



# Market View

P E R S P E C T I V E S   O N   W A L L   S T R E E T   F R O M   9 0   H U D S O N

One year ago, the economy was floundering and financial markets were in critical condition. The stock market (as represented by the S&P 500® Index <sup>1</sup>) was down more than 45% from its 2007 peak, yield spreads over Treasuries were still near record highs, and employers were shedding several hundred thousand jobs every month.


Predictions of a second Great Depression were not uncommon. Unprecedented monetary stimulus and other remedies, however, gradually restored some confidence to the financial system, and from the bottom on March 9, 2009, the S&P 500 surged more than 67%, portending to some a recovery in the economy as well.

Indeed, the recession that began in December 2007 appears to have ended, as the economy expanded by 2.2% in the third quarter of 2009 and by 5.7% in the fourth. In 2010, the economy is likely to continue to expand, though much of that may come merely from ongoing inventory restocking. In fact, with the removal of monetary remedies, the end of 2009's fiscal stimulus package, and the success or failure of various legislative proposals, 2010 could reveal how robust the "new normal" economy will be. This, in turn, will affect corporate earnings and the valuations the market places on them. Exploding fiscal deficits in the United States and other factors, however, raise the prospect of rising interest rates, which also will affect valuations.

*Addressing these and other topics this quarter are Lord Abbett Partners Milton Ezrati, Senior Economist and Market Strategist; Zane Brown, Fixed Income Strategist; and Rick Ruvkun, Director of U.S. Large and Mid Cap Equity Research.*

**Q: THE ECONOMY HAS SHOWN IMPROVEMENT, BUT SOME TROUBLING SIGNS REMAIN. ARE WE LIKELY TO SEE A DOUBLE-DIP RECESSION, AS SOME ARE PREDICTING?**

**Milton Ezrati:** We're continuing to get evidence that recovery is occurring. Retail sales are positive, the GDP [gross domestic



## Quarterly Outlook

February 2010

product] numbers for third and fourth quarters were positive, industrial production is going up, and new orders have risen. We haven't yet seen an improvement in the employment numbers, but this always lags. Even a short lag would mean that a run in jobs wouldn't occur until spring 2010.

We've also seen a dramatic moderation in layoffs, and that is what we would expect at this stage of the recovery. It would be unreasonable to expect jobs to *increase*, and, as a consequence, I don't see any reason to doubt the recovery scenario just because we haven't gotten an abnormal movement in the labor market.

What I think is a false issue is consumer deleveraging. That is, many have been saying that if we have a "new normal" in which consumers forgo consumption and instead pay down their debt, then the economy can't grow, and if they don't deleverage, then we have other problems. Right now, consumers are saving at a rate of about \$500 billion a year. At that rate, they can match spending with income, so that if income rises by 1–2%, they can raise spending by 1–2% and continue to pay down debt by \$500 billion a year. This amounts to about 4% of outstanding liabilities, so what consumers are doing is adjusting their balance sheets by 4% a year. That's not a great number, but it's not bad either. So they are deleveraging even as they continue to spend, so it's not binary, and it's not an on/off switch.

I believe we've already suffered the spending cutback. The panic of 2008–09 is when consumers adjusted their spending. Now, I'm not saying they're going to be in a steady state, but I really object to this belief that the consumers are deleveraging and that, therefore, they're not going to spend.

**Zane Brown:** In the past, when we've seen a double-dip recession, it has occurred because the Federal Reserve has been too aggressive too soon in tightening monetary policy. The Fed doesn't seem likely to go anywhere near that error this time round. So, a double-dip recession seems unlikely.

As Milton said, retail sales and consumer spending are increasing, and manufacturing is doing well. A couple of areas that normally lag are not doing well. Housing is lagging in this environment because of the overbuilding that had been done.

Unemployment may not lag by the 22 months that, historically, is normal, but it will lag. I think unemployment and lending are two areas where we'll need to see improvement before you get some tightening action by the Fed.

**Rick Ruvkun:** I don't think there's going to be a double-dip recession, but let's talk about what could cause one. First, the government stimulus is winding down. The Fed is going to stop buying mortgages on March 31. So there could be a rise in interest rates. But the optimists say that Fannie Mae and Freddie Mac will take up where the Fed leaves off, so rates may rise by only 50–100 basis points.

Those with a bearish outlook believe the economic recovery so far consists of inventory replenishment and government stimulus, so if the Fed raises rates, there will be limited growth there. I think the truth is probably somewhere in between.

Second, commodity prices could also rise significantly. I saw data recently that showed that demand from emerging markets is now equal to that of developed markets. The implication is that reflation of commodity prices will continue. If you combine that with the outside chance of conflict in the Middle East, then the possibility of oil prices going up is high. And if that happens, and the economy is growing at the "new normal" rate of perhaps 2.5%, then that could potentially throw us into a double-dip recession.

Third, the issues in commercial real estate haven't played out yet, and fourth, many government initiatives on the table would discourage both capital formation and economic growth. Higher taxes could include hikes on dividends and long-term capital gains, which could discourage investment. And if you consider credit card legislation, government intervention on executive compensation, and new proposals for the role of the Fed—those are all anti-growth.

