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# Portfolio Roundtable

## Inflated Inflation Fears?

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Rising inflationary pressures have become a greater concern for many investors. In a recent roundtable discussion, Janus Portfolio Managers John Eisinger and Matt Hochstetler, and Head of Fixed Income Strategy Colleen Denzler, weigh today's potential inflation risks. The group offers insights about the recent climb in commodity prices, the challenges firms may face with margin compressions and how the changing inflation landscape is shaping opportunities across fixed income and equity markets worldwide.

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**Colleen Denzler, CFA**  
Senior Vice President  
Head of Fixed Income Strategy



**John Eisinger**  
Portfolio Manager  
Janus Global Select Fund



**Matt Hochstetler**  
Co-Portfolio Manager  
Janus Emerging Markets Fund

### Q: How concerned are you about the current inflationary environment?

**Colleen Denzler:** There have been substantial increases in both core and headline inflation since the end of 2010, and the question now is whether this trend continues. The inflation lows in the U.S. are certainly behind us, but runaway inflation seems unlikely. Global commodity prices have risen sharply, but a significant increase in labor market inflation has yet to materialize. This, along with continued strict lending standards, should help contain any risk of hyperinflation, but in my opinion it looks like steadily rising inflation is here to stay.

**John Eisinger:** I would categorize the domestic inflation that has occurred as more of a passing price shock, driven by the dollar down/commodities up trade related to the Federal Reserve's (the Fed's) balance sheet. U.S. money supply

growth is in the low single digits, unit labor costs are negative and current CPI expectations are around 2.9%. Consequently, much of this inflationary pressure seems transitory, especially with the continued slack in the labor market.

**Matt Hochstetler:** In emerging market economies, core inflation has been primarily driven not only by higher economic growth but also the tremendous amount of government stimulus that occurred during the global financial downturn. This stimulus now has been pulled back, and there have been meaningful interest rate hikes in many of these countries, with most emerging market central banks taking responsible actions to stem inflation. I also think non-core inflation, particularly in agriculture and energy prices, has probably peaked.

### Q: Colleen, it sounds like you are more worried about inflation than John or Matt.

**Colleen Denzler:** I believe inflation pressure may be more persistent than many people anticipate. U.S. core inflation can be split into three general components: roughly one-third is highly volatile, one-third is somewhat volatile and one-third isn't that volatile. The highly volatile category is basically commodity driven, and prices in this segment have climbed dramatically over the past year. It typically takes nine months for these cost increases to go from top production down to the finished goods level and another 12 months to be passed on to consumers. With this in mind, it will take at least another two years or so for recent price increases to work through the system. Owners' equivalent rent and other less volatile prices are also rising. As a result, there is this systemic increase in core prices that has transpired and will probably continue for the foreseeable future. Granted, it's not from higher labor costs, and it's not from increased consumer spending. Instead, it's resulting from already embedded, top-down commodity price increases.

**John Eisinger:** But embedded 3% inflation isn't necessarily a bad thing ...

**Colleen Denzler:** In the long run no, especially if it is aligned with strong growth. Anything between 1½-3½% is reasonable on a historical basis. However, markets have become so used to 0.6% core inflation, the low reached during the past year, that there's now a fear factor involved even if any increases don't warrant hyperinflation. How this nervousness plays out in the markets depends on how the Fed exits its current balance sheet strategy. The end of quantitative easing (QE2) is coming in June, and there is a great deal of uncertainty around the Fed's ability to unwind this program. I anticipate an orderly exit, although it may create a higher interest rate environment. The Fed has taken on a huge amount of leverage throughout the financial crisis to protect the U.S. economic system from collapse. The last thing it wants to do is exit this strategy too quickly, which could prove catastrophic and mean all was done for naught.

### Q: Any other thoughts on how QE2 might affect inflation?

**Matt Hochstetler:** I actually worry a lot about the Fed stepping back from the U.S. Treasury market. This could be a transformational event in the long-term history of U.S. government yields. It may seem unlikely that a U.S. Treasury auction fails without Fed buying support, but I think there is an outside chance it could happen. Today, almost all U.S. Treasuries are being purchased by the Fed, and once

this ends the U.S. will be dependent on foreign demand, because as a country we don't save enough domestically to finance our own debt. I'm not sure the demand will be there at current yield levels. In essence, any emerging market facing the same set of fiscal circumstances the U.S. currently must navigate would be bankrupt and in International Monetary Fund (IMF) debt restructuring. Our 200 years of

capitalism clearly has bought some time with the markets, but there remains an unsustainable U.S. government deficit and no realistic plans of action to reduce it.

