Market Trends Beneath the Currency Waves

Capital Markets Board on exchange rates, earnings multiples and yield spreads

MARKET INSIGHTS
Second Quarter 2015

IN BRIEF

- Currency dislocations can last for years, but well-managed, competitive companies can thrive even in adverse environments.
- Not only has the technology sector exhibited high margins, but the use of technology has also helped to support valuations across the US equity market.
- The credit markets are sending a message to the equity markets that the direction of economic activity is upward, not in danger of collapse.

The Capital Markets Board meets to discuss issues that matter to long-term investors. This quarter's themes of currencies, valuations and spreads reflect the most noteworthy market topics that have emerged from our global team of research analysts and portfolio managers.

Currency volatility, competitiveness and earnings

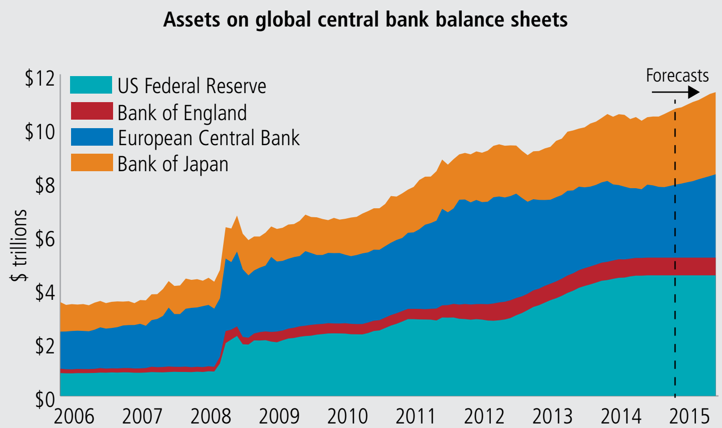
During this last year of rapid, pronounced currency moves, the US dollar has risen dramatically — especially against the euro, which has been getting as close to parity as it has been for 12 years. The Japanese yen and many emerging market currencies have also fallen drastically relative to the US dollar. Who are the winners and losers in what has been called a currency war? And how does currency volatility impact the analysis of country and company competitiveness and earnings?

Not your grandfather's currency war

When we think of currency wars, what generally comes to mind are the "beggar thy neighbor" policies of the 1930s, which were intended to gain share in export markets and boost growth at the expense of other trading partners. That might still be the design behind today's competitive currency devaluations in some emerging markets, with export protection as a primary goal and inflation as a secondary byproduct.

For developed markets, however, the primary objective recently has been to safeguard against disinflation and deflation. The approach has been idiosyncratic from country to country and region by region, but behind the policy actions in Japan and the eurozone, deflation has been the worry and increased competitiveness has been the side effect (see Exhibit 1).

Exhibit 1: Global central bank policies are easier now than during the liquidity constraints of the gold standard era.



Central banks easing so far in 2015

Australia
Canada
China
Denmark
ECB
India
Indonesia
Israel
Korea
Poland
Sweden
Switzerland
Thailand
Turkey

Sources: Bank of America Merrill Lynch, Bloomberg. Balance sheets as of 31 January 2015.

"This is about making sure that inflation expectations don't become unmoored."

Erik Weisman, Ph.D.
Fixed Income Portfolio Manager

Any discussion of the 1930s currency war must highlight the importance of the gold standard and the trade war. Shortly after the stock market crash in 1929, more and more countries began to abandon the gold exchange standard to loosen constraints on monetary liquidity and weaken the value of their currencies. Countries that stayed on the gold standard had to implement increasingly austere and deflationary macroeconomic policies to preserve their pegs, which drained liquidity from their domestic economies and the broader global system. The adversarial relationship between those who pegged to gold and those who did not resulted in a pernicious and volatile trade war.[1]

But now a different dynamic is at work, with most global central banks doing everything they can to provide more monetary liquidity. And unlike the 1930s, there are no parallels with the austerity-inducing gold standard peg or the global trade war. In a way, the current "currency war" could be a good thing if the additional liquidity from central banks can help to ease the path toward a normal market environment. Longer term, there may be problems if too much of this global liquidity makes its way into the broader system, but not for now.

