Eye on Equities

Stocks: Doom and Gloom Leave the Room

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Following the financial market crisis in 2008, investors fled to ultra-low-returning assets. This initial manifestation of risk aversion was quite understandable, given the events of that period, and, to no small extent, it also reflected forced selling. We believe lingering risk aversion, even as equity indexes recently traded near all-time highs, has been fueled in part by the crescendo of dystopian predictions. Moreover, a proliferation of niche asset class products—for example, inverse exchange-traded funds that rise if the market falls, and gold funds—that are poised to capitalize on doomsday scenarios, have garnered attention based on this fear. The good news is that, in recent years, the doom-and-gloom message has been slowly discredited by events—and may have reached its coda.

Ever since the equity markets fell halfway from their peak between October 2007 and March 2009, the sport of "dystopian forecasting" has crept from its rightful domain of the crackpot beehive of chat rooms and bar stools and has seemingly made its way into investor consciousness and legitimate financial news. These forecasters, who hold that the era of comeuppance and disaster is on the horizon, made their bones nearly five years ago by being correct for one shining moment: the 2008–09 equity plunge. This "I told you so" outcome seemingly validated all their über-bearishness over the years.

"I would expect equities to correct another 20% from here…there is a high risk of a double-dip recession in the United States."—Nouriel Roubini, 2010[1]

This is not, however, to say that there were not correct and well-argued prognostications of the 2008 financial crises that were grounded in solid research. But the doom-and-gloomers, having tasted victory, didn't know when to quit: many cataclysmic forecasts of the 2008 fallout were followed by prognostications of even greater peril in the years that followed. (We've provided select examples in this article.) Such forecasts were accompanied by recommendations by their respective advisory or asset management firms to hold cash, to hold commodities, and/or to short the U.S. dollar—recommendations that could not have served their clients well during that period.

Table 1. After Bottoming in March 2009, Stocks Outpace "Doom and Gloom" Investments
(Asset class performance % change)

Lipper Classification	2012	2011	2010	2009	01/01/2009 to 12/31/2012 Cumulative Return	01/01/2009 to 12/31/2012 Annual Return
Large cap stocks: S&P 500 Index[2]	16.00%	2.11%	15.06%	26.46%	72.37%	14.58%
Small cap stocks: Russell 2000 Index[3]	16.35%	-4.18%	26.85%	27.17%	79.86%	15.81%
Bonds: Barclays U.S. Agg. Bond Index[4]	4.21%	7.84%	6.54%	5.93%	26.84%	6.12%
Commodities: S&P GSCI Index[5]	0.08%	-1.18%	9.03%	13.48%	22.37%	5.18%
Cash: 30-day Treasury bills[6]	0.06%	0.04%	0.12%	0.10%	0.32%	0.08%

