U.S. Equities: Four Developments to Watch in 2021

Lord Abbett experts identify the trends that could shape the U.S. equity markets in the coming year—and their implications for investors.

Featured Experts

F. Thomas O'Halloran, CFA, J.D.
Partner & Portfolio Manager

Darnell Azeez, CFA
Managing Director, Portfolio Manager

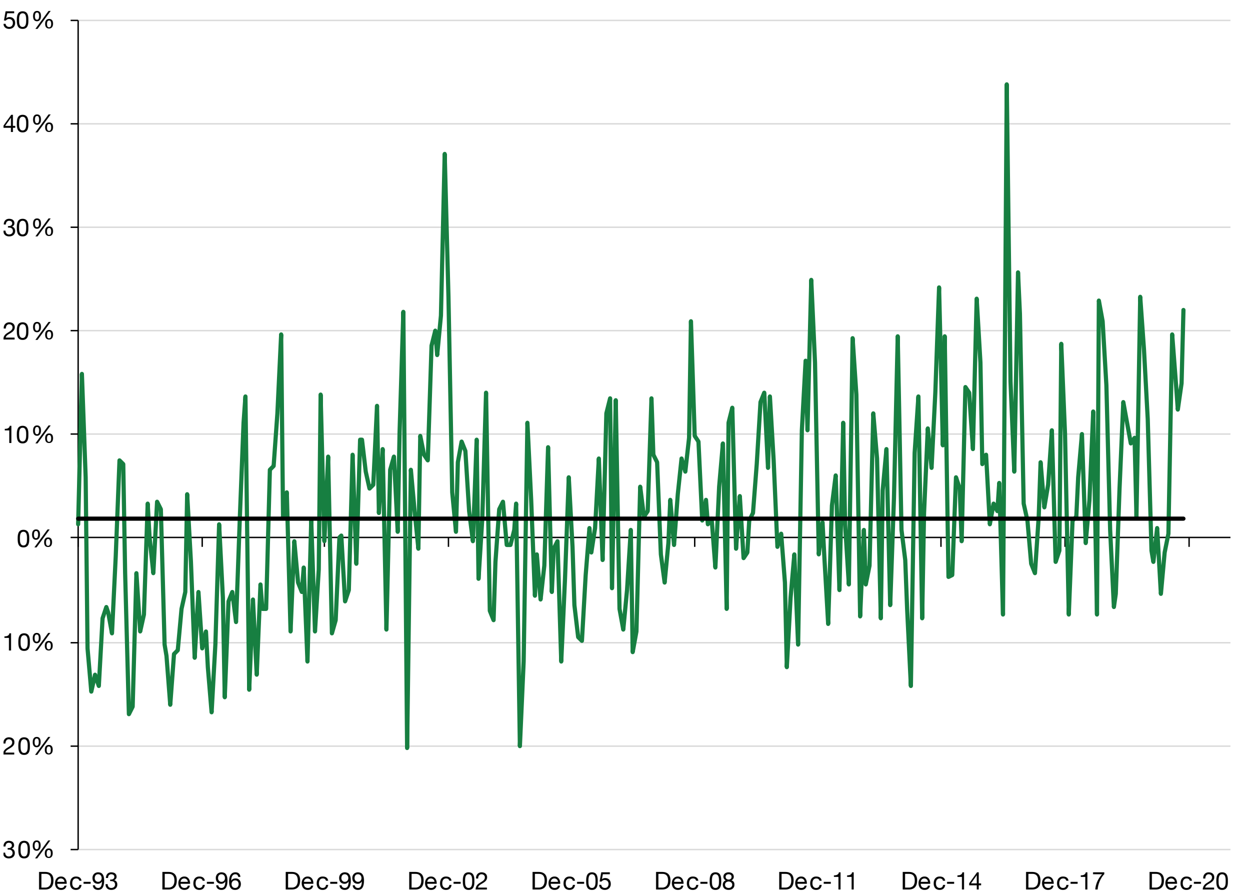
Jeffrey Rabinowitz, CFA
Portfolio Manager

Brian Foerster, CFA
Investment Strategist

Melanie Coffin, CFA
Associate Investment Strategist

Figure 1. Analysts Expect Good News on U.S. Earnings Will Be Front-Loaded in Fiscal 2021

U.S. balance of fiscal 2021 less fiscal 2022 earnings revisions (based on the S&P 500 index), January 1, 1993–November 10, 2020



Sources: J.P. Morgan "The Earnings Landscape," Nov. 10, 2020, and Lord Abbett..