Fundamental approach to assessing currency impacts

From a market perspective, the weakening euro should be a tailwind for export-oriented Europe and somewhat less of a headwind for the more domestically focused United States. Similarly, weaker currencies may also serve as a tailwind in emerging markets whose growth models are predominately driven by exports. Historical analysis suggests that equity markets in countries with weak and declining currencies tend to outperform those with strong and appreciating currencies, whether measured bilaterally against the US dollar or a trade-weighted basket.

Trying to forecast such movements can be extremely difficult. But by taking a fundamental perspective, we can look beyond the big-picture effects of exchange rate fluctuations to consider the specifics of each equity or credit issuer and to analyze whether other important factors are at play in the course of future earnings. For example, when exchange rates move unexpectedly, does the company have labor and material cost advantages that could override the impacts of competitive currencies? Is the balance sheet strong enough to withstand the harm of a currency shock? If a company hedges its exchange rate risk, how much does it pay for that insurance? Is the cost reasonable for the protection provided?

With the competitive environment changing over time, the sustainability of fundamental earnings drivers may need to be assessed at the company level and their exposures to currency transaction and translation risks at the portfolio level. Businesses have become increasingly global — over one-third of US and European earnings come from outside their respective regions — and so has security selection. What matters more than the region is the ability of companies to translate competitive advantages into long-term returns for their stakeholders.

Market valuations and profit margin expansion

We are often asked whether equity valuations are reasonable, especially in such a low-inflation environment. Yet throughout this business cycle we have seen US profits and margins continue to expand — even with mediocre GDP growth and sluggish revenue gains. Is the US market overstretched — that is, could profits possibly grow fast enough in the future to justify the prices being paid today? Can the ongoing margin expansion support the market at these levels?

[1] Arguably, in the absence of the trade war, if all countries had simultaneously abandoned the gold standard in the early 1930s, the combined effect would have been significantly looser monetary conditions and positive spillover effects around the world.

Are we paying too much for future earnings streams?

By all standard metrics, US equities are trading at a premium to non-US equities. We would argue that this premium is deserved for cyclical and structural reasons. Labor costs account for nearly three-quarters of US operating costs, and these are at the lows of the post–World War II era as a share of GDP. If such subdued unit labor costs are only a holdover from the recession, then we might expect them to move higher as the recovery continues, which would erode profit margins.

Over this business cycle, however, labor investment has been displaced by capital allocation decisions — share buybacks, dividends, mergers and acquisitions (M&A) — and disintermediated by technology. Such positive operating leverage has been the source of high margins. In 2014, US revenue growth was below normal at about 4%, but costs grew under 2%, so profits were up around 6%.

We track unit labor costs across other regions. Among developed markets, Europe and Japan have so far failed to make the competitive labor reforms that would bring this kind of profit margin expansion — and that would justify the valuation multiples we have seen in the United States. As for emerging markets, we believe that the relative outperformance of developed markets in general and the rerating of the US market in particular have been driven by earnings, not just accommodative monetary policies.

Margin sustainability outside the technology sector

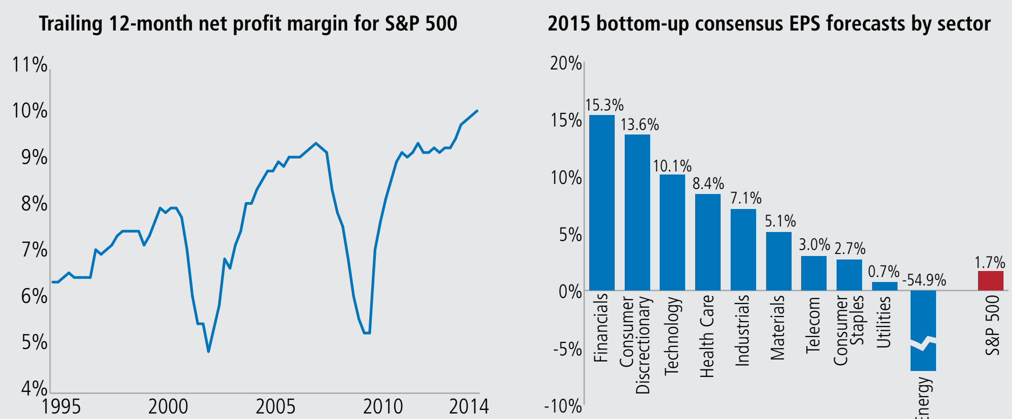
In the United States, the technology sector has been the notable leader in profit growth and margin expansion during this cycle. Nevertheless, we find that margins in other sectors have also been rising, well past levels that could be explained as rebounds from the last recession (see Exhibit 2). In our view, technology has been driving efficiency gains and margin expansions when used to enhance productivity across the US economy.