Source: Bloomberg.
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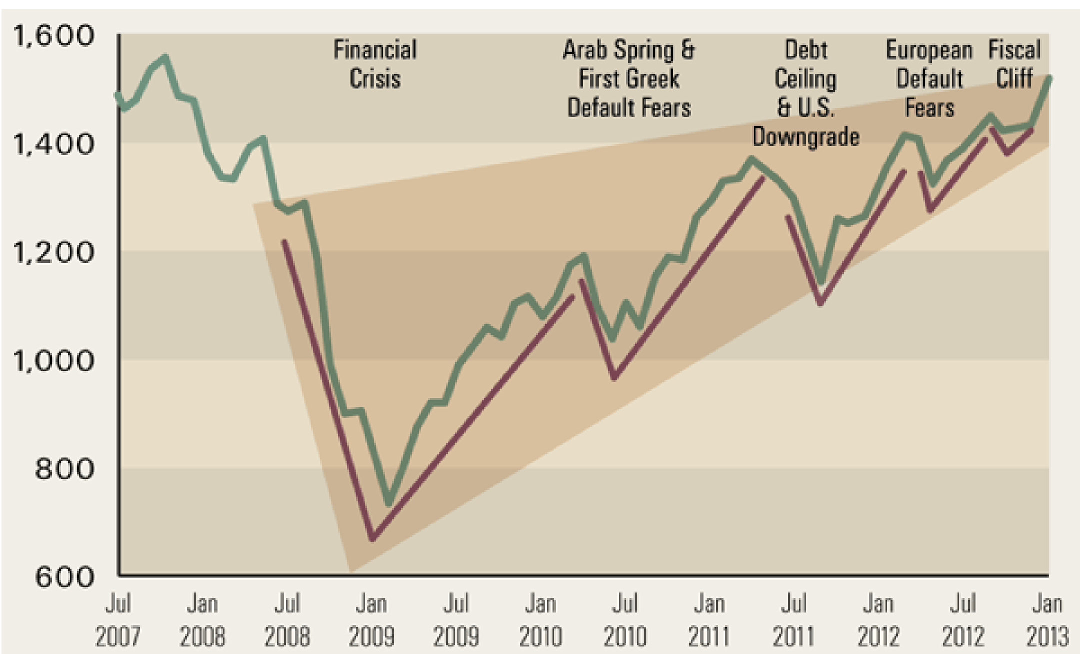
The Wall Street Cassandras, meanwhile, have kept busy. Citing a looming bankruptcy of the U.S. government or even the collapse of the dollar causing hyperinflation, there has been no shortage of plot lines for an imminent collapse of the U.S. economy and its capital markets. In such a scenario, only those with an underground stockpile of gold bars and cans of tuna will likely reap the rewards for their clairvoyance.

We believe the probability of a significant weakening of the U.S. economy and financial markets has diminished substantially. And as the equity market's multiyear advance continues in 2013, the apocalyptic perspective has faded from investor discourse on market fundamentals. A return to rational thought and market normalcy in the U.S. corporate environment, coupled with an economy growing at a sluggish 2% annual rate, may be considered a success compared with the dire outcomes that had been forecast and priced into valuations over recent years.

There is no question that macroeconomic headwinds remain, most notably the uncertainty around how historic central bank stimulus programs become unwound along with significantly larger national debts in the developed world. However, from the trough of pessimism in early 2009 to today, it is difficult to ignore the successes in rehabilitating the financial health of corporate America and, to some extent, the balance sheets of households.

Bull and Bear Markets Will Likely Happen, but Chaotic-event Risk Likely Has Diminished
Certainly, looking at just the behavior of equity indexes, the risk-on, risk-off reactions that have characterized the equity markets between 2008 and the first half of 2012 have declined quite noticeably. In Chart 1, we can see an illustration of the decline in the magnitude of V-shaped reactions to macro events in the S&P 500® Index.

Chart 1. Equity Markets Are Adapting to Diminished Macro Risk
S&P 500 Index (as of 01/31/2013)



Source: Bloomberg and Lord Abbett.
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Active equity managers look at this chart and generally view this trend as a positive for stock picking. It appears that an era where bouts of macro fear (risk off) and subsequent relief that the worst didn't happen (risk on) dominated the performance of stock returns is coming to an end. Investors appear once again focused on fundamentals. More important, however, investors who have viewed the 2008 experience as Exhibit A as to why they should no longer hold stocks are seeing a parting of the storm clouds, as demonstrated by the sizable outflow from cash and money market funds that created a strong rise in equity mutual fund inflows during the first seven weeks of the year.[7]

