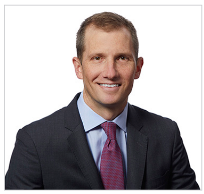
Weighing Risk and Opportunity in Q4

Our experts offer their views on key investment themes for what promises to be an eventful final three months of 2020.

Giulio Martini
Partner, Director of Strategic Asset Allocation



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Investment Strategist

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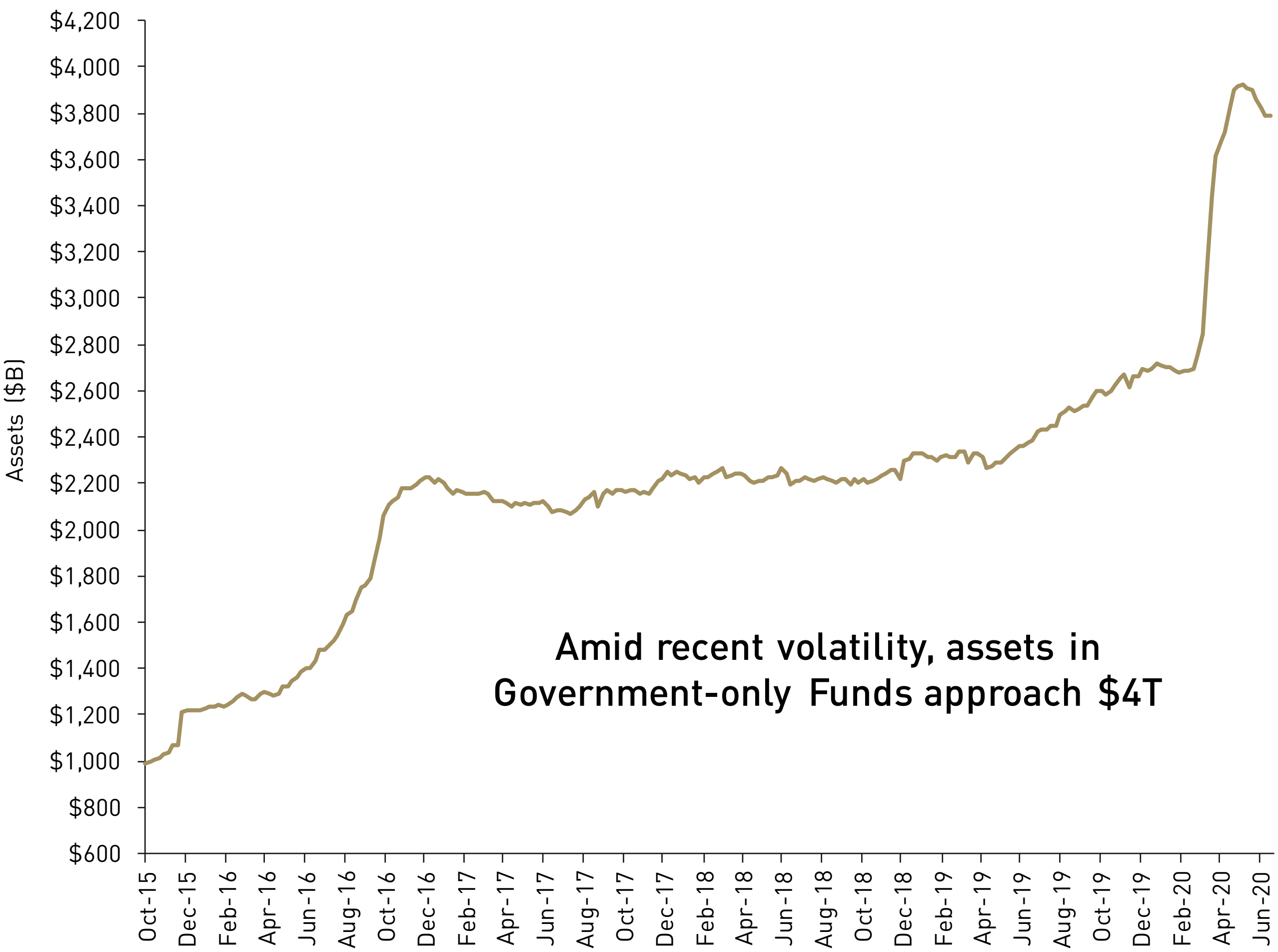
Director, Product Strategy

Figure 1. Investors Have Flocked to Zero-Yielding Government-Only Money Market Funds

