, emerging franchises. These are businesses that have truly unique and differentiated business models with a large addressable market. At Janus we strive to find those companies while they are in the small-cap space, and then sometimes to own them all the way up until they become large-cap companies and dominant global players.

Cyclical companies are another point of interest. Some cyclical companies have rallied significantly, but there are some who will win a significant amount of market share in their space as their competitors struggle or go out of business. The survivors will have the ability to further consolidate a fragmented market. Again, our focus is on finding the companies that are the clear winners, whose competitors are struggling.

Growth vs Value

The story here is still about financials and technology. For 2009, the performance difference between those two sectors was a staggering 44%. Technology names held up well and were a standout performer for most of the year, while financials also had an extraordinary year, but for different reasons. The primary factor driving the wide performance differential among growth and value indexes this year really has been the difference between those two sectors.

Looking ahead, it is important to consider how important a role each sector plays in the performance of a growth or value benchmark. Health care is an important sector to both, but slightly more important to large-cap growth. Energy is a far more important driver of value performance. Interestingly, and probably not intuitively, is that consumer staples is actually larger in growth indices than it is in value indices. It is important to note that Janus do not invest with regard to the market or index provider definition of a growth or a value stock, but rather by looking at growth or value metrics. What we try to do is not to just invest in growth or value stocks, but to find those businesses that have the best opportunity to deliver returns for our clients over the longer term.

For more information please visit our website www.janus.com, or contact your local team.

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