From Steroid-era Corporate Leverage to Healthy and Wealthy Balance Sheets

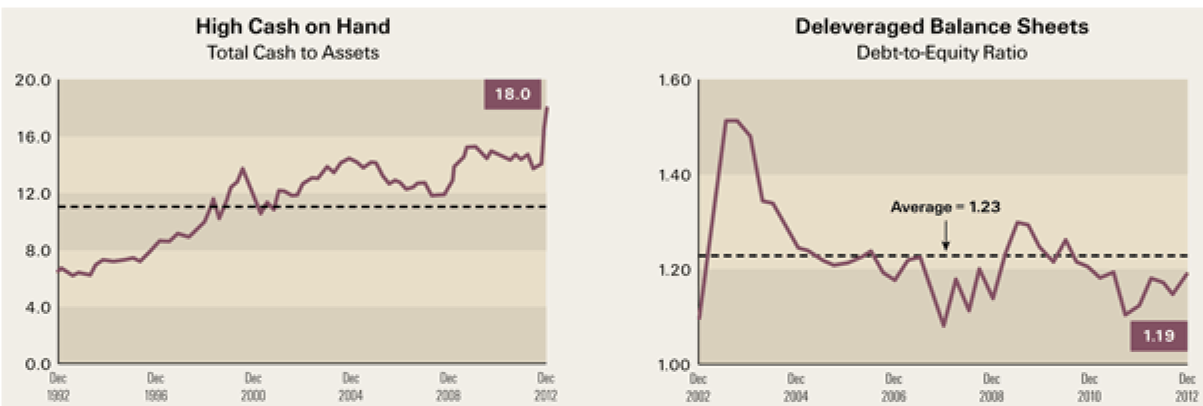
"I am just as convinced that people who have their money in U.S. dollars are going to be just as broke as people who had their money with [convicted financier Bernard] Madoff. I do not know how much time you have. At some point a year from now, the dollar could be dropping 5% a day"—Peter Schiff, CEO of Europacific Capital, 2008[8]

One of the positive outcomes from the pain of 2008 was the forced deleveraging of corporate balance sheets. As the result of a perfect storm of weak mortgage underwriting, cheap borrowing, and unchecked securitization of debts, it appeared that the pre-crisis corporate landscape in many U.S. sectors became heavily overleveraged, and many companies relied on this leverage to deliver profits. Return on invested capital was largely derived from a charged boost from leverage—say, turning a 2% return into a 15% return—rather than organic growth.

Once it was realized (alas, too late) that any decline in asset values would send companies and consumers into a rapid downward spiral, accelerated by debts and defaults, countercyclical policies by the Federal Reserve and at the fiscal level were enacted.

Looking at aggregate measures of corporate balance sheets and income statements today tells a very different tale about corporate health and earnings power. For one, cash within the S&P 500 is at historically high levels, while debt-to-equity ratios are below their long-term average. (See Chart 2.) In sum, companies have reined in debt and assigned higher hurdle rates of return before making new investments (since relying on debt to juice returns is no longer a core business strategy).

Chart 2. Measures of U.S. Corporate Health and Fitness Have Improved



Source: FactSet. All data are as of December 31, 2012. Each ratio or percentage is a weighted average of all companies in the S&P 500.

