

Market View

PERSPECTIVES ON WALL STREET FROM 90 HUDSON

In fits and starts, the economy continues to rebound from the credit crisis and the worst recession since the Great Depression. Manufacturing is up, consumers have begun to shop again, and businesses are starting to spend again on technology. But some hurdles remain. The housing market continues to struggle, and banks are still reluctant to lend. Job creation remains anemic, though not abnormally so at this stage of a recovery.

More important are risks arising from the public sector. Uncertainty created by the prospect of healthcare reform legislation has continued despite passage of the bill, making employers even more reluctant to hire. Skepticism about promised cost savings has added to growing anxieties about the country's fiscal condition and about the market for Treasury securities. Midterm congressional elections, therefore, loom large as a key to the economy's future direction.

Public sector debt issued by Greece and the other financially troubled countries of the eurozone pose a threat to the return of economic health to Europe, a major destination for U.S. exports. And while various forms of bailout have been proposed, they may only delay ultimate resolution of the problem, which will require economic pain for countries that are overly indebted.

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 Equity Research.

Q: WE'VE NOW HAD TWO CONSECUTIVE QUARTERS OF ECONOMIC GROWTH, BUT SOME STILL HAVE DOUBTS ABOUT THE RECOVERY. HOW'S THE RECOVERY PROGRESSING?

Milton Ezrati: We're seeing weakness in the housing market, though not a lot, and it doesn't necessarily mean a double-dip recession is coming, but I think it's a troubling



development. We didn't expect much strength there, but prices have come down a little bit, and buying activity has fallen off. It could, however, be just a statistical glitch, or it could be a result of the earlier spike in sales that occurred because of the \$8,000 government incentive offered to first-time homebuyers.

Aside from home sales, the consumer continues to spend moderately, as we anticipated. We're also seeing some strength in the industrial area due to inventory restocking. So, whether the recovery is gaining or losing strength, it's the weak recovery we have been expecting.

Zane Brown: In addition to housing, people continue to be focused on jobs. And with census workers, other government employees, and some private sector growth, we saw a positive employment number for March 2010.

This, of course, will help the consumer spending numbers. We saw consumption rise by 1.7% in the fourth quarter, and we're projecting 1.5% to 2% for the first quarter. This will support the recovery, as will business investment. So, the recovery that we projected is on track. The first and second quarters will be helped by inventory building, while the third and fourth quarters might be weaker, especially if we see only modest consumption growth and not much job growth. If we have growth in consumer spending of 1.5% to 2%, and not much job growth, second-half GDP will likely come in at 2% to 2.5%, respectable but not memorable.

Although we're seeing a drop in housing, we're seeing an improvement in auto sales, and add to that the fact that the average auto on the road is now four months older than it was a couple of years ago, and we might see more replacement buying later on. It doesn't mean we'll return to 16 million units sold annually, but improvement from 10 million to 12 million, will be meaningful.

ME: If the consumer is growing by 1.5% to 2%, that contributes 1.2 percentage points to gross domestic product [GDP] all by itself. That by itself produces a recovery,

a sluggish one, but a recovery nonetheless. But it could be helped by capital expenditures because we're seeing more spending on technology.

ZB: We've heard a lot about consumption in the first quarter not being sustainable, and indeed the consumer actually borrowed from savings—saved less and spent more—spending at a 3% rate, but that's not inconsistent with what we're suggesting. We're not suggesting that they're going to maintain that 3% increase. It might be closer to 2% or slightly below that.

Rick Ruvkun: I think economic growth is relatively strong, but I think an equally important question is, how much of the recent earnings growth—which has come mostly from cost savings, not top-line growth—is already discounted in the stock market.

Equity markets tend to trade *not* on the magnitude of the leading indicators, but on the “second derivative,” or whether the trend in the leading indicators is changing at a more rapid or less rapid pace. So, my concern is not whether the economy could slip back into recession but that it could grow less rapidly than the recent trend. We might have a flattening of the leading indicators, that is, a slowing in the rate of improvement. And with the S&P 500® Index¹ near 1,200, the market may have priced in a higher rate of growth than is likely.

But if we have a V-shaped recovery in corporate earnings, where we see operating earnings on the S&P 500 hit \$80 to \$85, then the S&P could go to 1,400, meaning there may be some significant additional upside. The research firm Strategas has published some earnings scenarios, and if you take the weighted average of their estimates, you get earnings of \$75 on the S&P 500. The market may have already priced this in.

You asked about the recovery, and I believe the recovery will be fine, though it is more tempered than a typical recovery. The other issue is that there will be high unemployment even in the face of that recovery.

ME: The leading indicators have built into them the money supply data, and we want that to slow down. The leading indicators overstated the strength in the economy in the recession because the Fed was pouring reserves into the system. Now the Fed is withdrawing them, and that's detracting from the leading indicators.

