

# Market View

PERSPECTIVES ON WALL STREET FROM 90 HUDSON

Last quarter, our panel concluded that resolving the credit crisis was critical to economic recovery. Before the fiscal stimulus plan could work, access to credit had to improve so that consumers and businesses could begin to spend. But access to credit depended in part on stopping the decline in housing so that mortgage-related securities could be accurately priced and eventually removed from bank balance sheets.

While progress has occurred in the credit and housing markets, this quarter a new threat has moved to the foreground: the possibility that investors in U.S. Treasuries will balk at the rapid rise in the fiscal deficit. Lord Abnett Partners Milton Ezrati, Senior Economist and Market Strategist; Zane Brown, Fixed Income Strategist and Director of Institutional Marketing; and Rick Ruvkun, Director of U.S. Mid and Large Cap Equity Research, discuss this new challenge, as well as the state of the economic recovery and where investors may find potential opportunities.

## Q: ARE WE OUT OF THE WOODS YET REGARDING THE CREDIT CRISIS?

**Zane Brown:** I think one thing we can say is that clearly credit markets are improving. We've definitely made progress toward normalcy. It's been the result of actions by the Federal Reserve and the Treasury Department, combined with some increase in risk appetite on the part of investors.

The TALF [Term Asset-Backed Securities Loan Facility] program has aided asset-backed securities enormously, and when commercial mortgage-backed securities [CMBS] are included this summer, it should aid CMBS as well. The Fed's commercial paper funding facility [CPFF] really isn't needed any longer. It has served its purpose. Liquidity has returned to the commercial paper market.

In the mortgage market, the Fed has been aggressively purchasing mortgage-backed securities. Over the past couple



of months, 30-year mortgages have been below 5 percent. That has allowed re-financings, and it has given first-time homebuyers an opportunity. In sympathy, investment-grade corporate spreads over Treasuries have narrowed, as have high-yield spreads—again, part of this was an increase in risk appetite—and the municipal market has improved

dramatically. However, Treasury yields have risen recently, and are undermining some of the improvement we have seen in the bond market.

**Milton Ezrati:** Debt issuance and the TED spread are also signs of improvement. The TED spread got to 460 basis points [bps] in October last year, and now it's back to 30-odd bps. [The TED spread is a measure of credit risk. It is the difference between the three-month London Interbank Offered Rate (LIBOR) and the yield on the three-month U.S. Treasury bill.]

## Q: HOW WOULD YOU ASSESS THE IMPACT OF THE FISCAL STIMULUS PLAN?

**ME:** One of the points we made last quarter, and I'm sticking to it, is that most of the stimulus bill was never countercyclical—it was always long term. The spending on roads and bridges is all under the control of state and local governments. They have to do the environmental impact statements, and they have to put projects out for bid. So, even in the best of environments, these things take a great deal of time, and that's why we haven't seen the money flow.

**ZB:** Only about 6 percent of the stimulus plan had been spent as of May 29, and that confirms what we said the last time, which was that we needed to have some of the credit problem solved first, because in order for people to make use of the stimulus program, they had to be able to borrow money and go out and spend money. Some of the incentives in the stimulus plan, such as the \$8,000 credit for first-time homebuyers, are less likely to be used if mortgage rates are at 6 percent.

**Rick Ruvkun:** In contrast to the fiscal stimulus plan, some people are pointing out that with all of this monetary stimulus, it would be surprising if we didn't have *some* "green shoots." So, I think it's true: things have gotten better, and the credit access has gotten better.

But we had inventory levels that had gotten really low due to this credit crunch, and the big question is, how much of this recovery is due to "demand pull-through," that is, demand that is coming from consumers, and how much is just inventory replenishment? It's a necessary but not sufficient condition that we had to open up the credit markets, and now we have to see demand from consumers.

The other issue is, to what extent has housing bottomed? With consumers making up two-thirds of the economy, if we don't have a real floor in housing prices, then the demand pull-through that we're all hoping for is not going to materialize. So, it's really key for us to focus on housing.

**ZB:** That is a great point. Last quarter, we really didn't think we'd have a lot of demand pull-through by this time. We just thought we'd have some moderation of cutbacks in spending by consumers. We've had that moderation, but we have yet to see any increased demand from consumers.

**RR:** Depending on which index you look at, we've already had a 30–45 percent bounce in the market since the low in early March. For the next 10–15 percent gain to occur, we're going to have to have customer demand, not just inventory replenishment. The economy has got to improve, and we'll know that's happening when we see an improvement in retail sales. We'll also have to see it in corporate earnings.

