LORD ABBETT

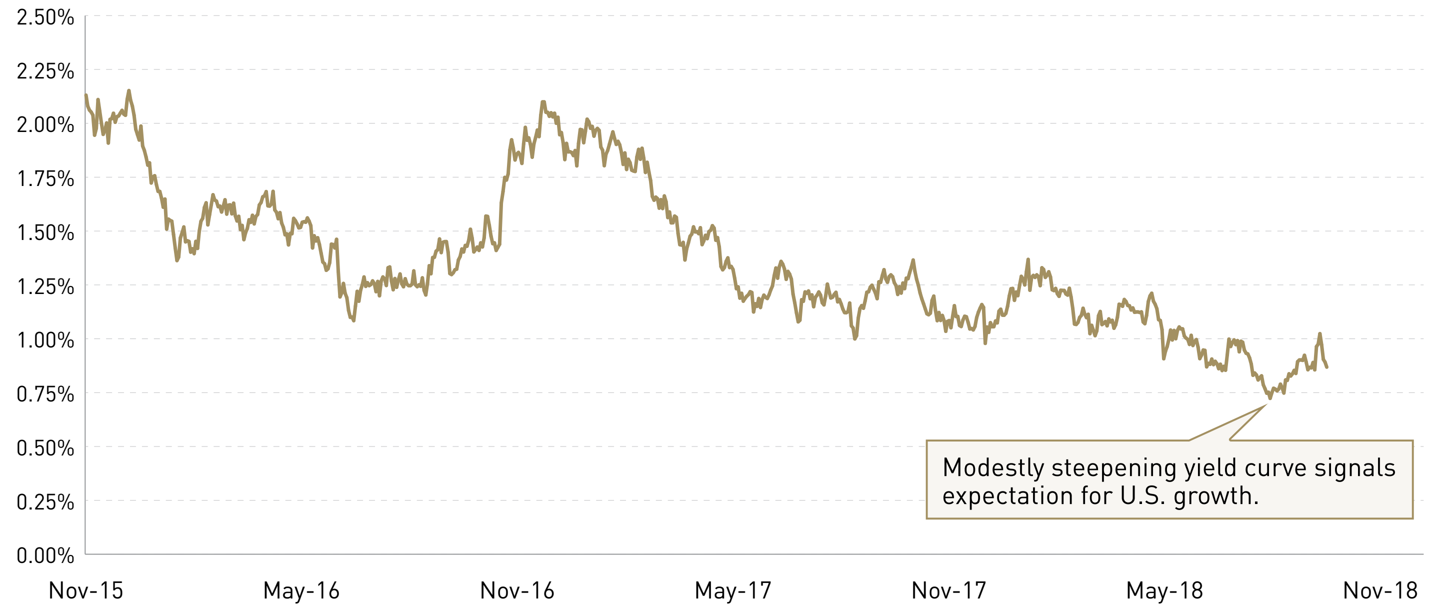
MARKET VIEW

TAKING STOCK OF THE RECENT VOLATILITY

In our view, a market sell-off in a fundamentally strong economic environment should not by itself be seen as a reason to abandon sound long-term strategies that offer investment opportunity.

MODESTLY STEEPENING YIELD CURVE SIGNALS IMPROVING EXPECTATIONS FOR U.S. GROWTH

U.S. GENERIC TREASURY YIELD CURVE (SPREAD BETWEEN 10-YEAR AND THREE-MONTH YIELDS), NOVEMBER 30, 2015 – OCTOBER 10, 2018



Source: Bloomberg and Lord Abbett

IN BRIEF

- We believe the recent drop in U.S. stock market prices is more like a normal correction after a strong rally than the beginning of a bear market.
- Investor expectations for U.S. economic growth, interest rates, and risk have not changed much from a year ago, and are already priced into the market. We think the United States remains in a strong position relative to the rest of the world.
- In our view, a sell-off in a fundamentally strong economic environment should not be seen as a reason to abandon sound long-term strategies that offer investment opportunity.

CONTRIBUTING STRATEGIST

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As unnerving as a sharp sell-off in the market can be, such corrections historically tended to be short-lived in periods of strong economic growth. In such an environment, history has shown that markets typically got back on their feet rather quickly and continued to rise again.

Although there can be no guarantee that the market will follow historical patterns, that's exactly what happened earlier this year. The U.S. stock market (as represented by the S&P 500® Index) peaked on January 26, 2018, sold off by 10% between late January and early February, retested its February 8 low on April 2, and then climbed steadily, hovering near record highs until the sell-off on October 10-11.

