Quarterly Investment Perspective

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Key Points:

- *Despite a slump in September, stocks ended the third quarter with gains, while bonds continued to appreciate in value. Volatility is likely to increase around the election, but history tells us that stock markets are likely to trend higher regardless of the outcome.*
- *The economic recession is likely over but the pace of the recovery is slowing. Despite growth flattening out across major economies recently, the aggregate global economy is currently not at risk of another recession heading into 2021. In the U.S., another large-scale fiscal stimulus package will be critical to extending the recovery.*
- *Maintaining a balanced mix of growth and defensive assets and being properly diversified is as important as ever. Moving to cash is not an enduring strategy. Sticking to one's investment plan during times like this can increase the chances of achieving investment success and substantially growing wealth over time.*

Market Review & Outlook

Stock markets continue to recover

Despite a slump in September, stocks ended the third quarter with gains. The global stock market in aggregate rose 8%[1] from July to September, once-again led by the small group of giant U.S. technology stocks that have prospered in the stay-at-home, remote-work environment. In aggregate, corporate profits have fallen significantly this year due to the pandemic, but many companies, particularly larger ones, have done well or not as bad as expected. Helped by massive stimulus, the U.S. stock market is back in positive territory this year, and international stocks, while behind, are getting closer to level. (See **Figure 1**.)

Bonds continue to appreciate

Bonds broadly gained in the third quarter as the U.S. Federal Reserve approved a shift in how it sets interest rates, signaling it would leave them low for years. Meanwhile, central banks worldwide have remained committed to buying government and other high-quality bonds to support the smooth functioning of bond markets and to keep interest rates low. These central bank bond purchase programs have benefited investors who own investment-grade bonds in their portfolios. Demand for safe bonds remains strong amid continued uncertainty about the future.

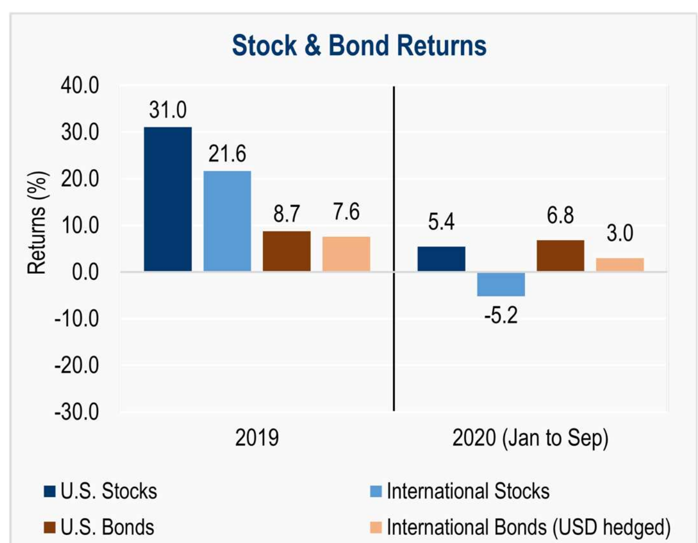

Figure 1. After a severe downturn in corporate earnings and the economy earlier this year, stock markets continue to recover. The U.S. stock market is positive again, as most U.S. businesses were quick to move to remote work, and many companies faced with financial risk were able to tap into government aid. Meanwhile, U.S. bonds have been one of the best performing major asset classes so far this year. Strong demand from central banks and investors have boosted high-grade bond returns.

Source: Morningstar, Russell, MSCI, Barclays. Data as of 09/30/2020. See endnote 2 for additional disclosures.

Volatility is likely to increase around the election

The U.S. election looms large, with the potential for drastically different implications on policy and markets. However, this dynamic is not uncommon when elections are upon us. This time around, tax and spend, regulatory, healthcare, and international trade policies are front and center. Uncertainty around these important policies—in addition to other concerns about rising worldwide COVID-19 cases and escalating tensions between the U.S. and China—is likely to dampen business sentiment further and increase financial market volatility.