Fund assets, October 7, 2015–June 30, 2020



Source: Bloomberg Index Services Limited and ICI Money Market Fund data. Data as of June 30, 2020 (latest available). For illustrative purposes only, does not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and not intended to predict or depict future results. You could lose money by investing in a money market fund. An investment in a money market fund is not insured by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund. A fund's sponsor has no legal obligation to provide financial support to the fund, and an investor should not expect that the sponsor will provide financial support to the fund at any time.

weighing risk

We've reached the home stretch of a remarkable year. What should investors be focusing on in the fourth quarter of 2020, with COVID-19 still bedeviling the world, global economies on the mend, and a contentious U.S. presidential election just a few weeks away? Here, we present a brief guide to some of the key investment themes for the final three months of the year, drawing on the insights of Giulio Martini, Partner and Director of Strategic Asset Allocation; Joseph Graham, Managing Director and Investment Strategist, Tim Paulson, Investment Strategist, and Stephen Hillebrecht, Director, Product Strategy.

Risk Assets Shrug Off Risk

One of the more notable developments in 2020 has been the strength in U.S. risk assets even as volatility remains elevated due to three major sources of uncertainty:

Development of a COVID-19 vaccine. At least one vaccine approval is expected by year-end, at latest, followed by widespread distribution in first half of 2021 and comprehensive distribution by year-end. Still, there are no guarantees as to the timing, and the efficacy, of any of the dozens of COVID-19 vaccines or treatments under development.

Further fiscal support for the U.S. economy. A double-dip recession could take place if another round of fiscal stimulus is delayed until the first quarter of 2021 or later. Intense partisan rancor and divided government could prolong subpar U.S. economic performance and handicap the earnings recovery.

U.S. election outcome. While Democratic candidate Joseph Biden holds a double-digit lead over President Donald Trump in several national polls, the prospect of a clear-cut outcome to the contest remains uncertain. The winner of the Presidential race and the party composition of the U.S. Senate may not be resolved until long after Election Day (November 3). A Trump victory likely would result in "more of the same" in terms of U.S. fiscal policy; if Biden wins, the sequence of prospective policy changes may not be known until the first half of 2021.

