MFS®

Authors

Robert Spector, CFA
Institutional Portfolio Manager

Sanjay Natarajan
Institutional Equity
Portfolio Manager

Robert M. Hall
Institutional Fixed Income
Portfolio Manager

BUILDING BETTER INSIGHTS®

ALERT BUT NOT ALARMED

IN BRIEF

- Easy monetary policy has contributed to investor complacency, yet central banks are starting to warn that such sentiment may go too far.
- Some equity markets have been rising faster than earnings, raising concerns that multiples are climbing too high above fair value.
- With fixed income risks tilted toward higher rates, we remain biased toward credit and vigilant about valuation and liquidity.

Macroeconomic overview

False dawns and serial disappointments

US Federal Reserve Chair Janet Yellen is known for her clarity, not for mincing words, and her recent congressional testimony was quite clear. Because of previous "false dawns" in the US recovery, monetary policy needs to remain stimulative. Not to be outdone, Bank of Canada Governor Stephen Poloz has claimed that "serial disappointment" in global economic growth causes him to focus on downside risks. Easy money remains the order of the day in Canada too.

Central bank policy

The message from global central banks is simple. Monetary policymakers have been content to conduct a real-time experiment with large balance sheets and record-low interest rates — even negative in real terms — until sustainable growth is at hand and, in the US case, labor markets are almost fully healed.

This is essentially an experiment within an experiment. In prior cycles, there was at least an attempt to be preemptive, removing accommodation before inflation pressures could build. But now, in a world of false dawns and serial disappointments, central bankers' reaction functions are designed to be slow. Such policy is not without risks. In the United States, for example, headline inflation measured by the Consumer Price Index (CPI) has risen from 1% to 2.1% since last fall, and core CPI (excluding food and energy prices) is also higher.

Global economic growth

As we assess the global economy, we continue to see crosscurrents that are unlikely to push the modest growth backdrop in either a positive or negative direction. On the positive side, US growth has picked up from the first-quarter slump of -2.1%, based on the latest GDP revisions,

to the advance estimate of a 4% second-quarter rebound. And thanks to mini-stimulus measures, China's pace of growth seems to have bottomed, which could help to anchor some improvement in emerging economies and global trade.

On the negative side, growth in the eurozone has lost momentum, even in Germany. Moreover, European and global growth rates are highly sensitive to mounting geopolitical tensions both directly through trade and energy supplies, and indirectly through the potential hit to confidence should any of the many crises escalate. We too are concerned about downside growth risks, especially after the imposition of further economic sanctions on Russia.

Financial instability

We also contemplate another risk caused by this grand monetary experiment — namely, financial instability. There is an element of complacency in financial markets that can be seen in some sentiment indicators and in limited volatility across asset classes. Partly justified by the declining volatility of both growth and inflation, the low-volatility backdrop in financial markets has made the "stretch for yield" a profitable investment theme.

This complacency has also been evident, to some extent, in investor confidence about how monetary policy could play out. With unprecedented central bank support over the past five years, equities have rallied alongside quantitative easing (QE), while bond yields have been kept abnormally low. Now that the Fed's QE is ending, policy will have to normalize, and so-called forward guidance is expected to manage this transition. Investors seem to believe that the normalization will be smooth. But what if growth and inflation trends indicate otherwise?

There is a certain irony in this. Central banks are contributing to investor complacency but, at the same time, warning that such sentiment has gone too far. The Bank of England (BoE) has suggested that complacency could undermine financial stability at some point, and the Fed has noted high valuations among biotech and social media companies, as well as reduced underwriting standards for leveraged loans. There have been indications that the exit from current policies may not turn out to be as smooth as investors have hoped. Could financial markets become the ones who are serially disappointed?

Equity overview

Valuations and volatility

Year to date, we have seen an unusual combination of winning sectors as utilities, health care, energy and technology have led the way. There have been specific reasons for each sector's solid performance:

- Utilities have provided a dividend-paying equity alternative to low bond yields, which have continued to compress despite the Fed's QE tapering.
- Health care has done well, thanks to the big pharma takeovers and the exuberance around biotech.
- Energy had been one of the cheapest sectors for three years as oil and mining stocks de-rated, but oil prices have picked up along with tensions in the Middle East.
- Technology has seen a resurgence, with business restructuring likely to increase the demand for old and new tech.

Yet when we look across all sectors, we see a puzzling disconnect between the buoyancy of the equity markets and the underlying economic and geopolitical developments. Equity markets have been rising faster than earnings, particularly in Europe and emerging markets (EM) where earnings are flat to negative — adding to the chorus of concerns regarding valuations.

Optimism about growth and earnings

The optimism about global growth is a function of better data from the United States and China along with expectations of additional monetary stimulus to kick-start slower-growth economies in Europe and Japan. Real-time signals of growth include stronger commodity prices and associated currencies, rising capital expenditures and more corporate-led mergers and acquisitions.

Providing additional fodder for US equity bulls, earnings have surprised to the upside. Even in the face of the revised -2.1% GDP contraction, the first quarter was decent, with earnings up 3.3% and revenue up 2.6%. Thus far in the second-quarter reporting season, earnings have been solid and sales expectations strong. Though European earnings have lagged, we expect them to improve as currency headwinds abate — especially for companies with EM-sourced revenues.

Sources of pessimism

The risk, of course, is that earnings growth does not come through as forecast, because with rates this low, it is unlikely that multiple expansion will continue to drive markets. And the list of downside risks now extends beyond earnings shortfalls to geopolitical risks — notably the conflicts in Gaza and Ukraine, just to name two in the headlines. There are also possible contagion risks from isolated events like the technical default of dollar bonds in Argentina and the deep loan losses requiring the bailout of the once-largest bank in Portugal.

