## 2020 Investment Outlook:

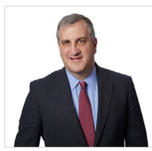
# In the United States, the Optimists May Prevail

**Our investment experts discuss the outlook for the U.S. economy and markets in a presidential-election year, revisit the U.S. recession narrative, and assess the circumstances that might indicate a return of inflation.**

*Contributing Managers*

**Thomas O'Halloran**

**Giulio Martini**



**Daniel Solender**

**Leah Traub**

**Kewjin Yuoh**

**Tim Paulson**

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*We recently gathered six Lord Abbett investment leaders for a wide-ranging discussion of the current market and economic environment and to elicit their views on key investment themes for 2020.*

*In this second of a special three-part Market View, our experts discuss the outlook for the U.S. economy and U.S. markets.*

*Our panel featured Lord Abbett Partners Thomas O'Halloran, Portfolio Manager for innovation growth strategies; Giulio Martini, Director of Strategic Asset Allocation; Daniel Solender, Director of Tax-Free Fixed Income; Leah Traub, a currency expert and Portfolio Manager for Taxable Fixed Income; and Kewjin Yuoh, Portfolio Manager for Taxable Fixed Income. Tim Paulson, Investment Strategist, moderated the discussion.*

When our panel of investment experts last met in May 2019 for our Midyear Outlook discussion, U.S. investors were reflecting a level of pessimism that seemed to belie our experts' expectations for continuing economic growth.

"In retrospect," Traub said, "it is clear that the market was focusing on the trade tensions between the United States and China and the slowdown in manufacturing as a result of those disputes. But we were looking at consumer sentiment and spending, which was super strong. And we did not see a spillover from the manufacturing slowdown to the rest of the economy."

The consumer is the major powerhouse behind U.S. economic growth – manufacturing less so, according to Traub. "And strength there remains a key factor behind our constructive outlook for the U.S. economy."

Yuoh added, "Whether it was an inverted yield curve or a trade-related global growth slowdown, the market was looking for a reason that the current business cycle might end. But Giulio [Martini] insisted that this expansion can keep going – given that there are a few things that usually kill expansions and we don't have those conditions just yet."

### Outlook for Recession

"That is correct," Martini said. "Recessions begin typically because the economy develops excesses – either excess demand that manifests itself in accelerating inflation (and we don't have that problem at the moment) or imbalances in financial markets which manifest themselves in valuations that are exaggerated or excessive leverage (and we don't have those problems at the moment either)."

"Another cause of past recessions or at least a contributing factor" Martini continued, "are spikes in oil prices, which have been implicated in every U.S. recession since the mid-1970s (and are also not a problem today). So there really isn't a cause that would make you think there will be a recession anytime soon, despite the fact that we've been growing for so long."

"The consumer is the major powerhouse behind the U.S. economic growth – manufacturing less so – and strength there remains a key factor behind our constructive outlook for the U.S. economy."

— Leah Traub

**In Brief**

- The recession narrative continues to evolve as investors look for evidence of what they fear most: an economic downturn. Our panelists see no evidence of a U.S. recession in 2020.
- Investors shouldn't assume that inflation protection in their portfolios is no longer necessary. U.S. inflation may be dormant, but we believe it's not dead.
- U.S. states and local municipalities are beginning 2020 in better fiscal shape than they have been in years. Given the tax benefits for U.S. investors, we believe demand for municipal bonds should remain strong.
- A presidential election year may contribute to volatility, but we believe the underlying fundamentals of the U.S. economy will provide ballast to the markets.

Looking to 2020 and beyond, Martini said, "I don't believe we're going to have a recession in 2020. And if we have one in 2021 the dynamic that's going lead to it has yet to really develop."

"Since we're in the longest U.S. economic expansion ever, 124 months and counting, everybody's kind of suffering from a collective case of 'end of cyclitis.' There's no clear recession narrative out there that's actually starting to play out. So I think people have started to kind of make one up. They simply won't accept that an economic expansion can go on for as long as this one has."

One of the recession narratives, according to Martini, is the expectation that trade and tariff tensions will lead to a slowdown in capital spending as businesses try to adapt. "And we've actually seen that slowdown in capital spending. he observed. "According to that narrative, the slowdown would then lead to a slowdown in employment, then consumer confidence would be hurt, then consumer spending would roll over, and that would take us into a recession. That's really not a sequence that we've seen in the past. But people are looking for a downturn kind of narrative. And that one kind of sounds logical."

"But it's exaggerated at almost every step of the way. What the slowdown in capital spending has given us is a decline from 2.3% average GDP for the current expansion to something like 2%. That fact is 2% growth doesn't come close to a recession. In fact, it's still above trend and it's still enough to bring unemployment down," Martini concluded.

### The Tax Effect

Solender reminded his peers on the panel that another reason for investor pessimism in the spring of 2019 was the impact of the Tax Cuts and Jobs Act of 2017, which reduced withholding from paychecks and placed a cap on withholdings on state and local taxes. "A lot of people in states like California, New York, and New Jersey found their tax bills were much higher than they had expected. Come April and May, they had big payments to make to the IRS, and that was an unpleasant surprise."

