

*Because the U.S. equity market remains cheap, it should be reflected in much of the expected earnings expansion.*

## **What Will Propel Equities Further?**

**by Milton Ezrati**

**Lord, Abnett & Co.**

The positive outlook for equities draws on many sources, but basically rests on two pillars: 1) continued economic growth that will sustain an earnings expansion and 2) still-favorable valuations prevail, despite the great rally since March 2009. Neither point, of course, is beyond complaint. Nothing in any investment outlook is absolutely secure. Now, as ever, prospects are overshadowed by a cloud of risks. But the likelihoods still favor the earnings growth and a favorable response from equity markets.

### **Economic Growth**

Continued economic growth is likely on four counts:

First, the housing market seems to have stabilized. Sales and construction, though still very depressed, seem to have jumped back from the temporary spring-summer lull. Though home prices continue to register worrisome declines, they should stabilize soon as a lagged response to the improved sales picture. To be sure, much still depends on the ability of mortgage lenders to manage the situation. For some time now, these lenders have held back on foreclosures in order to avoid glutting the market with additional inventory. Their need to feed out this so-called “shadow inventory” over time will limit any growth potential in the area, but their successful management of the last 12–18 months suggests that they should keep the situation stabilized going forward.

Second, the consumer has, clearly, done the heavy lifting of his and her financial retrenchment. During the recession, consumers were beset by a fear about the value of their home, which is, for most people, their major, if not only asset; fear about their financial wealth, as the stock market declined; and fear about their job, as layoffs soared. Though none of these factors could be described as healthy today, each has improved enough to minimize the risk of a recessionary relapse. Still more significantly, households have begun to address the debt overhang they had built up in the prior 30 years. Cutbacks in spending during the recession brought outlays well below income levels, so that now American households save at an average rate of \$630 billion a year, an amount equivalent to almost 5.0% of their outstanding liabilities. All households need do now to extend their debt retrenchment is maintain spending below income levels. If incomes rise 2%, 4%, 5%, or even by the about 3.0% recorded last year, households can increase spending accordingly and maintain this savings flow to support their “deleveraging,” as it is called.

As the modest increase in consumer spending propels overall, albeit slow, economic growth, the third factor here—strength in exports—should help the recovery as well. For years, exports have acted as a drag on U.S. economic growth, so much so that people

have taken underperformance for granted. But with the dollar down significantly during the last 10-plus years against just about every currency in the world, American producers now have price advantages enjoyed for decades. Exports have expanded at double-digit real rates, and that momentum should help the recovery going into 2011, if not make it especially robust.

Fourth, and finally, are the strong orders for new capital equipment by business, including for technology. Inspired, no doubt, by export growth as well as a quest for efficiency, those orders should turn into an accelerating spending flow as this year progresses.

### **Earnings Gains**

Even though the overall growth rate generated from these forces should lag the pace of the typical cyclical recovery, it still should produce a relatively robust earnings expansion of some 12–15% for the companies in the S&P 500<sup>®</sup> Index<sup>1</sup> in 2011. It may seem a stretch to go from anticipated real gross domestic product (GDP) growth of 2.0–2.5% to such an earnings expectation, but the figures builds on three levels:

1. Earnings are a nominal, not a real or inflation-adjusted figure. Since the United States can expect inflation of 1.5–2.0% in 2011, the nominal, domestic contribution to revenues growth should come in closer to 4%.
2. The companies in the S&P 500 get about half their revenues from abroad. Though Europe and Japan show overall growth potentials equally sluggish to those in the United States, if not even slower, the emerging economies, which are making an ever-larger contribution to these earnings, are growing at much faster rates. If, as it seems, they account for more than half of the overseas earnings of the S&P 500 companies, they can add considerably to overall revenues growth. Since, conservatively, emerging economies as a group should generate some 7.0% real growth in 2011 and see 3–4% inflation, they could easily contribute 10% growth to their portion of S&P revenues, which, when combined with the slower American, European, and Japanese contributions, should produce an overall revenue growth of about 7%.
3. Earnings should outpace revenues because of the huge operating leverage of American companies. This leverage develops because industry in the United States uses huge amounts of equipment and software in the production process. Since business must pay for that equipment in good times and bad—to maintain it, to depreciate it, and pay interest on the debt incurred to procure it—a big part of the cost structure remains fixed. In bad times, when revenues drop, these fixed costs ensure that much of the strain falls on the bottom line, which is largely why in 2008, when revenues fell some 14%, S&P earnings fell about 30%. But in recoveries, such as now, when the equipment gets brought back on line, the still largely fixed nature of costs means that most of the additional revenues drop to the bottom line, as in 2010, when single-digit revenues growth produced an S&P earnings expansion of some 35%. To be sure, the effect of operating leverage will