Stock markets are likely to trend higher post-election

If a material downturn in the markets were to occur before or on election day (which will likely end up being much longer than a day), the volatility would probably be emotion-driven and short-lived. Stock markets have tended to power through elections regardless of whether the outcome is a divided government, party change, or an undivided government. (See **Figure 2**.) A potential Democratic sweep would likely not prevent the stock market from moving higher over the 3, 6, and 12 months after the election.

Election Impact on Markets has Historically Been Short-Lived
Historical U.S. Stock Market Returns Before and After Elections
(50 elections events between 1948 and 2017)

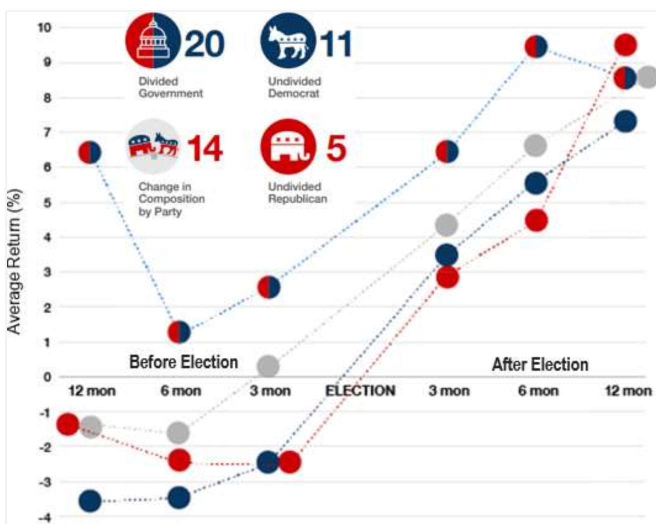

Figure 2. Although elections have historically affected financial markets, other factors also come increasingly into play over time, mitigating the political effect. Historically, 3, 6, and 12 months after the election, the political effect largely disappears (regardless of the election outcome) as many factors influence stock market performance.

Source: Lord Abbett[1], S&P Dow Jones Indices. Data from 1948 to November 2017. See endnote 3 for additional disclosures.

Economic Review

Economic recession is likely over, but the recovery is not

Although not officially declared yet, recessions in many major economies, including the U.S., likely ended in the third quarter. With the help of large-scale stimulus from governments and central banks, economic activity rebounded sharply from the COVID-19 induced collapse.

However, recent data show that the pace of improvement is slowing in many areas as leading economic indicators have leveled off. (See **Figure 3**.) The slowing pace is likely because we are now beyond the initial rebound phase, but more importantly, a worldwide resurgence in coronavirus cases is hampering business and consumer sentiment. In the U.S., uncertainty surrounding the imminent U.S. presidential election and the delay in additional government stimulus has further eroded confidence.

The Economic Recovery has been Strong but it is Slowing
Global Composite Leading Indicators
2020 Year-to-Date; Long-Term Average = 100

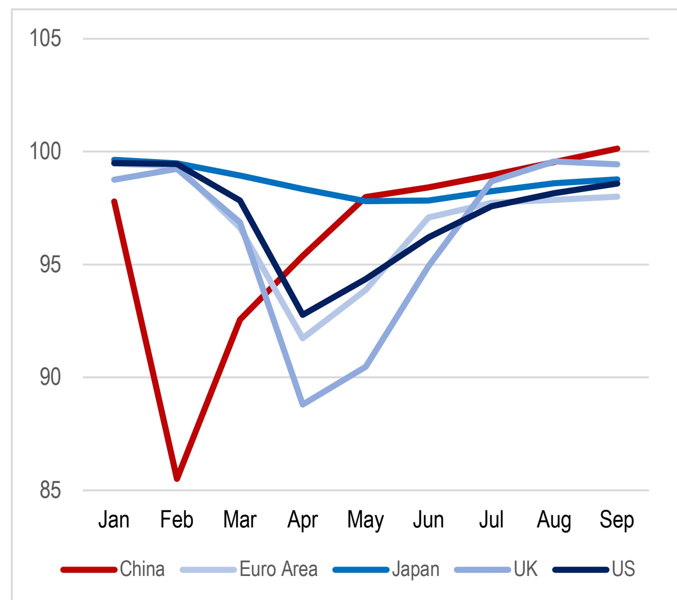

Figure 3. Global leading economic indicators, which provide early signals of turning points in business cycles, are telling us that things continue to improve, however the pace of improvement is slowing.

