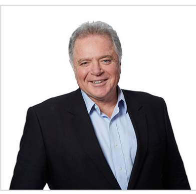
Mapping the Investing Landscape in a Changed World

Our experts offer their opinions on key trends for the global economy, fixed income, and equities in the second half of 2020.



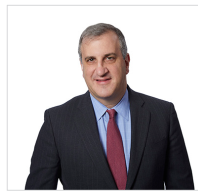


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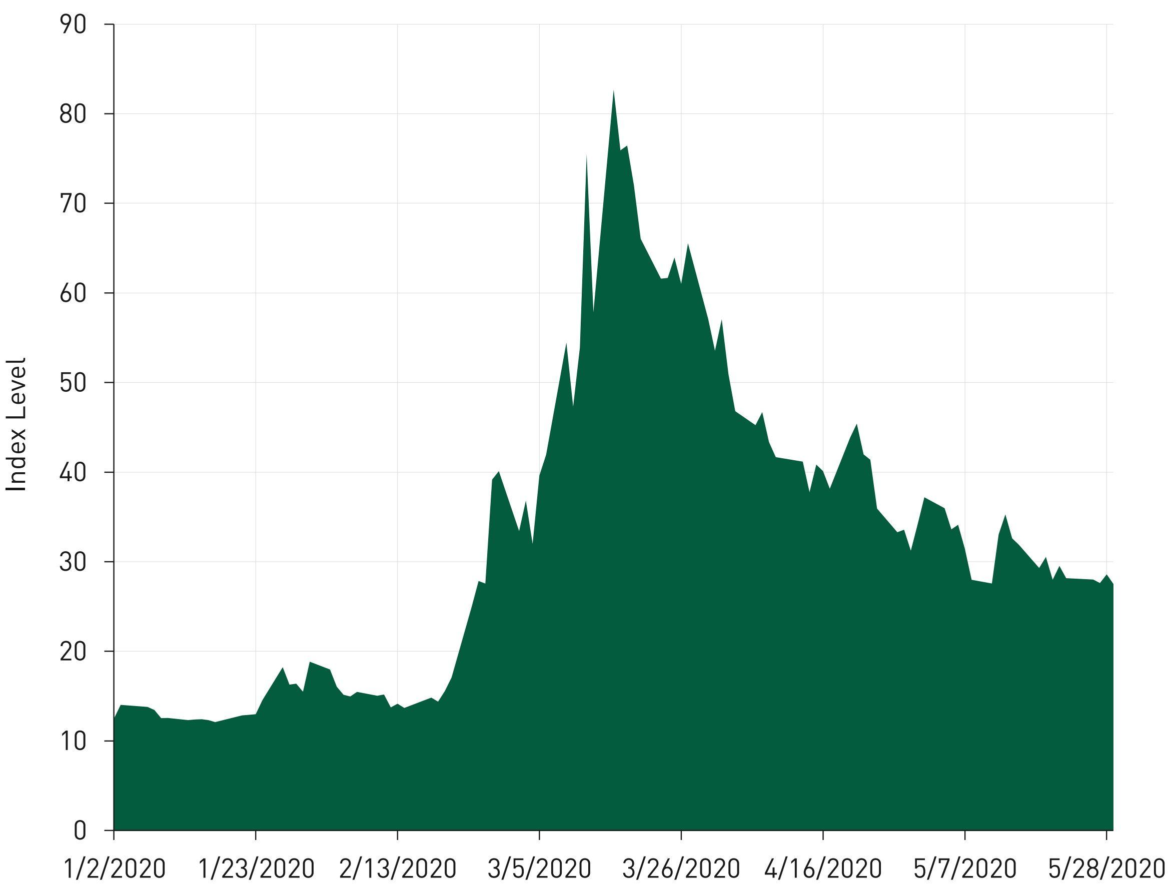
Figure 1. Volatility Has Pulled Back Since Spiking in March

CBOE Volatility Index (VIX, January 2, 2020¬-May 29, 2020)



Source: Yahoo Finance. Data as of June 1, 2020. The **CBOE Volatility Index, or VIX**, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility.
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INVESTING

We recently gathered a group of Lord Abbett experts to discuss the investment outlook for the second half of 2020. Panelists included Partners Giulio Martini, Director of Strategic Asset Allocation; Andrew O'Brien, Portfolio Manager for Taxable Fixed Income; Thomas O'Halloran, Portfolio Manager for Innovation Growth Strategies; Daniel Solender, Director of Tax-Free Fixed Income; Leah Traub, currency expert and Portfolio Manager for Taxable Fixed Income; and Kewjin Yuoh, Portfolio Manager for Taxable Fixed Income, Liquid Securitized Products. Tim Paulson, Investment Strategist, moderated the discussion. (*View an edited video version of this conversation*.)

When our investment experts last met in December 2019 to discuss the outlook for 2020, no one could have anticipated the COVID-19 pandemic, the tragic loss of life that followed, or the global financial shock that ensued as economic activity largely shut down. As our panelists convened again in June 2020, although there remained a possibility of a second wave of the virus, caseloads in the United States were declining, hospitals were no longer overwhelmed, businesses were reopening, albeit cautiously, and the financial markets were on the rebound. Following are highlights of the discussion.

