Midyear Outlook, Part 3:

Updates on Trade, the Curve, and the Fed

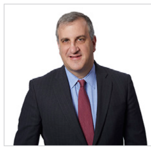
In a follow-up to our May roundtable, our experts weigh the factors poised to influence the second half of 2019—and their implications for investment portfolios.

Contributing Experts


Andrew O'Brien


Thomas O'Halloran


Giulio Martini


Daniel Solender

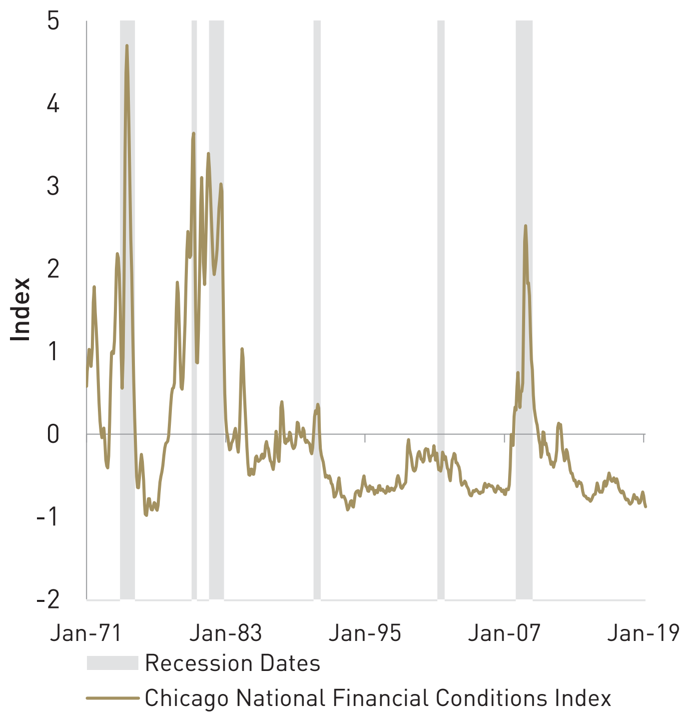

Leah Traub


Joseph Graham

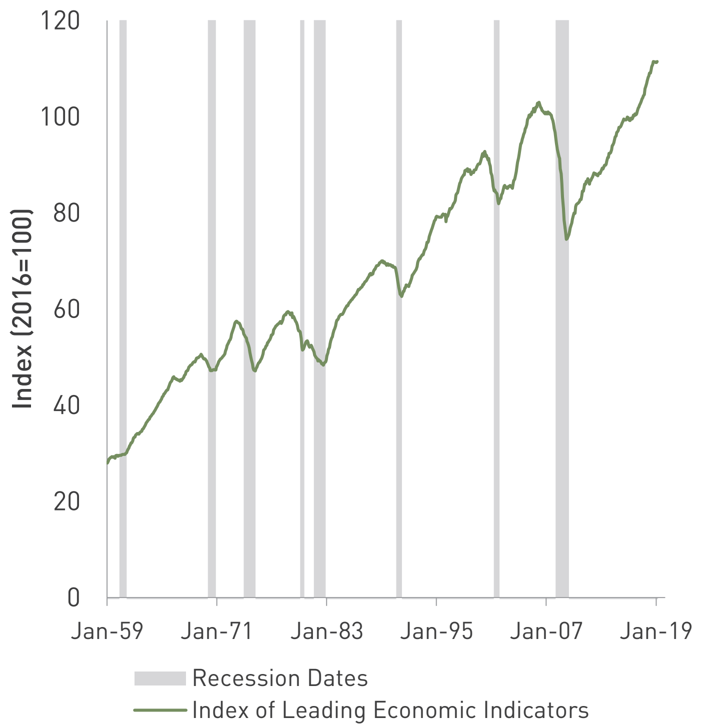
Chart 1. So the Yield Curve Inverted. What Are Other U.S. Economic Predictors Telling Us?

Chicago Fed National Financial Conditions Index (left), January 31, 1971–March 31, 2019; U.S. Index of Leading Economic Indicators (right), January 31, 1959–April 30, 2019

Broad financial conditions highly accommodative to faster economic growth



Economic indicators suggest faster growth to follow 4Q 2018 – 1Q 2019 slowdown



Source: Bloomberg and Lord Abbett. Data as of June 12, 2019.

Shaded areas indicate U.S. recession periods. The Chicago Fed National Financial Conditions Index is a gauge of U.S. financial conditions. The index tracks measures of financial stress and tightness of credit markets. The U.S. Index of Leading Indicators is used to predict the direction of economic movements in future months. The monthly index is composed of 10 economic components whose changes tend to precede changes in the overall economy.