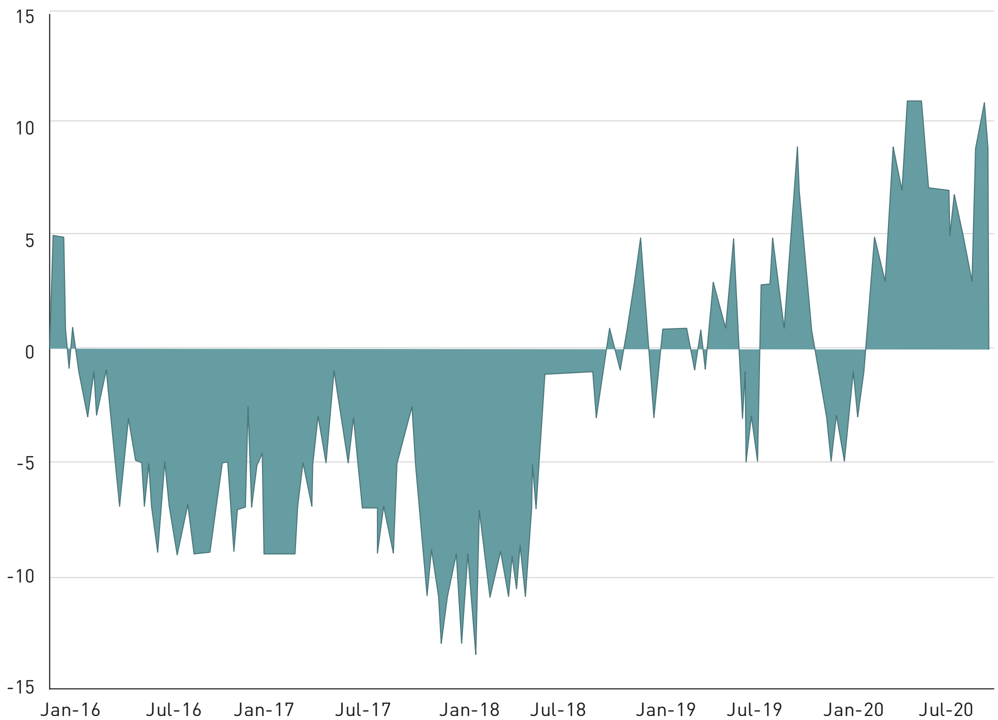
Uncertainty Has Led to Investor Caution

Even amid the market strength, investors appear to be positioned conservatively, suggesting the "pain" trade is for asset prices to continue rising, especially if there is clarity or resolution to the uncertainties listed above. Look at Figure 2 (next page), which depicts a behavioral risk metric compiled by State Street. As of September 30, institutional investors were well short of their benchmarks for holdings of risk assets. Indeed, the degree to which they are underweight risk assets is comparable to the height of the March-April 2020 market volatility—even as the S&P 500® Index hovers just below all-time highs and credit spreads have narrowed significantly.

Another indication of investors' defensive posture: the amount of cash sitting on the sidelines earning zero. Recent volatility led to a flight to government-only money market funds, despite yields near 0% (see Figure 1 on first page).

Figure 2. Institutional Investors Showing High Degree of Caution

Holdings-based risk score (see below), January 1. 2016-September 30, 2020



Source: State Street. Data as of September 30, 2020. A positive score indicates an underweight position in risk assets versus estimated benchmark weights across stocks, bonds, foreign exchange, commodities, and asset allocation positions.

Why is all this important? We believe the three uncertainties listed above represent two-sided risk, both upside and downside. The "risk-off" positioning indicated in Figures 1 & 2 suggests the asymmetry in potential returns is higher to the upside if the unknowns are resolved favorably.

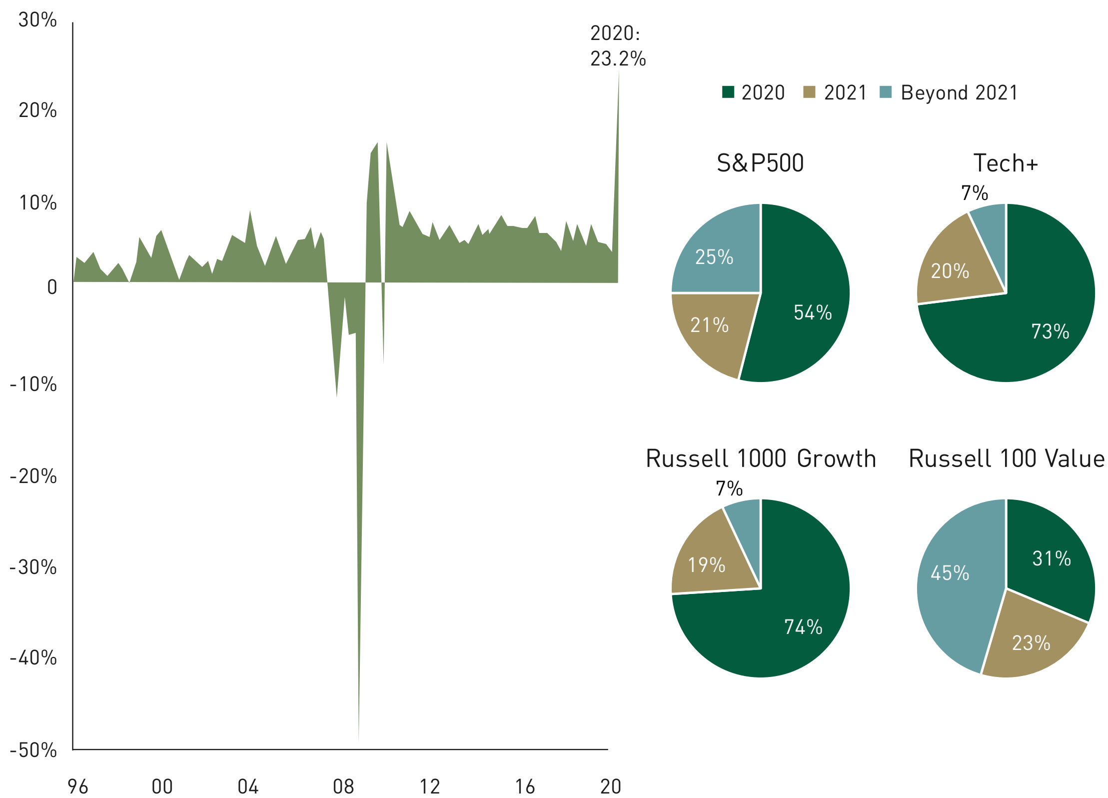
Against this backdrop, how do we assess prospects for major asset classes? Here are our views:

U.S. Equities

The crushing economic blow delivered by COVID-19 prompted equity analysts to severely reduce their estimates for corporate earnings per share (EPS) beginning in March. But a funny thing happened on the way to Armageddon: Positive EPS surprises were more significant than ever before in the second quarter of 2020 (left panel, Figure 3) and a large majority of companies are expected to exceed 2019 EPS by the end of 2021 (right panel).

