LORD ABBETT

ECONOMIC INSIGHTS

2021 Midyear Investment Outlook

June 24, 2021

Lord Abbett's investment leaders share their thoughts on key economic and investment issues that could shape the investment landscape in the second half of the year.

Read time: 7 minutes

Resurgence and recovery have been the watchwords of the first half of 2021, as the global economy regains its footing after the body blows of the COVID-19 pandemic. What might the second half bring? We convened a group of Lord Abbett investment experts to address the question. Our panelists included experts across the broad spectrum of Lord Abbett's investment strategies: Partners **Giulio Martini**, Director of Strategic Asset Allocation; **Thomas O'Halloran**, Portfolio Manager for Innovation Growth Strategies; **Daniel Solender**, Director of Tax-Free Fixed Income; and **Kewjin Yuoh**, Portfolio Manager for Taxable Fixed Income, Liquid Securitized Products. (**Register** to view a replay of a June 16 webinar featuring our experts.)

A common theme woven throughout the team's discussion, of course, was the unprecedented economic environment that has been created by both the COVID-19 pandemic and subsequent fiscal and monetary policy moves by the U.S. Federal Reserve (Fed). The conversation also focused on inflation uncertainty in an environment where we see pent-up consumer demand being unleashed on a supply chain dealing with labor and production headwinds.

Although some uncertainty is to be expected, the positive outlooks that prevailed at the beginning of the year remain mostly intact. Our experts believe strong economic growth and the recovery from a global pandemic are reasons enough to have an optimistic view toward the remainder of 2021. But numerous questions remain regarding how the transition to the "new normal" may signify changes to a policy regime that has been in place for decades.

Giulio Martini, head of the firm's multi-asset strategies, believes key macro developments to watch include the Fed's approach to monetary support and the potential impact of a desynchronization of supply and demand.

A Period of Transition

As the economy advances toward a full reopening, the transition will be marked by the removal of record levels of fiscal and monetary support that provided the bridge to the economic recovery. The pandemic also highlighted socioeconomic disparities within the U.S. economy, prompting more inclusive employment discussions within the Fed's policy considerations. Those considerations go hand in hand with a desire to specifically target 2% inflation going forward, as the Fed has since 2012. The policy thrust has not fully shifted toward a program that's decidedly inflationary, in our view.

But both the Fed and the federal government have voiced a desire to allow the economy to run hotter, with the goal of extending the benefits of economic growth to a broader range of people, including those who have been underserved in previous growth cycles. The ability to pursue that

goal depends on how the political scene unfolds. Generally, however, inflationary regime changes originate from changes in broader economic policy goals, and the Fed's goal of promoting a more inclusive economy raises that possibility.

Shorter-term considerations focus on a different dynamic: demand that has been stimulated by aggressive monetary and fiscal accommodations accessing supply that has not fully adjusted to the open economy. The potential desynchronization of supply and demand could continue to produce inflationary pressures over the next six-to-twelve months.

Beyond that time horizon, the inflation question remains. However, using history as a guide and looking back to the previous episode of stimulus removal, investor expectations of long-term inflation decreased sharply after removal of post-GFC (global financial crisis) fiscal and monetary accommodations.

We view the current belief that recent increases in key inflation indicators are transitory, and not part of a longer-term acceleration, is valid. Recent inflation uncertainty is understandable, since this growth cycle is unlike previous recoveries where the economy was healing from a recession caused by financial or economic stresses. We may indeed experience an inflation scare over the next six-to-twelve months, but if fiscal and monetary support are rolled back—as they were in the post-GFC period—that brief jolt will end up being a false alarm.

Daniel Solender, Partner and Director of Lord Abbett's municipal bond strategy, focused on how municipal bond issuers effectively navigated through the pandemic, and are well positioned for the transition to a full economic reopening.

