LORD ABBETT

MARKET VIEW

MIDYEAR OUTLOOK: OUR EXPERTS GIVE THEIR MACRO VIEWS

Lord Abbett investment leaders offer their insights on the macroeconomic and policy factors that could influence markets in the second half of 2018.

TABLE 1. SYNC AND SWIM: GLOBAL ECONOMIES CONTINUE TO GROW IN UNISON, FOR NOW

FORECASTED GROSS DOMESTIC PRODUCT (GDP) RATES, AS OF JULY 2, 2018

	Forecasted GDP Growth (%)		
	Q2 2018	Q3 2018	Annualized (Q2)
United States	0.8	0.9	3.3
Euro Area	0.2	0.2	1.0
Germany	0.4	0.4	1.4
France	0.4	0.4	1.6
Italy	0.3	0.3	1.0
Spain	0.9	0.9	3.5
United Kingdom	0.3	0.4	1.2
Japan	0.7	0.1	2.8
China (Y-O-Y)	7.0	7.3	—

Forecasts for U.S. growth continue to outpace those for most developed nations.

Source: Now-Casting Economics. Y-O-Y=year-over-year. Note: Calculations for annualized GDP based on originally reported figures before rounding.

IN BRIEF

- We convened five Lord Abbett investment leaders to discuss the macro factors that may affect economies and markets in the year's second half.
- Policy matters dominated the conversation. The experts discussed *monetary policy*, with a focus on potential moves by the U.S. Federal Reserve.
- The panel also weighed the economic impact of U.S. *fiscal policy*, especially in light of recent changes to the U.S. tax code.
- In addition, participants examined the implications of *trade policy* amid rising tensions among the United States and its key trading partners.
- Our experts identified other macro factors to watch in coming months, such as the U.S. debt-ceiling debate, geopolitical developments, and the shape of the U.S. Treasury yield curve.

While a number of trends that have supported global economic growth and financial asset prices in the first half of 2018 look set to continue, other factors have emerged that could affect the investment climate in the year's second half. In particular, developments in trade policy could weigh on global growth, and geopolitical events could produce a "September to remember," in the words of one Lord Abbett investment expert.

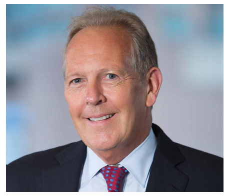
With that in mind, what should investors be watching in the final six months of the year? We recently gathered five Lord Abbett investment leaders for a wide-ranging discussion of the current market and economic environment and their views on key investment themes for the second half of 2018. In this, the first of a special three-part *Market View*, our panel examines second-half macroeconomic conditions. Part two will focus on the market environment, especially in terms of the direction of bond yields and key measures of investment risk. In the concluding segment, our experts will discuss how the factors outlined in parts one and two inform the outlook for key asset classes.

Our panel featured Lord Abbett partners Robert Lee, chief investment officer; 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. (Coming soon: Visitors to lordabbett.com will be able to access video and audio highlights of the panel discussion.)

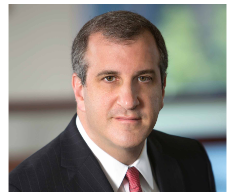
FEATURED INVESTMENT LEADERS

Robert Lee
Chief Investment Officer

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

Kewjin Yuoh
Portfolio Manager for Taxable Fixed Income

Lee outlined a logical framework for the macro discussion. The three key issues that investors should focus on in the second half of the year, he says, "all surround different forms of policy: monetary policy, fiscal policy, and trade policy."

Economic Backdrop

But first, a view of the current environment is in order. The panel acknowledged favorable global economic conditions. "We've had an excellent economic environment, with synchronized global growth [see Chart 1] that's led to a situation where company earnings have grown very rapidly and have exceeded investors' expectations," notes Martini. "The question is, for how long can this be sustained?"