From an inflation perspective, the concern is that at some point investors will lose confidence in U.S. debt because the only way it is being financed is through the Fed's printing presses. In a bad-case scenario, investors might stop buying dollars because they have low faith in the currency, and then inflation starts to rapidly rise. The U.S. is heavily dependent on imports, and if the dollar gets significantly weaker the price of imports could increase to unaffordable levels. This is how hyperinflation has occurred in numerous emerging markets in the past, by governments providing money to finance their budget deficits. The good news is that, despite U.S. fiscal problems, this scenario seems unlikely. There isn't a viable alternative to the dollar in the global economic system, which makes a 50-100% collapse difficult to support as a base case.

**John Eisinger:** The Fed's purchases are not resulting in higher levels of inflation because the increase in its balance sheet is being mirrored by increases in excess

reserves held at the Fed. Therefore, little money has made its way into the economy. In addition, there are examples of countries, such as Japan, that have faced difficult financial challenges and have still been able to fund most of their debt through domestic savers. But I don't believe it's that easy to self-fund debt in the U.S. given our country's lower savings rates. The U.S. could, however, likely find a real bid in Treasury auctions with the right yield levels.

**Colleen Denzler:** I don't agree with Matt's assertion that nobody is going to buy U.S. Treasuries after June. Look at the declining 30-year Treasury yields throughout the second quarter of 2011. That's not the result of the Fed buying debt; that's investors wanting a safe haven. Short term, I do agree that U.S. sovereign risk is increasing, but where do these flight-to-quality assets go if not to the U.S.? Standard & Poor's has put the U.S. on negative credit watch, but that isn't a downgrade. And more investors actually have been buying U.S. Treasuries since then. Longer term, there is no question the U.S. must put its financial house in order, but our country has accomplished this before. Granted, it's painful and can take a lot of time and political will, but it can happen.

#### Q: Do you expect commodity prices to continue to rise?

**John Eisinger:** That seems doubtful at this point. Keep in mind that there has been a one-to-one correlation with increases to the Fed's balance sheet and declines in the dollar. QE2 has kept U.S. interest rates extremely low, even as rates have been rising across emerging markets and Europe. In my opinion, the commodity trade largely has been driven by the weak dollar created by this interest rate differential, with investors increasingly buying hard assets across the commodity spectrum rather than U.S. currency. I expect the end of QE2 most likely means a stronger dollar and related commodity price declines, which should lead to global inflationary declines, especially if there is a slowdown in real GDP growth and incremental commodity demand in countries such as China and India.

**Matt Hochstetler:** I agree that global commodity prices probably have peaked from a technical perspective, and in Janus' emerging market strategy, I believe we are well-positioned for a decline in certain commodity prices. That said, the supply/demand dynamics of each commodity

segment is very different. For example, most platinum demand comes from catalytic converter demand, which is more dependent on typical U.S. and European GDP growth levels that seem realistic in the current economic rebound. Contrast that to iron ore or copper, which are both primarily driven by demand from China. If Chinese Gross Domestic Product (GDP) growth slows to below 5-6% there could be meaningful weaknesses in iron ore and copper pricing.

**Colleen Denzler:** We probably are at a point where commodities have reached their peak, or at least the pace of increases should slow down. Still, I expect prices to remain at sustained higher levels compared to the past five years. I was actually much more worried about commodity markets six months ago, because it wasn't clear where prices might top off. There is much more transparency around the issue now. Many of the contracts firms use to hedge their commodity costs are expiring, and companies may be in a better position to anticipate and plan for future pricing ranges to help manage any associated margin compressions.

#### Q: How have firms navigated rising commodity costs?

**Colleen Denzler:** The high corporate cash balances and major cost savings initiatives implemented over the past several years have offered firms a bit of a cushion against

rising raw material costs, but ultimately companies have had to make a difficult choice: reduce their margins, pass these increases along to consumers or offset them with

cost reductions somewhere else. Companies have to think long and hard about striking the right balance between these options. Nobody wants to raise prices in order to preserve a profit margin at the risk of killing their business.

