Three Market Divergences Signaling Potential Opportunities

We see three divergences between actual data and valuations that merit consideration as we manage our portfolios.

Contributor

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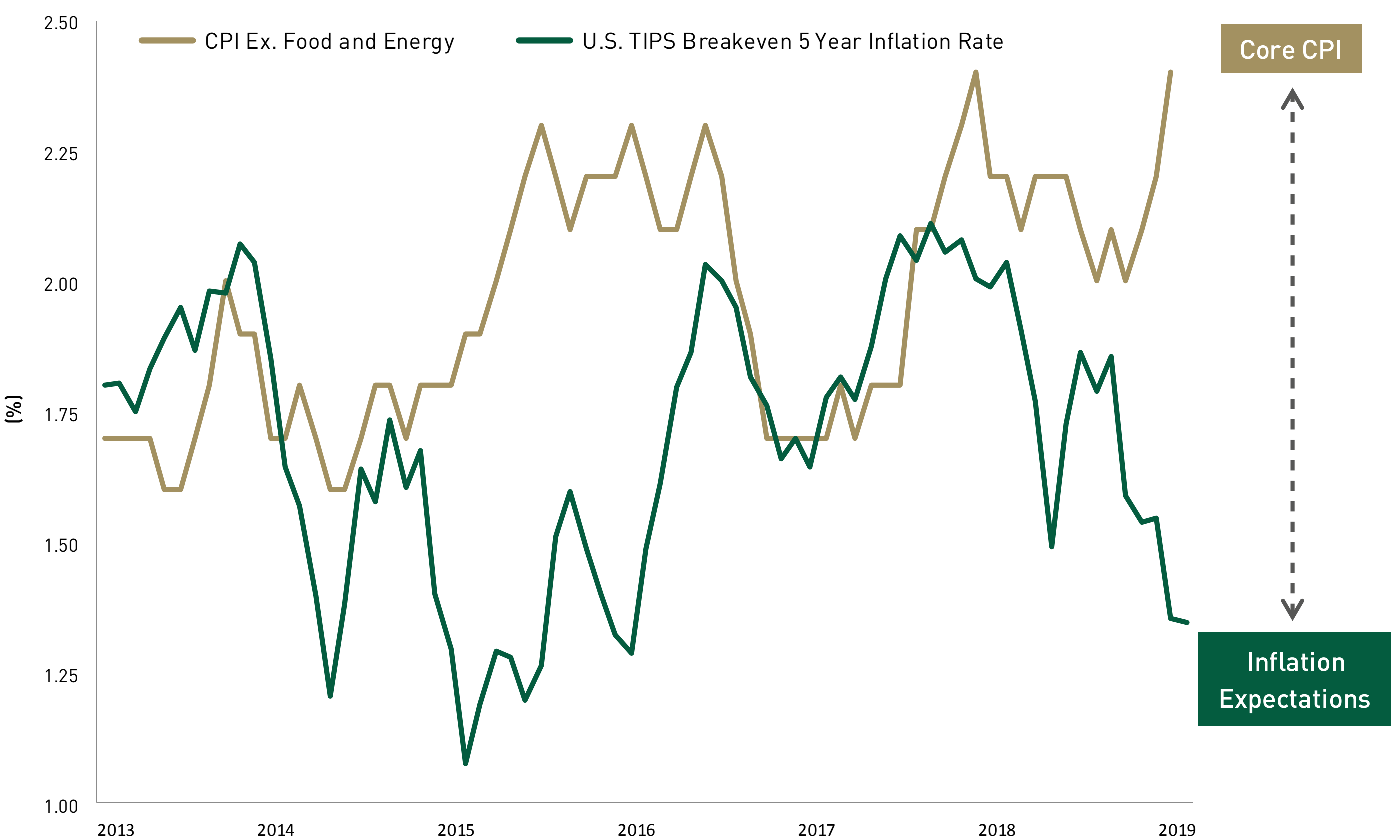
Chart 1. Might Investors Be Too Complacent about Inflation?



Source: Bloomberg.