In assessing the likelihood of whether the current period of growth is coming to an end, Martini points out that "expansions normally end because an excess develops—either in the real economy or in the financial system—that can only be resolved with a future period of slow or negative economic growth." He notes that one of those cautionary signals is excess demand, which manifests itself in rising inflation. "That's something we decidedly don't have right now," he says.

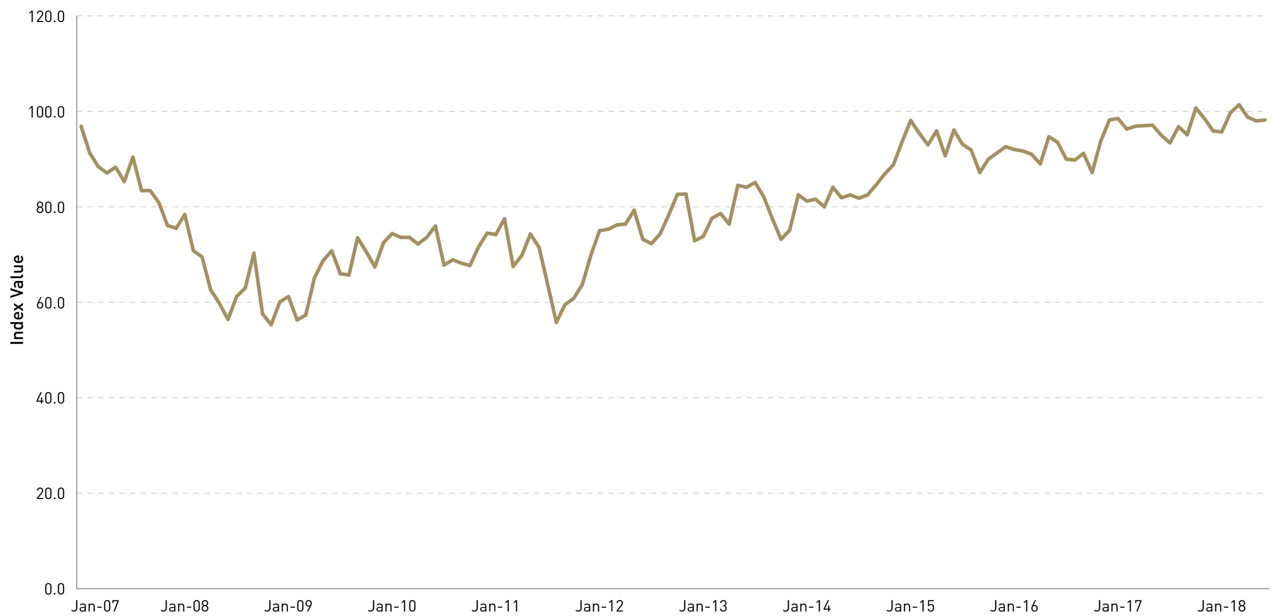
Inflation is "one of the most important questions for investors," adds Lee, with the shape of the yield curve, U.S. Federal Reserve (Fed) rate moves, and fiscal and trade policy all tied into the inflation outlook. "So far we've had very contained, stable inflation and inflation expectations within a pretty reasonable range."

But, cautions Lee, "investors shouldn't get complacent." He called the Fed's efforts to shrink its balance sheet "an experiment that hasn't really been tested in the United States." Further, inflation potentially could be fueled by trade-policy moves on the part of the United States and its trading partners, a topic that our experts discuss in greater detail later on.

The panel examined other aspects of the current U.S. economic scene. For the municipal bond sector, the continued economic strength represents a tailwind. "You have to look at the impact on the economy doing so well and a lot of the business that's coming

CHART 1. ROBUST CONSUMER SENTIMENT APPEARS TO SUPPORT U.S. GROWTH PROSPECTS

UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT INDEX, JANUARY 2007–JUNE 2018



Source: University of Michigan, University of Michigan: Consumer Sentiment [UMCSENT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UMCSENT, July 4, 2018.

from that," says Solender. Regarding general obligation bonds, revenues in most U.S. states are "way ahead" of budgets, he says, which may come as a surprise to many investors. As for revenue bonds, Solender singled out toll roads and airports as examples of sectors that are benefiting from the stronger economy. This strength has carried over to make overall municipal bond credit quality "very strong," he says.