Figure 3. The Surprising Strength of U.S. Corporate Earnings Amid the Pandemic

Percentage of companies in the S&P 500 Index providing upside earnings per share surprises versus analyst estimates, Q1 1996–Q2 2020 (left panel); percentage of market cap of indicated indexes forecast to exceed 2019 EPS levels for indicated dates



Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse (left panel); Standard & Poor's, Russell, Thomson Financial, Credit Suisse (right panel). Data as of June 30, 2020 (end of most recent quarter with fully reported corporate earnings).

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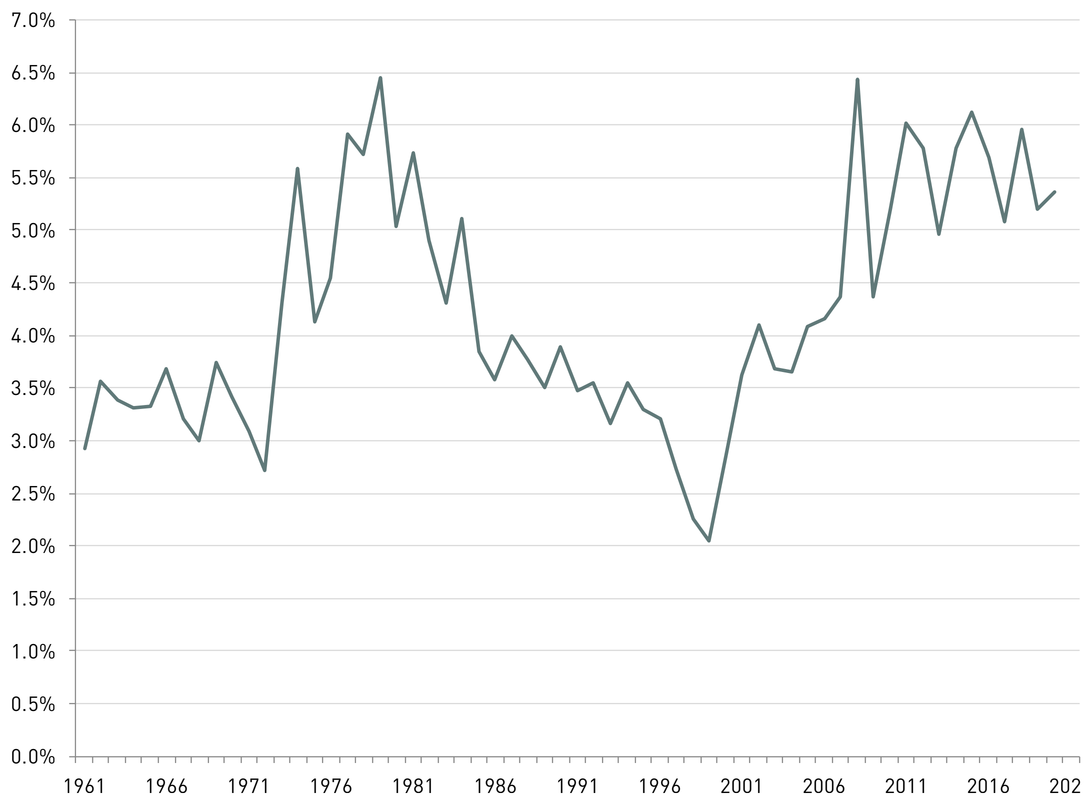
Even though U.S. stocks are selling at a high multiple of forecasted 2021 earnings, valuations are more reasonable when considered in the context of historically low interest rates. Based on the Equity Risk Premium (see Figure 4), which compares equity valuations to the 10-year Treasury bond yield, valuations do not seem especially elevated, and we believe they do not appear to be an impediment to higher prices in the months ahead.