The Shock Recession, Response, and Time to Recovery

Martini looked at the macroeconomic impact of the crisis in the United States and ventured an opinion as to when the economic recovery might begin.

The Shock Recession. "Normally," Martini explained, "businesses and people have eight-to-twelve months to adjust to the full extent of a recession. As the economy shut down in March to deal with the healthcare crisis, however, households, businesses, and the public sector were affected immediately and at the same time. An economic shock of this type is almost unprecedented. And because it came on suddenly and with full force, a sense of urgency developed among policymakers."

Policy Response. "The response of policymakers was also unprecedented – both in size and scope," Martini said. "The Fed [U.S. Federal Reserve] cut rates to just above zero almost immediately, supplied liquidity to keep markets afloat, freed up bank capital for additional lending capability, and teamed with the U.S. Treasury on nine separate credit facilities to support borrowing by households as well as small-, medium-, and large-sized businesses, and state and local governments. At the same time, Congress rolled out a comprehensive set of measures totaling just under $3 trillion, about 14% of GDP [gross domestic product], to also give support to businesses of all sizes, households, and state and local governments. "

While not perfect, Martini said, these measures "reduced the tail risk in the markets that would come from an economy just going over a cliff without any bottom in sight. And they did so by borrowing aggressively to insulate the economy from the full negative impact of the shutdown."

Economic Recovery. Martini believes the policy response is a key reason the market has been able to rebound so quickly from its lows in March, even before many of those policies have been fully implemented. He reminded his audience that it is typical, of course, for the market to rebound before a recession ends. "And as we know, this recession is extremely deep," he said. "But it's also likely to be extremely short. And in fact, we're probably going to see the economy picking up again this month [June]. So having the market bottom in March really isn't off when compared to past recessions."

As to how strong the economic recovery is going to be, and how well the market responds from here, Martini believes that will depend on when earnings are restored to something closer to their previous peak. "All of that," he said, "has yet to be determined. But the market rebounding and doing better, even as the economy is still crippled, is in fact typical. And I think we have economic policy coming to the rescue very quickly to thank for that."

LANDSCAPE

Outlook for Municipal Bonds

"What's interesting in the muni market," Solender said, "is that municipal bonds have been recovering and are now positive for the year (as of June 1, 2020) but, unlike the taxable fixed income markets, that's occurred without much support from the federal government – although there is an expectation of more help from Congress in the future."

Solender spoke of the difficulties state and local municipalities have been having as revenues decline in the economic downturn. "There's also been a decrease in revenues due to individuals' ability to defer their tax payments for several months," he said. "Despite the headwinds, state and local governments have been cutting expenses, doing what they have to do, without issuing bonds, because they have limitations on how much they can borrow. But I believe things are heading in the right direction for the muni market."

Declining Volatility

Looking at the taxable fixed income market, Yuoh credited the Fed's quick actions to restore liquidity in the marketplace as the key factor lowering volatility. "We saw a significant spike in volatility during the height of the crisis in March and April," he said. "Since then, volatility has fallen back to where it was pre-COVID-19, and expectations of future volatility are near historical lows." (See Figure 1, front page.)

"The low-volatility environment that the Fed has created through transparency, forward guidance, perhaps even yield curve control going forward—keeps interest rates low and creates the environment for a hunt for yield," Yuoh said, "that has been in place for ten years, and there's no reason to expect that won't be a driving force going forward."

"Of course," he continued, "We don't know exactly what's going to happen because of the nature of this crisis and the potential for a second wave of the virus as we head into the fall. But there have been several data points recently that show application for new business formations have returned to pre-COVID-19 levels. Activity in housing as well as small business formations has been on a gradual increase since mid-April."

The Weakness in Global Supply Chains

O'Brien believes the pandemic has exposed a weakness in global supply chains that will have a lasting impact in terms of trade and on the whole concept of globalization. "For many years," he said "U.S. manufacturers have been driven by the idea that you want to manufacture your product or source your inputs from the cheapest place possible, wherever in the world that may be. But the cheapest place may not necessarily be the place where the product is used, so you end up with very long global supply chains. Those supply chains can be fragile and, as we saw in the case of the pandemic, disruptions of a critical product line, such as pharmaceuticals and other healthcare supplies, are quite possible. Companies are starting to think that finding the cheapest place to manufacture product may not be the right focus. Instead, a better decision may be to ensure a robust supply at the point where the product is needed so there are fewer points of possible failure along the way."

O'Brien also views this as a matter of strategic interest for the United States and believes it will have regional trade impacts going forward.