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. **Past performance is not a reliable indicator or guarantee of future results.**

In Brief

- In a session with investment professionals on June 13, 2019, Lord Abbett experts offered updated observations on the investment backdrop for the second half of 2019.
- The panelists assessed how developments in global trade, the U.S. Treasury curve, and U.S. Federal Reserve policy might impact economies and markets in the second half.
- While trade may pose a challenge to global growth, the panelists believed that most economic indicators remain favorable for U.S. equity, high yield, investment-grade credit, and municipal bonds.

> "The yield curve could be giving us another false recession signal."
> — Giulio Martini

As a follow-up to our roundtable discussion in May, we gathered six Lord Abbett investment leaders on June 13 for a further exploration of the market and economic environment—and prospects for key asset classes—for the second half of 2019. This time, the forum was an interactive webinar attended by hundreds of investment professionals. (A replay of the webinar is accessible from our Midyear Outlook page.)

Returning panelists included Lord Abbett Partners Thomas O'Halloran, Portfolio Manager for micro-, small-, and large-cap growth strategies; Giulio Martini, Director of Strategic Asset Allocation; Daniel Solender, Director of Tax-Free Fixed Income; and Leah Traub, a currency expert and Portfolio Manager for Taxable Fixed Income. Joining the panel on June 13 was corporate-bond specialist Andrew O'Brien, Partner and Portfolio Manager for Taxable Fixed Income. Once again, Joseph Graham, Investment Strategist, moderated the discussion.

With a number of fresh developments influencing markets after our May 2 roundtable—namely, a sharp escalation of U.S.-China trade tensions, a re-inversion of the U.S. Treasury curve, and a marked shift in expectations for U.S. Federal Reserve (Fed) policy—our experts weighed in on the current economic and market environment, and prospects for key asset classes

Trade Winds

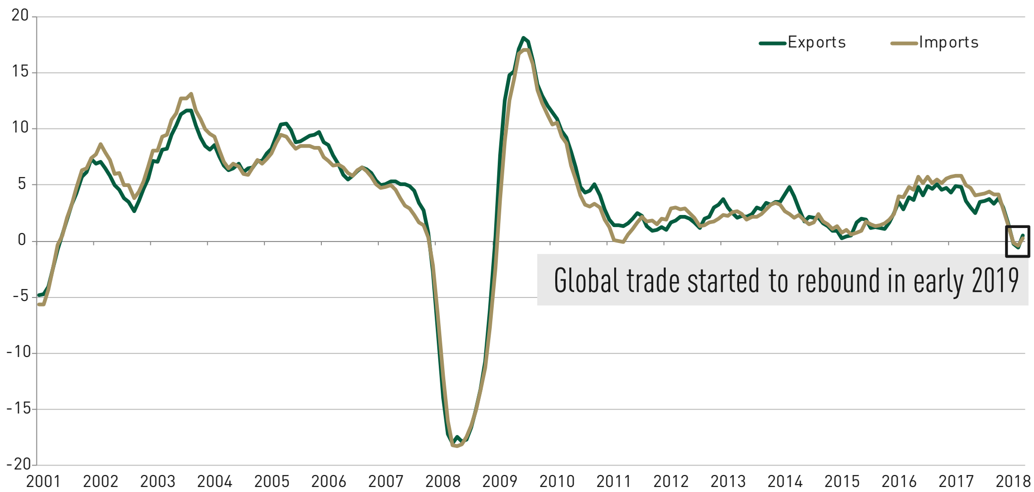
Following the implementation of new tariffs by the United States and China in mid-May, "the major worry right now is that there's a risk of escalation in global trade frictions," said Martini. "A conflict over trade that is damaging for both of them could cause global economic growth to slow sharply," he said. "This is the risk that I think investors are most worried about right now—and justifiably so."

Traub noted that trade friction, which has been developing on a number of fronts, is one reason why global central banks have tuned dovish. She cited year-over-year changes in global export and import trade volume (see Chart 2). "At the end of 2018, both of those went negative…the last time we had both of those series go meaningfully negative was during the 2008-09 financial crisis."

Economies like the eurozone, Japan, and many emerging markets are very sensitive to trade volumes, Traub added, "so this slowdown is really permeating the economic outlook" in these countries. "We started seeing a nascent recovery in early 2019 [Chart 2], but if U.S.-China trade tensions actually escalate, I think we may not see this little uptick continue."

Chart 2. Nascent Recovery in World Trade Could be Derailed by Tariff Escalation

Three-month moving average of world trade volume, December 31, 2001–March 31, 2019



Source: Haver Analytics. Data as of June 12, 2019.

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"The big worry for credit markets is *not* the Fed putting us into recession."
— Andy O'Brien

Dangerous Curve?

While it's true that an inverted U.S. Treasury yield curve has preceded every post-World War II U.S. downturn, the yield curve is not an infallible indicator of imminent recession, Martini said. "Yield curve inversions gave us some false signals back in 1966, briefly in 1984, again in 1995 and 1998, and this time around could be another false signal."