In any market sell-off, there is a scramble to understand why it occurred, and the tendency after a long winning streak is to suggest that a bear market is nigh. In this recent decline, there was a lot of discussion in the financial media about investor uncertainty, particularly with regard to interest rates, and falling investor expectations.

A CORRECTION, NOT A BEAR MARKET

There is little doubt among most market observers that the sell-off in early January was provoked by investors' concerns that the U.S. Federal Reserve (Fed) would raise interest rates by more than had been expected. Although the financial media has attributed this most recent sell-off to the same concerns, we do not share that conviction.

In fact, we believe that the Fed has been unusually clear about what investors can expect. It is adjusting policy on the basis of a longer-term set of considerations that have to do with whether inflation pressure is building, and how quickly, and whether the broader U.S. economy really needs higher rates. In its remarks following its Federal Open Market Committee meetings, the Fed has signaled that it is going to keep trying to tighten a few more times, at least until it reaches a fed funds rate target of 2¾–3¼%. Then it will probably pause and assess the likely impact on the U.S. economy of all of the rate hikes (since 2015) as well as its balance sheet changes as it unwinds a decade-long quantitative easing policy.

We know that investors are already expecting interest-rate increases. Based on fed funds futures data from Bloomberg, investors' expectations for Fed rate hikes have not changed much recently from early 2018 when the market first started pricing in sustained tightening by the Fed at a faster-than-expected rate. Inflation expectations have also been quite stable, despite recent hints that wage growth is accelerating. And notwithstanding the Fed's tightening to date, investors' expectations regarding the durability of U.S. economic growth have been improving, as evidenced by a modestly steeper Treasury yield curve (see Chart 1)

Together, these expectations amount to an essentially unchanged outlook from a year ago. In our opinion, expectations of continued U.S. economic growth despite rising rates will ultimately stabilize markets and provide the potential for even higher stock market prices going forward. ***That is why we are calling this a stock market correction, and not a bear market***.

LESS OPTIMISM OVERSEAS

But there also has been a sell-off outside the United States, where the economic fundamentals are quite different, and we need to be clear about that. Non-U.S. economies are much more dependent on trade than is the United States, and, after a sustained recovery from early 2016, global trade has entered into a cyclical slowdown that has not been fully priced into non-U.S. markets. The moderation in trade has been hurting the emerging markets (EM) and the eurozone the most. Tariff uncertainty is also playing a role as is a stronger U.S. dollar, which is a negative for EM economies. Earnings revision trends also have become less positive outside the United States, or in the case of EM economies, negative.

In comparison, the U. S. economy, due to its lower exposure to global trade and ongoing positive fiscal stimulus through tax reform, is in a much stronger position to sustain growth than the rest of the world. And there is, accordingly, more support for potentially higher stock prices in the United States.

WHY THE SUDDEN SELL-OFF?

Why did the market plunge so sharply? Sometimes it's just a confluence of factors – too much information for investors to be able to factor in during a reasonable period of time. There may be specific companies that are causing concern, or geopolitical hot spots, or threats of economic slowdown as a result of trade tariffs.

As we've discussed elsewhere, President Trump's agenda has positive elements (including tax reform and regulatory relief) which have helped corporate earnings growth, as well as potentially negative aspects (such as a slowdown in immigration, which could tighten the labor market, and tariff/trade wars). Perhaps we are now in the period where the positive parts of the agenda have already been factored in and the negative parts are part of the background noise that the market is just starting to reflect.

INVESTMENT STRATEGIES

In any event, Investors may be getting a little nervous, which is understandable. So here are a few investment perspectives which we think are timely for this kind of environment.

- *A market downturn in a period of strong U.S. economic fundamentals is an opportunity to buy, not a signal to sell, in our opinion.*
- We believe growth strategies always have a place in a portfolio, particularly in a time of strong economic fundamentals. As we pointed out in a previous *Market View*, there is more to growth stocks than large-cap telecom, and we believe there are many potential investment opportunities going forward. And because of the recent market downdraft, now those opportunities are more attractively priced.
- For investors who want to reduce their allocation to stocks, floating-rate loans offer the potential for yield as well as historically low correlation to the stock market.
- Other less risk-averse investors may want to consider high-yield bonds, where yield spreads have widened out a bit after reaching the narrowest recorded levels for this cycle.
- Finally and most fundamentally, we strongly believe that a diversified portfolio is a prudent long-term investment strategy that can help weather the market downturns.

SUMMING UP

In our view, a sell-off in a fundamentally strong economic environment should not be seen as a reason to abandon sound long-term strategies that offer investment opportunity. ■

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