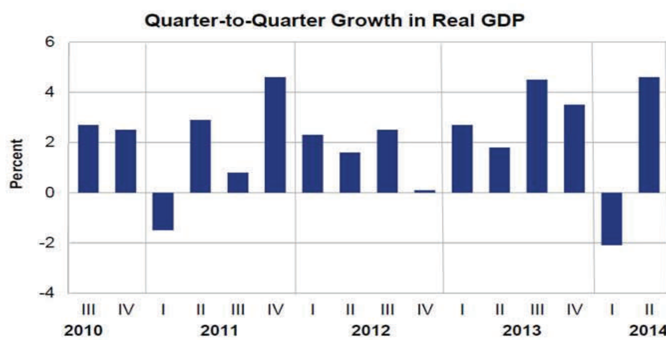
U.S. MARCHING ALONG AMID SLOWING WORLD GROWTH

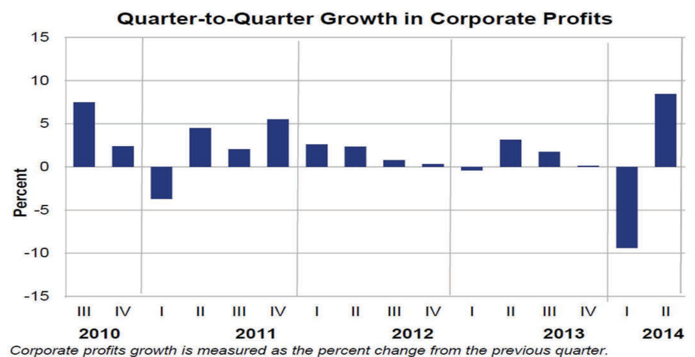
A number of issues are rattling the capital markets and the Standard & Poors 500 is now off more than 3% since establishing a high on September 18th. The image on the left shows how the S&P 500 has fared since then. The image on the right shows how it looks if we zoom out a bit and look back five years.

THE 'R' WORD BACK IN THE LEXICON

In an October 1st research note, S&P Economics noted that economic output (as measured by Gross Domestic Product) and corporate earnings within the U.S. have bounced back sharply in the second quarter from the pronounced contraction in the preceding quarter. Professional guessers seem to have dismissed the first quarter contraction as an aberration stemming mostly or even completely from an exceptionally harsh winter rather than from any fundamental economic weakness.



Real GDP growth is measured at seasonally adjusted annual rates.



Corporate profits growth is measured as the percent change from the previous quarter.

S&P thinks economic activity within the U.S. has strengthened further during the third quarter and expects healthy growth within the private sector to continue to offset muted government spending through the balance of 2014.

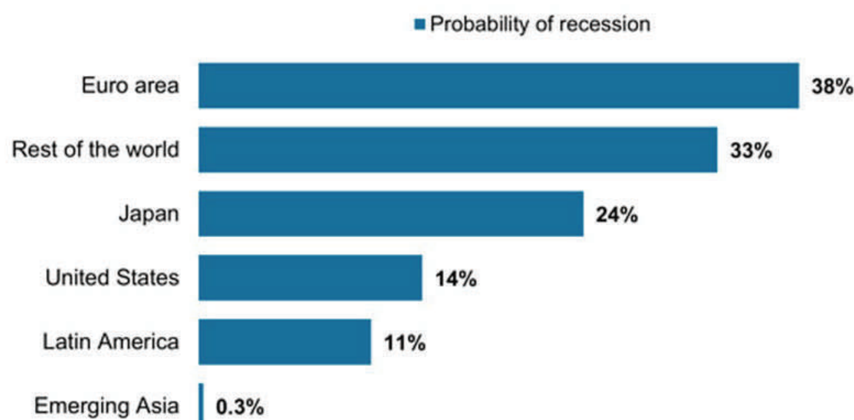
Corporations have already begun reporting third-quarter earnings and S&P estimates that, on average, analysts expect corporate profits to rise about 6.7% versus the third quarter of 2013, a figure that approximately matches the long-term rate of earnings growth in this country.

Furthermore, it is comforting to know that analysts expect earnings to increase across all 10 industry sectors with Telecom (+14.5%), Materials (+12.0%) and Health Care (+11.3%) leading the way. The Consumer Staples sector (think of cereal, shaving cream, and other things folks buy regardless of how poor they might be feeling) is expected to bring up the rear with earnings advancing just 2.9% versus a year ago. Of the 22 companies that have reported third quarter earnings results so far, 15 have bettered analysts' estimates, two have matched estimates, and five have missed expectations. All in all, that's pretty good.

