LORD ABBETT

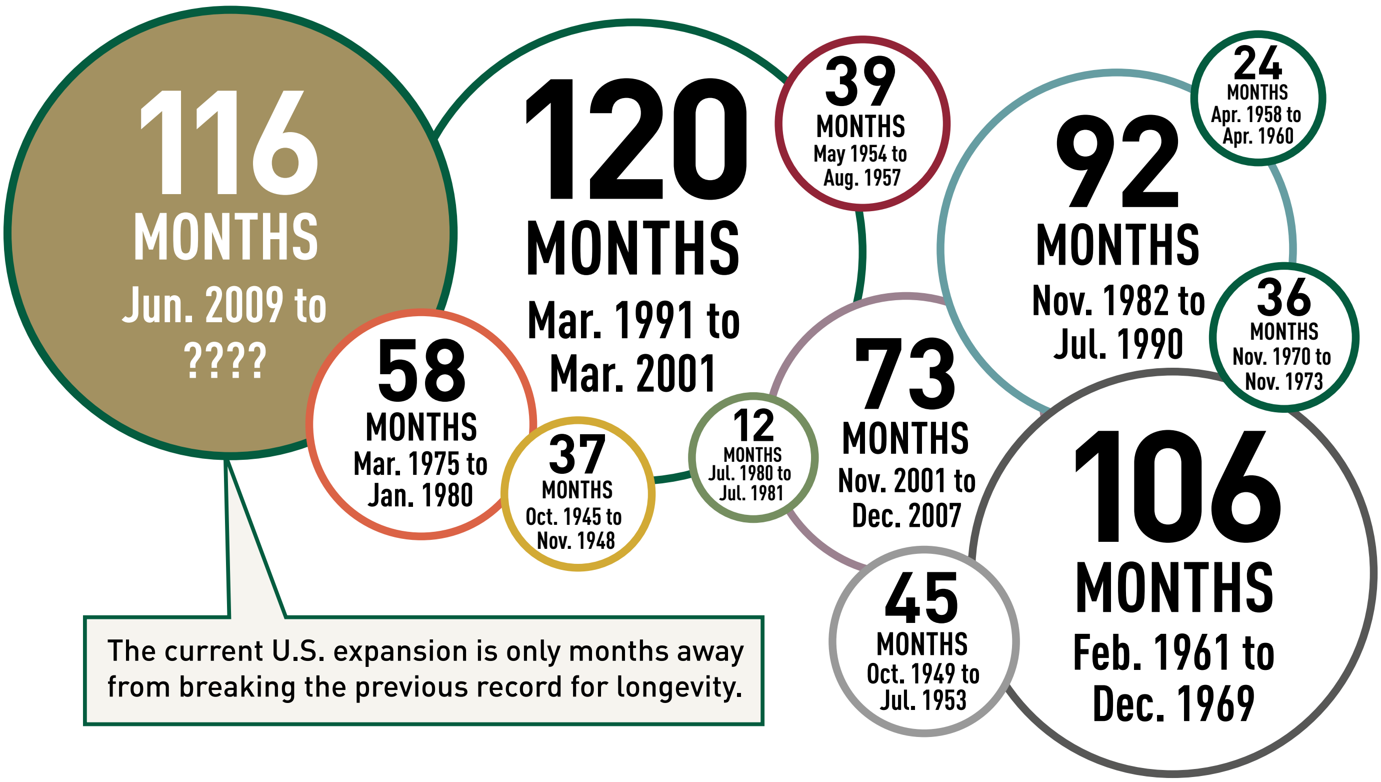
MARKET VIEW

INVESTMENT OUTLOOK: MARCH SADNESS, OR GLADNESS?

To kick off the final month of the 2019 first quarter, Lord Abbett investment leaders convened to assess economic and market trends for the coming months.

CHART 1. THE CURRENT U.S. EXPANSION IS CLOSING IN ON AN IMPORTANT MILESTONE

LENGTH (IN MONTHS) OF U.S. ECONOMIC EXPANSIONS FOR INDICATED PERIODS



Source: National Bureau of Economic Research. Data as of February 28, 2019.

IN BRIEF

- Lord Abbett investment leaders gathered in early March to share their insights on economic and market trends, and prospects for key asset classes.
- The panel represented a wide range of our firm's investment disciplines: multi-asset strategies, U.S. equities, U.S. taxable fixed income, and municipal bonds.
- The participants identified a number of factors to watch in the months ahead: the health of China's economy, developments in technology, muni-bond yield ratios, and whether a "patient" U.S. Federal Reserve will continue to refrain from interest rate hikes.