So, the kind of disappointment that Rick is describing, in which the improvement seen recently levels off, could happen. We could see less exciting statistics, and we are likely to see simultaneously a figure for GDP that, due to inventory re-stocking, suggests the economy is stronger than it really is.

RR: I think we're saying that the economy will be fine, but investors shouldn't focus on the published GDP number.

They should instead focus on whether the leading indicators are improving at a faster or slower pace, and whether that's priced into the market.

The bullish view is that the market is already taking this into account and is looking forward to high actual earnings. The bearish view is that it isn't, and anytime the second derivative of leading indicators—that is, the change in the rate of change—heads down, it acts as a headwind to the market.

ME: The bullish view may be correct because we've seen the market respond recently to disappointments in economic data. Earlier in the year, the market became over-exuberant because it was getting this stream of good economic statistics, and then it slowed, and we saw the market come down. So, this is the game we always play with the market—what does it know and what has it priced in?

ZB: Getting back to the economic recovery, you could actually argue that we're doing quite well. I think, Milton, you've written that on average it takes 12 to 14 months once a recovery begins before the economy starts to create jobs. Well, if we start creating jobs this month or next, that's seven to eight months, much sooner than the average, and as Rick is pointing out, the market is anticipating job growth sooner than September or October, which is what historical averages suggest.

What we've concluded is that even without job growth, we can expect GDP growth of 1.2% based on consumer spending and maybe a little more based on business spending. If we get job growth as well, then that would boost economic growth a little more.

Maybe in the second half of the year GDP will be closer to 2.5%, which would imply some job creation. But even if you get to that level, Rick is suggesting that the market may be anticipating a little better growth than that, given that we've seen such improvement in leading indicators.

Q: JOB LOSSES HAVE SLOWED DRAMATICALLY, BUT WHEN WILL THE ECONOMY START GENERATING NET GAINS IN JOBS?

RR: One thing I'd like to point out, and I need to footnote Walter Prah [Lord Abbett's Director of Quantitative Research], is that the duration of unemployment has never been higher. He's saying that because of the Fed's easy money policy, too many jobs were created that are no longer needed. His point is that there were a lot of people making good wages doing things that weren't in the best interest of the economy, and now they have to retrain to do something else. We don't need eight million people working as day traders or selling “no down” mortgages, for example.

There are two ways to look at this longer-than-normal unemployment. The bear case is that it won't change and the problem is intractable. The bull case is, if we can reduce unemployment, there will be a leveraged effect on economic growth that will occur as the consumer comes back.

ME: If you go back into the newspaper archives, every single recovery since the Second World War has been declared by the press to be jobless. But Walter may be right. There are probably a lot of people who have not come to terms with the fact that their old income and old way of life are no longer viable.

But there are other things going on as well. Business panicked in late 2008 and early 2009, and laid off people at an unprecedented rate, not just in terms of the numbers but relative to activity. So, we saw productivity improve during the recession, which never happens. That speaks loudly to the fact that companies laid off more workers than was necessary.

This is the way it usually works: businesses delay in laying people off because it's expensive to do so. They have an underemployed work force during the recession, and productivity goes through the floor. So, you have full-time employees who are just not working as hard as they can because there's less work to do. When the recovery starts, these people return to full employment. Productivity goes through the roof, but it delays the hiring for months because companies already have the necessary workers on board.

This time around, those workers are not on board; they were laid off during the panic of 2008–09. This suggests that although there is going to be a lag in jobs creation this time, as there always is, it will likely be shorter than in the previous recession, when it was 22 months from the turn in the economy to the turn in jobs.

So, the metrics we should watch during the next few months are overtime hours worked and temporary employment. They're the leading indicators for future hiring. The increase in temporary employment has begun, but the increase in overtime hours has not.

ZB: The unemployment duration is long, but this may be supported by a government that has extended benefits again and again. Benefits have never been extended this long before.

But we may see a recovery in employment soon. Historically, anytime we've had two consecutive quarters of economic growth above 3% employment has improved. So, we may see an improvement in employment in the next quarter or two.

ME: Adding to the hiring delay is the tremendous uncertainty of the legislative agenda. Companies are not rehiring because they're afraid. Who was going to hire while healthcare was up in the air? Who's going to hire now that

there is talk of a new environmental bill? So, the government is getting in its own way on the employment front.

I'll give you an example from the healthcare reform law. It says that businesses with more than 50 employees have to provide health insurance. But it's unclear whether a company that grows from 50 employees to 51 has to provide health insurance for everybody. And that really affects the way small companies hire. So, even with the legislation passed, it's unclear.

Q: SPEAKING OF THE NEW HEALTHCARE LAW, WHAT IS ITS LIKELY IMPACT ON THE ECONOMY AND ON MARKETS?