**John Eisinger:** In most cases, consumer spending continues to be restrained, and most companies that try to pass on costs are likely to see demand disruptions. People remain price sensitive and may choose to do without or shift to generics or private label alternatives. If this happens, units will fall, and the companies will be forced to lower prices. This is one of the reasons I don't

believe developed markets are facing systemic inflation. This is a price shock led by a short-term spike in commodity prices that I expect will naturally correct at some point, either because demand falls or supply increases.

**Matt Hochstetler:** In emerging markets, pricing power generally has lagged inflation, and many manufacturing companies have faced margin compressions over the past several quarters. We're hopeful that central bank action across these countries will lead to inflation declines and associated margin rebounds, because we believe that higher cost inflation unambiguously is bad for margins at the market level.

### Q: Do margin compressions represent a serious threat for investors?

**Colleen Denzler:** I believe higher commodity levels are here for the next nine to 12 months, and it is crucial to assess how companies are handling these price increases on a case-by-case basis. Some companies are altering their products to reduce production costs in ways that may not be that obvious to end users. Levi's is an example. Think about skinny jeans or jeans with fewer or smaller pockets. Both styles require less cotton, which helps control production costs. This type of creative thinking can help firms incorporate higher commodity prices in a manner that's good for the company without higher consumer costs. Where it gets difficult is for firms where production costs are rising, margins are already low and product refiguring isn't really a viable option.

Also, the recent rise in commodities isn't necessarily bad for all firms. This is a wonderful environment for companies involved in selling commodities. It's also positive for financial companies looking for the continuation of a steep yield curve, which even a moderate level of inflation would imply. There are also examples of companies that have been successful in

passing along increases. It is doubtful they will reduce their prices, even if commodity markets decline. Or consider grocers who have the ability to sell their generic brand versus the name brand, which can be quite a financially rewarding business for them.

**John Eisinger:** It's not only different by company but by country as well. There's more of a systemic inflation problem in emerging markets such as Brazil, which is experiencing double-digit money supply growth and wage increases. However, central banks in the region are aggressively addressing the risk that their economies are overheating, and if inflation peaks and interest rates start to fall, these countries' stock markets could respond very favorably. In developed nations, U.S. firms face a slightly more difficult path than European companies from the point of view that many are at near record high margin rates and, therefore, particularly susceptible to any potential negative impact from demand destruction or input cost inflation. This could be a risk for U.S. equities in the second half of this year.

### Q: Investors sometimes view emerging markets as one block. Do inflation dynamics vary by country?

**Matt Hochstetler:** Absolutely. Over the next decade emerging market economies collectively will be larger than the U.S. and Western Europe combined. Viewing this diverse group as one segment is the same as assuming that what happens with U.S. GDP will also happen in Japan or Spain. For example, India is a huge oil importer. Higher oil prices are horrible for its economy, but higher oil prices are a huge positive for Russia and many Middle Eastern countries.

I expect headline inflation will continue to be difficult for Brazil, China and Russia for the next quarter or two, which leads me to believe that their central banks will continue to hike interest rates in the coming months. Higher rates, in fact, are already being priced into these markets, and as commodity prices start to stabilize, the big question is whether or not further inflationary pressures remain. I don't see that happening given tighter monetary policy, pullbacks in stimulus spending and trade surplus deterioration.

**John Eisinger:** It will be interesting to see what Asian central banks, in particular, do when growth slows. If they don't get inflation under control beforehand and then start to ease, these countries could experience prolonged high-inflation environments, which could lead to stagflation and job losses. Currently, we don't anticipate this will be the case and instead see strong potential in these markets. In China, the Shanghai Interbank Offered Rate has been rising from below 2% in 2009 to almost 6%

since the start of this year. It's currently down to 4½%. Historically, the Chinese equity market has outperformed when rates have fallen. I believe the Chinese government will be able to engineer mid-single-digit real GDP growth, which should translate into low-digit nominal GDP growth on a multi-year basis. If inflation slows as we expect it to, this could be a very positive stock climate, especially since this market has underperformed the S&P 500 by more than 30% during the past 15 months.

### Q: In summary, what's your inflation outlook?

**Colleen Denzler:** I expect inflation will continue to rise, but it's not out of control. Our expectation for core CPI is just over 2% for the next 12 months. That is significantly higher than where it's been, but it is not unreasonable by historic standards and definitely not at hyperinflation levels. With respect to interest rates, it has become much more difficult to make accurate forecasts in the U.S. and around the globe over the past two years. It isn't just about interest rate parity or inflation; it truly is about fundamental changes in the risk profiles of many of these governments. Sovereign risk, even in the U.S., is much harder to analyze at this point than company risk, which is why we are focusing so much of our fixed income attention on individual security selection in the corporate arena. We believe this is the area where we can add the greatest long-term investment value.

