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MARKET VIEW

FIXED-INCOME OUTLOOK: OUR EXPECTATIONS FOR 2018

Lord Abbett experts offer their views on the prospects for key asset classes in the coming year.

IN BRIEF

- What factors might influence fixed-income markets in 2018? We asked Lord Abbett investment professionals for their views.
- For U.S. fixed income, Tim Paulson, Lord Abbett investment strategist, sees strong economic growth, supportive central banks, and positive technicals continuing to support bond markets.
- Brian Arsenault, Lord Abbett investment strategist, says the backdrop fostering a positive environment for U.S. high-yield credit remains in place.
- In emerging markets (EM), John Morton, Lord Abbett portfolio manager, notes benign global economic conditions, and an improving macro outlook for many EM economies, particularly in terms of growth.
- For municipal bonds, Daniel Solender, Lord Abbett partner and director, observes that most of the positive trends during 2017 should continue into the new year, including favorable supply/demand conditions and overall credit quality.

From rate hikes to geopolitical upheavals to a proposed overhaul of the U.S. tax code, this has been an eventful year for fixed-income markets. As 2017 draws to a close, what, then, should investors be watching for as the calendar changes? What follows are insights on key asset classes provided by, respectively, Tim Paulson, Lord Abbett investment strategist, fixed income; Brian Arsenault, Lord Abbett investment strategist, leveraged credit; John Morton, Lord Abbett portfolio manager, Emerging Market Corporate Debt Fund; and Daniel Solender, Lord Abbett partner and director, municipal bond strategies.

U.S. FIXED INCOME

Tim Paulson

Policy accommodation from central banks should continue to support riskier assets and growth.

For risk assets, 2017 was a strong year, characterized by low volatility and accelerating global growth prospects. As one would expect, higher-beta assets, such as equities, high-yield bonds, and emerging-market debt, were the primary beneficiaries. As we head into 2018, we expect to see more of the same, albeit with lower overall return targets, thanks to continued accommodative tendencies from central banks around the world, an increasingly coordinated pattern of accelerating global growth, and a positive technical backdrop of significant global liquidity.

In our view, policy accommodation from central banks should continue to support riskier assets and growth in two different ways. First, these policies keep financial conditions easy around the world, helping boost economic growth. Second, they create a market environment in which investors are continually incentivized to move into riskier investments in order to achieve higher returns.

None of that would matter, however, without solid underlying fundamentals. But we have reached a point where most of the economies worldwide are participating in the global growth story. It is not necessarily rapid growth, but it is a far better scenario than markets were expecting a year ago. We can see the results in the form of strong earnings, higher equity markets, and tighter credit spreads. As long as this concomitant growth—across both developed and emerging markets—continues, all risk assets have the potential to perform well, led by the higher-beta sectors. And at this point, there are no data to suggest anything other than an extension of this developing growth story, and, potentially, another year that favors higher-returning risk assets.

So, given this environment—strong growth, supportive central banks, and positive technicals—what is our expectation for markets in 2018? Yields likely will rise, albeit slowly, and consistent with economic growth. Credit spreads may well continue slowly to tighten, although not as much as they did in 2016 and 2017. So, instead, we believe the best performing strategies will be those that have higher yield, and don't need price appreciation to generate returns. Two categories that come to mind here are U.S. high-yield bonds and emerging-market corporate bonds (more on those below).

There are risks, of course. Geopolitical risks are impossible to predict, and can roil markets. Data could turn sour, and in turn be used to threaten a pullback in growth, or even recession. So then in such situations, one question we will need to ask ourselves during periods of stress is whether there has been a fundamental change to the global growth outlook or to the tendencies of global central banks to prevent downturns. Barring such a material shift, though, we think market pullbacks will continue to represent good opportunities to add to risk assets.

U.S. LEVERAGED CREDIT

Brian Arsenault

We expect defaults to continue to trend lower in the new year.

After a lengthy period of smooth sailing in 2017, the U.S. high-yield bond market experienced some volatility late in the year. Nonetheless, the benchmark BofA Merrill Lynch U.S. High Yield Index returned 7.2% year to date through November 30, 2017. There have been a variety of reasons cited for the volatility, including impending U.S. tax legislation and rising geopolitical tensions—which we believe, however, are not the key drivers of the weakness. We note instead that the selling was driven by company- and sector-specific developments, not a weakening in overall market fundamentals.

Despite this recent volatility, we believe that the backdrop fostering a positive environment for high-yield credit remains in place. Our first reason to believe such is that economic growth appears to be on a steady, if unspectacular, track in the United States. Growth prospects in Europe and Asia also are positive. With

U.S. inflation firmly in check, the U.S. Federal Reserve (Fed) should be able to proceed with its program of policy normalization. Also, high-yield default rates remain well below historical averages, according to J.P. Morgan index data.

At the sector level, we note that telecom, health care, retail, and media are facing secular headwinds, which are impeding them from benefiting from the improving economy. These sectors are being challenged by issues ranging from "cord cutting" in media/telecom to the impact of e-commerce on retail and various investigations into generic pharmaceutical issuers. To be sure, valuations on some of these groups may reach more appealing levels in the months to come, providing opportunity in select names. Meanwhile (as of late 2017), we are more positive on prospects for the energy, transport, and metals/mining groups.

