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MARKET VIEW

U.S. Stocks: Beyond the "Rate Tantrum" Volatility

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Despite the recent market volatility, we believe high-growth stocks remain better-positioned than so-called "bond proxy" names. Here's why.

Following the equity market selloff—one that might be classified as something of a "rate tantrum" in response to new economic data suggesting hints of potential inflation and a move higher in 10-year U.S. Treasury yields—investors may take this opportunity to scrutinize their equity exposure. As they do, it's worth noting that:

1. Recent data reports offer signs of strengthening economic growth.

2. Even as interest rates creep higher, they remain at historically low levels.

3. We have transitioned from a liquidity-driven phase of this bull market to a phase driven by improving economic and corporate fundamentals.

These developments should suggest that the selling was not "the beginning of the end," but rather a step forward toward more "normal" market conditions. Market participants are adapting to a new rate regime and, we think, markets will ultimately continue to move higher (despite recent bouts of volatility) as investors focus on U.S. economic strength, with technological innovation continuing to lead the way among market opportunities.

Against that backdrop, we note that the substantial gains in the broader U.S. equity market (as represented by the S&P 500® Index) in 2017 that extended into the first month of 2018 (before the volatility of early February) represented a distinct break from prior years. A bevy of robust growth stocks led the market, while there has been pronounced weakness occurring among overvalued low-growth, low-volatility bond-like stocks (see Table 1). These stocks often are called "bond proxies" and frequently are found within the real estate, utilities, consumer staples, and telecommunications sectors (the "RUST" sectors for short).

Table 1. "RUST" Never Sleeps? Tell That to Bond-Proxy Investors

Sector	YTD Return (1/31/2018)
Consumer Discretionary	9.34%
Information Technology	7.63%
Health Care	6.65%
Financials	6.48%
Industrials	5.31%
Materials	4.14%
Energy	3.81%

Sector	YTD Return (1/31/2018)
Consumer Staples	1.59%
Telecommunication Services	0.55%
Real Estate	1.89%
Utilities	3.07%
S&P 500	**5.73%**

The 4 “RUST” Sectors

Source: Bloomberg and Lord Abbett. The information shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future. **Past performance is not a reliable indicator or a guarantee of future results.**

What, exactly, constitutes a bond proxy? Companies that pay the bulk of their earnings out in dividends and, consequentially, have a high dividend payout, while also having very low volatility in their earnings, can often trade in a very similar pattern as U.S. Treasury securities (hence, the “bond proxy” moniker). These companies also have very mediocre, if not declining, underlying earnings because they are either no longer in the growth phase of their corporate life-cycle or they are in heavily regulated industries, such as utility and telecommunication companies. These bond proxies also can be found in the consumer staples sector, where profit margins can be thin and companies are compelled to pay out the bulk of their earnings in dividends because they cannot generate returns higher than their cost of capital.

Such stable-income characteristics cause these stocks to trade with a high correlation to U.S. Treasuries in certain types of markets, and this certainly occurred following the global financial crisis of 2008–09. Because many investors believed U.S. Treasuries carried higher risk due to their historically low yields, the perception appears to have been that it was “safer” to own bond-like equities than actual U.S. Treasury bonds.

The result of this high demand for bond proxies during the period of the U.S. Federal Reserve’s program of quantitative easing (2010–16) has been a dramatic increase in their valuations and their increased weight in various equity market indexes. Consequently, many investors have taken on new factor risks within their equity allocations, with interest-rate risk being a major one. And as interest rates continue to edge higher (the yield on the 10-year U.S. Treasury note, for example, recently moved to four-year highs), investors may be wise to continue to scour their portfolios for exposure to these types of stocks.

If the RUST stocks have “corroded” in value, what was fueling the recent gains in the market prior to the recent tumult? Growth equities (as represented by the Russell 1000 Growth Index) were the top performers in the U.S. domestic equity market in 2017, according to FactSet. This performance was driven by a strong fundamental backdrop and favorable secular trends for many high-growth industries. As we have noted before, the secular growth story that recently drove the market higher has many subplots, such as: e-commerce continues to disrupt marketplaces; cloud computing transforms entire industries; and biotechnology advances revolutionary treatments for chronic and life-threatening diseases.

For these reasons, an allocation to the companies that embody innovation in the global economy today continues to make sense for investors looking for growth from their equity portfolios. However, investors may wish to check for RUST stocks before making any commitments to investments purporting to be truly growth-oriented. This warning is especially true of broad-based, passive-equity vehicles, which have significant holdings in the RUST sectors as a result of the flawed nature of index construction, which defines growth as the lack of value, and places many of the most expensive stocks in the growth index despite their lack of true underlying revenue growth. (See Table 2.)

Table 2. Many of the Biggest "Growth" Companies Display Slow, or No, Growth

Price-to-earnings ratios and three-year growth rates (historical) for the top 20 companies, by market capitalization, in the Russell 1000® Growth Index, as of December 31, 2017

Holding	*Historical 3-Year Sales Growth (%)	Price to Earnings
Apple	7.6	14.8
Microsoft	0.7	25.2
Amazon.com	23.6	272
Facebook Cl. A	48.2	30
Alphabet Cl. A & Cl. C**	17.3	32.5
Home Depot	6.5	25.7
UnitedHealth Group	15.3	22
Visa Cl. A	13.1	27.7
Comcast Cl. A	7.2	19.4
Boeing	0.5	29.1
AbbVie	11.6	17.4
PepsiCo	-1.7	23
Mastercard Cl. A	9.2	33.2
McDonald's	-5.6	26.4
3M	-0.7	26
Altria Group	3.2	21.7
Coca-Cola	-7.1	24
Walt Disney	4.1	17.3
NVIDIA	23.7	46.1
Verizon Communications	-0.1	14.1

Source: FactSet.

*Historical three-year sales growth data as of 12/31/2017.

**Alphabet, Inc. Class A and Class C share holdings have been combined. Price to earnings ratio shown is an average of the two share classes.

Note: Average overlap data as of 12/2012 to 12/2017. The historical data shown are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. The information shown is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

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This characterization of growth has been particularly problematic for investors, due to the hefty valuations accompanying RUST stocks in recent years. According to data from the Leuthold Group, the valuation premium associated with low-volatility stocks (based on a proprietary index) was near its highest levels in more than three decades as of early 2017, evoking comparisons to the tech-stock bubble in 1999. By contrast, valuations on Leuthold Group's proprietary index of high-beta stocks (i.e., those found in equity market segments such as high-growth technology, biotech, and consumer discretionary) were near multi-decade lows, looking attractive relative to their underlying organic growth.

As investors consider how to assess their equity allocation after the "rate tantrum," those who are looking to avoid the potential low-growth pitfall of indexing their growth exposure may be wise to consider an equity strategy focused on innovation and accelerating revenue growth, given the historical upside presented by these fastest-growing stocks. As we have discussed previously, for those interested in high-growth equity strategies, **a highly active approach** incorporating both fundamental and technical analysis may merit special consideration, given the idiosyncratic nature of this market segment.

The Russell 1000 Index® measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Beta is used in the capital asset pricing model (CAPM), a model that calculates the expected return of an asset based on its beta and expected market returns. Also known as “beta coefficient.”

The **price-to-earnings (P/E)** ratio is the valuation ratio of a company's current share price compared to its per-share earnings. It is calculated by dividing the current stock price by the earnings per share for the preceding 12 calendar months.

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