"Tentacles of technology have stretched into all the different sectors of the market."

Kevin Beatty
Chief Investment Officer, Global Equity

For example, retailers using better tracking technology may be able to keep inventories to a minimum, boosting asset turnover, margins and returns on equity. In the energy sector, oil and gas reserves that were once off limits because extraction methods were too costly have now become accessible through improved drilling and seismic technology. Significant benefits are already being derived from the technology going to work in the biopharmaceutical arena. Even social media and web-based applications are finding broader relevance outside the technology sector.

Exhibit 2: With the stronger dollar and weaker oil, the earnings cycle may be more differentiated.



Sources: FactSet, Deutsche Bank. Margins as of 31 December 2014, EPS estimates as of 13 March 2015.

As a similar story has been repeated in industry after industry, we believe that margin expansion has supported the upward march of the US equity market. Though historical experience indicates that margins tend to revert to their long-term averages, the contributors to this narrative — labor costs and technology advances, along with lower energy prices — are likely to continue for some time before being competed away.

Of course, the stronger US dollar and weaker crude oil prices are likely to suppress margins in certain sectors such as materials and energy (see Exhibit 2, page 3). So we acknowledge that the investment environment has become more sector-specific in 2015 — especially if the nearly six-year run of margin expansion is drawing to a close.

Credit markets and the business cycle

A debate we often hear is whether equities lead the credit market or credit leads the equity market. After all, the first place to look for financial strain is usually among high-yield issuers, where defaults and bankruptcies are not uncommon facts of life. The high-yield market reflects and anticipates stress through the spread above the risk-free rate — typically the yield on the 10-year US Treasury or other sovereign government bond.

Late in 2014, that spread widened, signaling distress first among energy issuers that were reeling from the steep drop in oil prices and then rippling through the market to affect nonenergy issuers. Yet fundamentals outside the energy sector remained strong, pushed forward by free cash flow, access to new funding and low defaults by any historical comparison. So far in 2015, the high-yield market has recovered and spreads have tightened again. Can the attractiveness of credit be sustained by an extended business cycle?

Absolute and relative attractiveness of high yield

We have been considering high-yield spreads on a relative basis, but with rates this low, do we need absolute yield to protect us from defaults and losses in the credit markets? Admittedly, central bank bond-buying programs have been good for riskier fixed income assets — by stabilizing the economy, providing a backstop of liquidity and keeping the business and credit cycle alive at the macro level.

The micro level brings us back to the tenets of active investing, in fixed income as in equity: Do the fundamental research, understand the issuer from the bottom up, and build a good portfolio, bond by bond. That means looking at balance sheets — leverage ratios and interest coverage — to assess how companies are servicing their debt. US issuers in particular have taken advantage of historically low interest rates to get out of commercial paper and short-term debt at the front end of the yield curve and to extend their durations at extremely low coupons.

"The wall of maturities that we used to say the high-yield market would never get over has been pushed out by at least four years."

Bill Adams, CFA
Chief Investment Officer, Global Fixed Income

In high yield, we also think about the default window, which is strongly correlated to bank lending standards, and those have also improved steadily — another sign that the credit market has gone a long way toward fixing itself in an absolute sense. We recognize that high yield will inevitably experience periods of volatility, but in the absence of triggers, we do not seem to be on the precipice of the credit cycle. As long as we believe that the state of the US economy is still strong and that the US Federal Reserve will start to move above the zero bound this year — albeit slowly — then we will continue to favor credit relative to other fixed income investments.

Are we getting close to the next recession?

Ignoring the warning signs of economic contraction can be costly, as we saw when the Great Recession of 2008 – 2009 cut the level of the S&P 500 Index in half. Without one infallible signal, our approach is to follow a group of indicators that anticipated trouble during past business cycles, watching for deterioration in multiple indices that have been associated with economic stress.