Figure 4. U.S. Equities Appear Attractively Valued versus 10-Year U.S. Treasuries

Equity risk premium, January 1, 1960-September 30, 2020



Source: http://www.stern.nyu.edu/~adamodar/New_Home_Page/data.html and Lord Abbett. Data as of July 31, 2020 (latest available). The risk premium is the rate of return on an investment over and above the risk-free or guaranteed rate of return, in this case the S&P 500 Index versus 10-year U.S. Treasuries.

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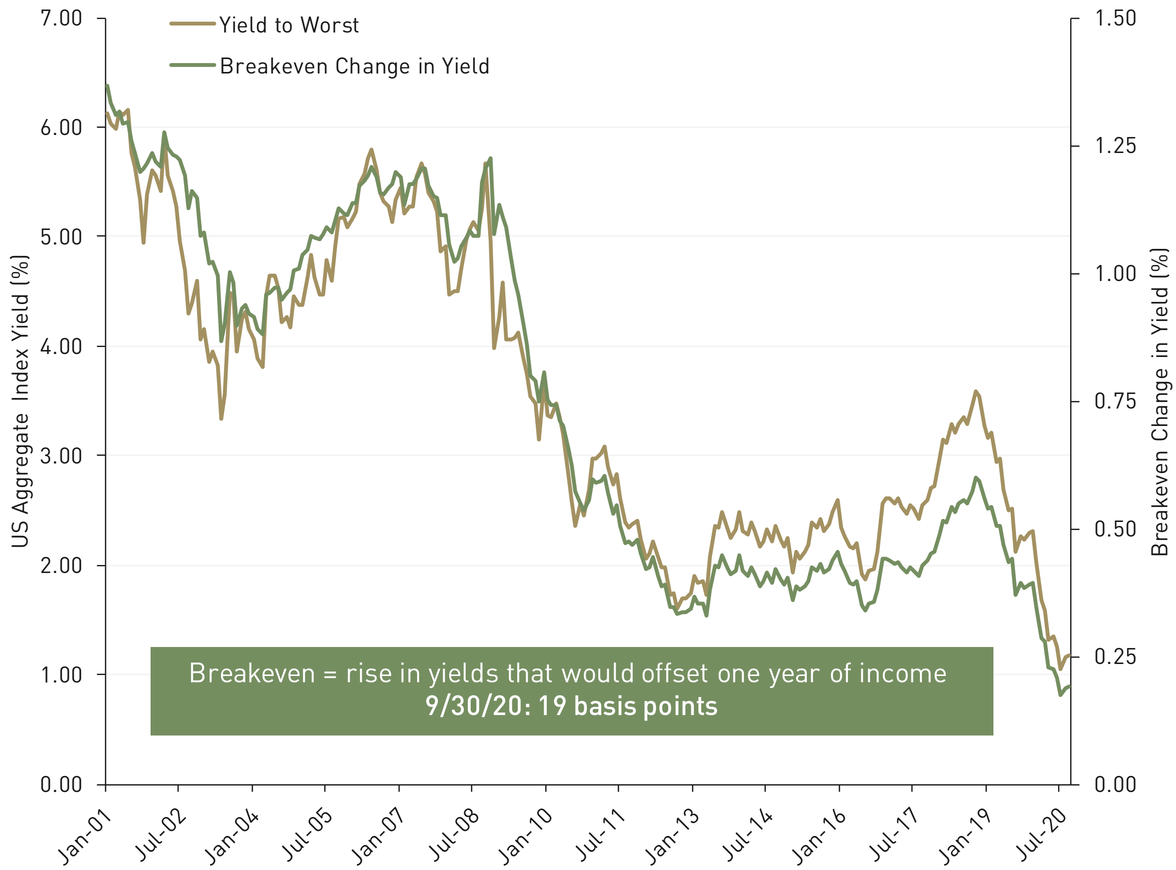
As far as specific approaches to equities, we believe the current environment argues for an allocation to innovation growth stocks, which have managed to maintain high levels of earnings per share growth through the pandemic, as they benefit from long-term, transformational trends in technology. For those who wish to have some exposure to high-growth sectors but are concerned about a potential market pullback, we think that convertible securities may represent a worthwhile approach. Convertible bonds historically have participated in the upside of rising equity markets, while limiting downside during difficult markets, resulting in attractive risk-adjusted returns over the long-term.

U.S. Fixed Income

The market action in 2020 has left investors in traditional core bond strategies with some unappealing choices. Core bond yields have declined as duration has extended. Historically low yields result in little margin of safety in core bonds; thus, even small moves in yields can have a significant negative impact on returns (see Figure 5).