RR: We had an internal all-hands meeting on this the other day, and it was difficult to come to definite conclusions. But that just means that we've been paying attention.

The question we tried to answer was: How does this affect the stock market? During our debate, we had certain epiphanies. Someone pointed out, for example, that during the past year some healthcare stocks did better than others. The ones that performed better were healthcare service companies such as HMOs, and the ones that did poorly were stocks like biotech and pharmaceuticals. Now some people said biotech and pharma did relatively poorly because they have higher margins, and industries with higher profits are a natural area for targeted government action.

HMO stocks probably rose because they could benefit from the mandate that everyone purchase health insurance. But these companies have razor-thin margins, and we don't know what the unintended consequences of the law will be.

Some argued that healthcare stocks would be fine because the government wouldn't want to hinder an industry that is so innovative. But others pointed out that the defense industry is not only innovative but is also strategically important to the country and important for our security. And the government has regulated their rates of return, and the multiples of those stocks are extremely low. So, why would healthcare be any different from defense?

The performance of healthcare stocks, however, may not be about healthcare reform at all, according to another view, but about the economy. If the economy recovers strongly, then investors won't overweight these stocks; they'll buy cyclical stocks. If the economy double-dips, investors will go back to healthcare because it's a defensive sector, and the downside risk is limited.

Despite the confusion about what is in the new legislation and what the unintended consequences could be, some broad conclusions are possible. The new healthcare reform law adds

to taxation and adds to regulation. It increases healthcare costs in return for more coverage.

On the other hand, the law is so complicated that it's difficult to boil it down to one pithy piece of advice. But the prevailing opinion internally is that multiples on healthcare stocks will compress until we know with certainty what the rules of the game are.

ZB: As for its broader impact, the new law is a huge economic hurdle. It increases taxes, and if employers are forced to offer healthcare insurance, that increases the cost of employment. This legislation not only makes it more difficult to add employees, it also makes the United States less competitive globally.

This reform also slows capital formation. Anybody who wants to make an investment will now second-guess: How can I do this without increasing my taxes? Reform was never about containing costs—it was about expanding coverage.

ME: If I were an employer, the last thing I would want now is employees. So, companies will go for labor-saving devices, and our productivity is going to soar, but we're going to have an underclass that we subsidize.

The bottom line is that you can't provide healthcare to more people more cheaply.

The Congressional Budget Office [CBO] said the bill would narrow the deficit, but it assumed the reform would generate higher tax revenues. The assumption was that when businesses were free from the expense of healthcare because the government picked it up, they would pay their workers the difference. This would be taxable income and would boost tax revenues.

Another assumption is that there will be a \$250 billion "fix" for doctors. But that is not in the bill that was passed. The bill also assumed 10 years of revenues, but only six years of expenses.

ZB: Keep in mind too that the CBO isn't allowed to make its own assumptions. All the assumptions are handed to them by Congress, and the CBO calculates costs and revenues based on those assumptions.

RR: One unintended consequence of this is that the attraction of a medical career will decline, and there will eventually be supply constraints and access problems for people in rural areas. In a real sense, the fear is that the United States will emulate a European model.

ME: There is one huge difference with Europe. In Europe, the doctors work for the government. In the United States, we have the plaintiffs bar. We have to keep the doctors independent and "sue-able." So, they can't be employees of the government. That's why the United States has to work through the insurance companies.

Q: THE QUESTION OF GOVERNMENT SPENDING RAISES THE QUESTION OF THE CRISIS IN EUROPE. WHAT ARE THE IMPLICATIONS OF THE DEBT CRISIS IN GREECE AND THE OTHER TROUBLED COUNTRIES OF EUROPE?

ZB: Applying this crisis to the United States, as a country we are not substantially better than Greece when it comes to budget deficits and excess debt. Additional government spending programs leave little hope that this situation will change anytime soon. We're already seeing these concerns reflected in the Treasury market as yields creep higher.

We have yet to see the impact if investors such as China decide to back away from the Treasury market. Maybe they wouldn't intentionally back away, but they're about to publish their first trade deficit, and this suggests they may have less money to direct at Treasury securities. A pause in their purchases will have an impact on yield.

Add to that the hope that at some point our banks start lending again, and they'll end up purchasing fewer, and probably even selling, government securities. So, in our opinion, there's nothing hopeful on the horizon for Treasury yields, either short term or long term, especially when it comes to supply and demand.

ME: I would make a distinction between us and the Greeks. The United States in the end can always print money, which means we will not legally default on the debt. We may pay our creditors in dollars that are worth much less, but we won't legally default.

The Greeks, however, do not print euros, so they can go bust. They have no control over the currency in which their debt is denominated.

RR: Isn't the issue really the other PIIGS [Portugal, Italy, Ireland, Greece, Spain] and whether France and Germany will stand by when all these other countries start to have similar problems? If they bail out the PIIGS, all they're really doing is kicking the can down the road. They haven't really solved the problem. So the real question is, if they can't let the other PIIGS fail, is the problem intractable?