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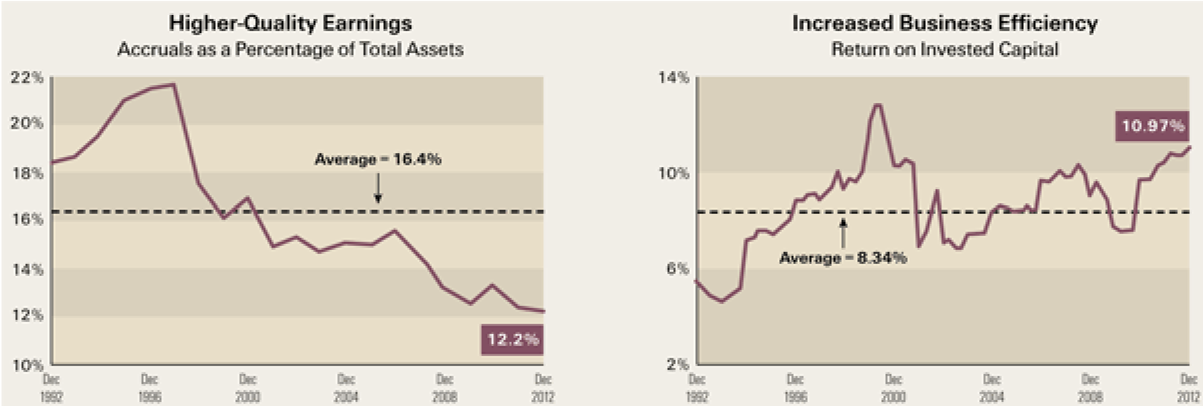
In addition, the quality of earnings from an accounting standpoint also has demonstrated historical efficiency, with revenues reported from accruals across the S&P 500 at historical troughs, meaning companies are realizing actual sales as cash sooner than at any time in the past 20 years. At the same time, the aggregate measures show that companies are more prudent in how they spend their capital, both in keeping debt financing under control and setting a higher bar for return on invested capital. The measures also show that the past four years have demonstrated both financial restraint and higher success in delivering returns to shareholders. (See Chart 3.)

Chart 3. U.S. Companies Are Managing Their Balance Sheets and Capital Projects More Efficiently



Source: FactSet. All data are as of December 31, 2012. Each ratio or percentage is a weighted average of all companies in the S&P 500.

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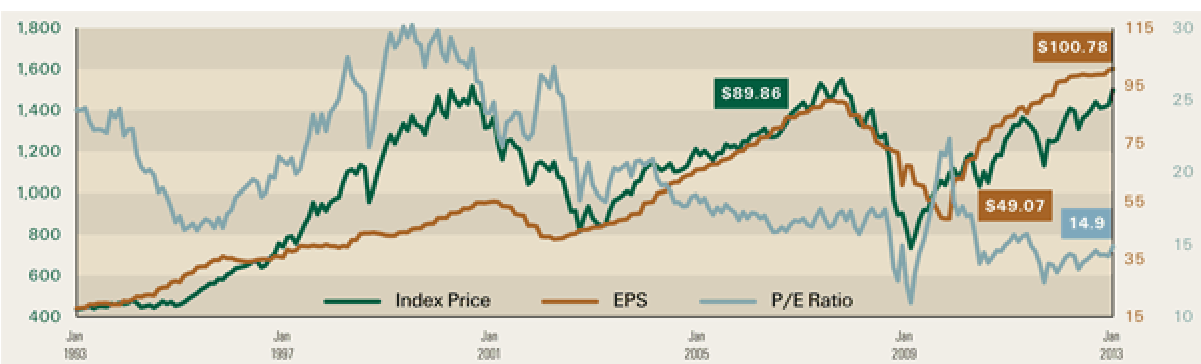
As Earnings Have Soared, Equity Valuation Remain Compressed

It appears that the execution of better-managed U.S. corporations, coupled with a highly accommodative macro policy environment, has led to enormous growth in profits, with earnings per share of the S&P 500 having doubled from the trough in 2009 through January 2013—a growth rate of roughly 20% per year during that time. Yet, while corporate health, profitability, and financial execution have all improved substantially over the past four years, the valuation of stocks has stagnated. Looking at Chart 4, this divergence tells a powerful story regarding the attractiveness of U.S. equities for long-term investors.

"This bear market is of Supercycle degree, the biggest since 1720–1784. It should, therefore, include a decline deeper than the 89% decline of 1929–1932. A decline of 91.5% or more would carry it below 1,000…bottoming in 2016."
—Robert Prechter, CEO of Elliot Wave International, June 2010[9]

Chart 4. Earnings Have Soared, While Stock Valuations Remain Low

S&P 500 Price, Earnings per Share, and P/E Ratio
(as of 01/31/2013)



Source: Bloomberg. Earnings per share (EPS) are based on market convention index earnings, calculated by summing up the equity member contributions (trailing 12-month earnings per share of the member company equity multiplied by the number of shares of the equity in the index) and dividing the sum by the index divisor.

