Innovation Investing through the Current Market Rotation

Which areas of innovation may be best positioned during the current market shift?

Featured Contributor

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Figure 1. Innovation Adaptation

How Lord Abbett's Innovation Investing team has responded to the recent stock market rotation

Sector	Increased Exposure	Decreased Exposure
Technology	Semiconductor makers and producers of and semiconductor capital equipment	Cloud software
Health Care	Medical devices	Biotech
Consumer	Home improvement products/services	e-Commerce and streaming technologies
Communications Services	Largest industry names; other companies with greater degree of exposure to economic cycles	–

Source: Lord Abbett. Information as of June 4, 2021. For illustrative purposes only.

Innovation Investing

In a previous *Market View,* we explored the recent equity market rotation and how it related to what we view as three, broader, secular stock market themes: innovation, vulnerability, and durability. Here, we will zero in on the first part of the equity troika—innovation—and how Lord Abbett investment teams have been adapting to this current market environment.

As a result of the increasingly successful vaccine rollout and a powerful economic recovery, the rapid expansion of business and consumer spending related to the reopening of the U.S. economy and associated inflation uncertainty have dramatically changed preferences and behaviors among equity investors, while leaving the overall level of major stock averages little changed. We have seen three key shifts that are impacting innovation-oriented stocks:

1. **Purge of speculative excesses.** Rising risk aversion is working off numerous speculative excesses related to day trading, speculative buying into Special Purpose Acquisition Companies (SPACs), and cryptocurrency trading.
2. **Preference for economic sensitivity.** Capital is flowing to shorter-duration equities, i.e., those most likely to experience inflection today as the result of the economic re-opening. This group includes value stocks that were hit hard by Covid-19 but are bouncing back dramatically; traditional cyclicals like banks, energy, and industrials; and cyclical growth stocks like semiconductors that are seeing strong demand growth.
3. **Multiple contraction.** As a result of the shifts in capital away from stocks with higher price-to-earnings (P/E) ratios and into rapidly recovering names, combined with booming corporate earnings growth, we are starting to see P/E multiples retreat at a time of rising optimism about the economy and corporate earnings. In our view, this is typically not a sustainable combination, and this rotation will likely overshoot meaningfully just on sentiment, while fundamentally strong, accelerating growth companies see their valuations reach attractive, multi-year lows.

Responding to a Changing Dynamic

Since "vaccine day"—November 9, 2020, when the Pfizer-BioNTech COVID-19 inoculation showed stunning efficacy—our innovation equity team has been making shifts in our portfolios to adapt to the changing market environment. Furthermore, after the Georgia runoff election in the U.S. reversed the premise of divided government and confirmed a Democratic voting majority in the U.S. Senate, the policy environment changed substantially, particularly around the magnitude of federal stimulus spending. That event caused us to adapt further. As a result, we changed our emphasis in our key sectors away from secular growth names to more economically-sensitive areas of the economy (Figure 1, first page).

Looking Ahead

We have shifted our emphasis in certain sectors to adapt to the current environment as we progress through this period. There is an enormous amount of fiscal and monetary stimulus in the U.S. economy, accelerating a reopening-fueled expansion that was already in progress. However, while the fiscal stimulus will have a meaningful stimulative effect in the near term, we think the combined influence of:

- potentially higher taxes in 2022
- the economic drag of a $30 trillion U.S. national debt
- a declining population growth rate
- the disruptive effect of innovation on many vulnerable industries in the economy
- continued geopolitical risks, primarily from China, Russia, and cyberterrorism

will likely offset the near-term "supply shock" we are experiencing, as well as this year's "the pandemic is over" summer spending binge. So, while U.S. interest rates may very well rise from here, we believe there are some noteworthy forces that should keep them in a manageable range for the foreseeable future. This, in our view, should continue to create a favorable backdrop for innovation-oriented equities for the longer term.

Lastly, we know that the stock market discounts the future. As equity investors continue to price in significantly higher inflation, when we finally do get to that point where price increases level off (or fall off), U.S. Federal Reserve (Fed) policy adapts, and short-term rates rise to historically normal levels, the market may once again start to appreciate the secular growth inherent in innovation. Where might that growth come from? In all likelihood, a continuation of the massive secular trends that have been under way in recent years, i.e., the genomics revolution, the dominant e-commerce and streaming technologies, the rapid evolution of artificial intelligence, robotics, blockchain, electric and autonomous vehicles, and more. The tech revolution is still young; we think recent pullbacks in these areas of innovation represent a brief detour from their potential path to long-term gains.