

Market View

PERSPECTIVES ON WALL STREET FROM 90 HUDSON

Markets continued to rebound strongly in the third quarter of 2009, and the economy appears to be on stronger footing. Investors looking for yield are becoming less risk-averse and have shifted into riskier assets, including the high-yield bond market. Stocks also have enjoyed a strong rebound, but memories of last year's collapse may still be too fresh for some investors to return completely just yet.

Their caution may stem from a number of unanswered questions. Many may be worried about a "new normal" in which consumers give up previous spending habits in order to save more. If such a shift occurs, it could mean slower economic growth, lower corporate earnings, and a less bullish outlook for stocks. Investors also may be waiting to see whether banks will be hit by another round of credit write-downs. Banks appear to be more cautious, and lending to small and medium-sized businesses has dried up, though that may be due in part to a lack of demand. Also lurking is the question of the dollar. Will a combination of rising fiscal deficits and a monetary policy that could turn out to be too loose for too long sink the dollar and lead to inflation levels reminiscent of the 1970s?

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

Q: HOW MUCH PROGRESS HAVE WE MADE IN RECOVERING FROM THE FINANCIAL CRISIS AND THE RECESSION IN THE LATEST QUARTER?

Milton Ezrati: We've seen two things since the last time we met. First, we've seen a modest uptick in retail sales, and I underscore "modest." So, in that respect the recovery is going according to plan. Consumers are not roaring back, but they're beginning to spend. And in the housing area, there has been an



end to the cutbacks in new home construction. We've seen an end to the declining sales, we've seen an end to the decline in prices, and we've seen an end to the decline in building activity. And it speaks loudly to the fact that we're no longer in freefall.

Zane Brown: In the credit markets, we've seen one of the biggest rallies in

non-Treasury securities in the past 20 years. High-yield spreads over Treasuries are now down to 800 basis points [bps]. They were over 1,800 at one point. Also, throughout this time, we've had huge supply. We're probably on track, if this continues, to set a record in speculative-grade debt issuance this year. We would not have expected such a vibrant market, having started this year with high yield perceived as radioactive waste.

Furthermore, recent new issues have been oversubscribed. There's so much interest in high yield that when we try to buy \$50 million or \$70 million of an issue, for example, we may end up getting an allocation of only \$20 million. It's surprising to see so much money directed at the high-yield market this soon after a credit crisis. We're also seeing huge debt issuance on the investment-grade side, though I don't think we're on track for the same kind of record.

When it comes to Treasuries, of course, we do have huge auctions there, and every week seems to set a new record for supply. Last quarter, we wondered whether foreign investors would continue to want to buy our debt—but, in fact, we have had an increase in interest among foreign investors.

And the interest continues to be very strong. The yield was below 3.2% on the 10-year Treasury as of early October, and that's despite the fact that the Federal Reserve's program for buying Treasury securities ended in October.

We've been saying that investors should consider investing in a way that they get paid while they wait, and I think people are buying into that. High-yield bonds may be acting as a substitute for equities for a lot of investors. [However, investors

should consider their goals and risk tolerance before making any investment decision.]

Q: ARE YOU A BELIEVER IN THE “NEW NORMAL”—THE IDEA THAT CONSUMERS HAVE PERMANENTLY SCALED BACK AND THAT GROWTH WILL BE LESS ROBUST THAN IN THE PAST?

Rick Ruvkun: The question is whether the economic recovery we’ve seen so far is just due to a return of normal production levels and inventory replenishment, or whether it is due to demand pull-through. That is, is consumer spending getting back to normal? We don’t know yet. We also don’t know how much of this recovery is due to government stimulus and the “cash for clunkers” program, which accelerates growth in the present and may borrow from the future.

Hope springs eternal that this is really demand pull-through. But, with expectations of high unemployment and possible job loss, you may continue to see consumers cutting back on their debt, which should mean that their savings rate will remain high and their spending will stay low. So, I believe that it may take a long time for the consumer to deleverage, and that coming out of this recession we’re going to have anemic growth.

We could also have latent inflation if we can’t rein in our budget deficit. And Washington may decide it would rather print money and inflate than solve budgetary deficits. Those are all things that undermine the dollar in the long term, and that’s the elephant in the room.

ZB: I agree with this concept of a new normal. Baby boomers are at a point where they should be saving a lot more, especially now that they realize their net worth may not be what it was at the beginning of last year [2008]. So, I think that translates into less spending and slower growth.