Figure 5. Core Bonds Have Little Room for Error When Rates Move Even by a Small Amount

One-year breakeven for Bloomberg Barclays U.S. Aggregate Bond Index, January 1, 2001–September 30, 2020



Source: Bloomberg Barclays Index Data. Data as of September 30, 2020. A basis point is equal to one one-hundredth of a percentage point. The breakeven change in yield is the approximate rise in market yields that would negate one year of income, as measured by the starting index yield.

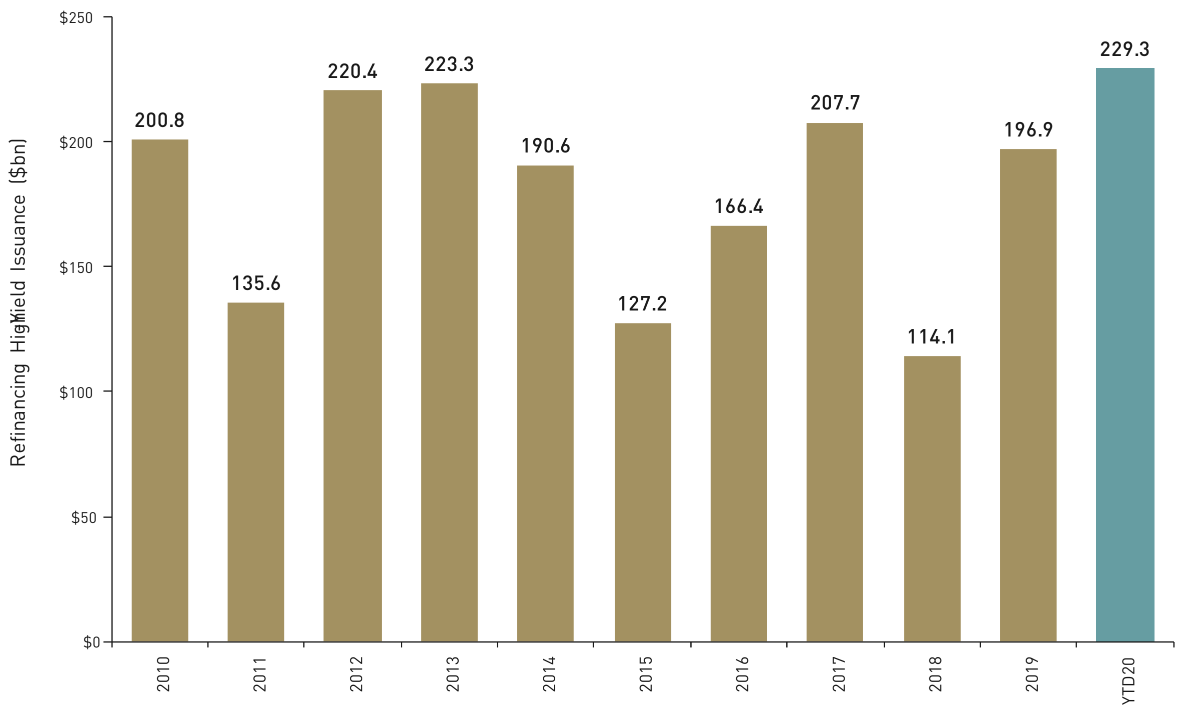
Performance quoted above is historical. **Past Performance is not a reliable indicator or guarantee of future results**. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results.

Given the paltry yields on offer in core, income-seeking investors may wish to consider an allocation to credit. Amid the volatility of 2020, the credit markets have been open, with record issuance of investment grade and high yield corporate bonds this year. Importantly, this has primarily been used for bondholder friendly activity. Within high yield, the majority of issuance has been for refinancing, which reached historically high levels in 2020 through September 30 (see Figure 6, next page). This has allowed issuers to shore up their balance sheets by lowering borrowing costs and extending maturities of existing debt.

Within the investment grade space, companies have issued debt and cut capital spending, leaving record amounts of cash on corporate balance sheets. (See Figure 7, next page.)