Sources: Organization for Economic Co-operation and Development (OECD). Data from January to September 2020. See endnote 4 for additional disclosures.

Economic Outlook

The risk of a "double-dip" recession is low

Despite growth flattening out across major economies, the aggregate global economy is currently not at risk of another recession heading into 2021. Severe and synchronized nationwide shutdowns seen in the earlier days of the pandemic will likely not be repeated, sparing the economy from another contraction. Slowing the spread of the virus could be done with relatively less economic impact going forward. Localized and temporary restrictions will be increasingly implemented to limit social interactions and conserve health care resources, similar to those taken recently in many parts of Europe due to the sharp rise in cases. (See **Figure 4**.)

The road to a full recovery will be a long one

Although the recession may be ending and the risk of another is low, economic recovery will likely take longer than we want. The virus will continue to be the biggest threat to the recovery until a vaccine or viable treatment becomes widely available, and people feel safe enough again where activity returns to some sense of normalcy. Until then, most economies will likely continue to grow at a slow rate and operate below full-recovery levels.

This environment will require continued stimulus from central banks to ensure businesses (and governments) can continue to borrow, as well as additional government fiscal support. In the U.S., another large-scale fiscal stimulus package will be critical to extending the recovery. Regardless of who wins the election, there will likely be some sort of stimulus enacted.

On the Minds of Investors

What has driven the stock market rally, and will the rally continue?

The stock market has experienced a full "V" shape recovery this year while the economy and earnings have not. Amid the worst economic recession since the Great Depression and the largest corporate earnings decline since the 2008/2009 Global Financial Crisis, the stock market has recovered quickly from the March lows and hit new record highs in September. Additionally, the bulk of the stock market's recovery has been driven by companies with digital advantages, including e-commerce platforms, microchip makers, social media networks, and communication services.