ME: It’s also important to remember that even an anemic recovery for a year or two could produce very good earnings. The economy in nominal terms was flat last year, and earnings fell 40%. So, there is tremendous operating leverage on the bottom line, and it works both ways. The consensus number for operating earnings on the S&P 500® [Index]¹ in 2010 is about \$75 a share. [Operating earnings on the S&P 500 were \$49.51 in 2008. The consensus estimate is \$55 for 2009.] It sounds like remarkable growth, but it’s not inconceivable at all because there is so much operating leverage on the bottom line.

Q: WE’VE SEEN BOTH STOCKS AND BONDS PRODUCE STRONG RETURNS THIS YEAR. WHAT IS DRIVING THESE GAINS, AND WHAT MIGHT WE EXPECT IN THE NEXT FEW MONTHS?

RR: We’re seeing that markets are more correlated. At the same time that stocks and bonds are doing well, gold and Treasury inflation-protected securities [TIPs]² are rallying.

The question is, why is this happening? These assets typically do not all move together. The fact that they’re all going up at the same time suggests that the drivers may be the massive monetary and fiscal easing, increased risk appetite, or investors chasing performance—or all three.

ME: It also means that the Fed is supporting the Treasury market.

RR: It could also mean investors are trying to manage against both deflation *and* inflation. The odds are increasing that there will be both—deflation in the short term and inflation in the long term. So, investors may be adopting a barbell strategy in which they hedge against both eventualities.

I think what is really happening here, though, is that people are hedging against the end of quantitative easing. [Quantitative easing is undertaken by the Fed after it has attempted to increase the money supply and stimulate the economy by lowering the fed funds rate to zero (it currently is 0.00–0.25%). If lowering rates fails to add more liquidity to the financial system, the Fed will purchase Treasuries and other assets from banks using money it has created electronically.]

I would suggest that the consensus view is that quantitative easing will end by June 2010, and since markets tend to discount six months in advance, this likely puts the tipping point at around Christmas [of 2009]. That is, this could be when the prospect of a removal of the liquidity punch bowl by the Fed, which could lead to a rise in interest rates, may cause investors to reduce their risk appetite.

ZB: Let me suggest a different take on this issue. It could be that the reason Treasuries are so low in yield and high in price isn’t a function of the Fed buying Treasuries but is indeed a function of people having confidence in the Fed.

The Fed is doing what you would expect it to do, which is gradually moving away from all of the liquidity it has provided. And the authorities are doing that by ensuring that their level of purchasing securities is gradually ending. Their purchasing of Treasuries ended in October. They’ve defined when they’re going to stop buying agency bonds and mortgage-backed securities, and that will be the end of March 2010. So, you have to have an end to that before the Fed can go in the other direction.

You also have had a dramatic decline in the amount of funds that are offered by the Fed’s Term Auction Facility [TAF], which reached \$150 billion per month in three different monthly auctions; that’s now down to \$30 billion per month. [TAF provides short-term loans to banks. It was one of the first tem-

porary lending programs implemented by the Fed in response to increasing reluctance by banks to lend in the interbank market during the early stages of the credit crisis in December 2007.]

So, that money has been pulled out, and the monetary base and the money supply are actually lower now than they were at the beginning of the year. We're already seeing an end to easing, whether you want to call it quantitative or otherwise. We've seen stability in the money supply beginning in January or March, depending on which measure of monetary aggregates you want to use. So we haven't seen a continued buildup in liquidity; it's actually starting to reverse.

ME: To reinforce that, the various exchange-traded funds that short Treasuries have gone down in value. That suggests that people may be less concerned about the Fed's ability to withdraw the liquidity.

RR: But TIPs are up, and the price of gold is up. So the signals are mixed.

ZB: To reinforce your earlier point, Rick, I think many investors are not sure which direction the economy is going, so they may be thinking, "We've never owned gold or TIPs before, but we hear all this concern about inflation, so let's put some in our portfolio just in case."

Q: HOW LIKELY ARE CAPITAL MARKETS TO REACT TO THE END OF QUANTITATIVE EASING AND A POSSIBLE RISE IN INTEREST RATES?

RR: I think that they *are* going to react. Others say, this is an efficient market, and everybody knows this is going to happen, so it's already priced in. But I think it's not priced in. As I said earlier, I believe that markets start discounting six months in advance, so if quantitative easing is expected to end in June 2010, and if it's expected to lead to higher interest rates, that would mean the market would react right around Christmas [2009].

ME: I agree. It's not priced in. But if we're correct and the cycle started in March, which is when spreads over Treasuries started coming in and the equity market started to move up, then by 2010 we would be well into the recovery. In that case, it wouldn't be unusual to see a transition from small cap, growth, and higher-risk assets toward large cap, value, high quality. There is a lot of historical evidence for that kind of trend.