The bottom line: We are still relatively constructive on the U.S. high-yield market, and expect defaults to continue to trend lower in the new year. *[Remember that high-yield, lower-rated securities involve greater risk than higher-rated securities.]*

Returns on another leveraged-credit sector, floating-rate loans, have trailed high yield thus far in 2017, but remained solidly positive, with the representative Credit Suisse Leveraged Loan Index up 3.9% through November 30. (Note that the investment-grade benchmark Bloomberg Barclays U.S. Aggregate Bond Index gained 3.4% during the same period.) We believe the floating-rate market will continue to benefit from low default rates, and that a slightly more active Fed may help enhance all-in yields on the asset class. The key challenge remains the pace of loan repricings. If the asset class continues to attract inflows and interest from collateralized loan obligation investors, companies likely will be able to refinance outstanding deals with lower coupons, which may temper the benefit from rising interest rates.

EMERGING MARKET CORPORATE DEBT

John Morton

We expect a widening growth gap between emerging and developed markets.

Our long-held positive stance toward emerging-market (EM) corporate debt has been supported by two factors: a benign global backdrop and an improving macro outlook for many EM economies, particularly in terms of growth. With 2018 drawing near, we maintain our constructive view of the EM corporate story.

It is true that the past month or so has been a bit of a rough patch, including some volatility, but the emerging-market corporate debt space has been through such episodes before, and we see pull-backs as good opportunities for investors to purchase these securities at attractive prices. *[Although, there is no guarantee that this market trend will continue in the future.]* Indeed, the asset class, as represented by the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified, was up 7.6% year to date through November 30. This is because our base case still calls for a continuation of the coinciding global recovery, a widening growth gap between emerging and developed markets, and continued "lower for longer" levels of global interest rates.

As for the largest emerging-market economy, we expect China's growth to remain robust. Commodity prices have picked up, supporting terms of trade (that is, export prices relative to import prices) in emerging economies, broadly speaking. Europe's strong cyclical momentum also is a plus for EM economies.

Indeed, there are signs of a change in market dynamics, including the lack of contagion and the impact of growing domestic pension funds, which act as a cushion. If these changes are structural rather than transitory, such a development could signal that EM corporate bonds, as an asset class, are becoming more of an investable alternative to their developed-market counterparts. *[Note that international investing involves risks, which are often heightened for investments in emerging/developing markets or smaller capital markets.]*

MUNICIPAL BONDS

Daniel Solender

In 2018, muni investors will be closely watching tax-code changes and the Fed's interest-rate moves.

As we approach the end of 2017, it is uniquely challenging to develop a municipal-bond market forecast due to the uncertainties surrounding the U.S. tax bill currently making its way through Congress. Features of the original drafts, especially the House version, could lead to dramatic municipal-bond market changes, particularly if private-activity bond issuance is eliminated because issuers such as airports, hospitals, and universities can no longer borrow at tax-exempt rates. Still, when thinking through the probabilities of potential outcomes, our base case is that if a tax bill attains approval, it likely will not result in the most punitive outcomes for municipal-bond issuers.

With this as our starting point, we believe 2018 likely will be a positive year for the municipal-bond market, although expected returns likely will not be as high as they were during 2017. The strong showing in the past year—the representative Bloomberg Barclays Municipal Bond Index returned 4.6% year to date through November 30—reflected the market recovery after the sell-off at the end of 2016, in a pique of response to the U.S. presidential election. Globally, asset-market volatility has been low, as the Fed has been successfully tightening policy, and market expectations are that the Fed will continue to make gradual changes, which will be partially targeted toward restraining interest rates from rising dramatically. This is important for the municipal-bond market because relative value is often calculated based upon the ratio of municipal-bond yields to Treasury bond yields. As of this writing, the yield ratios have been on the lower end of the range in recent years, but close to their historical, pre-2008 (credit crisis) levels.

Because the municipal-bond sector is dominated by individual investors, with approximately two-thirds of the bonds in retail hands, according to Federal Reserve data, the market's direction can change quickly based upon investor sentiment. While most of the trends from a positive 2017 remain in place, the market in 2018 could potentially feature many similarities. Some of the specific trends that likely will continue are:

- Strong demand for mutual funds and separately managed accounts due to the attractive tax-equivalent yields compared to other markets;
- Average levels of new issue supply, as issuers remain concerned about adding too much debt due to uncertainties regarding economic growth and tax policy; and
- Positive credit trends as most municipal-bond issuers continue to have steady revenue growth, while containing expenses in the slowly growing economy.

Demand for professional management of municipal-bond portfolios could actually increase after the Municipal Securities Rule-making Board's new markup rule becomes effective. Certainly, issuers facing credit or fiscal challenges, such as Puerto Rico and Illinois, will remain in the headlines, as they work through their issues. But the historically strong overall credit quality and low default rates of the municipal-bond market likely will continue to present attractive investments for investors. *[Investors should be aware that the municipal market can be affected by adverse tax, legislative, or political changes, and by the financial condition of the issuers of municipal securities.]*

IMPORTANT INFORMATION

A Note about Risk: TThe value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results. Special risks are inherent to international investing, including those related to currency fluctuations and foreign, political, and economic events. The securities markets of emerging countries tend to be less liquid, especially subject to greater price volatility, have a smaller market capitalization, have less government regulation and may not be subject to as extensive and frequent accounting, financial and other reporting requirements as securities issued in more developed countries. Further, investing in the securities of issuers located in certain emerging countries may present a greater risk of loss resulting from problems in security registration and custody or substantial economic or political disruptions. 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. No investing strategy can overcome all market volatility or guarantee future results. Diversification does not guarantee a profit or protect against loss in declining markets. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

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Glossary of Terms

The **Bloomberg Barclays Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index is a broad measure of the municipal bond market with maturities of at least one year.

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, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

The **BofA Merrill Lynch U.S. High Yield Constrained Index** is a capitalization-weighted index of all U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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The **J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD):** The CEMBI is a market capitalization weighted index that tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries.

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