run its course as the business expansion matures, but enough should persist in 2011 to bring 12–15% earnings growth out of the 7% revenues growth, a conservative expectation, actually, considering that it shows less than half the bottom-line leverage of last year.

### **Market Gains**

Because the American equity market remains cheap, there is every reason to look for it to reflect a good part or all of the expected earnings expansion. Such a conclusion may seem strange after such a great rally, but in fact, the price gains of the last 22 months or so have actually lagged earnings growth. The market's value has actually improved throughout the rally. Price-earnings multiples presently stand at only 15–15.5 times last year's earnings, about equal to the average of the last 30 years or so. Since the most conservative interpretation of such multiples would characterize the market as fairly valued, prices should keep up with the expected earnings growth. But since bond yields universally stand today well below their averages of the last 30 years, a more generous characterization of the equity market would describe it as relatively cheap, and so even better able to pace or exceed earnings growth.

Of course, plenty of risks threaten this positive outlook. Monetary policy this year must balance between providing enough liquidity to support the economy and resisting the temptation to provide excessive, that is, inflationary, amounts of liquidity. Also investors are looking for the government in Washington to do something about the country's long-term budget deficit problems, not to turn policy around on a dime but to offer a credible plan to deal with the longer-term problem. If the authorities fail on either of these policy fronts, the market will face a headwind. At the same time, Europe's sovereign debt crisis, though managed to date, threatens to steal liquidity from a global financial markets and detract from equity gains. Separately, the drift toward trade or currency war threatens to stifle economic growth and, consequently, market prospects. This is only a partial list of the major risks. But investors should be mindful that there are always risks. The likelihoods suggest that most of these problems will remain contained while economic growth and the earnings growth it fosters propel the equity market up farther in 2011.

<sup>1</sup> The S&P 500<sup>®</sup> 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.

### **A Note about Risk:**

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. Investing in international securities generally poses greater risk than investing in domestic securities, including greater price fluctuations and higher transaction costs. Special risks are inherent to international investing including those related to currency fluctuations, foreign, political, and economic events. These risks can be greater in the case of emerging country securities. The value of fixed-income securities will change as interest rates fluctuate. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Debt securities are also subject to credit risk, which is the risk that the issuer will fail to make timely payments of interest and principal. No investing strategy can overcome all market volatility or guarantee future results.

*Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor, and Foreign Affairs, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.*

*The opinions in the preceding economic commentary are as of the date of publication, are subject to change based on subsequent developments, and may not reflect the views of the firm as a whole. This material is not intended to be relied upon as a forecast, research, or investment advice regarding a particular investment or the markets in general. Nor is it intended to predict or depict performance of any investment. This document is prepared based on information Lord Abbett deems reliable; however, Lord Abbett does not warrant the accuracy and completeness of the information. Consult a financial advisor on the strategy best for you.*

**Investors should carefully consider the investment objectives, risks, charges, and expenses of the Lord Abbett funds. This and other important information is contained in a fund's summary prospectus and/or prospectus. To obtain a prospectus or summary prospectus on any Lord Abbett mutual fund, contact your investment professional, Lord Abbett Distributor LLC at (888) 522-2388 or visit us at [www.lordabbett.com](http://www.lordabbett.com). Read the prospectus carefully before you invest.**