RR: Then the question is, how far down will the dollar go, and will the economic recovery be V-shaped or U-shaped? We don't know what earnings will be, but I agree that there will be a rally in high-quality stocks. We're going from lower quality and risk-seeking to more high quality because rates are going to

rise. Typically, rising rates have meant that investors seek quality and more predictable cash flows.

ZB: I'm not sure rates are set to rise. You could have more compression of spreads. Spreads are still where they should be coming out of a recession. They spiked up in investment-grade and in speculative-grade credits relative to Treasuries during the credit crisis. They're now back down to levels where they should be when the economy moves from recession to recovery.

RR: That could depend on what the default rates will be. If we have default rates that are normal during a V-shaped recovery, then I would agree with you. But if we have higher defaults because the recovery becomes U-shaped, then spreads may stay wider than during the old normal. So the new normal might include wider spreads.

ZB: I think you can have slow growth and still have a return to near-normal default levels because defaults are really a function of zero to negative growth. A company's first priority is to pay its debt, so if you get slight growth, defaults are likely to fall. If you end up with 1.5% growth instead of 4%, I think you'll still have a lot of companies surviving. There won't be a lot of return on equity, but there will be repayment of debt.

If you look at defaults, and if you look at distressed debt levels, we're already seeing improvement. Looking at bankruptcies over the past nine months, the first five of those months averaged 15 defaults for a total of \$25 billion a month, and the last four months averaged nine defaults for an average of less than \$8 billion a month. So, defaults are declining.

In fact, Moody's Investors Service [the credit ratings agency], which had been expecting default levels of around 14%, is now expecting they won't go higher than 12%. And they expect that by next July defaults will return to the historical average, which is about 3.8%.

So, we're already seeing the evidence that defaults likely won't be so bad. That should attract people into high yield, which should continue to compress spreads relative to Treasuries, as you would expect as you go into a recovery, whether it's V-shaped, U-shaped, or otherwise.

Q: TURNING BACK TO THE ECONOMY, IS CREDIT AVAILABILITY A PROBLEM?

ZB: In the high-yield market, we may see record issuance this year, which is unusual in this environment. You would expect people to still be somewhat reluctant so soon after a credit crisis. We're also seeing huge debt issuance on the investment-grade side, though not at the same level. So credit seems plentiful in these markets.

RR: Some of us think that credit has been very much available to large businesses, but not to small businesses. The government has solved the credit availability issue for large business by, in effect, backstopping their debt.

ZB: I don't know that I'd say that the money being lent in the corporate bond market is just based on a belief that the government is going to backstop it. As for small companies, they borrow largely from banks, but they just haven't been borrowing. There has been little increase in commercial and industrial loans. It's apparent that banks have tightened credit standards, but there also hasn't been a great deal of demand.

ME: To come back to the inventory issue, that will be the test. When they start rebuilding inventories, the small and medium-sized businesses will go to the banks and ask for credit. Right now the banks aren't lending because they haven't been asked.

But I think we're going to see signs of improvement. Industrial production is picking up faster than all other indicators in the economy. That means rebuilding of inventories. And we will see, with a normal lag, if the banks lend. So we're really at a crucial point.

ZB: This is just anecdotal, but local businesses I know are saying that finally the banks are opening up. They're saying to customers, "You can have your credit line again," and that's just happened in the past few weeks.

ME: One banker I spoke to in Georgia is with a medium-sized bank, and he said they're lending to their regular customers, but not to the questionable customers. There are a lot of people they lent to years ago whom they don't like, and as they pay their loans, they just close out their accounts. But regular customers, with whom they have had a long relationship, are continuing to receive loans. So the aggregate figures, which show a decline in lending, are masking two very different attitudes toward clients.

Q: ON THE QUESTION OF THE DOLLAR, HOW CONCERNED SHOULD INVESTORS BE ABOUT FURTHER DEPRECIATION?

ME: I would say the dollar is tied in with when the Fed ends quantitative easing. If the Fed fails to act, the dollar will reach that tipping point sooner. They won't tell us when they will end quantitative easing, but [Fed chairman] Bernanke has said when this recovery has sufficient momentum, they'll do it.

If the Fed does act, then it's a question of what the other central banks will do. Investors will move toward the currency that they think is managed best. If the Fed fails to end quantitative easing, that means the dollar is not well managed, and so investors will desert the dollar. If the Fed acts and

European central banks fail to act, then investors will move toward the dollar. If the Europeans act and we don't, then the dollar will crash.

RR: I think the question is, is the decline in the dollar a cyclical issue or a structural issue? If it's cyclical, that would mean that the dollar is down temporarily, and with economic recovery, it will reassert itself. A structural condition would mean that we can't solve it overnight, and that it could even mark a new era in the U.S. economy.