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U.S. Equities

Editor's note: This Market View *is excerpted in part from a forthcoming white paper offering a detailed examination of factors that could influence global equity markets in 2021.*

Time to wrap up an eventful (okay, that's an understatement) 2020 and look ahead to another, perhaps less trying, year. Last week, *Market View* presented viewpoints from Lord Abbett investment leaders on the macroeconomic picture and prospects for U.S. fixed income in 2021. In this, the second of a three-part investment outlook for 2021, we will focus on four major themes for U.S. equities in the year ahead and their implications for investors. Contributing their insights are Partner & Portfolio Manager Thomas O'Halloran; Managing Director and Portfolio Manager Darnell Azeez; Portfolio Manager Jeffrey Rabinowitz; Investment Strategist Brian Foerster; and Associate Investment Strategist Melanie Coffin.

1. An Accelerating Technology Revolution

As the global pandemic forced the shutdown of economies around the world, a significant number of companies were able to maintain operations and adapt to the new remote environment. They did so by offering technological advancements that promote digital productivity and conquer distance through innovations in cloud technology, artificial intelligence and virtual empowerment. These events highlight the power of the technology revolution which has essentially kept the economy moving during the crisis. Biotechnology and the development of the COVID-19 vaccine also benefitted from the tech revolution through advancements in genomic sciences, underscoring how innovation and adaptability can transform businesses and economies on a global scale.

While we think these trends will continue to lend support to U.S. equity markets in 2021, we are also looking to the years that follow. The longer-term narrative in the U.S. economy is that innovation is marked by formidable, long-lasting trends; we think investors need exposure to those trends in their portfolios. We believe these businesses are poised to win through organic growth and by displacing less agile companies and industries.

2. Cyclical Stocks and the U.S. Recovery

The global pandemic severely affected economically sensitive stocks. The vaccine news of November 2020 subsequently produced a rally in these issues based on an expected economic recovery unfolding in 2021. Cyclical industries such as Financials, Industrials, and Energy could benefit from an easing in the pandemic crisis in 2021, and we believe these stocks may have more upside ahead. Indeed, these issues could potentially benefit amid the broad recovery in corporate profits that analysts are expecting in 2021, based on earnings forecast revisions (see Figure 1, front page).

That said, which cyclical issues should investors focus on in 2021? Within the broader cyclical category, there are resilient companies that adjusted to the crisis through cost-cutting initiatives, inventory controls and gains in efficiency. We have seen a significant improvement in corporate balance sheets during the year (as discussed in the previous *Market View*) which is also indicative of how certain companies quickly adapted their business in order to be better positioned for the future, beyond the cyclical upswing expected in 2021.

For investors, we would emphasize the concept of *durability*, as it relates to business models, long-term financial metrics, and corporate management. We think investors should have some exposure to durable companies with solid track records for earnings and revenue growth that are more closely tied to the economic cycle.

3. The Search for Income in a Low-Rate World

With government bond yields around the world near all-time lows, we think dividend-paying stocks could garner more attention in the year ahead. The COVID-19 crisis prompted an increase in the number of companies that reduced or ceased dividend payments. Looking ahead to next year, the stronger corporate balance sheets mentioned earlier could prompt companies to boost payouts to shareholders, resulting in better dividend yields in 2021.

More importantly, within our approach we are focusing on those companies that remained income-producing during the crisis and have competitive business models, strong balance sheets and management teams committed to returning money to shareholders.

Four Developments

For investors seeking income and total return, companies that have consistently grown their dividends have historically provided a relatively attractive risk versus reward profile, with lower volatility than the broad equity market. Those features may prove appealing to investors seeking a potentially lower-risk way to maintain equity exposure in 2021.

4. Equity Valuations after the 2020 Rally

In the December 7, 2020, *Market View*, we addressed investor concerns about whether today's equity valuations, in the wake of the strong 2020 market advance, have reached seemingly excessive levels as they did during the "dot-com bubble" of two decades ago. However, when data is used rather than gut feeling, these concerns appear misplaced.

We think there's no better place to focus than technology, which was the epicenter of the collapse in 2000-02. While valuation multiples within the information technology sector today are modestly higher than that of the overall S&P 500® Index, they are anywhere between one-half to one-third of what we saw in the late 1990s and early 2000s, depending on the methodology used.

