Behind the Market's Third-Quarter "Stealth Shift"

Improving economic data and enhanced support from key central banks, especially the U.S. Federal Reserve (Fed), helped lift markets late in the quarter, confounding the doomsayers.

Contributor

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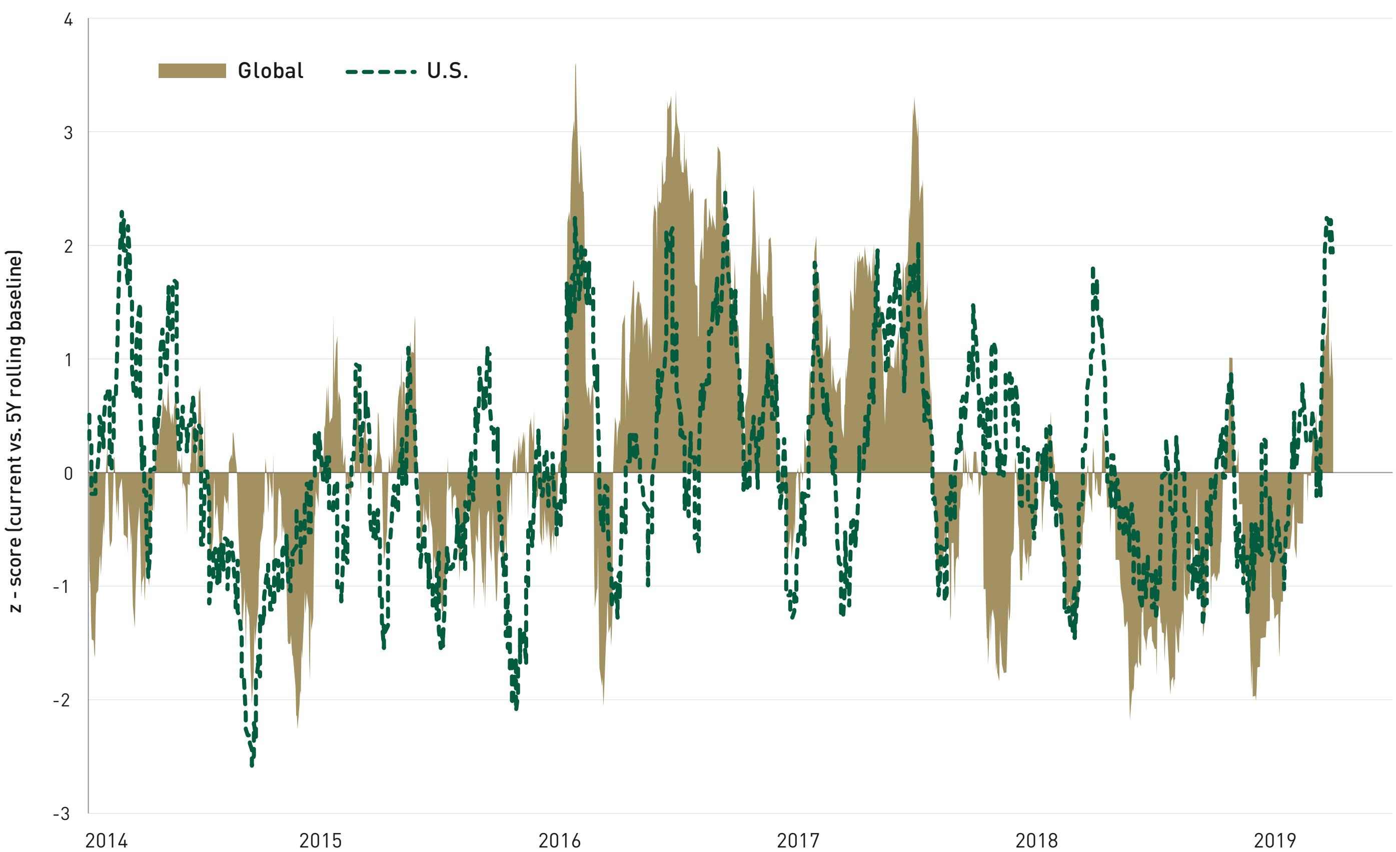
Chart 1. Economic Data Have Started to Outperform Forecasts After a Long Stretch of Shortfalls

JP Morgan Economic Activity Surprise Index, (2014-September 09, 2019)*



Source: Bloomberg. Data as of September 9, 2019.