Positive Forces at Play

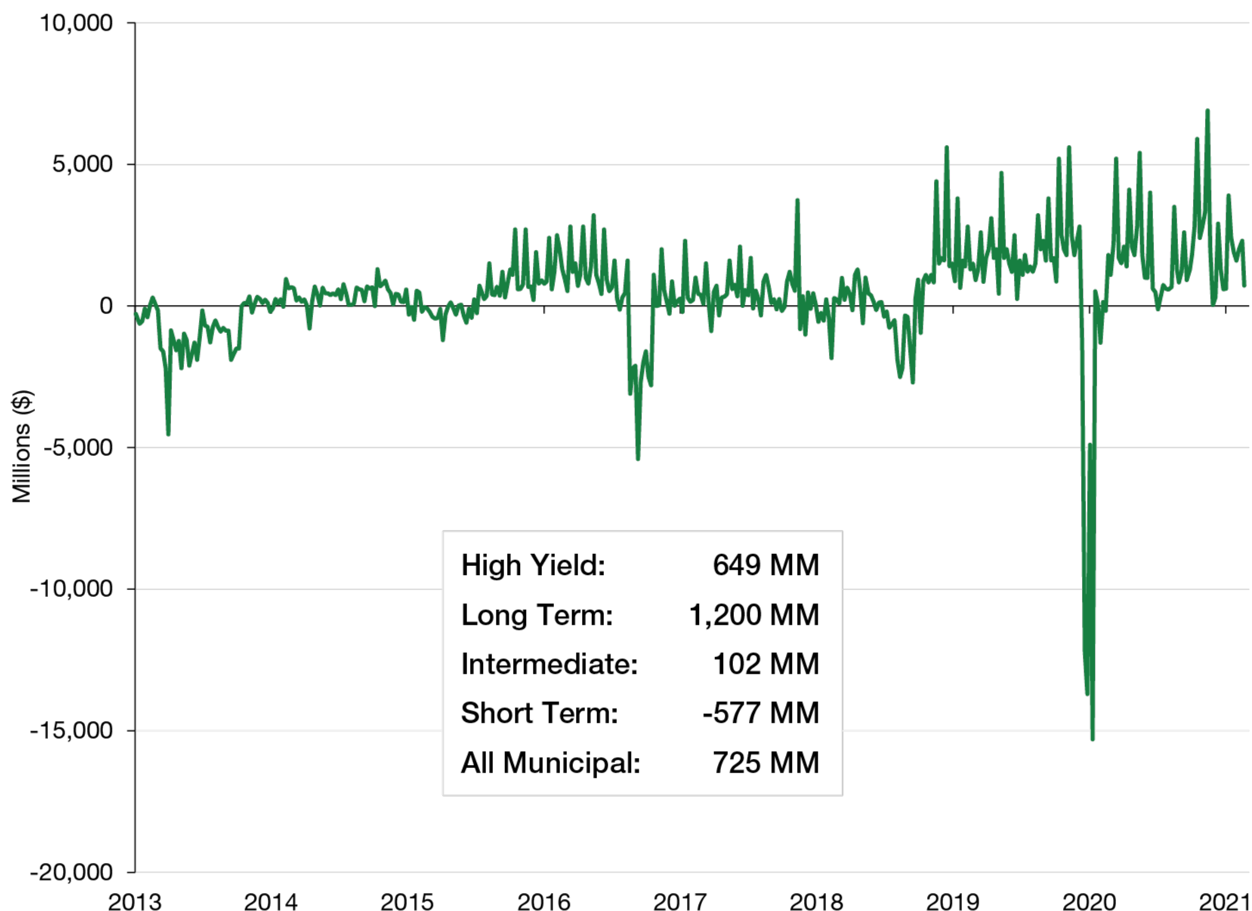
Strong growth prospects following a complete economic shutdown a little more than a year ago are a very positive development, and perhaps somewhat overshadowed by recent inflation concerns. The municipal bond market is well positioned for the economic reopening, and there are a number of positive forces at play that contribute to our constructive view.

Sectors severely impacted by the shutdown, such as airports, universities, and transportation systems, experienced only small negative moves in credit quality. We think a complete reopening will allow these sectors to revert toward more normal usage and revenue levels, and the overall, historically-high credit quality of municipal bonds stands to benefit from accelerating economic growth.

Technical factors continue to be supportive. Mutual-fund demand for municipal bonds has remained robust, with net inflows posted every week in 2021 through May. About $4.7 billion of combined inflows across high yield, investment-grade, and long, intermediate, and short maturities has been invested in municipal bond funds this year through May 19th, according to Lipper (see Figure 1). On the supply side, issuance has been lower in healthcare, education, and state and local governments, while the transportation, utility, and housing sectors have surpassed last year's pace.

Figure 1. Record Municipal Outflows in March and April Have Recovered

Weekly municipal bond fund flows have been positive in every week of 2021 through May 19, 2021.