In short, S&P thinks the anxiousness that investors are currently exhibiting will ultimately be quelled by solid underlying investment fundamentals. Notably, however, S&P has gone through the exercise of calculating the probability of the U.S. experiencing another recession over the course of the next year. For now, it estimates those odds to be 10% - 15%. Let's take a look at some other gremlins that seem to be finding their way into investors' collective consciousness.

RECESSION ON THE IMF'S RADAR, TOO

According to the International Monetary Fund, the eurozone's (18 countries that have adopted the euro as their official currency) chances of falling into recession have roughly doubled to about 38% since April as the threat of deflation imperils the region's growth prospects. Although a near-term recession is still officially improbable, the world's largest and third largest economies (the U.S. and Japan) do appear on the following list and are associated with recession probabilities that are materially above zero. Of note is that the IMF figures the "rest of the world" stands a one in three chance of experiencing a recession within the next year.



The IMF thinks the eurozone's three largest economies, Germany, France and Italy, now face lower growth prospects than it had previously figured. Based on weaker growth trajectories, the IMF figures these economies are now more susceptible to even comparatively minor economic shocks. The result is a commensurate rise in the probability of recession.

The IMF's most recent downward revision to its global economic outlook marked the fourth year of what it referred to as serial disappointments in global growth prospects. Because downside risks appear to have increased, the IMF warned it may have to trim its estimates next year, too.

EUROZONE DEFLATION ALSO A CONCERN

Persistently falling prices are poisonous to an economy since they induce people to postpone purchases in their pursuit of maximum utility. As each economic entity is increasingly induced to halt its spending, economic activity slows. A deflationary spiral occurred in the 1930s, but instead of adopting policies to thwart deflation (to encourage at least some inflation), policymakers adopted policies that actually exacerbated the situation. The result was The Great Depression. While the IMF is certainly not intimating anything this severe, it does estimate the probability of the eurozone experiencing at least some deflation between now and next June at a non-trivial 30% and it is now on record of reminding policymakers within the European Central Bank (the ECB, Europe's equivalent of our Federal Reserve system) to be mindful of the threat. None of that is good news, but investors do have a pretty good track record of enjoying the assumed cure of monetary stimulus.

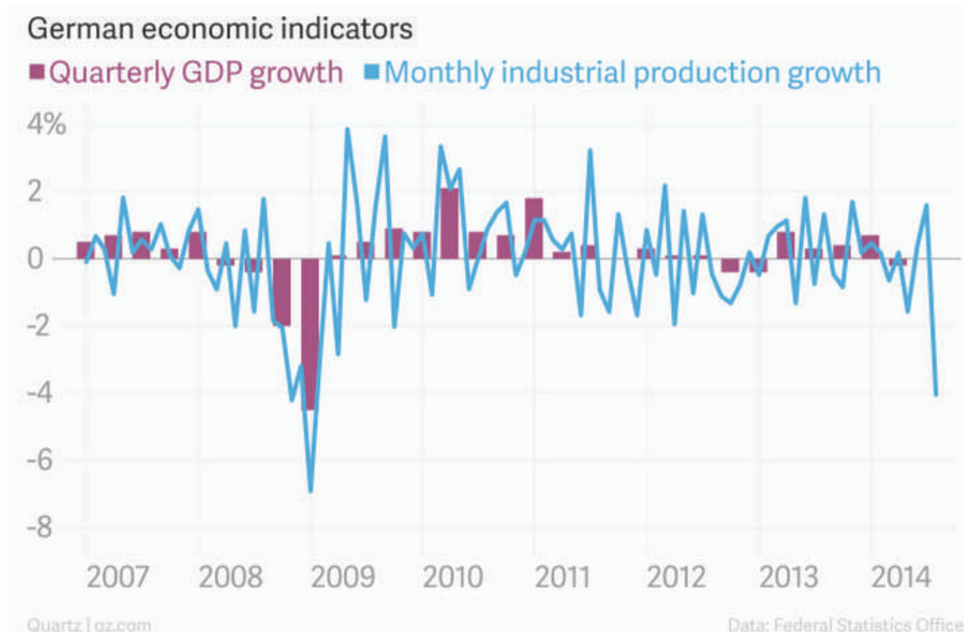
For the sake of comparison, the recurring threat of deflation over the past few years is one reason the Federal Reserve kept its foot on the proverbial gas pedal and continued to expand the monetary base within the U.S. Unsurprisingly, some of those newly created funds found their way into the capital markets pushing asset prices higher. So, central bankers are especially sensitive to the threat of deflation (much more so than inflation) and will usually act accordingly, but just to make sure central bankers in Europe are properly tuned in, the IMF has encourage them to be prepared to buy assets of eurozone nations to the extent the threat of deflation worsens. Translation: The IMF is encouraging the ECB to be prepared to step on the gas the same way the Federal Reserve has in the U.S.