O'Halloran focused on the robust U.S. consumer sector. "That's where 70% of the spending is," he notes. Longer-term trends in technology have made the consumer experience "vastly better," he says, lending support to current and future spending.

Yuoh agreed: "If you look at consumer sentiment, we're at higher levels than we were before the Great Recession." (See Chart 2.) He says this indicates a "bifurcation" that investment professionals have to consider. "In the United States, with this very strong environment with the consumer, all leading indicators are continuing to trend upward."

But that's where the prospects for the United States and other nations may diverge, according to Yuoh. For example, investors are contending with the implications of signs of weakness in emerging-market economies, as well as uncertainties of how trade tensions will affect growth in China.

Martini had one further observation on China: "One of the things that's going on right now ... is a clampdown [by the Chinese government] on the growth of shadow banking in an attempt to reduce financial risk." He believes it may be difficult to fully gauge the potential spillover effect upon the rest of the world from this "attempt to put the Chinese economy on a sounder financial footing."

Monetary Policy

The direction of U.S. monetary policy emerged as a particular focus for the panel. Lee recapped recent developments, noting that the Fed began tapering asset purchases in 2013, before finally ending them in 2014; in December 2015, the central bank implemented the first of seven rate hikes. And while the Fed has stepped up the pace of hikes in 2018, from a historical perspective the pace "isn't extremely fast." For Lee, the key questions are: Is the Fed ahead of, or behind, the curve on inflation? In reducing monetary accommodation, is it "taking the punch bowl away" too quickly?

"If you look at credit spreads in various fixed income sectors, and if you look at the stock market overall, I would say risk markets tend to be more comfortable with the pace of Fed tightening," Lee says.

Martini notes that in addition to the Fed's tightening moves since December 2015, the central bank has allowed the securities that it added to its balance sheet from the asset-purchase program to roll off as they mature. "What we're seeing is a situation where previously the Fed had been keeping its balance sheet constant," he says, but the Fed allowed it to expand, from $1 trillion to $4.5 trillion, at the height of quantitative easing (QE). The balance sheet represents risk that the Fed has taken out of the markets and chosen to hold itself, he says. As the balance sheet shrinks, Martini explains, the Fed is transferring risk back into the market that it previously had held on its own books.

"The change in Fed policy is one of those factors that you have to add in on top of earnings, low inflation, and all the other things that matter in the environment," Martini says. "And it's difficult to assess that, because we've never been through anything like this before."

Fiscal Policy

The passage of the U.S. Tax Cuts and Jobs Act in December 2017 was intended to spur economic growth in the United States, at a time when the economy was already expanding at a steady clip. While the legislation had a notable impact on economic data and asset prices in 2018, the longer-term effects remain to be seen. Yuoh observes that the U.S. economy had just come from "an incredible monetary policy experiment" with the Fed's asset purchase program. In the QE era, the United States had experienced an unusually long, nine-year expansion marked by steady, if unspectacular, growth. Now, with the addition of fiscal stimulus, Yuoh asks, "what if we return to a normal business cycle?"

In the past, notes Lee, fiscal stimulus measures would happen during a recession or periods of economic weakness. "This time it's been pro-cyclical," he says. Labor markets had already been tightening, and the economy was advancing at a steady pace, "and yet we got a pretty substantial fiscal stimulus package." Much like the Fed's balance-sheet unwinding, there is little historical precedent for pro-cyclical stimulus, Lee says. "It's an open question as to whether that will lead to inflation, and whether the effects will be short term and/or longer term."