*The JP Morgan Economic Surprise Index captures shifts in economic growth projections by looking at the recent history of economic activity that digresses from consensus expectations. **Past performance is not a reliable indicator or guarantee of future results**. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

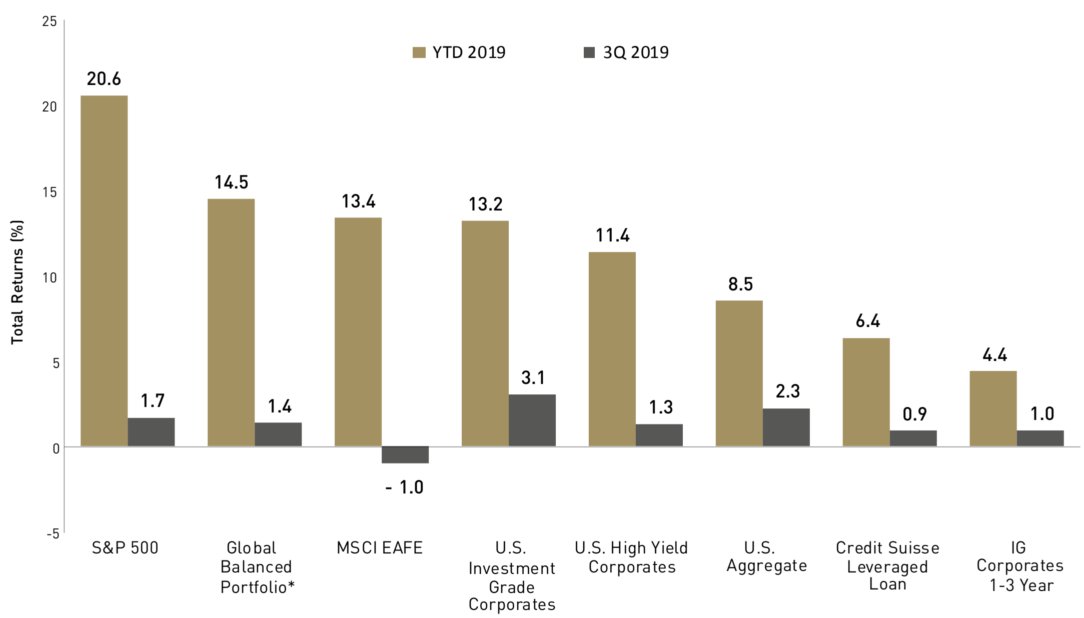
In Brief

- Embedded in the market's performance over the past year has been a laundry list of global worries.
- Despite all the uncertainty, investor sentiment started to shift for the better in September 2019, reflecting, in large part, the Fed's decision to support the markets with another rate cut in September.
- There was also growing recognition of strengthening U.S. economic data although, interestingly enough, the improving data went almost unreported by the financial media.

Despite a sharp pullback in August, risk assets rose almost across the board in the third quarter ended September 30, 2019. The S&P 500® Index was up 1.7% for the quarter. Bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond index, rallied 2.3%.

The positive third quarter returns added to what has been a really strong year through the nine-month period ended September 30, 2019, as illustrated by a globally balanced portfolio (see Chart 2) returning 14.5% year-to-date.

Chart 2. Asset Prices Rose Broadly in the Third Quarter as Bond Yields Declined



Source: Bloomberg.

YTD as of September 30, 2019. As represented by S&P 500 Index, MSCI EAFE Index, Bloomberg Barclays U.S. Corporate Investment Grade Index, Bloomberg Barclays US Corporate High Yield Index, Bloomberg Barclays U.S. Aggregate Index, Credit Suisse Leveraged Loan Index, and Bloomberg Barclays 1-3 Year U.S. Corporate Index. *45% S&P500 Index, 15% MSCI ACWI ex U.S., and 40% Bloomberg Barclays U.S. Aggregate Index (rebalanced monthly). **Past performance is not a reliable indicator or guarantee of future results**. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