FEATURED INVESTMENT LEADERS

Giulio Martini
Partner, Director of Global Asset Allocation

Thomas O'Halloran
Partner, Portfolio Manager for Growth Strategies

Daniel Solender
Partner, Director of Tax-Free Fixed Income

Kewjin Yuoh
Partner, Portfolio Manager for Taxable Fixed Income

Timothy Paulson
Investment Strategist

Could a notorious "murderer" be threatening the U.S. economic expansion? What big trend is poised to drive growth equities in the months and years to come? And will the U.S. Federal Reserve (Fed) have to "sit on its hands" in 2019 because of a shift to a "patient" policy stance? These and other intriguing topics were addressed by Lord Abbett investment leaders on March 4, 2019, as they gathered for a wide-ranging discussion of the current market and economic environment.

This time, our panel featured Lord Abbett partners Giulio Martini, director of global asset allocation; Thomas O'Halloran, portfolio manager for micro-, small-, and large-cap growth strategies; Daniel Solender, director of tax-free fixed income; and Kewjin Yuoh, portfolio manager for taxable fixed income. The discussion was moderated by Lord Abbett investment strategist Timothy Paulson.

Paulson kicked things off by asking Martini to provide a broad outlook of current economic conditions as a way of framing the conversation.

The Macro Backdrop

"There are three broad strategic points that are important to keep in mind," Martini told an audience of Lord Abbett professionals. "The first one is the importance of China to global growth." Martini pointed out that China is not yet the largest economy in the world, but it is the largest contributor to global economic growth. According to data from the World Bank, over the past five years, some 50% of global gross domestic product (GDP) growth in dollar terms has come from China. And what that means, said Martini, is that "the business cycle in China has global ramifications," not only for neighboring trading partners but the United States and the euro area.

Martini's second key point: Should U.S. economic growth continue, July 2019 would mark the longest business expansion in U.S. economic history (see Chart 1). "We have never had a longer period of uninterrupted economic growth as [in] this climate," said Martini. "And the important thing is that, despite the advanced stage of the business expansion, inflation is still very low."

"Now, business expansions don't die from old age," Martini continued. "They are either murdered or they commit suicide." The "murderer," in the past, has been the Fed responding to rising inflation by tightening monetary policy. With inflation expectations well contained (see Chart 2), "we do not have that situation," he said.

And the "suicide" scenario? That would stem from a systemic financial problem that careens out of control—such as the U.S. subprime crisis of 2007–08—"and we don't have that either."

Martini's final point involved two unknowns that are "going to keep troubling investors for as long as this expansion lasts." The first question mark is when the U.S. business cycle will begin to slow significantly, potentially leading to heightened volatility in financial markets. The second is whether Fed policy will leave interest rates above, or below, the so-called natural rate, at which economic growth and prices of goods and services are on trend consistent with the Fed's 2% target. Below that interest rate, the economy will tend to grow rapidly; above that rate, monetary policy becomes restrictive. "The problem with a natural rate of interest," said Martini, "is that nobody knows what it is."

Growth Equities

Growth-stock specialist O'Halloran brought appreciative smiles to his Lord Abbett colleagues with his initial declaration: "I am very bullish on equities." He cited the long U.S. economic expansion and low inflation described by Martini. "This is a great environment for equities."

Apart from current economic and market conditions, O'Halloran sees growth stocks being driven in the years to come by one overwhelming trend: the technology revolution. "You can see it in so many parts of the economy." He cited the convenient, on-demand delivery of goods and services from internet-based retailers and food-delivery firms. He provided another example: technology's impact on the increased availability and value of entertainment offerings. For historical context, O'Halloran noted that one New York professional baseball legend commanded a salary of $100,000 in 1963, at the time among the highest in the sport. Fifty-six years later, the top free agent in Major League Baseball signed a deal worth $330 million over 10 years, an exponential expansion made possible in part by the growth of digital media.

O'Halloran also spoke of how the advance of technology has extended to healthcare. He said drugs produced by today's biotech companies "are vastly better than those that are owned by the big pharmaceutical companies," a development that has informed a number of his team's portfolio decisions in recent years. Elsewhere, advances in Internet search and network connectivity—especially the rollout of 5G networks in the United States and elsewhere—likely will provide additional investment opportunities in the years to come, according to O'Halloran. "So the tech revolution makes me very bullish on equities overall, and very bullish on growth, because it is allowing disruption at a pace never seen before."

But even for an equity bull, "there's a lot to be concerned about." said O'Halloran. "We are near full employment, so there's always a

CHART 2. U.S. INFLATION EXPECTATIONS REMAIN MUTED

FIVE-YEAR CPI SWAP BREAKEVEN RATES (IN PERCENT), MARCH 10, 2014–MARCH 8, 2019

Source: Bloomberg. Five-year inflation expectation is represented by the five-year zero coupon inflation swap rate. 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. Investors may experience different results. Returns during other times may vary. Due to market volatility, the market may not perform in a similar manner in the future. Like all investments, inflation derivatives involve specific risks that should be carefully evaluated. Although these securities are more complex than typical stock and bond investments, they entail similar liquidity and potential default considerations.