Widespread M&A announcements generally herald a cyclical peak. The rapid creation of credit at an accelerating pace that exceeds the run rate of the economy signals an overheating economy. Another harbinger of recession is the inversion of the yield curve — that is, shorter-term rising above longer-term interest rates. Purchasing managers' indices have reflected a forward-looking perspective, while private-sector profit as a share of nominal GDP tends to slip and fall about one year ahead of a recession. Before 1980, excess capital, labor and inventories were the forerunners of economic contractions; since then, monetary policy has been the primary driver.

Of these signals, M&A activity is rising but still trails the prerecessionary levels at previous market peaks. In our view, none of the measures we monitor suggests that a recession is imminent — especially when US real rates, adjusted for inflation, are negative and likely to remain below levels that would precipitate an economic contraction for some time. Both market and macro factors imply that this business cycle could play out for the next several years.

Our outlook on regions and asset classes is generated from our investment research in the context of the key insights driving the markets.

EQUITY	OUTLOOK	INSIGHTS
United States	Favorable	Valuations are high but supported by disciplined management teams, conservative capital deployment, strong balance sheets and returns to shareholders through buybacks and dividends.
Europe	Favorable	The currency backdrop is constructive, valuations are relatively attractive and M&A activity is starting to pick up. Though there is still little evidence of labor reforms or earnings gains, using debt to buy equity could offer some potential enhancements.
Japan	Neutral	Limited signs of structural reform include an increased focus on return on equity. The weaker currency is helping earnings and valuations look reasonable. Quantitative positive and negative signals net to neutral.
Emerging Markets	Neutral	Every country has different dynamics. We are more optimistic about Asia than Eastern Europe and Latin America, which is so dependent on commodities and growth in China.

FIXED INCOME	OUTLOOK	INSIGHTS
US Treasuries & Agencies	Unfavorable	We are bearish on Treasuries, which appear overvalued relative to US macro fundamentals. We expect a bear flattening, or yields on shorter maturities rising faster than those on longer-term debt, as the Fed begins to hike this year.
Global ex US Sovereigns	Unfavorable	While there are no rate hikes in sight outside the US, and scope for yields to fall further in some countries, low and even negative yields are unappealing.
Emerging Market Sovereigns	Neutral	In a bifurcated market with mixed fundamentals, a number of countries need to address macroeconomic imbalances. Yet we see some reasonably valued opportunities.
Investment Grade Corporates	Neutral	We continue to favor the lower end of the quality spectrum (BBB-rated). Regionally, US high grade corporates have better fundamentals than those in Europe and emerging markets.
High Yield Corporates	Favorable	We are most bullish on this sector, which we expect to outperform in 2015. US high yield has the most supportive fundamentals. Valuations are getting interesting in emerging markets, but are less so in Europe with the ECB's QE in play.
Collateralized Debt	Neutral	Commercial mortgage-backed securities (MBS) offer a good trade-off between yield spread and interest rate sensitivity, or duration. Agency MBS are likely to trade directionally with Treasuries, so we are wary of extension risk.
Municipal Debt	Neutral	Interest rate risk makes us somewhat cautious, but high-yielding munis are still an attractive proposition for income-oriented taxable investors. Fundamentals are solid for most municipal credit sectors.

We travel the world conducting our own investment research, evaluating corporate management teams and analyzing the competitive landscape. We listen to central bankers and other policymakers to put together a picture of where world economies are heading. We collaborate across our global research platform to share our best ideas.

James T. Swanson, CFA
Chief Investment Strategist
Joined MFS in 1985

William J. Adams, CFA
Chief Investment Officer, Global Fixed Income
Joined MFS in 1997

Kevin Beatty
Chief Investment Officer, Global Equity
Joined MFS in 2002

Robert M. Almeida, Jr.
Institutional Equity Portfolio Manager
Joined MFS in 1999

Robert M. Hall, Jr.
Institutional Fixed Income Portfolio Manager
Joined MFS in 1994

Ben Kottler, CFA
Institutional Equity Portfolio Manager
Joined MFS in 2005

Benjamin R. Nastou, CFA
Quantitative Portfolio Manager
Joined MFS in 2001

Sanjay Natarajan
Institutional Equity Portfolio Manager
Joined MFS in 2007

Robert Spector, CFA
Institutional Fixed Income Portfolio Manager
Joined MFS in 2005

Erik S. Weisman, Ph.D.
Fixed Income Portfolio Manager
Joined MFS in 2002

MARKET INSIGHTS presents the collected perspectives on global markets emerging from our research process and designed to help our clients make prudent long-term investment decisions.

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