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Fear has been a powerful force in the market since 2008 among investors, households, and corporate finance chiefs. There clearly are a number of headwinds that could keep valuations constrained further, both at the macro level and at the corporate-spending level. Unemployment and housing, for example, remain key factors as to whether the recovery in progress muddles along, strengthens, or weakens. Slow growth in hiring, substantial cash on hand, and restrained investment in growth projects have held back companies from realizing their full earnings power, thus reflecting an ongoing degree of risk aversion. We believe, though, that investors who have remained on the sidelines will continue returning to investing in long-term growth through equities as the fear of a market calamity subsides.

There will, of course, likely still be bull and bear markets, recessions and expansions. However, investors are right to reconsider the reason they owned equities in the first place: the opportunity for long-term growth. Equity, after all, represents ownership in a growth proposition—a share of a company that seeks to grow profits through, for example, innovation, execution, and prudent financial management, with some volatility along the way. The Federal Reserve and the U.S. government are expected to continue to act and react to economic data with countercyclical measures aimed at moderating the business cycle. These efforts to moderate economic and business cycles will likely continue to play havoc with the forecasts of analysts of the fringes of the bull-bear spectrum. Often, their forecasts have built-in biases that discount such countercyclical policies.

The powerful events of the past four-plus years have yielded extreme predictions in greater proportion than much of the extent of damage done during the financial crisis itself. A more careful look at data, reality, and corporate strength today, though, is finally pushing dystopian despair to the brink of irrelevance. Maybe the über-bears are ready to return to hibernation.

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[1] Nouriel Roubini, CNBC, May 20, 2010. Since the close of trading May 10, 2010, the S&P 500 Index has risen 34% (through March 11, 2013). The economy marked its third consecutive year of expansion in 2012.

[2] 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.

[3] The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

[4] The Barclays Capital Aggregate Bond Index represents securities that are U.S. domestic, taxable, nonconvertible, and dollar-denominated. The index covers the investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

[5] The S&P GSCI (formerly the Goldman Sachs Commodity Index) serves as a benchmark for investment in the commodity markets and as a measure of commodity performance over time.

[6] The U.S. Dollar Index is a measure of the value of the U.S. dollar relative to a basket of six foreign currencies.

[7] Investment Company Institute data, February 2013.

[8] Peter Schiff, "U.S. Hyperinflation," podcast, December 17, 2008. Since the close of trading December 17, 2008, the S&P 500 has risen 72% (through March 11, 2013). The U.S. Dollar Index has risen 4% in that time.

[9] Since the close of trading June 1, 2010, the S&P 500 has risen 45% (through March 11, 2013). We'll check back in 2016.

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Glossary of terms:
Earnings per share (EPS): Earnings per share (EPS) is calculated by dividing a company's total earnings by the number of outstanding shares.

Price-to-earnings (P/E) ratio: The price-to-earnings (P/E) ratio is the relationship between a company's share price and its earnings. It is calculated by dividing the current price per share by the earnings per share.

Debt-to-equity ratio: A company's debt-to-equity ratio is derived by dividing its total long-term debt by its total assets minus its total debt.

A Note about Risk: The investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy.

Brian Foerster, CFA, Director, Equity Strategist, drives equity product strategy for the firm and serves as an extension of various equity strategy teams. He also participates in equity product development and actively monitors industry activity to ensure Lord Abbett is offering competitive solutions to meet the needs of our clients and prospects. Mr. Foerster began his career at Lord Abbett in August, 2012. Prior to joining Lord Abbett, he served as Capital Market Strategist for Invesco, Ltd. He also worked as an Investment Analyst with ING Investment Management. Mr. Foerster earned a BA in economics from Boston College and is the holder of a Chartered Financial Analyst designation. He has been in the financial services industry since 1995.

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