Meanwhile, many continue to hope for a decoupling of emerging economies from Europe and the United States. But I don't think China, for example, is rebounding as strongly as people think it is. They're spending a lot of money, but it's the government that is doing the spending. It's not their consumers who are doing the bulk of the spending.

**ME:** That's right. China's economy is two-thirds of the U.S. economy, and half of it is investment spending.

**ZB:** So, decoupling isn't happening, and demand in the United States will have to rebound for a full recovery to occur. That may be helped by additional spending from the stimulus program, which has yet to unfold. But it's unlikely that will happen in just one quarter.

We could see the beginnings of some spending that will result from purchases that consumers can no longer put off. Given this pent-up demand, consumers could start purchasing at a slightly faster pace. It's not likely to be strong enough to generate 3 percent growth in GDP [gross domestic product], however.

**ME:** Retail spending growth has gone from negative to about zero. This does not have to get back to the 3.5–4.5 percent level—which is what we were seeing in 2003, 2004, and 2005—to make an impact on the economy; it just needs to show some positive growth. And Rick's right, housing is the fulcrum.

Nobody expects any growth in housing, but the issue is, when does the erosion stop? There are some positive signs: inventories have come down from about 12 months' supply last year at this time to about nine months. At the current pace of sales, especially if the builders continue to cut back, we could have a more normal inventory of five to six months' supply before summer is over.

We're already seeing some slowdown in the amount of cutback by builders, which means they're more comfortable with the amount of existing inventory—this is the inventory of all unsold houses nationally, not just new homes. [The resale market is about 10 times the size of the new home market.]

So, we've had sales numbers stabilize and tick up slightly, for existing homes. And now we're beginning to see a turn in the price of real estate. I know the data from S&P/Case-Shiller® Home Price Index look awful, but they're focused on select metropolitan areas.

The National Association of Realtors has a national number that turned up three months ago. Now, it's not strong, but it's a lot better than a negative number. So, in the housing situation, there is reason to expect that the downward pressure will end this summer, if it hasn't ended already.

That will do two things: One, it will relieve some of the strain on the consumer because the house he or she owns is no longer losing value. But more importantly, it will facilitate the purchasing of troubled mortgage assets targeted by PPIP [Public-Private Investment Program; a program designed by the Treasury Department and the Federal Reserve to finance the purchase of troubled assets from banks]. Investors have not wanted to deal with this debt because they've had no idea what the underlying mortgages are worth. If the price of housing stabilizes, then you have people who can actually price this debt and start to bid on it.

**ZB:** With the stabilization of housing prices and the belief that housing prices are no longer declining, we'll also see those people who are on the sidelines waiting for housing prices to bottom beginning to buy second homes, or even buying their first homes.

Continued improvement in housing is really contingent on the Fed being able to keep 30-year mortgage rates below 5 percent. They've crept up over 5 percent for the first time in

several months. If the Fed can't keep these rates below 5 percent, then this emerges as a problem all over again, because the opportunity for a lot of people to buy for the first time or to refinance will be lessened.

**Q: WILL THE ECONOMY TURN POSITIVE THIS YEAR?**

**ME:** I think the economy will give us positive GDP numbers before the year is out. It could happen in the third quarter, because we have had tremendous inventory de-cumulation economy-wide. All that has to happen is for the de-cumulating to stop, and we'll get an enormous kick in GDP. Half the GDP decline in the first quarter was inventories.

One of the reasons we had such tremendous layoffs was because companies were cutting back on inventories, which cut back on production. Inventories declined far more than sales. And productivity rose, which means companies cut back on employment even more than they did on production. That's not to say that the economy is really good—it's just to say that things aren't as bad as they look.

**RR:** I think the economy will be less bad this year. First, the good news is, we've got an upward-sloping yield curve.<sup>1</sup> The bad news is, it could be upward sloping because the dollar is no longer the currency of last resort [i.e. safe haven], because China is saying they don't like the fiscal deficits, and because we may have latent inflation. So, while the green shoots look great, there's some likelihood that we may have latent inflation and that the demand may not be there at the end of the tunnel.

One thing I'm concerned about is that the Treasury auctions may not be successful in the summer because of the capricious spending by the administration and Congress. It's a big potential problem.

I think the Treasury auctions over the next three or four months will provide some clarity. If the auctions aren't successful, and if there is any rhetoric that the dollar is not the currency of last resort, then the recovery could stall.