CPI data as of August 31, 2019 and TIPS data as of September 30, 2019. **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

- Reports on the U.S. consumer price index (CPI, excluding food and energy) have showed year-over-year inflation exceeding market expectations for three straight months, yet inflation expectations continue to trend lower.
- Meanwhile, real (inflation-adjusted) yields are also quite low relative to current economic data. Although such a divergence suggests that the market is pricing in a material economic slowdown, the data so far does not support this view.
- It's a rare occurrence, historically, when dividend yields in the stock market are above the yield on U.S. Treasuries. Given valuations, we continue to see opportunity in equities.

MARKET

In our last *Market View*, we noted the factors that helped lift markets at the end of the third quarter, confounding the doomsayers. Here we discuss key disconnects between data and valuations and the opportunities they have created.

Instead of trying to predict the future for markets or economies, we believe investors are better served by asking whether the information they are considering is already reflected in market valuations. In our opinion, successful active managers look for divergences between actual data and valuations, because these differentials create investment opportunities. We see three divergences that merit consideration as we manage our portfolios.

1) **Real yields (ex-inflation) and inflation expectations are pricing in a much more negative economic and inflationary environment than we are likely to experience, in our opinion.**

We've now had three consumer price index (CPI, excluding food and energy) reports in a row where consumer prices have exceeded market expectations year over year (see Chart 1). And yet, inflation breakevens—market expectations for inflation in the future—have fallen sharply. While expectations can certainly differ from current levels, the magnitude of this differential today is striking, and typically does not persist. We think investors may be too complacent about the risk of a repricing of those expectations in 2020, which could have important implications for interest rates and U.S. Federal Reserve (Fed) policy.

2) **There is also a divergence between real yields embedded in Treasury Inflation-Protected Securities (TIPS) and U.S. gross domestic product growth.**

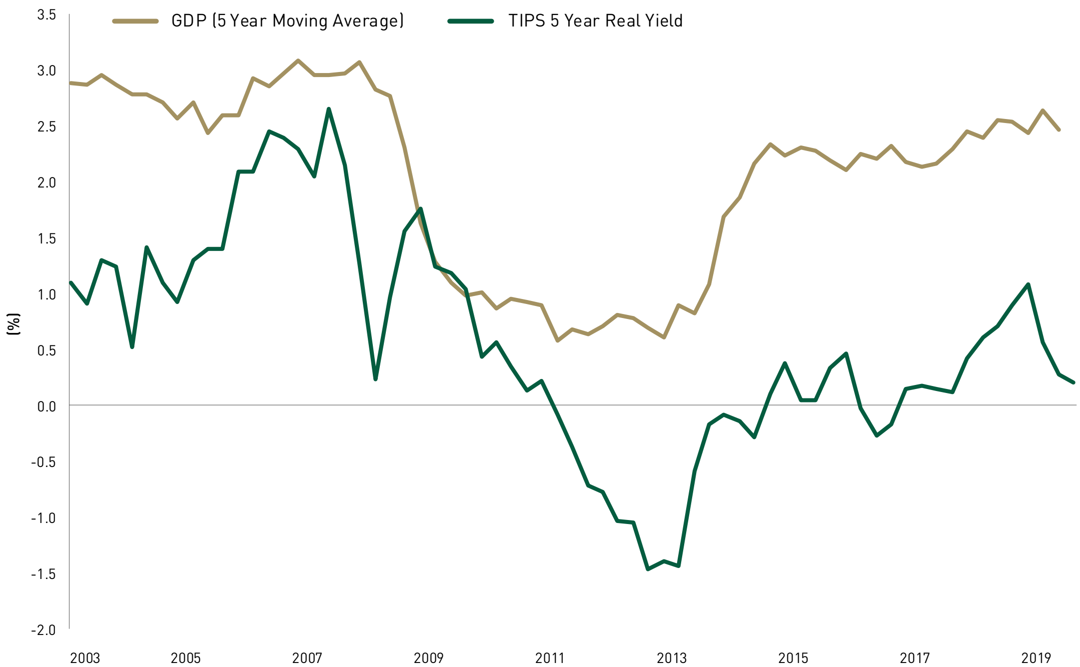
Real yields have collapsed along with yields in the broader U.S. Treasury market, apparently in anticipation of an economic slowdown. But that slowdown has not yet materialized, and even if it does, the fall in yields associated with economic deterioration has likely already occurred, in our opinion. Both nominal (outright) and real yields may be too low for the current level of economic activity.