Investors were also concerned about what the Fed [U.S. Federal Reserve] was going to do in terms of interest rates, Solender said. "With the Fed's easing in July and then again in September and October, consumers have grown more comfortable. Their borrowing rates are lower. They're earning good money in the stock market. They may even be getting used to higher taxes!"

The good news extends to the state and local level as well, Solender added. "Tax payments have added to surpluses all over the country, including in California (which just experienced its largest surplus ever), New Jersey (where the surplus allowed them, for the first time in a decade, to put some money into a rainy day fund) and Illinois (which just made its first full bond payment this year [2019])."

"We have to get concerned a little bit on the federal level," Solender said, " where the deficit is growing. The U.S. economy has to keep growing to pay for that. But that's something that people are looking at in the future; they are not as concerned about that now."

Solender also mentioned the positive impact of the Tax Act on municipal bond mutual funds, which as an industry has seen inflows of $70 billion year-to-date (as of November 30, 2019).

### Inequality of Economic Gains

While mindful of all the good news about consumers, Yuoh added a cautionary perspective related to the inequality of the gains.

"There are a lot of good things going on for the consumer," Yuoh said "whether it is the wealth effect, low interest rates, and strong household balance sheets. But consumer confidence and sentiment indicators have been trending down a bit over the last six months, and the quality of jobs that have been added is not high – kind of the higher risk, more precarious, lower-wage type of jobs. "

"Nearly 28% of U.S. consumers have a FICO score [a measure of consumer credit risk] below 650," Yuoh continued. "That means they're paying rents because they can't get a mortgage. And they're borrowing cars at excessively high interest rates. That's a large chunk of the population that isn't participating in this 'consumer-led' recovery. So to the extent that we are basing our outlook on the health of the U.S. consumer, there is a certain amount of volatility that should be factored in as a result of these economic disparities."

### A Presidential Election Year

Speaking of volatility, Solender reminded everyone of what may be a key factor behind U.S. market volatility in 2020 – the presidential election.

"One of the wild cards next year will be how the China-U.S. trade talks develop. China may even delay a trade agreement to see if they will still have to negotiate a deal with President Trump going forward or with someone else."

Solender reminded the panelists that the U.S. stock market turned on a dime with every bit of news about the trade talks in 2019. "So there should be a lot of uncertainty built into our 2020 outlook in terms of how U.S. markets will perform," he said.

### Valuation Headwinds

Yuoh agreed. "When we're looking at an event risk like trade disputes or an election, we think of it in terms of the impact it will have on markets. With regard to elections, markets generally do better after the event. And that's because the market has already priced in uncertainty risk by keeping valuations at somewhat higher levels. Once the uncertainty is lifted, valuations typically return to more normal conditions."

Yuoh further elaborated on this point following the panel discussion:

> *"I like to think about volatility with regards to the pricing of the unknown and separately, the unexpected. Using the 2016 election as an example, given the "unknown" and uncertainty around an outcome, volatility should be higher and spreads should be wider to compensate for the unknown leading up to the event. Then, once the event passes and the outcome is known, volatility should decline all else being equal; hence, as we observe, risk assets generally do better post-election.*
>
> *The 'unexpected' is when the outcome is a non-consensus result and one of significant surprise, again a la Trump and the 2016 election. Post-event, the 'unexpected' drives volatility yet higher, but again, this can be an opportunity to purchase when the event has little ramifications on the immediate fundamental outlook. Once the 'unexpected' result and the higher premium initially attached to volatility and risk have passed, valuations can again return to values which reflect fundamentals."*

"But if you look at valuations right now," Yuoh continued, "it would seem that we're not pricing in enough uncertainty for that event risk, for the unknown and the unexpected. In fact, the divergence between valuations and fundamentals is very stark to me. That's something we will have to pay close attention to in 2020. So to Dan's [Solender] point, that could be a headwind to valuations at least in the coming year."

> "I don't believe we're going to have a recession in 2020. And if we have one in 2021, the dynamic that's going to lead to it has yet to really develop."
>
> — Giulio Martini

The election is "front and center right now" according to O'Halloran, "especially with impeachment in the news. And I agree with Kew that this will affect volatility and act as a headwind. I'm already seeing this in the growth market where a lot of individual stocks with stable earnings growth are now worth more than fast growth stocks. I haven't seen that for a couple of years now. "

Solender added, "Volatility will be a factor for markets in 2020, as the polls move up and down and trade talks continue, or not, but no matter what seems to happen, the U.S. economy continues to show strength and inflation is staying low – and those factors will have a positive impact on markets in 2020."

"Tax payments have added to [local and state] surpluses all over the country, including in California, New Jersey, and Illinois."