**John Eisinger:** I think low-to-moderate inflation is probably the base case going forward. In terms of stock opportunities, we are finding individual securities that look incredibly cheap, in our opinion, based on an overreaction by the market. Some financials in Brazil are quite interesting, as are select consumer-related industrial companies in places like China. In developed markets, addressing sovereign issues clearly is the most prudent thing to do long term, but it is creating a difficult investment environment short term. Austerity measures, rising taxes, negative

GDP in some markets...it's not pretty. Given some of these dynamics, we think it may be time to shift global equity assets toward emerging markets.

**Matt Hochstetler:** Looking back at the end of 2012, I think we'll see that current inflationary concerns were overstated. Longer term, I believe inflation across emerging markets will continue to be higher than in the U.S., based on the substantial growth paths of many of these countries. With 14 million people moving to cities every year in China and 4-5% expected annual GDP growth in Brazil it is difficult to imagine lower inflation rates relative to the U.S. and other developed markets.

In my opinion, the risks presented by Western government balance sheets are a far bigger problem. I believe many of these countries are insolvent, and the path and pace at which this issue is resolved will be the biggest driver in global markets. It isn't inconceivable that at some point highly rated corporates will be able to finance their debt at better rates than the U.S. government. Still, there is little doubt that inflation fears are creating opportunities in today's markets. In these types of turbulent climates, I believe Janus' deep research capabilities offer a tremendous competitive advantage, and I think we are incredibly well positioned to select the types of companies that can navigate – and thrive – as these dynamics continue to unfold.

# About the Panelists

## Colleen Denzler, CFA

Colleen Denzler is Senior Vice President, Head of Fixed Income Strategy. In this role, Ms. Denzler serves as a strategic partner between investment management and distribution, with an emphasis on providing investment expertise internally and externally pursuant to Janus' fixed income capabilities. She also serves as an investment representative to institutional and intermediary clients globally. Additionally, Ms. Denzler serves as a macro economic analyst providing intelligence to the fixed income team regarding the U.S. and global economy and the implications for interest rates, inflation and bond performance. Prior to joining Janus in May 2008, Ms. Denzler's experience included more than seven years as Vice President and Senior Portfolio Manager, Director Fixed Income Liaison with American Century Investments where she was responsible for the management of a \$400 million California intermediate municipal bond fund. Ms. Denzler also spent more than 10 years in portfolio management with Calvert Asset Management where she was responsible for the management of eight portfolios including a core bond fund, a long government fund, three state specific municipal bond funds and three money funds. Ms. Denzler received her bachelor of science degree in finance from Radford University. She holds the Chartered Financial Analyst designation and has 25 years of financial industry experience.

## John Eisinger

John Eisinger is Portfolio Manager of the Janus Global Unconstrained Equity and Janus Opportunistic All Cap Growth strategies and Portfolio Manager and Executive Vice President of the related funds. From April 2003 to January 2008, Mr. Eisinger served as an equity research analyst, focusing on the technology, financial and consumer sectors. Prior to joining Janus in April 2003, Mr. Eisinger was an equity analyst for five years, working at Fidelity Investments, Bowman Capital and Palantir Partners LP. Mr. Eisinger received his bachelor of science degree in finance from Boston College, Carroll School of Management, where he graduated summa cum laude. Mr. Eisinger has 13 years of financial industry experience.

## Matt Hochstetler

Matt Hochstetler is Co-Portfolio Manager of the Emerging Markets Equity strategy, a position he has held since September 2010. Mr. Hochstetler also serves as an equity research analyst. He joined Janus in June 2005 as a research intern and became a permanent member of the investment team in July 2006. Prior to joining Janus, Mr. Hochstetler worked at Bain & Company for several years. Prior to joining Bain & Company, Mr. Hochstetler worked at Chase Capital Partners. Mr. Hochstetler received his bachelor of science in foreign service from Georgetown University, School of Foreign Service, where he graduated magna cum laude, with departmental honors, and Phi Beta Kappa. He also holds an MBA from Harvard Business School where he graduated with high distinction as a Baker Scholar. Mr. Hochstetler has 8 years of financial industry experience.

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