Despite the fact that the eurozone faces a material threat of recession, we currently plan to maintain exposure to European equities based on the notion that the ECB's expected response might help

them more over the next several years than a recession might hurt them in the near term.

IMF FRETS ABOUT GERMANY ...

Because Germany's economy is primarily export based, it has begun to slow as a result of reduced demand both outside, and especially, within the eurozone where member states continue to reign in spending in the aftermath of the euro-debt crisis. In the following image, you'll see that orders for goods and services produced by Germany have plummeted more than at any time since the meltdown of 2008/9.



Consequently, the IMF has trimmed its 2015 growth forecast for Germany to 1.5% from the 1.7% it had forecast in July.

... AND CHINA ...

The Chinese economy is slowing, too. Although the IMF is still forecasting relatively high annual economic growth of 7.4%, it recently warned that China faces a range of near-term growth risks. The World Bank went further and actually trimmed its growth forecasts for this year, and next.

A more recent article from Reuters cited a number of ills that seem to justify recent fretting by the IMF and World Bank. Those ills include a sagging property market that, due to its size, is bleeding over to other areas within China's economy. As an example, retail sales growth has slowed to its slowest pace in over three years (to a still robust 11.7%, though). And, deflation at the producer level is now

expected to have persisted into its 31st consecutive month. In short, China's economy is still growing, but it does seem to have the hiccups and it now seems likely that the pace of growth within the world's second-largest economy has probably slowed in the third quarter of 2014.

… AND ITALY, AND THE UKRAINE, AND THE MIDDLE EAST

The IMF expects Italy to enter its third consecutive year of recession as policymakers struggle to restructure the Italian economy to boost competitiveness. The IMF also feels that conflicts in Ukraine and in the Middle East coupled with, as it puts it, "overly-optimistic financial markets" provide the ingredients for a potential correction. The IMF concludes that if growth disappoints or geopolitical tensions flare, borrowing costs could spike which could fuel volatility in bond, equity and currency markets, and further complicate the challenge of reducing high public and private debt.

EBOLA IS NOT HELPING, EITHER

Epidemiologists seem to agree that because the Ebola virus is not an airborne threat and because those who are infected are thought to not be contagious until they are symptomatic, it does not have a high degree of plague potential. Nonetheless, the rate of infection has grown exponentially since spring and it has infected and killed a number of health care workers who were thought to have been protected. In addition to wigging out the public, Ebola does pose a threat to the airline and tourism industries.

FED POLICY

Economic data for the U.S. has been pretty good lately. Whereas investors had previously learned to react positively to poor economic news over the past several years on the premise that it would spur the Fed to pump more money into the system, the converse now appears to hold true. Good economic news is still welcome, but investors now worry that overly good news may induce the Fed to halt and or even reverse its still-ongoing stimulus program faster than it otherwise might.

Equities have been in a funk lately, but investors were officially relieved on October 8th after the Fed released the minutes from its September policy meeting. In short, those minutes indicated that the Fed remains determined to take a cautious approach toward raising interest rates and normalizing monetary policy as the U.S. economy continues to recover gradually. According to those minutes, economic activity continued to expand "at a moderate pace," but not fast enough

to raise fears that the Fed will reverse its stimulus program or raise interest rates anytime soon.

The Fed's primary objective is to achieve (relatively) full employment and price stability. Although the official unemployment rate has now fallen to around 5.9% (its lowest level in six years), the Fed is aware that this statistic is distorted by substantial numbers of job-seekers who have become so discouraged that they are no longer counted as being part of the potential workforce and by others who are underemployed. Accordingly, the Fed seeks further improvement in the employment picture. To the extent inflation does not appear to be a threat (and so far it appears not to be), the Fed is not likely to reverse its current course in the immediate future.

As expected, the Fed held steady on its plan to reduce the rate at which it pumps additional stimulus into the U.S. economy in October from $25 billion to $15 billion. But overall, investors cheered and equity prices soared. Trading in the futures market indicates that, among those who express their opinions by risking their own capital, the consensus view is that the Fed's first interest-rate hike may not occur until sometime next summer.

RESEARCH FIRMS SURPRISINGLY POSITIVE

I already mentioned that Standard & Poors thinks that near-term angst will subside as higher corporate earnings make equities more attractive. S&P also thinks the prospect of continued, albeit moderate, earnings growth suggests that the general equity rally may last a while longer, although not at last year's impressive pace.

Milton Ezrati, chief economist for the Lord Abbett family of mutual funds, believes that even though equity prices have risen significantly over the past five years, current earnings multiples are not materially different from their long-term averages. This suggests that, at worst, cautious investors might regard stocks as being approximately fairly valued and, therefore, able to appreciate along with those modestly advancing earnings .