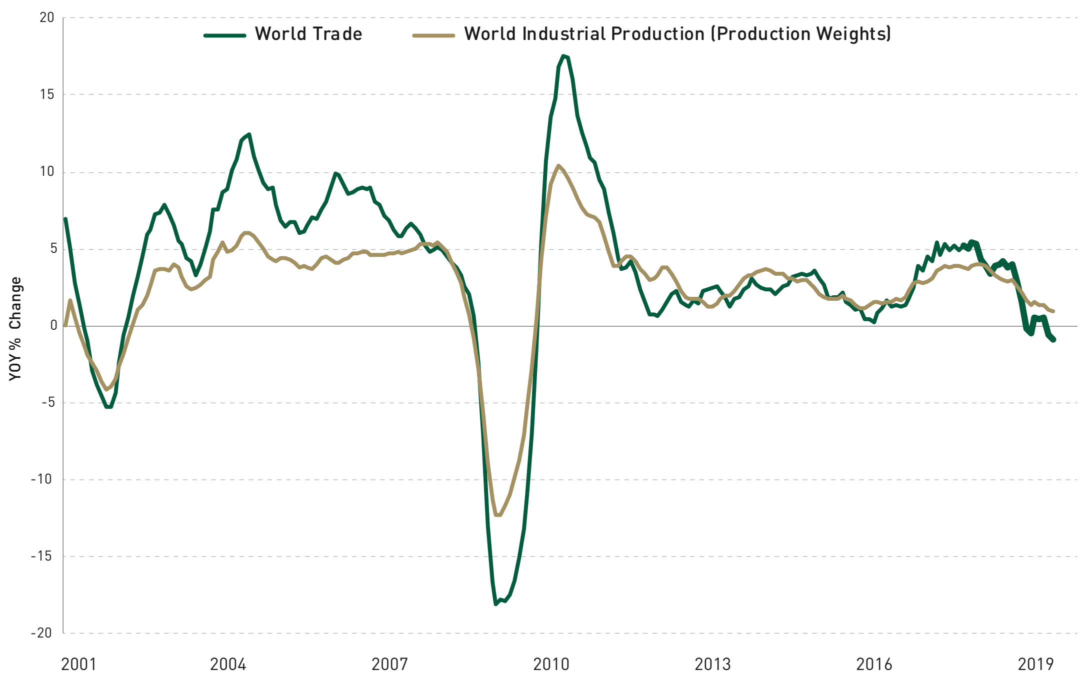
Of course, the strong returns so far in calendar 2019 reflect a considerable bounce-back from the poor performance of the 2018 fourth quarter. The S&P 500, for example, peaked at an index value of 2931 on September 20, 2018, which means that the equity benchmark had risen only 1.6% from that peak as of September 30, 2019.

Because markets in the United States have been trading in a narrow range for the past year, it would be incorrect to say, therefore, that 2019 to date has been a year when investors fundamentally changed their expectations for the market. In fact, until very recently, valuations in the United States have adjusted downwards for most of the past 18 months. And investor sentiment has been largely pessimistic.

Trade Concerns and "Cyclitis"

Embedded in the market's performance over the past year has been a laundry list of global worries. The biggest worry, in our opinion, has been, and continues to be, concerns about a worsening global trade conflict between the United States and China. On the consumer side, rising tariffs on Chinese imports to the United States threaten to increase prices on consumer goods. Corporations face the potential for increased costs and lower profits if they are forced to redirect supply chains from China and shift production to other countries. Trade uncertainties may cause companies to delay expansion plans and lead to an even sharper slowdown in global economic growth. This turbulence is already proving disruptive to global trade (see Chart 3), which shows a recent growth rate of below zero—a very rare degree of weakness outside of global recession.

Chart 3. Uncertainty about Tariffs and Trading Relationships Has Caused a Sharp Slowdown in Global Trade



Source: Bloomberg.

Data as of July 31, 2019 (3-month moving average). **Past performance is not a reliable indicator or guarantee of future results**. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

But the uncertainty surrounding issues of global trade, while significant, is not the only factor that has been feeding investor concerns. There is also a phenomenon which we will call "cyclitis" —i.e., a fear that the decade-long expansion phase of the current U.S. credit cycle is near an end and that a recession is nigh. The markets have started to price in some things which are typically (although not always) characteristic of the end of an economic expansion, such as the dreaded inverted yield curve, whose reliability as a predictor of recessions we have discussed here. The large amount of "BBB"- rated corporate debt now residing in ETFs and comingled funds, and the $17 trillion in negative-yielding debt (largely in Europe and Japan) are also factors troubling investors.

The fundamental problem has been that many of the concerns we face today are new to our collective experience—particularly negative-yielding debt. Bonds yielding below zero were thought to be impossible, and the consequences of negative yields going back to positive values are fraught. The risk presented by negative-yielding debt is, therefore, totally unknown; it cannot be priced into the market with a probability distribution that we are familiar with. And such uncertainty is very damaging to business confidence and financial behavior.

A Shift in Investor Sentiment

Despite all the uncertainty, however, investor sentiment started to shift for the better in September 2019, reflecting, in large part, the Fed's decision to support the markets with another rate cut in September, following the first one in July.

There was also growing recognition of strengthening U.S. economic data although, interestingly enough, the improving data went almost unreported by the financial media. But the JP Morgan Economic Activity Surprise Index (see Chart 1 on first page) captured the point at which the data started to exceed investor expectations during the third quarter.