If Treasury auctions don't fail because of fears the administration is spending too much, then a lot of these green shoots make sense, because it means things are getting better. But if investors vote "no confidence" in our government with respect to these auctions, then housing could struggle, the consumer could struggle, and all bets could be off.

This outcome is not logically necessary, but the probability is higher now than at any time since President Carter. It was significant that when Treasury Secretary Geithner recently told an audience of Chinese students that China's holdings of dollars were safe, they laughed at him.

Second, in addition to the Treasury auctions, the other issue is, as I mentioned, demand pull-through. I don't know how strong that will be yet because we're still waiting for the bulk of the stimulus to be spent.

But if I had to guess, I would say the economy this year will muddle through. I don't think GDP growth will be as bad as the bears fear, but it won't be 1–3 percent. It will probably be 0–1 percent.

**Q: SO, THE UPWARD-SLOPING YIELD CURVE, WHICH IS NORMALLY A POSITIVE SIGN, COULD INSTEAD BE FLASHING WARNING SIGNALS?**

**ZB:** To put some numbers on Rick's concern, this year we have to finance over \$1.8 trillion, and that's about 13 percent of GDP. That's a huge number. The real question here is, can the Treasury continue to finance everything without causing Treasury rates to go dramatically higher?

The market is worried about commodity inflation, and it's worried about growth in money supply. The upward slope is also a sign that China has shifted its holdings. China owns more Treasuries now than at the beginning of the year, but the average maturity of those holdings has changed significantly. The country has increased dramatically its purchase of Treasury bills with maturities under two years and sold off holdings with maturities of two to 10 years. That has produced some steepness in the yield curve.

In addition, the universe of buyers for 10-year maturities is smaller than that for short-term securities, and that leads to some steepness as well, especially with the Treasury issuing more and more supply.

**ME:** I agree, the market is worried about inflation. Some people believe the Fed is still stuck to the Taylor rule, and that it won't be raising rates for a long time. [The Taylor rule says that as long as there is excess capacity in the market, inflation presents no problem and the Fed can maintain a loose monetary policy.] I don't believe the Taylor rule, and I don't think the market believes the Taylor rule, but the Fed does.

I think we can, however, overdo the intensity of the inflationary argument here, at least in terms of the dollar. I think the dollar's retreat of the last few weeks is part of the healing process. We had a lot of people flooding into Treasuries in 2008. They were terrified, and they had to buy the dollar to get the Treasuries. The dollar rose, except against the yen, which was also considered a haven in this environment. Treasury yields went way down, and spreads over Treasuries got very wide. And now, the shrinking of the spreads, the rising of the

Treasuries, and the shrinking of the dollar against everything except the yen is the unwinding of this process.

So, that's what I think is happening immediately, and it has nothing or very little to do with the long-term inflationary concerns, which I don't discount. I think those concerns are real. But I don't think that's what we're seeing here and now. So, the upward-sloping yield curve is not a sign of inflation—not yet.

**Q: IS THERE A TIPPING POINT AT WHICH THE FISCAL DEFICIT BECOMES TOO LARGE, THE BOND MARKET BEGINS TO REFLECT THAT, AND RISING INTEREST RATES DERAIL THE ECONOMIC RECOVERY?**

**ZB:** I think we're at that tipping point now. To me the tipping point is rates on 30-year mortgages that are over 5 percent. [The national average rate on a 30-year mortgage was at 5.8 percent as of June 23, 2009, according to Bankrates.com.] If you look at the weekly numbers, generally when mortgage rates are below 5 percent, refinancings and new mortgages increase. If the mortgage rate goes higher than 5 percent, these activities decline dramatically. So 5 percent seems to be the tipping point. We need to get the yield on the 10-year Treasury down to about 3.5 percent in order to get 30-year mortgage rates below 5 percent.

**RR:** The key thing I'm looking at is whether the auctions are unsuccessful this summer. That has huge implications for price-earnings multiples, and there's a tipping point on that as well. There are those who believe that if rates break out on the upside, and we have latent inflation, then it will be problematic for everything.

It's going to be interesting because you have an economic slow period in the summer, so if demand pull-through occurs, it's not going to happen until the fourth quarter. So, if the Treasury auctions are going to fail, that could happen before September.