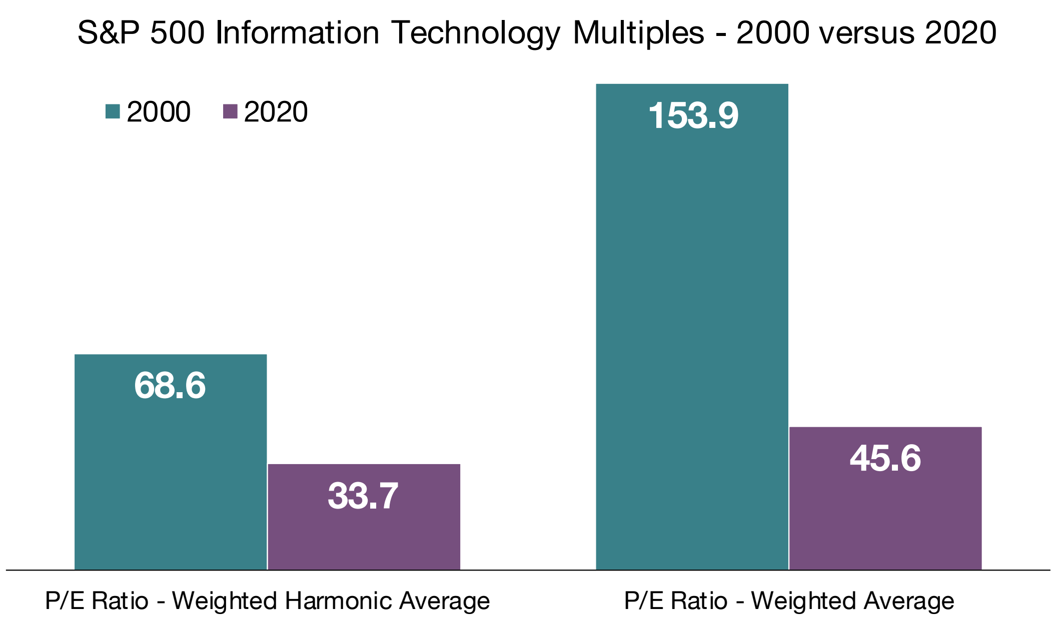
For example, on March 10, 2000 (when the Nasdaq Composite Index reached its highest level of the dot-com bubble), the information technology sector's P/E ratio was 68.6x, more than twice the current P/E ratio of the sector (as of November 23, 2020). Note that the standard methodology for P/E ratios uses data "harmonization" techniques that limit the impact of extreme outliers. When that technique is eliminated, the weighted average P/E of the tech sector in early 2000 was 153.9x, compared to 45.6x today. The disparity between the weighted average in 2000 and the weighted harmonic average points to numerous stocks with severely extreme valuations within the index.

Further, the valuations of today's technology sector are anchored to actual profitability and operational strength, in our view. Indeed, unlike the fledgling tech darlings of the 1998-2000 era that offered promising business models and little else, we have seen a sharp, sustained surge in sales that reflects the much healthier environment for key areas of technology that play an important part in the U.S. economy.

Next: Our experts assess prospects for the municipal bond market in 2021.

Figure 2. How Do Today's Tech Sector Valuations Stack Up against the Peak Levels of the 1999–2000 "Dot-Com" Boom?

Price-to-earnings ratios at March 10, 2000 and November 23, 2020



Source: FactSet. Data compiled November 23, 2020. This chart illustrates the difference in valuations from (1) the date at which tech-sector valuations reached their highest level during the so-called "dot-com" bubble (March 10, 2010) and (2) and a representative reading from today's market (November 23, 2020). **Weighted harmonic average** reflects the exclusion of stocks with extreme outlying valuations to more accurately represent sector valuations.

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No investing strategy can overcome all market volatility or guarantee future results.

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Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Glossary and Index Definitions

Earnings per share (EPS) is a company's earnings divided by the number of shares outstanding. EPS can also be computed for an index such as the S&P 500.

Price-to-Earnings Ratio: Stock analysts calculate a price-to-earnings ratio by dividing a stock's current price by its earnings per share on a trailing 12-month basis. A **forward price-to-earnings ratio** is calculated by dividing a stock's current price by estimated future earnings per share.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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