We don't know which way it's going to go, but I think this long-term debt that we're facing means that it is a structural debt, and that eventually the dollar may not be the world's reserve currency. There are reports that OPEC [Organization of Petroleum Exporting Countries] and other oil-producing countries might move away from pricing oil in dollars. And you see the trial balloons out of China about the need for an alternative to the dollar as a reserve currency.

I just think it's something you want to watch in the background. You don't want to invest based on this, but it's something we have to watch. And that's why TIPs and gold have become popular hedges.

ME: Even if they pull this off—the Fed and the federal government—and they defend the dollar, there's no reason to expect the dollar to rally very much, particularly against emerging-market currencies. So there's every reason to consider being overseas. Emerging markets may not be a home run, they may not be your salvation if the dollar crashes, but they are not likely to hurt you very much if the dollar is defended.

ZB: Let me suggest that you can have a 20% improvement in the dollar in the next six months. The Fed doesn't have to pull away the liquidity punchbowl all at once. It can take it away a cup here and a cup there. It's already stopped filling it; and if it starts to demonstrate that it can gradually reduce the liquidity that it has provided, investors may believe in an effective exit strategy, that the economy is going to grow, and that they can have more faith in the dollar. That means they could buy high-yield bonds, for example, or high-quality stocks.

There's still the question of whether the dollar will remain the world's reserve currency, but in this environment, the dollar could indeed improve from its current levels.

ME: To address the debt and the question of the dollar, all the federal government needs is a credible plan. These huge deficits are done—they're here. They don't have to turn this around immediately; they just have to have a credible plan for turning it around, and the market will buy that because the market wants to buy that. But it has to be credible.

RR: So it may be hard to determine the magnitude of the economic rebound because several factors may constrain it. We've got the quantitative easing issue, we've got the credit availability issue, and the third issue is the dollar.

Q: BESIDES HEDGING AGAINST INFLATION, WHAT SHOULD INVESTORS CONSIDER DOING IN THIS ENVIRONMENT?

ZB: In the Treasury market, there really is a risk that we are at levels that can't continue in this same direction, that yields almost certainly have to be higher than they are even though we have low levels of inflation. The enormous amounts of supply and the fear that at some point we might have higher inflation, which is indicated by interest in TIPs and interest in gold, suggest that Treasury rates should be higher. That shouldn't prevent improvement in corporate bonds, and it shouldn't prevent improvement in commercial mortgage-backed securities.

I also think there is still plenty of room for spreads in the high-yield market to narrow relative to Treasuries. Spreads are close to 800 bps now, and although we won't get down to 300 bps anytime soon, there is certainly interest in the junk bond market, either as a proxy for equity securities or as part of a barbell strategy with short-term, high-quality securities. And that interest could drive spreads narrower.

The hope is that we're going to have less in the way of defaults, and that's reinforced by recent trends as well as evidence of at least some positive growth.

ME: The Merrill Lynch All Convertibles Index³ is up about 42% through early October, so that also suggests that junk is acting as an equity proxy.

RR: If investors buy equities, they should consider buying those that are of higher quality, that is, those that historically have had high and stable earnings, are backed by strong, predictable cash flows or a secure dividend [dividends are not guaranteed and may be raised, lowered, or suspended altogether by the issuing company], and have a strong balance sheet, that is, low leverage. Now is not the time for a "Hail Mary" pass. You should consider increasing your quality, which is normal for the later stages of a recovery. So investors may want to take on less risk, that is, lower beta.

ZB: So, on the equity side, investors might want to consider high-quality companies, but on the fixed-income side, there may be better value in the part of the market that has greater risk. That could be in investment-grade securities; there's likely to be spread compression there, and also in the high-yield market, though not necessarily triple-Cs, because the same thing that happened in the stock market happened to triple-Cs—they've skyrocketed. So higher-quality aspects of the high-yield market also are likely to do well.

ME: I would add municipal bonds, because there the spreads relative to Treasuries are even richer than on the corporate side.

[Of course, investors should always consult a financial advisor on the strategy best for them based on their individual circumstances, goals, risk tolerance, and investing time horizon.] ■

¹ 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.

² Treasury inflation-protected securities (TIPS) are Treasury bonds that are designed to protect investors against inflation. The interest and the principal are indexed to the Consumer Price Index, and the quoted yield is the “real” return, the amount the investor receives in addition to the rate of inflation.

³ The Merrill Lynch All Convertibles Index contains issues that have an aggregate market value of greater than \$50 million. The issues are U.S. dollar-denominated, sold into the U.S. market, and publicly traded in the United States.

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