Source: Lipper. Data as of 05/19/2021. The historical data are for illustrative purposes only, do not represent any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results.

The Biden administration's proposed changes to personal and corporate U.S. tax rates could further enhance demand, lending additional appeal to our outlook going forward.

Tom O'Halloran, head of the innovation equity team at Lord Abbett, emphasized the need to strategically adapt to changes in the investment environment and assess cyclical as well as secular growth opportunities.

Room for Optimism Within Innovation Growth and Durable Value

We've experienced a distinct rotation of equity preferences in 2021. The anticipated strong recovery in economic growth and corporate earnings produced a move toward cyclically-sensitive sectors, while broad market averages have continued to climb. Investor optimism is certainly warranted, in our view, given the depth of uncertainty experienced last year and the exceptional speed of development and deployment of the COVID-19 vaccine.

Sectors that experienced a significant pullback due to the pandemic have bounced back this year. Conversely, capital shifting away from higher P/E (price-to-earnings) growth stocks toward economic recovery themes has pushed valuation ratios lower for many fundamentally-sound companies at a time when economic growth is accelerating, corporate earnings are rising, and optimism abounds. Inflation concerns have also played a role in diverting assets from longer-term growth names to more near-term cyclical opportunities. We believe a reversion is likely, as valuations of innovative growth companies reach increasingly attractive levels.

Figure 2. 2020-2021: A Tale of Four Markets

Growth outperformed value in the first 10 months of 2020, while value has led following the vaccine announcements.

	PRE-COVID	PANIC	RESPONSE	VACCINE
Index Performance (%)	12/31/2019 – 02/19/2020	02/20/2020 – 03/23/2020	03/24/2020 – 11/08/2020	11/09/2020 – 05/31/2021
S&P 500	5.08%	-33.79%	58.58%	20.86%
Russell 1000 Growth	9.26%	-31.46%	75.49%	12.04%
Russell 2000 Value	-2.09%	-43.14%	53.12%	56.44%

Source: S&P Global and FTSE Russell. ***Past performance is not a reliable indicator or guarantee of future results.*** *The S&P 500 Index is widely regarded as the best single gauge of large-capitalization U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of the available market capitalization. The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000® Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.*

As mentioned earlier, we think there is room for optimism across innovative growth companies that enabled the economy to move forward during the pandemic and durable, more cyclical value companies with competitive business models and solid track records for earnings and revenue growth. Looking further ahead into 2021, as Fed policy, rates, and inflation normalize, we anticipate adapting our emphasis toward lasting, secular growth trends in innovation.

Kewjin Yuoh, lead Portfolio Manager for the firm's taxable fixed-income strategies, pointed to the potential for volatility stemming from inflation and Fed policy uncertainty within his positive, intermediate-term outlook for credit.