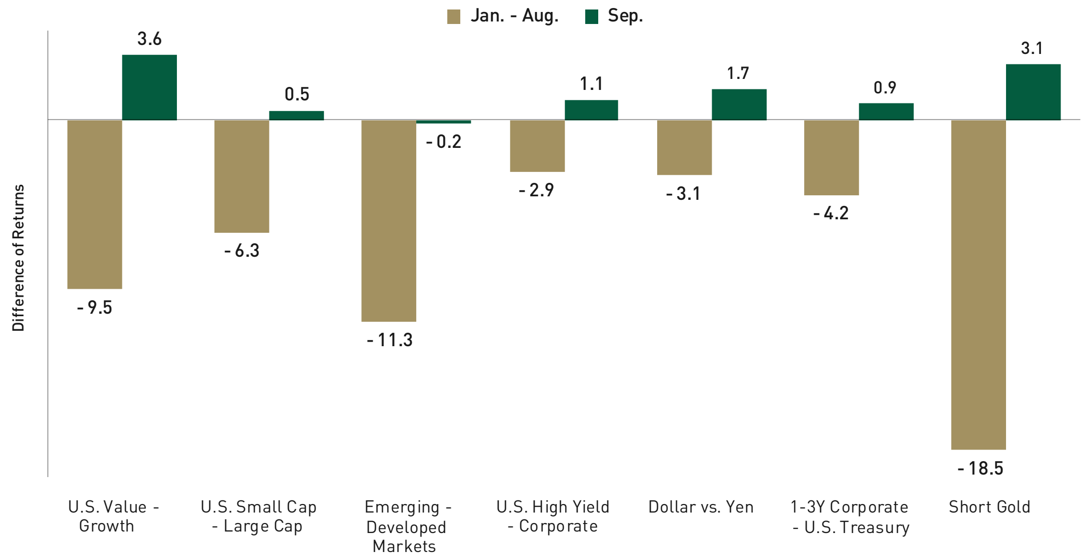
In September, with a shift in market sentiment, we also witnessed a rotation in market leadership, as noted in Chart 4 (next page). You can see the change most dramatically in short gold positions. Gold is an asset that trades with systemic risk concerns, i.e., gold tends to rally when risk concerns are high. Short gold (i.e., short positions in the metal) was down 18.5%, meaning that if you were long gold in the first eight months of the year, you made 18.5%. But that reversed in September, when the price of gold fell—and being short paid off.

You can see the shift in other risk assets as well. The Japanese yen typically rallies against the U.S. dollar in a risk-off environment, which it did through the first eight months of the year, by 3.1%. That reversed in September. High yield versus investment-grade corporates, small cap versus large cap, value versus growth—all the internals of the market started to shift in September versus their performance in the prior eight months.

It is in times such as these, when perceived reality wrestles with the actual data, that we believe investment opportunities arise. In next week's *Market View*, we examine how such a divergence in market opinion has been creating new investment avenues for active managers to explore.

Chart 4. Market Leadership Changed as Investors' Outlook Shifted from Negative to Positive

Sector leadership as measured by returns of respective benchmarks, (as of September 30, 2019)



Source: Bloomberg.

Data as of September 30, 2019. Returns shown represent the difference between indexes.

U.S. Value - Growth as represented by Russell 1000 Value Index and Russell 1000 Growth Index. U.S. Small Cap - Large Cap as represented by Russell 2000 Index and Russell 200 Index. Emerging - Developed Markets as represented by MSCI EM and MSCI World. U.S. High Yield – Corporate as represented by Bloomberg Barclays US Corporate High Yield Index and Bloomberg Barclays US Agg Corporate Index. 1-3Y Corporate - U.S. Treasury as represented by ICE BofAML U.S. Corporate 1-3 Year Index and Bloomberg Barclays US Treasury Index. Short Gold as represented by the returns an investor would have realized by taking a short position in gold. A short, or a short position, is created when a trader sells a security first with the intention of repurchasing it or covering it later at a lower price.

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The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market.

The **Bloomberg Barclays U.S. Corporate Investment Grade Index** is the corporate component of the U.S. Credit index. The U.S. Credit index is defined as publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in Industrial, Utility, and Finance sectors

The **Bloomberg Barclays 1-3 Year U.S. Corporate Investment Grade Index** is a component of the U.S. Credit index. The U.S. Credit index is defined as publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The **Bloomberg Barclays U.S. Aggregate Corporate Index** is the corporate component of the U.S. Aggregate Bond Index, which represents securities that are SEC-registered, taxable, and dollar denominated.

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The C**redit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market.

The **ICE BofAML 1-3 Year U.S. Corporate Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with between one and three years remaining to final maturity.

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The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

The **MSCI ACWI (All Country World Index) ex-US** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States.

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The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The **Russell Top 200® Index** measures the performance of the 200 largest companies in the Russell 1000 Index, which represents approximately 68% of the total market capitalization of the Russell 1000 Index.

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