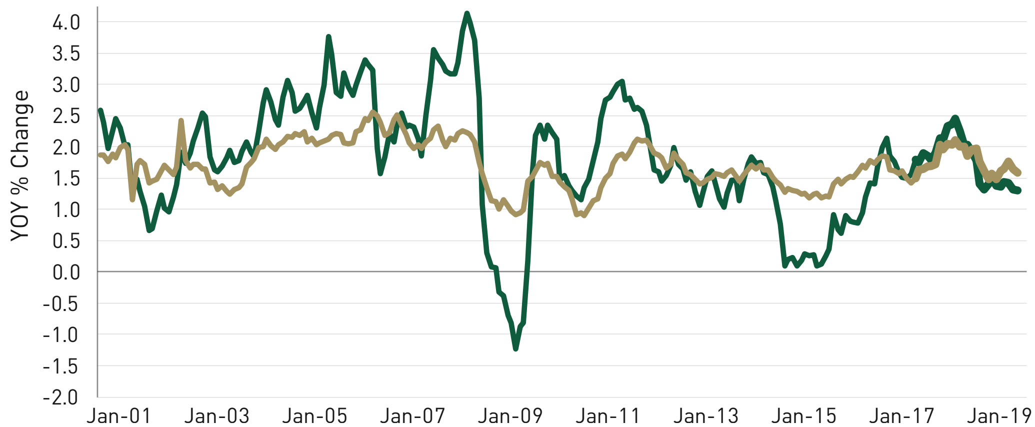
— Dan Solender

## The Risk of Inflation

Paulson asked the panel to address the subject of inflation. Will it, as Solender suggested, remain low in the United States in 2020?

**Chart 1: The U.S. Federal Reserve's Favored Inflation Indicator Remains Below 2%**

*U.S. PCE deflator (all items and ex-food and energy), January 31, 2001-October 31, 2019*




Source: U.S. Bureau of Labor Statistics. Data as of October 31, 2019.

"Well, I'm a Sherlock Holmes fan," Martini said. " I think the way to solve the mystery of why we've had such a long period of good asset market returns, interest rates very low, equity market valuations above historical norms, spreads tightening to sort of below historical norms in many part of the credit market etcetera, is that the inflation dog hasn't barked yet."[1]

"And let me just say definitively," Martini continued, "that inflation is dormant, but it is not dead. I don't think inflation will be a story for 2020 in the United States or in the rest of the world. But I do think the dog will bark again in 2021 and beyond."

"One of the classic signs of inflation," Martini said, "is wages starting to accelerate consistently and beyond productivity growth – something that happens when the unemployment rate gets to a very low level. We see that unfolding right now. And even though it's not pressing or accelerating rapidly enough to generate widespread price increases, if the economy keeps growing and the labor market stays as tight as it is, or tightens further, we're going to see that translate into higher prices. Inflation is not a near-term problem. But we can't just forget about it and start investing as if it's never going to return or that inflation protection in the portfolios isn't necessary."

O'Halloran agreed. "We can't write inflation off. But we're certainly very surprised that it hasn't surfaced by now. And that's why a number of people were thrown off by the Fed's rate cuts in 2019, after having raised interest rates for quite a while and shrunk the balance sheet. Those rate cuts provided fuel for the equity markets all year."

O'Halloran believes the technology revolution is having an impact on lowering U.S. inflation, because "it is cutting down on distance, space, and time and the costs associated with those factors. That is certainly the case with e-commerce. And the impact [of the tech revolution] as a force containing inflation is, if anything, getting more powerful as the processing gains continue to grow exponentially."

"The tech revolution is doing a very good job in a free-market system of providing more and better things and services for the same price to consumers," O'Halloran said. "That's an ongoing trend. And consumer spending is the powerhouse of the U.S. economy. The U.S. economic expansion is still healthy; inflation is under control; our system of laws is very robust and will carry us through any political controversies – all of which makes me bullish for equities going into 2020," he said.

**Fed Accommodation**

"I think all of that adds up to a little bit better outlook for 2020 than we had for 2019," Martini said. Going into 2019, investors were relentlessly pessimistic. Cash levels early in the year were as high as they had been since 2008-09. Investors were looking for safety. Going into 2020, I think it would really be quite a surprise for investors if things turned out to be better than expected rather than worse than expected.

"Even a little bit of a slowdown would not be bad. It would allow the Fed to maintain low interest rates. And the fact that the Fed is still in a position where it can respond to an economic slowdown by providing monetary support and monetary accommodation has been very, very important to the financial markets," Martini concluded.

> "The divergence between valuations and fundamentals is very stark to me. That's something we will have to pay close attention to in 2020." — Kewjin Yuoh

**Next:**
**Lord Abbett investment professionals assess prospects for key asset classes in 2020.**

[1] The 1892 book, the *Memoirs of Sherlock Holmes*, by Sir Arthur Conan Doyle, contains a collection of short stories. One of the stories is "Silver Blaze," a mystery about the disappearance of a famous racehorse the night before a race and the murder of the horse's trainer. Sherlock Homes solves the mystery in part by recognizing that no one he spoke to in his investigation remarked that they had heard barking from the watchdog during the night. In short, the absence of expected facts can have meaning.

> "The impact [of the tech revolution] as a force containing inflation is getting more powerful, as processing gains continue to grow exponentially" — Tom O'Halloran

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