ME: They don't have a solution, but the Europeans have too much invested politically in the euro to let these countries fail. The rules say these countries should be kicked out or fined. The PIIGS can't afford a fine, and they're not going to kick them out because then the eurozone starts to dissolve.

It is an intractable issue, and the only way that Germany and France can step up to the needs of the weak players is to gain some control. So, Greece and the others will become less sovereign in their fiscal policy, as is already the case in their monetary policy. More and more fiscal policy will be

conducted by the European Union, ostensibly, but really by the Germans and the French.

A drop in the euro would be something of a solution because then Greece's labor and products wouldn't be so overpriced. But as the Europeans come up with a solution—and I think they will—the euro will stabilize. I don't think it will rally against the dollar, but it will stabilize.

What we've seen in the dollar/euro exchange rate year to date, especially if it stabilizes, is not enough to unwind seven years of dollar declines. Right now, Europe has priced its goods much more expensively than the United States, even at current rates.

What's happening in Europe may be blunting the rise in yields in the Treasury market as investors flee to the safety of Treasuries.

ZB: When we initially heard about Greece in the press, the word “contagion” was thrown around. People panicked. Yield spreads on high-yield bonds widened by 100 basis points over Treasuries. Investors then gradually concluded that Europe would find a solution. In the process of various attempts at a solution investors became less sensitized to what they categorized as a foreign problem, and gradually we saw domestic risk appetites increase.

In the bond market, investors continue to push toward longer maturity risk and higher credit risk. High-yield spreads are now lower than they've been in this cycle, down to about 610 basis points over Treasuries, whereas at the height of Greece concerns they were at 720–730 basis points.

Q: WHAT ABOUT THE GOVERNMENT DEBT PROBLEMS AT THE STATE AND LOCAL LEVEL?

ZB: While much has been written about the increase in municipal defaults, we need to keep things in perspective. Last year, they amounted to less than one half of 1%. Also, these defaults are generally very small issues, sold locally, and are unrated.

Importantly, instead of defaulting, troubled cities and states will more likely compromise the quality of life because there will be budget cutbacks. They'll have to fire teachers, reduce education spending, cut back on firemen and policemen, even parole prisoners earlier. But they'll make required debt payments.

If you look at major cities and states, it's true that you probably want to be cautious about California, and you don't want to own a lot of municipal bonds from cities like Detroit. Even in those cases, their credit ratings will be downgraded, but defaults are unlikely.

RR: A big issue is, how much will states be able to raise taxes on the highest earners before those earners move to low-tax states such as Florida or Texas? At some point,

there's a risk they will exercise their option to move to “greener pastures” with lower fiscal deficits.

The point is that the percentage of tax revenue that comes from the top earners is huge; the tax base is not very broad. When you combine the precarious nature of the tax base with huge pension obligations arising from the low retirement age for state workers, it's a very dangerous precipice.

Q: WHAT OTHER RISKS DO YOU SEE ON THE HORIZON?

RR: We can't dismiss the possibility of a rise in protectionism. There has been a lot of “saber rattling” by our government about China and the low value of the yuan, which contributes to their huge trade surplus with us.

ZB: The danger of protectionism is especially acute when you have politicians playing the populism card, which is happening increasingly. Also, there is a risk that the Treasury Department could classify China as a currency manipulator, meaning that it is keeping the yuan artificially low in order to gain an unfair advantage in international trade. This possibility comes up every six months, when [the] Treasury [Department] is required to report on the currency policies of our trade partners, and there has been increasing pressure from Congress to put this label on China.

ME: Also, Senator Chuck Schumer [D-NY] has again proposed a tax on Chinese goods, and in Europe, French president Nicolas Sarkozy has been making protectionist statements as well.

RR: The midterm U.S. congressional elections and the political mood are also a risk. In the 1980s and 1990s, there existed a rising sentiment toward capitalism because people believed they could become rich. Tax rates were also lowered to provide an incentive for innovation, and many people hoped to become the next Internet millionaire.

But today, with 10% unemployed and fears among some people who believe that it could go to 20%, the political mood could become more populist, and the United States could become more European-like in sentiment. This could, for example, mean a greater emphasis on protecting the disenfranchised versus lowering tax rates to promote growth initiatives.

So the midterm elections are key. Will those who believe in the free market, and believe that government has gotten too big, carry the day, or are we going to have a more European-type approach?

The equity markets seek a stable environment that keeps interest rates and corporate earnings on a predictable trajectory. A populist change may impact not only earnings per share by raising taxes, but also lower multiples with higher interest rates. ■

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. The index is unmanaged, does not reflect the deduction of fees or expenses, and is not available for direct investment.

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(04/10)