Figure 6. The Torrent of U.S. High-Yield Issuance in 2020 Has Gone Mainly to Refinancing Existing Debt

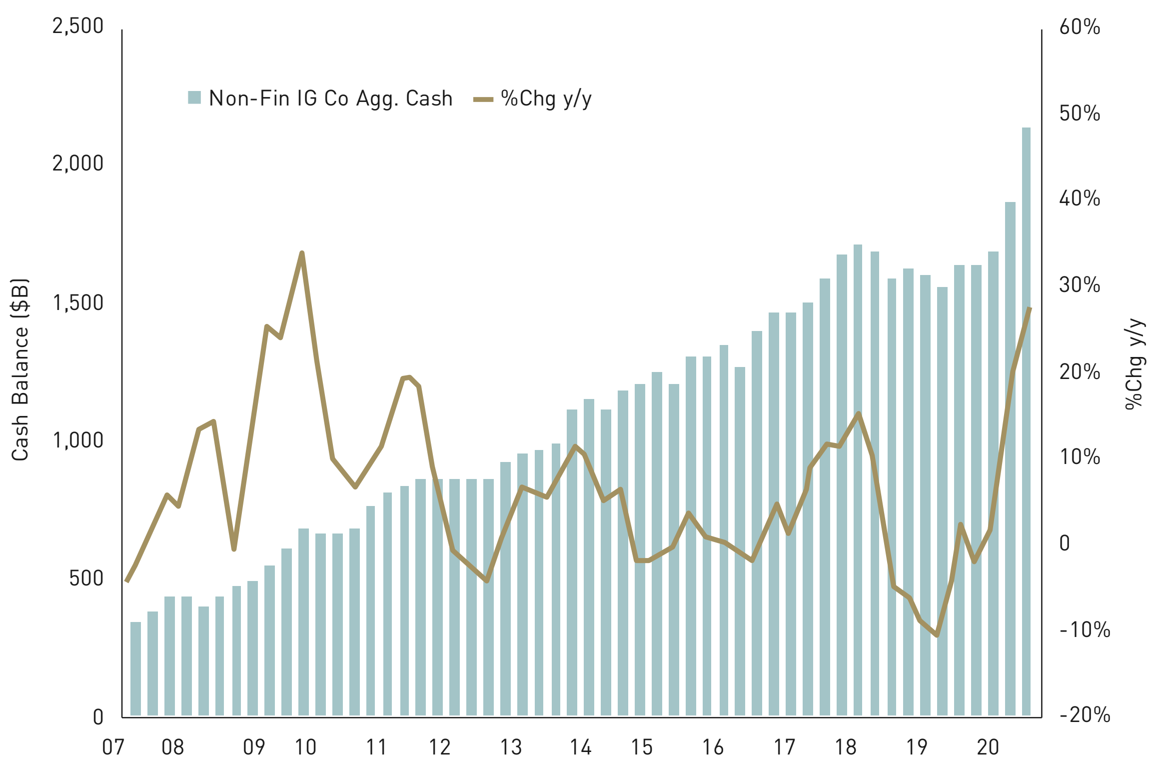
Refinancing activity for the years 2010–2020 (through September 30)



Source: JPMorgan. Data as of September 30, 2020.

Figure 7. Strong Pace of Debt Issuance in 2020 Has Shored Up Balance Sheets of Investment-Grade Issuers

Data (quarterly) for non-financial investment grade companies for the period January 1, 2007–September 30, 2020



Source: FactSet and Barclays Research. Data as of September 30, 2020. Year-over-year change calculated using current-quarter cash balance versus the same quarter one year ago.

As a result of these actions, the wave of ratings downgrades seen in the first two quarters of the year has dissipated, and market expectations for high yield defaults (based on J.P. Morgan data) have been coming down from levels predicted a few month ago.

A Final Word

Obviously, the course of the pandemic, uncertainty over the status of U.S. stimulus legislation and a rancor-filled U.S. election represent potential risk. But investors appear to have reconciled those risks given the gains in financial markets, though much caution remains. We believe current fundamentals support valuations in asset markets and should any or all of the "Big 3" risk factors achieve some form of resolution, or at least turn out better than the market expects, asset markets have the potential to post additional gains for the fourth quarter of 2020 and maintain that strength into the next year.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk. Credit risk is the risk that debt issuers will become unable to make timely interest payments, and at worst will fail to repay the principal amount. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements. The municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state and local taxes may apply. Investments in Puerto Rico and other U.S. territories, commonwealths, and possessions may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems. The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

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A **pain trade** occurs when a popular asset class or widely followed investing strategy takes an unexpected turn that catches most investors flat-footed.

Risk asset generally refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

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The **Russell 1000 Index®** measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

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