The Sharp Rise in Euro Area Cases Has Resulted in Localized Lockdowns

7-Day Moving Average of Daily COVID-19 Cases in the U.S. and the Euro Area

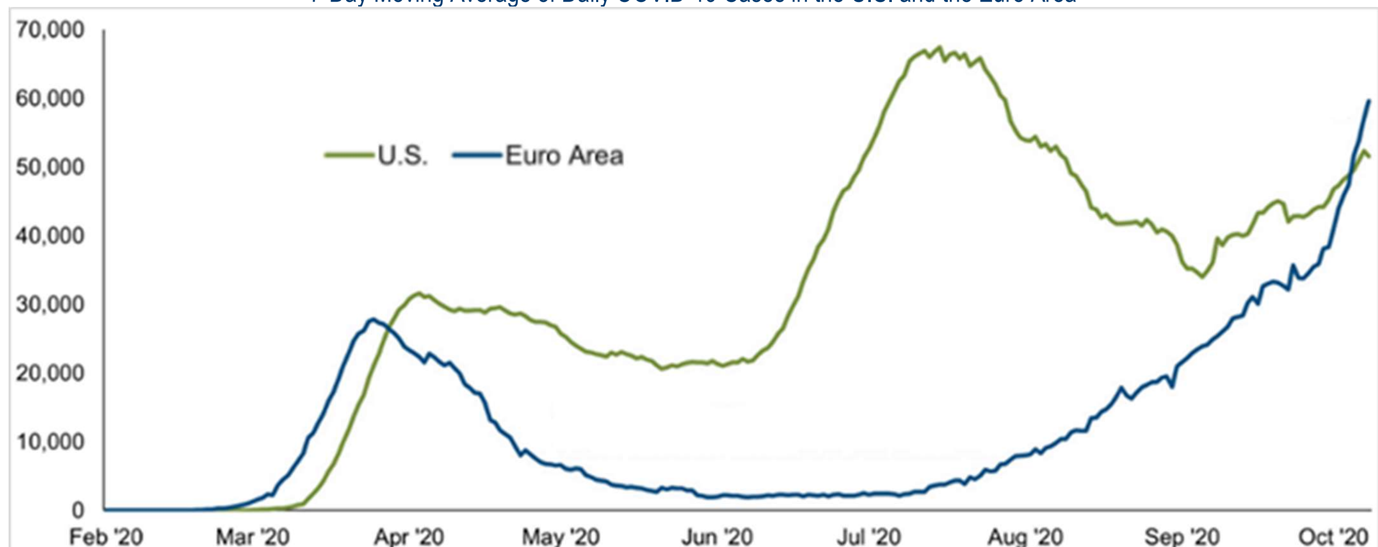

Figure 4. The euro area —the 19 countries that use the euro— successfully flattened the curve after the first wave of infection but is now seeing more new cases than the U.S. The sharp rise in cases has prompted new curfews, closures, and restrictions in many parts of Europe.

Sources: Payden & Rygel, John Hopkins University. World Health Organization. Data as of 10/16/2020.

The markets have been driven by the economic improvement that has already occurred and optimism about the potential for further improvement in economic activity down the road. This is part of the reason why the stock market rally is believable. Granted, this positive outlook has been (and will continue to be) dependent on massive stimulus and significant progress on COVID-19 vaccines and drug therapies. Despite recent delays and setbacks, we believe that Washington will pass additional fiscal stimulus and that scientists will develop an effective vaccine or treatment.

Additionally, the rally is believable because aggregate (12-month-forward) corporate earnings growth forecasts have been consistently trending higher after bottoming in May. (See **Figure 5**.) Although corporate earnings, on the whole, have suffered during the pandemic (with the exception of some technology and healthcare companies that actually grew earnings), expectations are for aggregate earnings to start growing again as soon as the first quarter of 2021.[6] In other words, the stock market (as usual) has been pricing in a substantial future earnings recovery well ahead of it happening.

The rally may pause, as it has done recently ahead of the U.S. election and amid delays in Washington passing an additional stimulus package. Or it may temporally suffer a significant pullback in a contested election scenario or if COVID-19 cases continue to increase at a fast rate this winter. However, the stock market rally will likely continue beyond these brief periods of volatility. As we get closer to moving past this pandemic, the recovery in stocks will eventually broaden out to the many sectors and industries of the market that have not yet participated in the rally. (See **Figure 6**.)

Portfolio Management

Maintaining a balanced mix of growth and defensive assets is as important as ever

Despite high uncertainty and market volatility today, we believe there is a strong case for maintaining portfolio allocations to growth assets (i.e., risk-based investments like stocks). The implications of extremely low-interest rates, unprecedented government support for individuals and businesses, a greater understanding of COVID-19, and a focus on re-opening, will likely lead to a new economic cycle and corresponding bull market.

Earnings Estimates Continue to Trend Higher After Bottoming in May

S&P 500 Index Price vs. Earnings per Share (EPS)

Figure 5. Stocks are currently pricing in a substantial earnings recovery well ahead of it happening. However, it is typical for stocks to rally (or decline) well before earnings do.

Sources: John Hancock Investment Management, FactSet. Data as of 9/30/20. See endnote 5 for additional disclosures.