In the muni market, the tax bill has had "a tremendous impact," notes Solender. He says that provisions of the legislation that removed the ability of municipalities and issuers to refinance bonds in advance of their call dates had reduced municipal new-issue supply by around 20%, year to date (through June 28). Meanwhile, a considerable amount of muni issuance that would have occurred in 2018 was pushed into December 2017 based on concerns about other provisions of the tax bill. As a result, Solender says, the supply of new issues in the muni market is very low, "slowly picking up, but still behind the pace of previous years." At the same time, limits on tax exemptions, such as the deductibility of state and local taxes and mortgage interest, have spurred demand for muni securities, especially in high-tax states such as New York and California.

Trade Policy

The first half of the year offered an avalanche of headlines on trade—everything from the sometimes contentious re-do of the North American Free Trade Agreement (NAFTA), to the trade negotiations between the European Union and a Brexit-bound United Kingdom, and worsening trade relations between the United States and China amid a volley of tariff threats. Martini believes trade policy is "something to worry about" because there historically have been very few trade wars, and thus little guidance as to how the current situation may play out.

If trade conflicts escalated to the point that reciprocal tariffs were implemented between the United States and China, the United States and the European Union, and among the three NAFTA signatories and other trading partners, the impact on global economic growth likely would be negative, says Martini. Extensive trade conflicts could slow global economic growth by "two or three tenths of a percent ... from what looks to be a pretty strong year right now," he says. The direct impact of the trade war wouldn't be devastating, but what might hurt global economies are the effects on uncertainty for businesses that might change their investment decisions, or delay investments in the United States or in other countries. "It would really create some uncertainty about the broader policy environment," he adds.

Yuoh says financial markets have been reacting to the uncertainty that Martini referenced. He thinks there could be a "healthy" debate about what the endgame is for the U.S. administration with regard to trade policy and protectionism. But "without knowing what that endgame is or how we get there," investors in global asset markets will demand risk premiums for that uncertainty.

"I think the base case is that pragmatism will prevail," says Lee. But he adds that "one needs to take a step back as well and look at the broader, longer-term issues." He cited the rise of populism and economic nationalism, not just in the United States but also in other developed nations. "These are complicated, longer-term issues which one needs to really think about."

What Else to Watch

What other macro factors, beyond the economic and policy considerations already discussed, could influence markets in the second half? For one thing, a crowded geopolitical calendar. "When you look at it, this could really be a 'September to remember,'" says Martini. He cited the following developments expected for September and early October:

1. U.S. congressional negotiations around the debt ceiling;
2. A potential U.S. government shutdown should those negotiations fail;
3. A possible conclusion to the investigation by U.S. special counsel Robert Mueller into Russian interference in the 2016 U.S. presidential election;
4. The scheduled wrap-up of Brexit negotiations by U.K. legislators;
5. Related U.K.-EU negotiations; and
6. Continued friction between Italy and the rest of the European Union over budgetary rules.

"All of those things could definitely…increase uncertainty around a range of outcomes," Martini says.

Lee addressed other, longer-term geopolitical risks: the progress of denuclearization negotiations with North Korea, the withdrawal of the United States from the Iran nuclear deal, ongoing tensions with Russia, and continued instability in the Middle East, especially as it relates to oil supplies. "I don't think the picture is particularly dire" for any of those situations, "but I think some of the risks have increased," he says.

In munis, Solender expects that recently enacted amendments to two rules related to municipal-bond pricing from the Municipal Securities Rulemaking Board designed to provide greater transparency on pricing and trade data could affect investors' approach to purchasing municipal securities.

Yuoh suggested that market watchers monitor developments in the U.S. yield curve, especially as investors react to Fed policy moves in the months to come.

Finally, O'Halloran noted many of the concerns expressed in the course of the discussion, especially as they relate to equities. "I take those very seriously," he says. But he believes investors should continue to focus on developments in technology and the positive impact they have on consumers and businesses. O'Halloran thinks "the innovation boom that we're in the midst of right now" could help drive equity prices higher in the current year, and over the next several years.

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