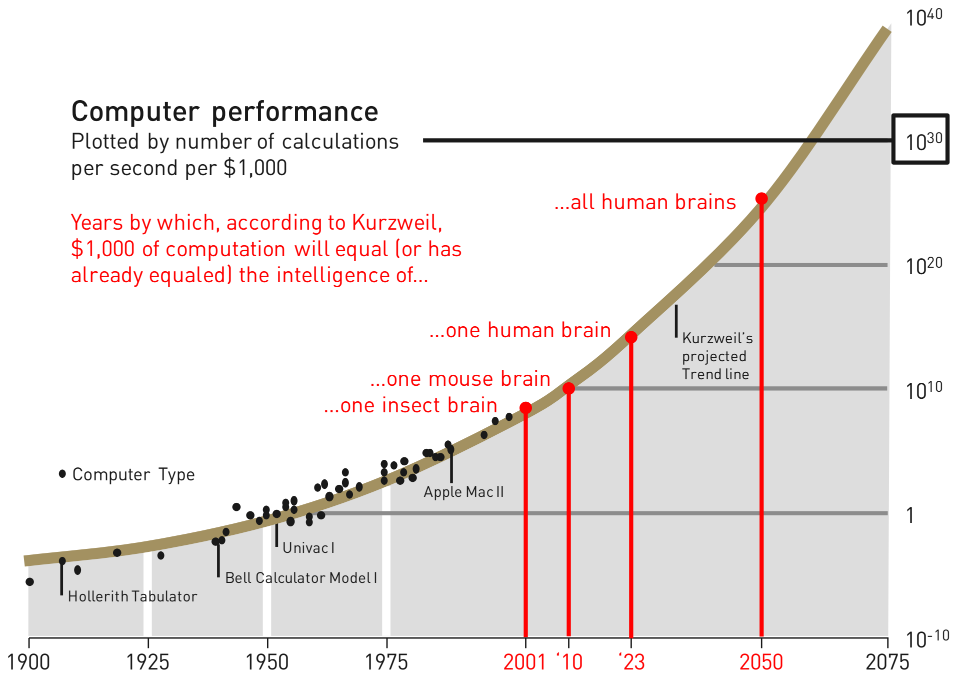
A Global Perspective

Speaking from a global standpoint, Traub said we can expect a rolling recovery just as we started with a rolling crisis. China was the first to be hit by the virus and was the first to begin recovery. Europe was next and then the United States.

"China and Germany are two countries that have a lot of resources that they can bring to bear," Traub said. "They were in good fiscal positions coming into the crisis and they were able to marshal those resources in order to get their economies to recover more quickly. We believe other countries in Europe, such as Italy, are going to have a little bit harder time. Italy, for example, was hit hard by COVID-19 and, even though it is starting to recover, it has a lingering debt and deficit issue that will slow its progress economically."

Figure 2. The Power of Technology is Growing Exponentially

The Kurzweil Curve below shows that the power of technology will keep growing exponentially. By 2050, you may be able to buy a device with the computational capacity of all mankind for the price of a nice refrigerator today.



Source: Ray Kurzweil, "The Singularity is Near" (2005).
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"What's been very encouraging," she continued, "is the response that we're seeing from the broader European Commission and the European Central Bank to provide an unprecedented level of support to all of the Euro-Area countries."

Traub said that emerging markets in general did not have the economic or healthcare capacity to deal with the virus, and some may experience sovereign defaults. "Latin America, in particular," she said, " is currently in the depths of the COVID-19 impact and has been hurt in a number of sectors, including tourism, commodities, and trade. There will be challenges ahead."

Investment Opportunity

Investors are just beginning to wake up from the economic shock, according to O'Halloran. And that's understandable. "After all," he said, "we were suddenly in a severe secular bear market in terms of equity prices. The S&P 500® Index declined 35% at the low in March. That doesn't happen very often. "

"This was a forced recession," he continued, "almost a forced depression. As Giulio [Martini] has put it, the virus was like a natural disaster, but not like a tsunami or an earthquake where the nation's capital stock is obliterated. Our capital stock is intact, and we will come back stronger, largely as a result of technological innovations that have allowed us to adapt, such as telemedicine, video conferencing, and e-commerce."

"In my opinion," O'Halloran said, "the digital side of the economy was strengthened by this experience, and it will continue to be future drivers of change" as computing power continues to expand. (See Figure 2.)

One of the "interesting" questions O'Halloran is considering now is "whether the value of the nation's capital stock will actually be enhanced by the increase in productivity that technology will allow."

O'Halloran said he is "bullish on equities overall. Value investing works, because value stocks are very cheap. Growth works because there is so much innovation in the economy. And income works because people want yield and will move to dividend-paying stocks in this low-interest rate environment. In my opinion, each one of those investment choices would be rational in this environment."

A special note of thanks to Judith Mangiero, who was instrumental in the preparation of this Market View. *Judith is concluding a two-decade run of editorial excellence at Lord Abbett to pursue new adventures from her headquarters at an undisclosed location in the Pocono Mountains. We will miss her greatly.*

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. 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 municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. 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. 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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Fed refers to the U.S. Federal Reserve.

A **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.

The **CBOE Volatility Index, or VIX**, is a real-time market index created by the Chicago Board Options Exchange that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments.

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