COMPARATIVE ADVANTAGE STILL GOES TO EQUITIES

Even if equities were somewhat overvalued, they're still at least somewhat attractive on a relative basis. In terms of income, the rates available on cash deposits still approximate 0%. By contrast, the S&P 500 offers an average dividend yield of almost 2%. That may not seem like much of a yield advantage unless you also realize that cash has historically yielded about 2% *more* than cash. This

make equities comparatively attractive to cash in terms of income-generating ability and it suggests that equities might be able to absorb a rise in interest rates better than might otherwise be expected.

SOME FUZZY STOCK MATH

Standard & Poors estimates that corporate earnings might match the long-term average and advance by 6.7% over the next year. So, what might that mean for stock prices?

On October 7th, the IMF trimmed its estimate of global economic growth for 2014 from 3.4% to 3.3%. For 2015, it trimmed its forecast from 4.0% to 3.8%. For the sake of conservatism, let's assume the global economy grows by 3.5% over the next year. We might then assume that corporate revenues grow by that same 3.5% as they share proportionately in that growing world pie. Because corporations are, on average, profitable, corporate earnings ought to grow at a rate greater than 3.5%. To sidestep some of the calculation tedium, let's conservatively assume corporate profits grow 33% faster than corporate revenues. This results in annual corporate earnings growth of about 4.7% (3.5% times 1.33).

As Billy Mays might have said in the middle of an Oxyclean commercial, "But wait! There's more!" Companies often use some of their free cash flow to repurchase shares of their stock in an effort to increase the earnings that flow through to the remaining shareholders (you). Presently, companies are buying their shares back at an annual rate of around 2.5%. However, employees who have been granted stock options sometimes exercise those options. This results in new shares being created which then nullifies a portion of the shares bought back by companies. On a net basis, let's assume that net share buybacks amount to 2% per year. This has the impact of increasing the earnings that flow through to remaining shareholders by about that same 2% (slightly more if you're a securities analyst). With this adjustment, we have now made a case for at least 6.7% in annual corporate earnings growth (4.7% + 2.0%).

Billy Mays also liked to repeatedly sweeten his deals, so let's do that by including the impact of dividends. If we assume a 2.0% dividend yield, we could, on average, conservatively look for an annual total return of around 8.7%. Now, it may well be that an 8.7% return from equities does not adequately compensate investors for the risks embedded in owning equities, but in absolute terms, an 8.7% return is far better than the returns offered on cash, savings deposits, and bonds.

BUT, THE ACTUAL RETURN ON EQUITIES COULD VARY WIDELY

In that last paragraph, I qualified that annual, 8.7% return by including the phrase, "on average." Alternatively, I might have hedged by writing, "all else being equal,' or some other similar phrase. In reality, things are unlikely to remain equal. And although I still believe that equities are the preferred long-term asset class, investing in equities requires perspective and patience.

Data pertains to the S&P 500 Time Period	Earnings Growth (Inflation Adjusted)	Cumulative Return on Equities	Annualized Return on Equities	Change in Price/ Earnings Multiple
14 Years, 2 Mos. Ending August 30, 2014	48.5%	36%	2.2%	-32%
15 Years Ending June 30, 2000	115.0%	668%	14.5%	180%
15 Years Ending June 30, 1985	3.7%	164%	6.7%	-34%
15 Years Ending June 30, 1970	-4.6%	71%	3.6%	25%

Source: Bloomberg; Lord Abbett calculations

The graphic below depicts corporate earnings growth during sequential 15-year periods (and one that's almost 15 years). For a given period of time, look at corporate earnings growth. Then, for that same period of time, look at the returns generated by equities. Over long periods of time, returns afforded to equity investors have been very uncorrelated with the changes in corporate earnings. For instance, even though corporate earnings were solidly positive during the period ending in 2014 and slightly negative for the period ending in 1970, the returns afforded to investors in the 1970 were almost twice as high. A similar lack of proportionality can be seen when comparing any two rows.

The problem is that over a given period of time, "all else" is decidedly unlikely to be equal. In general, investors' appetite for stocks will be influenced by their expectations for growth, inflation, tax rates, and all sorts of risks. In general, investors' willingness to bear risk is extremely variable. This can be seen by looking at the 15-year period ending in 2000 (aka the "DotCom Bubble" or "Tech Wreck"). During this period of time, corporate earnings advanced 115%, but returns to stockholders soared 668%. Why? Prior to 2000, investors became increasingly convinced that no price was too high to pay for the shares of any company that appeared to be in a position to benefit from advancing technology. So, the prices of stocks soared in relation to their earnings capacity ... for a while.

Nothing of any particular severity appears to be brewing at the moment, but it's worthwhile to understand that even if corporate earnings do modestly advance as expected, equity values are not necessarily going to rise commensurately. This is why we like to keep a substantial portion of each portfolio invested in assets other than equities. — Glenn Wessel