Assessing Volatility and Opportunity

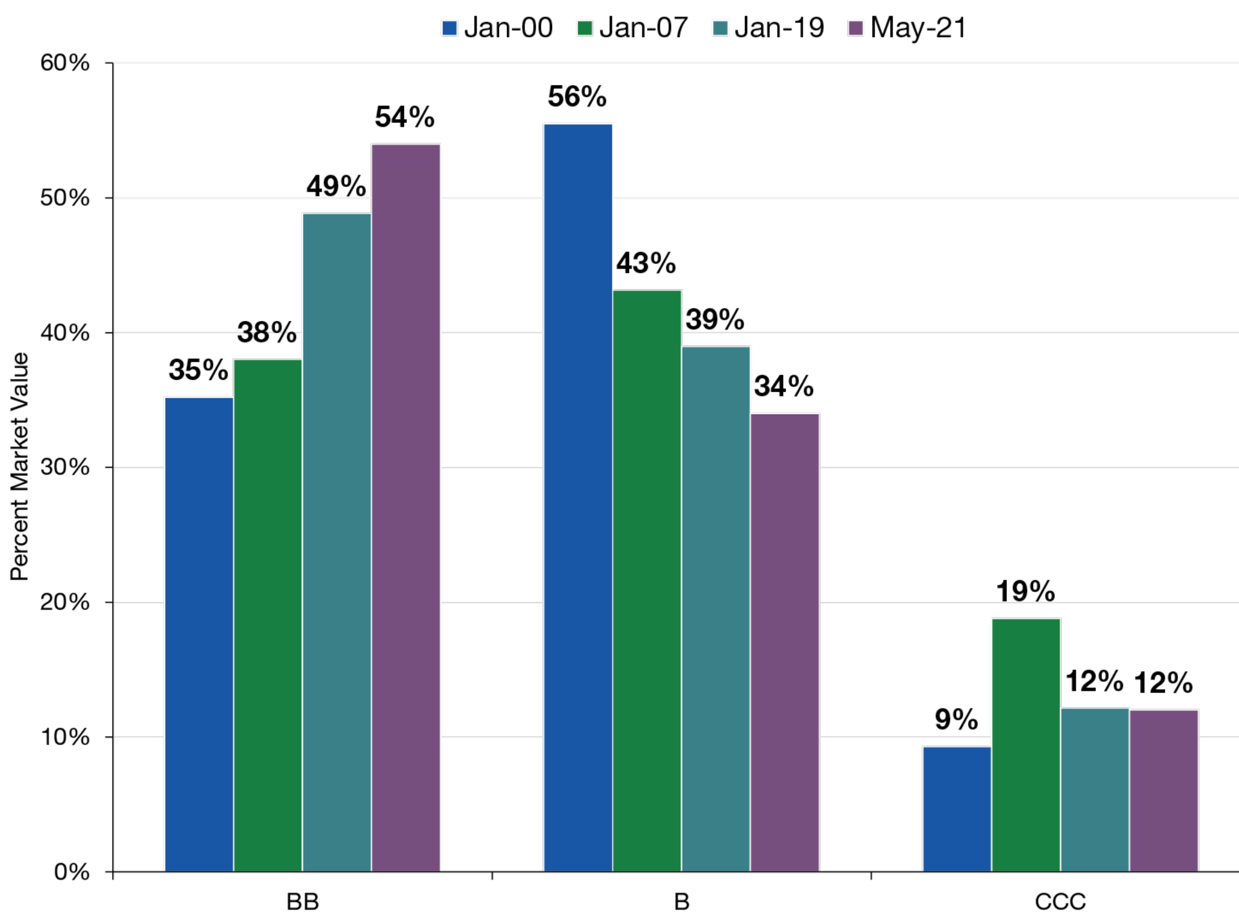
Fixed-income investors tend to be watchful of potential volatility drivers, especially coming off the year we had in 2020. Inflation concerns and uncertainty over future Fed policy moves, in light of the recent discussion focused on delivering a more inclusive recovery, have the potential to generate volatility. Additional uncertainty stems from the unfamiliar nature of the Fed's policy directive to pursue flexible, average inflation targets in an environment with potential inflation tailwinds.

The question many investors have pertains to fixed-income valuations in tandem with these risks. Aside from factors that may cause spread widening within select credit industries or rising interest rates generally, over the longer-term, real yields are the drivers of yield increases, in our view. Currently, the impetus behind the rise in real yields is expanding economic growth—a scenario that is typically constructive for credit and is the basis for our positive intermediate-term outlook.

Over the last year, record levels of corporate bond issuance have been purposed toward improving capital structures, interest coverage, and available cash on balance sheets, which has also bolstered overall credit quality. Expanding economic growth could further the trend already seen in the U.S. high yield bond market. Based on the credit-quality breakdown of the ICE BofA U.S. High Yield Constrained Index, BB-rated high yield bonds comprised 54% of the index as of the end of May 2021, compared to 35% in 2000 (see Figure 3).

Figure 3. Historically-High Quality Ratings Mix for U.S. High Yield

Credit quality breakdown of the ICE BofA U.S. High Yield Constrained Index



Source: ICE BofA U.S. High Yield Constrained Index. The index tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below-investment-grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed-coupon schedule, and a minimum amount outstanding of $250 million. 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. ***Past performance is no guarantee of future results****.*

With economic strength supportive of credit fundamentals, our positive outlook over the intermediate-term favors high yield corporate credits over investment-grade corporate credits that

are less vulnerable to a rise in rates, given their shorter duration. Bank loans also offer a potential opportunity to capitalize on the reopening trade while minimizing potential interest-rate risks.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk. Credit risk is the risk that debt issuers will become unable to make timely interest payments, and at worst, will fail to repay the principal amount. There is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income. In addition, bonds are subject to other types of risks, such as call, credit, liquidity, interest-rate, and general market risks. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

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A **basis point (bp)** is one one-hundredth of a percentage point.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure.

Price-to-earnings (P/E) Ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

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