LORD ABBETT

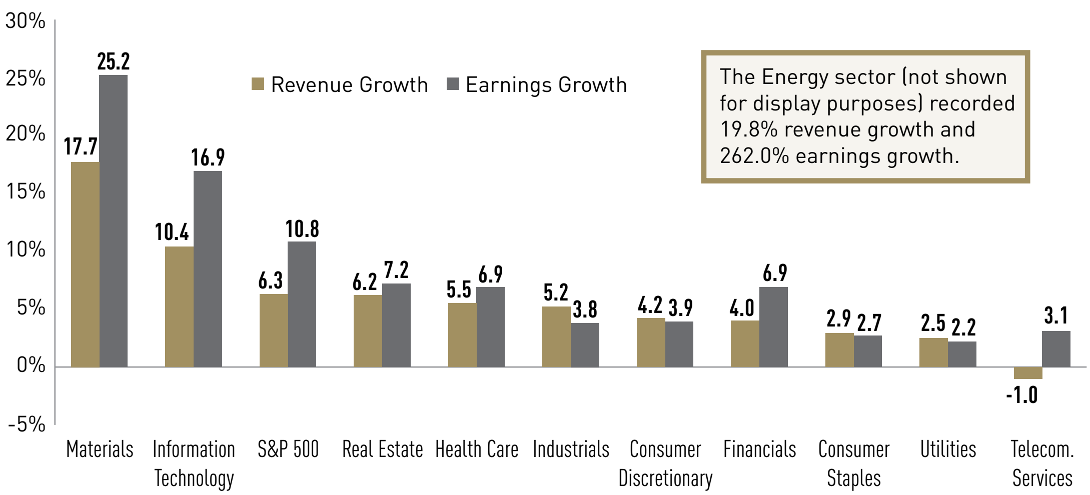
MARKET VIEW

U.S. EQUITIES: A DEFIANT—AND DURABLE—BULL MARKET

Nine years after the market reached its low point amid the financial crisis, key indicators may signal continued strength in U.S. stocks.

CHART 1. IN ADDITION TO STRONG EARNINGS, MANY SECTORS POSTED ROBUST TOP-LINE GROWTH IN 2017

REVENUE AND EARNINGS GROWTH FOR S&P 500 SECTORS IN CALENDAR 2017



Source: FactSet.

The historical data shown in the chart above are for illustrative purposes only. Index is unmanaged, does not reflect the deduction of fees or expenses, and is not available for direct investment. Past performance is not a reliable indicator or guarantee of future results.

The knee-jerk selling in U.S. equity markets in February 2018, prompted by data showing higher-than-anticipated U.S. wage growth, quickly gave way to a widely anticipated rebound as fourth-quarter 2017 earnings rolled in. To us, this recovery underscores the fact that fundamentals continue to overpower macro and political concerns. So, it seemed strangely appropriate that this past Friday, March 9, 2018—a day on which major U.S. indexes jumped, in part, on renewed optimism on global economic growth—marked the ninth anniversary of the market bottom reached during the calamity of the global financial crisis of 2008–09.

Some observers might call that date the beginning of the current bull market. And though that might be technically true, we would argue that its more accurate start date was in September 2011, following the market turmoil caused by the U.S. debt-ceiling debate and the downgrade of the U.S. government's credit rating by Standard & Poor's. At any rate, it's been a while.

But for those naysayers intent on calling this the "very late innings," or the beginning of the end, of the earnings recovery that has powered the current bull market, recent earnings reports show that corporate America isn't really listening. Neither, it seems, are Wall Street analysts. As we have been saying over the past year, while the fact that corporate earnings continue to beat estimates, delivering robust bottom-line results, and is certainly positive for stocks, the more persuasive sign that the bull market has become healthier is *top-line revenue growth* in many sectors. (See Chart 1.) And that narrative has only strengthened during fourth-quarter earnings season, which is just about completed.

According to FactSet, 77% of the companies in the S&P 500® Index that have posted fourth-quarter 2017 results thus far reported upside revenue surprises relative to analyst estimates, the highest

IN BRIEF

- The broad U.S. equity market has bounced back from a recent sell-off amid data showing strong corporate earnings growth in the fourth quarter of 2017.
- Even more encouraging, however, may be the robust revenue growth reported in many sectors, a trend that appears poised to continue.
- To be sure, there are potential headwinds for U.S. equities. Aggressive increases to analyst earnings estimates could make it harder for companies to top projections.
- Also, investor sentiment may be dampened by the prospect of increases in interest rates. However, a modest rise in rates likely will not have a meaningful impact on equity prices.
- *The key takeaway*: Although there can be no assurances, the recent earnings season has provided encouraging signals on corporate profits, which could lend further support to the current bull market.

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CHART 2. INFLATION EXPECTATIONS, THOUGH HIGHER, REMAIN MUTED

FIVE-YEAR, FIVE-YEAR FORWARD INFLATION EXPECTATION RATE, MARCH 11, 2013–MARCH 8, 2018

Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis.

Note: The five-year, five-year forward inflation expectation rate is a measure of expected inflation (on average) over the five-year period that begins five years from the date of measurement.

percentage since the data provider began tracking this statistic in 2008. In line with that metric, 73% of reporting companies announced a positive earnings surprise for the fourth quarter. By any metric, overall earnings growth was robust for 2017.

WHAT SHOULD WE BE WATCHING NOW?

Amid all the positivity, there is, perhaps, one plotline of the equity-strength story that could present an issue down the road. Wall Street analysts, after underestimating the strength of the earnings recovery for several quarters, have aggressively been raising their earnings-per-share estimates this quarter, for the first time in a decade. If we were to look for something to worry about, given all the positive surprises this quarter, it could be that the bar has now been raised in terms of analysts' earnings expectations, making it more difficult for companies to beat these marks in coming periods.

Market watchers are also concerned that inflation and interest rates could rise faster than expected, prompting more volatility in the broad equity markets. This, however, is a much better problem to have, so to speak, than the one that dogged the markets for the past decade—i.e., that the U.S. economy was walking a fine line between barely positive growth and deflationary pressures, despite massive stimulus from the U.S. Federal Reserve (Fed).

In the case of inflation, the current concern is that prices of goods and services will begin to accelerate, given the current strength of the U.S. economy. But these fears may be overstated, based on inflation expectations data compiled by the U.S. Federal Reserve Bank of St. Louis (see Chart 2). Five-year expectations for the rate of inflation sat at 2.14% on March 9, just barely above the Fed's stated 2% threshold.

What about the prospect of rising rates? For those companies that have demonstrated a high degree of interest-rate sensitivity over the past nine years—namely those with a high dividend yield coupled with low growth and low pricing power—this type of environment could be quite hostile. For companies in more rapidly growing segments of the market, or in areas that benefit from higher economic growth and that have pricing power, a moderate increase in interest rates would not necessarily be a negative. Even if rates do tick up modestly higher, such a development likely wouldn't have a meaningful effect on stock prices in the near term

SUMMING UP

Overall, the U.S. economic expansion could very well still be in the middle innings, given that we've only now entered a period of fundamental improvement in corporate revenue growth. We've still not seen true signs of accelerating wage growth or robust, broad-based inflationary pressures. What we have seen is continued organic growth in the more innovative segments of the equity markets (e.g., biotechnology, digitization, e-commerce) and renewed organic growth in more cyclical areas. These are healthy signs for U.S. economic growth, which, in turn, bodes well for those companies aiming to boost top-line growth.

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