Past performance is no guarantee of future results.

risk that inflation could flare up." He also cited global trade tensions as another potential headwind. "But, generally, I'm positive on the market and on growth," he concluded.

Municipal Bonds

Solender started off his segment by noting that the growth conditions outlined by O'Halloran were also favorable for the municipal bond market. As muni-bond investors, "we want growth, profitability, and strong tax revenue."

Amid a steepening municipal-bond curve and heightened investor interest in the asset class, "things are really good in the muni market right now," Solender said. Some of the factors that had caused difficulties in the tax-free market last year—volatility in interest rates and concerns about the effect of changes in tax policy—are less of a factor now. Client discussions no longer begin with questions about how his investment team is dealing with rising rates, Solender added, "which is a good thing."

With volatility less of a concern, "investors are getting comfortable in extending out the muni yield curve," he said. Whereas one year ago investors were focused on short- and intermediate-term munis, they are now interested in issues across the maturity spectrum, he added.

Solender acknowledged that the 2017 U.S. tax legislation has had "a huge impact" on the market. For one thing, the lower corporate tax rate has led to less demand for muni bonds from banks and insurance companies. That has been "a big deal" for the market, as these companies had traditionally been major purchasers of municipal bonds.

But while banks and insurers have been shrinking their muni portfolios, other buyers have stepped in—especially retail investors, who traditionally have composed the largest segment of the market. Solender noted that flows into municipal bond mutual funds through the end of February 2019, as measured by Lipper, were coming in at a near-record pace, and that flows had rebounded strongly after turning negative in late 2018. That strength has been reflected in declining muni-bond yield ratios to U.S. Treasuries across the maturity spectrum.

Citing broad-based strength in issuer credit quality and rising tax revenues for state and local governments across the United States, "overall, the muni market is in really good shape right now," Solender said.

U.S. Taxable Fixed Income

Yuoh began by pointing to the surprising reversal that had set the stage for much of the market action in early 2019. After the Fed had indicated throughout 2018 that it intended to hike rates, Chairman Jerome Powell said on January 4, 2019, that the central bank would be "patient" with regard to further tightening. "Six months ago, at a similar panel discussion, I said I thought that the Fed would hike rates three more times in 2019, so naturally I'm going to say that the Fed has a credibility problem," Yuoh joked.

As the audience laughter subsided, Yuoh said that the dramatic turnaround in the Fed's outlook did have serious implications for the Fed's perceived credibility in setting policy expectations. "I think when you have a situation where the Fed turns on a dime like that, walking back everything that they've been talking about in years prior about how the economy was doing and how inflation was expected over the longer term—and for them to acknowledge China and markets as a point of concern—it's something to pay attention to."

With the Fed's credibility potentially under question, even with an uptick in inflation and a strengthening in key economic indicators, the central bank "can't necessarily turn right back around" and change its mind on its current policy forbearance, according to Yuoh. Thus, policymakers may have to "sit on their hands" until economic conditions change to such a marked degree that they feel justified in reversing course and raising rates again. The Fed's decision to step back and "take itself out of the market" has given rise to the current fixed-income market characterized by "extremely low volatility," he said. And with the Fed intent on preserving its credibility and refraining from further tightening, volatility may continue at these low levels for some time, Yuoh said.

When asked about what to look for in such a market environment, Yuoh said "the answer's always in valuations." He noted that in September 2018, his team reduced risk in its portfolios, and began adding risk again in December 2018.

What about current valuations? Yuoh believes the key lies in so-called "soft" economic indicators—those that measure current consumer or business sentiment, or future intentions. "The strength of the soft economic indicators—at least those soft economic indicators that we find useful—really hangs on the strength of the consumer," he said. He noted that consumer sentiment and confidence measures were recently at or near historically high levels. That strength in soft economic indicators would have to persist, he noted, to offset some of the downward trends in "hard" data (e.g., manufacturing), as well as other soft data, and to justify the valuations that we see today. Currently, his team considers valuations in U.S. taxable fixed income to be "fair to slightly full."

One Final Thought

Paulson wrapped up the session by humorously contrasting the perceived worldview of equity investment professionals ("always optimistic") and their fixed-income counterparts ("glass half-empty types").

"But the point here is that there is value in bringing all these different perspectives together," he said, especially at a firm that holds collaboration—among investment teams, research units, trading desks, and ultimately, company-wide—as a core value. ■

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Gross Domestic Product (GDP): The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Risk asset describes any financial security or instrument that is not a risk-free asset (i.e. a high-quality government bond). Risk assets generally encompass equities, commodities, property, and all areas of fixed income apart from high-quality sovereign bonds.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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