"Meanwhile, other indicators that are as reliable as the yield curve—if not more so—are not signaling that a downturn is imminent," Martini added. In particular, he cited a gauge of broad economic financial conditions compiled by the U.S. Federal Reserve Bank of Chicago (see Chart 1 on front page). This measure is signaling that "financial conditions are quite easy." Also, a basket of leading economic indicators has continued to climb in recent months. "So we're not getting a recession signal from these two things," Martini concluded.

Solender noted that "we keep getting questions from muni-bond investors about how we're dealing with a flat, or inverted, yield curve." The answer? "The key point is that the muni yield curve remains upward sloping, which means that investors can still pick up additional yield at longer maturities," he said. "We're definitely moving in a different direction than Treasuries."

Fed Watching

Graham noted a question from one audience member who observed that interest-rate forecasts from many investment firms "aren't keeping up with what the market is implying" in terms of expectations for three rate cuts by the U.S. Federal Reserve (Fed) over the next six-to-nine months.

"It's not at all unusual that the market would get out ahead of the Fed and economists' forecasts," Martini responded. "I do think that it's very unclear how much the Fed's going to move right now because we've got a situation where the economy still looks pretty strong." In his view, "it all comes down to whether the Fed believes things are going to slow down because of problems overseas."

If that happens, the Fed may believe it needs to move early in order to offset a potential U.S. downturn. The Fed can afford to do this so late in the expansion, Martini figures, because inflation is still below its 2% target. "So they may well take out an 'insurance' cut." For his part, Martini thinks the Fed "might not cut rates at all" at its July meeting, "but might continue to say that it is prepared to do so."

Speaking for bond investors, O'Brien said he believes that "if you worry about what could be a problem for credit markets, it's not going to be the Fed putting us into a recession…the Fed has said that it's on hold and likely to be supportive" for risk assets in the months to come.

"The muni curve remains upward sloping…we're definitely moving in a different direction than Treasuries."
— Dan Solender

Investment Checklist

Graham surveyed panelists about the prospects for their respective asset classes.

Corporate Bonds: O'Brien noted that historically, corporate credit "does fine" in an economic environment with modest growth, much like the current U.S. situation. He added that high yield, an asset class that's more oriented toward U.S. growth, may be appealing to investors as it is "a little bit less exposed to international volatility and the potentially weaker growth that we're seeing overseas."

O'Brien also spotlighted U.S. leveraged loans. "People may think of loans as being best suited to periods of rising rates, but in the current environment, yields remain quite attractive," especially when compared to various maturities of U.S. Treasuries.

Growth Equities: "We had an equity market correction in the fourth quarter of 2018, which set the stage for a better 2019 in stocks as the Fed turned dovish from hawkish in the span of three months," O'Halloran said. He also cited a favorable U.S. economic backdrop. "But what's really driving the stocks in our growth portfolios," he opined, "is the continuation of the technology revolution." (This video offers a deeper dive on O'Halloran's views.)

With "an abundance of growth" fostered by rapid changes in technology, and amid an expanding U.S. economy marked by low inflation, "the environment for growth has been good this year," O'Halloran said. "Barring some big change in the backdrop, we believe that it will continue to be good."

Municipal Bonds: "We've definitely gotten off to a strong start to the year," said Solender. Among the potential tailwinds he sees for munis: rising demand from investors who are feeling a bigger tax bite from the U.S. tax legislation enacted in 2017, and reduced supply as a key category of munis—advance refunding bonds—was eliminated by the tax bill. (Read more of Solender's views on high-yield muni bonds and prospects for the broader muni market.)

Finally, Solender asked the audience to keep a key concept in mind: tax-equivalent yields on municipal bonds. "You have to remember that tax rates can make a big difference—if you look at the tax equivalent yield based on your own bracket, you get a sense of just how attractive yields for many municipals bonds are right now, in our view."

2020 Vision

We will check back in with our experts in November to gather their thoughts on what 2020 may bring for the global economy and markets. In the meantime, stay tuned to lordabbett.com for more insights from our investment leaders.

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. The principal risks associated with bank loans are credit quality, market liquidity, default risk and price volatility. While bank loans are secured by collateral and considered senior in the capital structure, the issuing companies are often rated below investment grade and may carry higher risk of default. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. The municipal market can be affected by adverse tax, legislative, or political changes, and by the financial condition of the issuers of municipal securities. 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. 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 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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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.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

T**ax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond in order to see which bond has a higher applicable yield.

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.

The **Composite Index of Leading Indicators** is used to predict the direction of global economic movements in future months. The monthly index is composed of 10 economic components whose changes tend to precede changes in the overall economy.

The **Chicago Fed National Financial Conditions Index** is a gauge of U.S. financial conditions. The index tracks measures of financial stress and tightness of credit markets.

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