These low levels of both inflation expectations and real yields relative to today's economic data suggest to us that the market is currently pricing in a material economic slowdown from current levels of activity. In our opinion, investors expecting to see rates fall in reaction to a slowdown in economic activity may be disappointed—rate market and inflation expectations are already pricing that in. Conversely, if economic activity muddles along as it has been, but fails to surprise the market to the downside, we could see a repricing of interest rates, resulting in higher rates and a steeper yield curve without any meaningful change in economic fundamentals.

DIVERGENCES

Chart 2. Given Steady Improvement in U.S. GDP, Are Real Yields Too Low?

Real GDP growth and five-year TIPS real yield (2003-2019)



Source: Bloomberg.

GDP data as if June 30, 2019 and TIPS data as of September 30, 2019. **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.

Another way to view this is in considering an index of economic surprises. That is, how has economic data differed from expectations? Although recent results have been mixed, they have been beating expectations by a considerable margin. Investors wondering about recent equity market strength in the face of seemingly negative economic headlines may consider that equity markets have been responding to the fact that the data was significantly better than expectations that were priced into valuations.

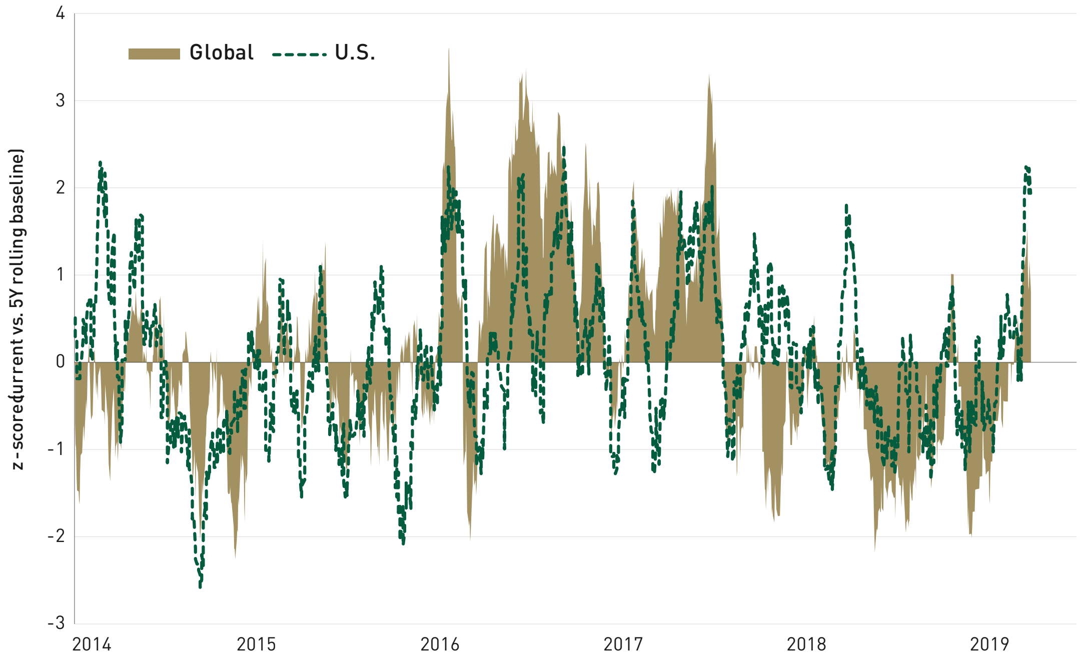
3. Dividend yields in the stock market have been above the yield on U.S. Treasuries.

In our opinion, bond market valuations suggest there is still opportunity in equities.

It's a rare occurrence, historically, when dividend yields in the stock market are above the yield on U.S. Treasuries. But that is where we have been recently (as of September 30, 2019), with the yield on the S&P 500 Index at 1.9% and the yield on the 10-year Treasury at 1.5% (see Chart 4).

Chart 3. Economic Data Have Started to Outperform Forecasts after a Long Stretch of Shortfalls

Real GDP growth and five-year TIPS real yield (2003-2019)



Source: Bloomberg.

Data as of September 30, 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. A Z-score is a numerical measurement used in statistics of a value's relationship to the mean (average) of a group of values, measured in terms of standard deviations from the mean. If a Z-score is 0, it indicates that the data point's score is identical to the mean score. **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.