That's the bear case. I don't believe all of these events will happen, but they're worth considering.

**Brown:** If rates did go up by 100 basis points, it would be meaningful because it would affect housing. It would pull people away from trying to buy a new home or a second home, and that would demand a response in the form of encouraging Fannie Mae and Freddie Mac to start building their portfolios again.

**Ezrati:** Let me just return to this inventory accumulation idea, because I think it's important. The economy, we've said, is going to grow modestly. But as inventories swing from

destocking to restocking, they add a great deal to GDP. They're catching up, but once they've caught up, they don't accumulate so fast. So, we could have a quarter or two of very good-looking headline growth, but that would be indicative of very little about the fundamentals.

**Brown:** To put some numbers around that, as Milton mentioned before, if we get spending by businesses, government, and consumers growing at 2.5% this year, we could have GDP growth of 5% in the first half of the year because of the inventory restocking.

#### Q: IF ECONOMIC GROWTH UNDER A "NEW NORMAL" SCENARIO IS MODEST, AND IF UNEMPLOYMENT REMAINS HIGH, HOW LIKELY IS IT THAT RATES WILL GO HIGHER IN THE SHORT TERM?

**Ruvkun:** ISI Group [a research firm] believes there are at least six reasons interest rates will go higher this year: 1) rising GDP; 2) budgetary needs; 3) foreign central banks buying fewer Treasuries; 4) seasonal factors (yield spreads usually widen over the course of the calendar year); 5) expectations that the Fed is going to tighten; and 6) heightened risk appetite by investors.

Rising rates imply a steepening yield curve, and there are two ways to look at that. The bulls are saying, "An upward sloping yield curve is typically a sign the economy is improving." The bears are saying, "What is the market seeing that we're not seeing? Maybe inflationary expectations are higher than the bulls think."

Those who don't worry about inflation have to explain not only why the yield curve is so steep but also why gold is up so much and Treasury Inflation-Protected Securities [TIPS] are up so much. [*Treasury Inflation-Protected Securities are a form of Treasury notes that offer protection from inflation by increasing coupon payments and the principal investment to adjust for rising prices.*]

**Ezrati:** Toward the middle of the year, there will be a moment of truth for the Fed. The market is just beginning to look at the structural deficit issue, but as the economy continues to show forward momentum and as investors become more comfortable, they're going to start thinking more long term. And that's going to bring them to Fed policy and the structural deficit issue. So, as the year progresses, people are going to start asking policymakers, what are you doing?

The Fed has made it clear that they're waiting for job growth to turn positive before they'll raise rates. But I have confidence because, as Zane has pointed out previously, they've already started to step up to the plate and do the responsible thing and withdraw liquidity.

Fiscal policy is more problematic. The Obama administration has paid some lip service to the need to deal with structural budget deficits, but that isn't enough.

**Brown:** There are various upward pressures on interest rates. Not only do you have the additional supply of Treasuries, but also there's not much yield to attract investors, and my fear would be that we're going to see lower prices and higher yields even as early as the first quarter because investors are starting to get tired of earning next to nothing on those short-term assets.

Also, more and more people are beginning to believe in an economic recovery. Even now, the economy is going from inventory liquidation to inventory accumulation, and that will push up GDP in the first quarter. That will reignite fears of inflation in the long run, but in the short run, it may appear to some that the economy is getting ahead of itself and that the Fed is way behind.

#### **Q: ARE THERE OTHER SIGNIFICANT RISKS OUT THERE THAT INVESTORS SHOULD BE AWARE OF?**

**Ruvkun:** I think these structural budget deficits are a big deal. I attended an ISI Group conference in mid-January of 500 senior institutional investors, and they were surveyed about their confidence in President Obama's agenda. On a scale of 1 to 100, 32% rated him below 20, indicating extreme dissatisfaction.

But participants also rated the chances of Republicans regaining control of the House as low. So, if you take that to mean that President Obama will still have the bully pulpit, and we'll still have these structural deficits, then the dollar could eventually retreat and inflation expectations could rise. (On the other hand, the dollar has strengthened recently on talk that China may tighten monetary policy to slow its economy. A slower Chinese economy would reduce demand for commodities, easing prices, and since the dollar tends to move in the opposite direction of commodity prices, it could strengthen.)

But Milton, to your point about fiscal policy: If the dollar plummets or if rates rise significantly, I believe that could force the Obama administration and the Democrat-controlled Congress to rein in spending. Many of us hope that the Massachusetts senate election and midterm congressional elections will send Congress a signal that they need to control spending.

I think the elephant in the room is also the sovereign debt issue. We had Dubai, we had Greece, and many of us believe that until the European Union and the United States get their

houses in order, we just won't know how great the sovereign risk is. Participants at the conference I attended in January were also asked what they thought the biggest investment risks are, and sovereign debt was number two, after higher interest rates.