**ME:** If Rick's concern is legitimate, and I think it is, then there's going to be a political response, because President Obama cannot have this thing fly apart. If the bond market blocks the economy from recovering, which I think it can, then President Obama can see what's going to happen to his popularity ratings. So, I think there will be some rethinking of his programs. Cap and trade, raising taxes, ending the tax deduction for charitable contributions, a value-added tax (VAT)—all these things are not good for stimulating the economy.

If the green shoots die on the vine because of higher interest rates, and the stock market goes back down, and the real estate market doesn't improve because the mortgage rates are up,

and the price of housing continues to fall, I can't believe the public won't say, "Hey, wait a minute, you've been in office now for nine months, what happened?"

So, President Obama's popularity could go down. If we get this negative scenario, the next thing we look for is his popularity rating declining.

**ZB:** There is one good result that could come out of this: an increased awareness of how much it's costing us and how much financing we have to do. So, we may have a slightly different approach to future spending, including healthcare and entitlement programs.

**Q: HOW SHOULD INVESTORS POSITION THEMSELVES IN THIS ENVIRONMENT?**

**RR:** In the stock market, a bad Treasury auction could provide the impetus for a retesting of the bottom hit in March 2009. Some have predicted a retesting of the bottom, so what could cause that retest? A bad auction.

**ZB:** If we hit a yield of 4 percent on 10-year Treasuries, that could also cause a retest. And we're not that far off. We touched 2.06 percent in December 2008, and now we're at 3.86 percent. That's a huge move.

From an equity standpoint, you could characterize the market as still cheap if you look at it in terms of earnings yield, but whether it is cheap really depends on whether demand pull-through occurs and on whether we avoid anything adverse in the summer Treasury auctions. So, you have to have both of those, or I think you're in for a retracing of recent equity gains, or a standstill at best.

**RR:** If rates were to go up, the market would not be considered cheap. That's the key issue. If GDP grows by 0–1 percent, and rates tick up, then the stock market is likely to decline. But if rates stay where they are now and GDP grows 0–1 percent, it'll probably be nominally higher.

**ME:** I think we can say that there are a lot of risks, and barring them, the market looks very attractive. But you have to have an eye on inflation, the Treasuries market, and rates rising.

**ZB:** Now, if you have an economy that muddles along for a protracted period, then you may still want to consider owning spread product. You still want to get paid while you wait, and spreads over Treasuries don't have to compress any further. In fact, they could even widen out a little bit, and as long as defaults don't increase dramatically, the income stream could offer an attractive return.

If you're wrong and things start to improve, then you could still enjoy some price appreciation. Of course, if things really go south, then fear of defaults will cause spread widening; but

if the most likely scenario is muddling through, then spread product, whether it's high-grade corporates, high yield, or the municipal market, may be considered.

Spreads over Treasuries have come in, especially in the high-yield market. But in the last two slowdowns, the spread in the high-yield market didn't get above 1,100 bps, which is exactly where it is now. So, it still represents great value.

**ME:** If Rick is right about inflation, the inflation is probably further out on the horizon. The key here is the fear of inflation—the market's reaction to prospective inflation—as opposed to inflation itself. With the world economy as soft as it is, it's not an imminent threat. The threat we're talking about here is the market's reaction to the fear. Inflation is not an imminent threat, but the market's reaction to inflation is an imminent threat.

**RR:** In equities, I think the good news is that the most dire economic scenarios of a few months ago appear to be off the table, and investors have regained some of their risk appetite. Nevertheless, we may not be out of the woods yet, so you want to have a barbell approach, selecting some stocks that are appropriate for a muddle-through scenario and others for a more robust economic recovery.

Under muddle through, which I think is most likely, you want high-dividend-paying, high-quality stocks. Under the more robust recovery, there are people who believe that while history may not repeat itself, it does rhyme, and that, therefore, as in past recoveries, you should consider early-cycle cyclical stocks. That is, you might want to consider cyclical or high-beta stocks in sectors such as industrials, transportation, energy, or technology.

The early-cycle cyclical trade has run so far, so fast, however, that it could be mostly played out. So, for this end of the barbell to work, the market needs to see an improvement in earnings, which will indicate the more robust recovery may, in fact, be occurring. I don't think you can be 100 percent on either scenario—you have to be nuanced. ■

<sup>1</sup> The yield curve shows the relationship between yields and maturities on fixed-income securities, typically Treasury bonds. Normally, the curve slopes upward from left to right, with shorter maturities, shown on the left, offering lower yields, and longer maturities, shown on the right, offering higher yields.

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