Typically, when the stock market yield exceeds bond yields, the stock market starts to outperform the bond market quite strongly. And we believe we've started to see that; even though bonds continue to rally, equity markets are rallying more. If the pessimism starts to fade and the economy really starts to improve—as it has already in housing and consumer spending—we believe there will be material room for this relationship to normalize. Again, market moves are about relative considerations, and right now, we believe equity market valuations appear unusually attractive relative to interest rates.

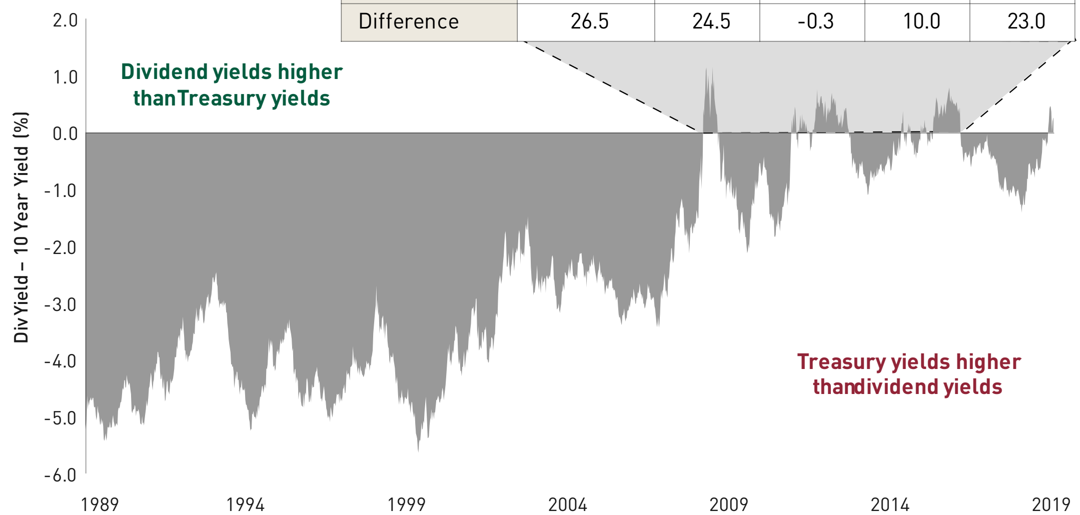
For investors who are looking for yield in a very low-yield environment along with the potential for price improvement, investments that emphasize harvesting dividend yield may warrant a closer look.

POTENTIAL

Chart 4. U.S. Equities are Currently Offering Higher Yields Than Treasuries

S&P dividend yield versus 10-year Treasury yield (1989-2019)*

	Index Returns over following 12 months				
	12/1/08 - 11/30/09	10/1/11 - 9/30/12	2/1/15 - 1/31/16	10/1/15 - 9/30/16	2/1/16 - 1/31/17
S&P 500	25.4	30.2	-0.7	15.4	20.0
10 year Treasury	-1.1	5.7	-0.4	5.4	-3.0
Difference	26.5	24.5	-0.3	10.0	23.0



Source: Bloomberg. Data as of September 30, 2019. *As represented by the Bloomberg Barclays U.S. Treasury Index. **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.

Summing Up

As we pointed out in our previous *Market View*, we believe investment opportunities are at their highest when perceived reality wrestles with the actual data. As active managers, we look for times like these because it will often present new investment avenues to explore as we manage portfolios for our investors. In our opinion, this is such a time.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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Glossary of Terms

The **Consumer Price Index (CPI)** measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation. Essentially it attempts to quantify the aggregate price level in an economy and thus measure the purchasing power of a country's unit of currency.

A **bond yield** is the return an investor realizes on a bond.

A **Dividend yield** refers to a stock's annual dividend payments to shareholders, expressed as a percentage of the stock's current price.

The **real yield** is the nominal yield of a bond minus the rate of inflation. If a bond yields 5% and inflation is running at 2%, the real yield is 3%.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bond designed to help investors protect against inflation. These bonds are indexed to inflation, have U.S. government backing, and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

U.S. Treasury bills, notes, and bonds are fixed-income securities issued by the U.S. government.

The **Bloomberg Barclays U.S. Treasury Index** is the U.S. Treasury component of the U.S. Government Index. The index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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