**Brown:** One reason sovereign debt is a risk is these problems come at a time when people generally increase their risk appetites and are venturing either into U.S. equities or into high-yield bonds. If all of sudden people are reminded that there's a lot more risk out there in the form of sovereign entities being unable to fulfill their obligations, then people might just pull back in and say, "It's not over yet." It would also be a risk to the economy because it would stop the flows that would ordinarily go to the stock market.

As for the structural deficits, I think there is a chance that foreign central banks could begin cutting back on purchases of Treasuries. They may be getting tired of buying Treasuries and may buy other things with their dollars, or they may just start dumping dollars, which would create a problem. So it seems that we are not likely to have as much support in the Treasury market this year, and I think the 10-year Treasury could go from 3.75% currently to 4.5%.

#### **Q: WE'VE NOTED THAT HIGHER TREASURY RATES COULD CAUSE THE RECOVERY TO STALL. ARE THERE OTHER LIKELY IMPACTS IF INTEREST RATES RISE SIGNIFICANTLY?**

**Brown:** In a recovery, Treasury prices typically will fall due to excess supply, but you end up with prices of non-Treasury securities actually appreciating and yield spreads compressing. We've already seen a lot of that in this recovery, but I think there's room for more and that you're likely to have a better-than-coupon year in high-yield bonds, where there could be some price appreciation.

The steepening of the yield curve has less of an impact on high yield because there is little demand for these securities if they have terms longer than 10 years. But generally, when you have an upward-sloping yield curve, the economy is recovering, and investors are looking more at the underlying credit strength of the issuer. So, the steepening yield curve does less harm to high-yield credits than it does to Treasury securities.

**Ruvkun:** The real risk to your high-yield thesis is defaults. So, to the extent we think we will not have a double-dip recession, the thesis holds.

**Brown:** With regard to the investment-grade sector, I think spread compression on corporates and high-quality CMBS [commercial mortgage-backed securities] will provide returns

somewhere between those of Treasuries and high yield. A lot of that has to do with risk-taking. People will want to take more risk, and some of that will likely result in purchases of non-Treasury securities, not just equities.

**Ruvkun:** It seems that the riskiest of that group will be CMBS, with the commercial real estate exposure, especially the lower tranches.

**Brown:** Generally, what we're looking at are the 'AAA' tranches, and those should continue to do well—but you're right, the lower tranches just have too much risk.

**Ezrati:** The spreads on the 'AAA' tranches relative to Treasuries are the only ones that have come in; the others have remained wide because of those fears, so there may be value there even with the risk.

#### Q: WHAT ABOUT THE IMPACT ON EQUITY MARKETS?

**Ruvkun:** If GDP grows at 3.5% to 4%, that would be a tailwind for stocks, but if rates rise, as seems likely, price multiples are likely to compress. So it's possible that what investors gain in year-over-year earnings growth because of GDP growth, they may lose due to multiple compression.

Stocks are already discounting at least some portion of this GDP growth and profit growth, but as we look forward to higher rates, the market is probably going to monetize the earnings at lower multiples. And the question is, how much lower?

I think you're going to see a lot of volatility this year. I think at some point we're going to see the market applauding this economic expansion and ignoring the higher rates on the horizon. But as we get closer to a hike in rates by the Fed, or, alternatively, a slowing in the rate of improvement in the leading indicators, you'll probably have compression of multiples.

**Ezrati:** Multiples compression would be typical at this point in the cycle. What the market has done is run up the multiples in anticipation of 2010 earnings numbers. I'd be surprised if it could sustain the pace of 2009, so if it slows

down its pace, we're likely to see multiples compress as the earnings are reported.

**Ruvkun:** I think the consensus view is that the market will rally through June. But if everybody expects that, it might rally only through March. And my guess is that as we get closer to the Fed raising rates, there will be a headwind.

But there will be periods when we won't know how much of the expansion is due to inventory restocking, how much to government stimulus, and how much is the "new normal" growth rate. When we see the new normal and higher interest rates, then we might see the market pause, probably in the middle of the year.

I think the question is, if we don't know what economic growth will be under the "new normal," then what is the long-term growth rate for earnings? Also, the multiple the market places on those earnings is very tied to whether there are inflation expectations. We would probably agree there's an 80–85% chance of a "Goldilocks economy" over the next two years, that is, not too hot and not too cold. But the probability of hyperinflation is now higher than in the past—some would even say it's greater than 10%—and if there is going to be hyperinflation, then equities will have a lower multiple.

The character of the market leadership is also likely to change. Last year, it was early cyclicals, that is, consumer discretionary and technology. Now the mantle is likely to move to later cyclicals, which typically means materials, industrials, and energy, and potentially more stable growth companies.

But the risks of both hyperinflation and deflation are higher than they were five years ago. It may be a chance of one in 10 for each, but combined that's a significant "tail risk." It's possible the market will swing from excitement over earnings growth to fear of those two risks, which could produce some volatility this year. At year-end, however, I think we'll be modestly ahead. That could mean a market return of perhaps 5% and, with dividends, approximately 8%. ■

<sup>1</sup> The S&P 500<sup>®</sup> 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. The index is unmanaged, does not reflect the deduction of fees or expenses, and is not available for direct investment.

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