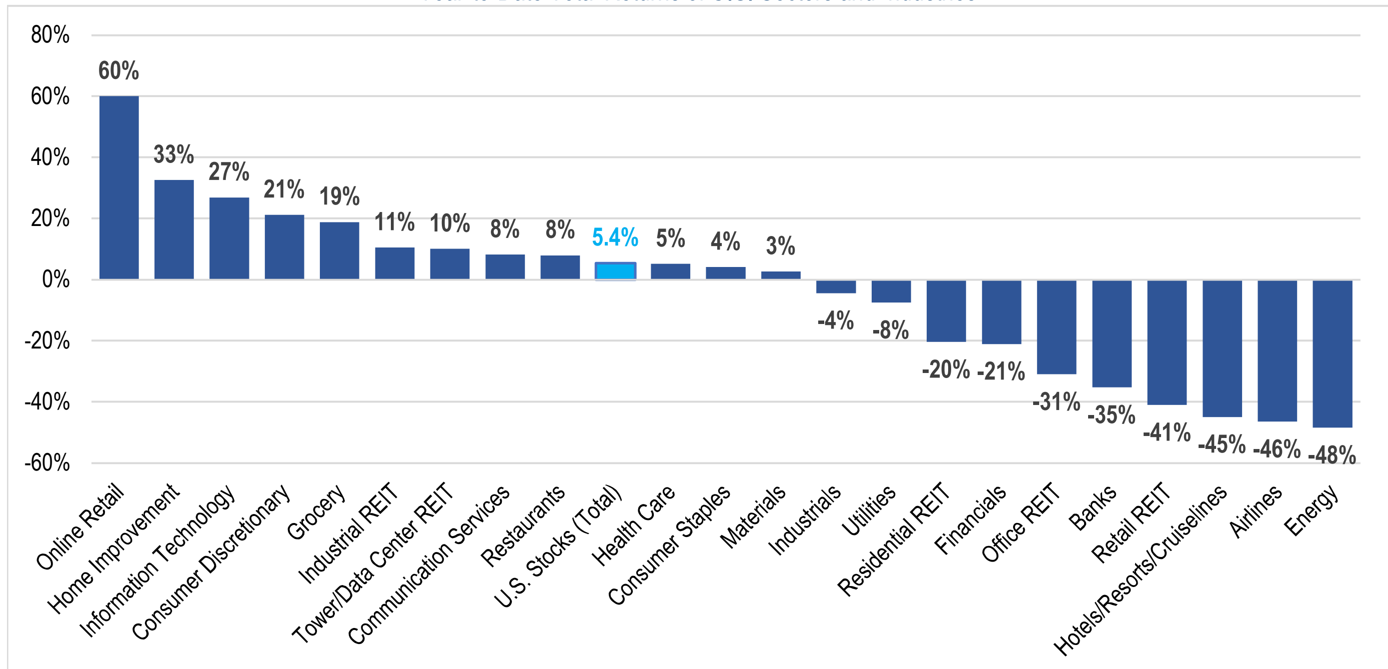

Figure 6. Although the aggregate U.S. stock market is now positive again in 2020, some sectors and industries of the U.S. economy have been hit hard, including banks, hotels, retailers, airlines, energy companies. As we get closer to moving past this pandemic, the recovery in stocks will eventually broaden out to sectors and areas of the market that are still beaten down.

Sources: Morningstar Direct. Standard & Poor's. Data from 01/01/20 to 9/30/20. See endnote 7 for additional disclosures.

There is also a strong case for balancing a portfolio with defensive assets (i.e., high-quality bonds). Uncertainty around major government policy shifts, a significant setback in the world's quest to get past the pandemic, and a global economy that is still healing, will likely result in big swings in the financial markets.

Pairing together growth and defensive assets in a portfolio is beneficial for a few reasons. It helps investors stick to their financial plan and achieve their long-term goals by making it easier to stay invested and significantly grow their wealth over time. It also gives investors the ability to rebalance, which is to opportunistically buy assets when they sometimes become deeply discounted (e.g., during temporary stock market selloffs) and to reduce portfolio risk when assets become more expensive.

Maintaining proper diversification is also important

When building, advising on, and managing portfolios for clients, we incorporate the above strategy on multiple levels. At a higher level, we look at the mix between growth and defensive assets in a portfolio. On a lower level, we focus on the assets *within* those growth and defensive buckets.

On the growth asset side of the portfolio, this means diversifying across (and rebalancing between) U.S. and international securities; real estate and infrastructure investments; and growth, value, large, and small company stocks. This diversification helps portfolios participate in market growth while avoiding concentration risk in areas of the market that are very expensive or are hurting amid the pandemic.

On the defensive asset side of the portfolio, this means diversifying across (and rebalancing between) U.S. and international bonds; government and corporate bonds; taxable and municipal bonds; and short, intermediate, and long-term bonds. This diversification helps to maintain some portfolio protection while potentially enhancing future bond returns during what will likely be a prolonged low-interest-rate period.

Moving to cash is not an enduring strategy

One of the principles of our philosophy is that most investors should stay invested for as long as possible. Our philosophy is contrary to an approach that suggests that one should try to "time the market" by getting out when markets conditions get bad, staying in cash for a period, and buying back in the market later on.

Although timing the market sounds logical, in practice, it is tough to get right more times than not. Often, it can result in missing out on significant returns during recovery periods. Additionally, what makes staying in cash particularly challenging today is that the return (or interest earned) on it is nearly zero. Over time, even with a low level of inflation, investors end up effectively losing money on cash.

Market timing between stocks and cash is not an enduring investment strategy. Instead, the enduring approach is to stay invested in a properly balanced and diversified portfolio and implementing a disciplined rebalancing process when needed. Sticking to one's investment plan during times like this can increase the chances of achieving investment success and substantially growing wealth over time.

Sources & Endnotes

[1] Source: Morningstar Direct. Global stocks as measured by the MSCI ACWI IMI NR USD, returned +8.11% from 7/1/20 to 9/30/20.

[2] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index.

[3] https://www.lordabbett.com/en/perspectives/marketview/two-key-observations-caveat-on-2020-election.html Analysis based on data tracking inflation-adjusted S&P 500 Index price returns. Election events include both off-election and presidential elections. Divided Government is when at least one out of three of the president, Senate, and House are in the hands of one party and the other two are in the hands of the other.

[4] The composite leading indicator (CLI) is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long-term potential level.

[5] The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Earnings per share (EPS) is a measure of how much profit a company has generated calculated by dividing the company's net income by its total number of outstanding shares.

[6] Factset. https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_101620A.pdf

[7] Source: Morningstar Direct. Online Retail is represented by the S&P 500 Sub/Internet Retail Index. Home Improvement is represented by the S&P 500 Sub/Home Improvement Retail Index. Information Technology is represented by the S&P 1500 Information Technology Index. Consumer Discretionary is represented by the S&P 1500 Cons Discretionary Index. Grocery is represented by the S&P 500 Sub/Food Retail Index. Industrial REIT is represented by the MSCI USA IMI/Industrial REIT Index. Tower/Data Center REIT is represented by the MSCI USA IMI/Specialized REIT Index. Communication Services is represented by the S&P 1500 Telecom Services Index. Restaurants is represented by the S&P 500 Sub/Restaurants Index. U.S. Stocks (Total) is represented by the Russell 3000 Index. Health Care is represented by the S&P 1500 Health Care Index. Consumer Staples is represented by the S&P 1500 Cons Staples Index. Materials is represented by the S&P 1500 Materials Index. Industrials is represented by the S&P 1500 Industrials Index. Utilities is represented by the S&P 1500 Utilities Index. Residential REIT is represented by the MSCI USA IMI/Residential REIT Index. Financials is represented by the S&P 1500 Financials Index. Office REIT is represented by the MSCI USA IMI/Office REIT Index. Banks is represented by the S&P 500 Ind/Banks Index. Retail REIT is represented by the MSCI USA IMI/Retail REIT Index. Hotels/Resorts/Cruiselines is represented by the S&P 500 Sub/Hotels Resorts&Cruise Index. Airlines is represented by the S&P 500 Sub/Airlines Index. Energy is represented by the S&P 1500 Energy Index

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Important Disclosure Information

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