As for the global economy, sluggish European growth has raised fears of deflation, while the US housing market has been sending mixed signals. In all regions, businesses and consumers remain cautious, and without private-sector spending, the drag from restrained public-sector spending may continue to hamper growth. Though central bank policies are still supportive overall, there is always a risk that interest rates may rise earlier than expected.

What is particularly concerning is that these risks have coexisted in an environment of historically low volatility. We saw evidence in the global equity selloff at the turn of the month that unforeseen events have the potential to disrupt relatively calm markets. Nevertheless, we think that the strength of corporate balance sheets continues to offer a call option on earnings growth. Multiples have climbed enough above fair value to provide a smaller margin of safety, which makes us alert but not necessarily alarmed.

Portfolio positioning

While we recognize the risk of holding high-yielding stocks heading into a policy-tightening cycle, there is still considerable uncertainty about the timing of the first rate hike. So we fail to see compelling arguments for abandoning quality defensives in favor of cyclical names that need strong top-line growth to benefit from operating leverage. As a result, our preference for high-quality companies in developed markets (DM) remains intact. Although selectively attractive valuations have warranted some tactical moves into EM, we do not believe this has become a sustained structural shift.

Fixed income overview

Pick your poison

Central bankers have succeeded in artificially suppressing interest rates, and income-starved investors have responded by bidding up anything that offers decent yield. Fixed income valuations have risen to the point where allocating money to bonds has become an exercise in identifying the least expensive of the pricey options.

Interest rate risk

Against a backdrop of improving US economic data and the Fed's gradual normalization of monetary policy, the prospect of higher Treasury yields could lead to the underperformance of strategies focused on the highest quality, most rate-sensitive bonds. With the yield on the 10-year note close to the bottom of its 12-month range, and enough factors in play to limit how far yields rise in the near term, we think this benchmark yield could struggle to break through 3% this year. Nevertheless, we recognize that only a modest increase in rates could wipe out the coupon income from Treasuries, producing flat to negative total returns.

Credit markets

Using the excess yield offered by the credit markets to help insulate total return against price declines looks like a more viable strategy to us — albeit one that is not without risk given such tight valuation. Spreads per unit of risk have been low by historical standards, while the risk profile has become decidedly asymmetric, in that spreads could tighten further if low volatility persists but have far more room to widen if higher volatility returns. The paradox is that low volatility breeds complacency about valuation and encourages more aggressive risk-taking, leaving portfolios vulnerable to systemic shocks.

Neither interest rate nor credit risk looks particularly compelling, so our preference when "picking our poison" is to opt for a credit-biased approach, while remaining vigilant about valuation and liquidity risk. Selectivity is critical; a bond issuer's fundamental faults may be glossed over while a carry trade is underway, but not when rates spike, equities sell off or geopolitical tensions inspire fear. Defensive, lower-beta names with low event risk look most attractive to us.

Secondary market liquidity has become a greater consideration post-Lehman, as capital requirements and balance sheet conservatism have constrained the liquidity provided by dealers. This could make a graceful exit from the credit markets more challenging if market sentiment deteriorates quickly. Across credit markets, we constantly reevaluate the risk/reward relationships. When the potential downside threatens to outweigh the expected upside, we are increasingly willing to sacrifice carry for liquidity and safety.

Global diversification

Diversification of interest rate exposure is another tool we use in global portfolios to help enhance risk-adjusted returns. Though no rate market is ever completely independent because the global rate environment influences all markets, we find that correlations between markets vary over time. At present, asynchronous business cycles indicate divergences in monetary policies, so we believe there may be opportunities to add value by tilting away from US Treasury duration toward rate exposure in markets where macro conditions support an easing bias. This rate positioning could warrant hedging currency exposure, since the factors that benefit rate markets are often unfavorable for currencies.

In our view, the Fed and the BoE will likely respond to better macro conditions by becoming the first major central banks to raise policy rates. As a result, we have been underweight US Treasuries and UK gilts and more constructive on the dollar and the pound relative to other DM currencies.

On the other hand, we have been overweight duration in the eurozone, where the pace of growth appears to be waning and deflation still threatens. The European Central Bank faces increasing pressure to ease monetary conditions, which could also drive euro depreciation. As spreads to German bunds have compressed, we have reduced exposure to peripheral markets like Spain, Italy and Ireland, shifting assets to the core eurozone markets. While we do not anticipate that the widening of peripheral spreads is imminent, the risk/reward proposition has become less attractive. ■

The views expressed are those of the author(s) and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice from the Advisor.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Issued in the United States by MFS Institutional Advisors, Inc. ("MFSI") and MFS Investment Management. Issued in Canada by MFS Investment Management Canada Limited. No securities commission or similar regulatory authority in Canada has reviewed this communication. Issued in the United Kingdom by MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorized and regulated in the conduct of investment business by the U.K. Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS, has its registered office at Paternoster House, 65 St Paul's Churchyard, London, EC4M 8AB and provides products and investment services to institutional investors globally. Issued in Hong Kong by MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is a wholly-owned, indirect subsidiary of Massachusetts Financial Services Company, a U.S.-based investment advisor and fund sponsor registered with the U.S. Securities and Exchange Commission. MIL HK is approved to engage in dealing in securities and asset management-regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO"). Issued in Singapore by MFS International Singapore Pte. Ltd., a private limited company registered in Singapore with the company number 201228809M, and further licensed and regulated by the Monetary Authority of Singapore. Issued in Latin America by MFS International Ltd. For investors in Australia: MFSI and MIL UK are exempt from the requirement to hold an Australian financial services license under the Corporations Act 2001 in respect of the financial services they provide. In Australia and New Zealand: MFSI is regulated by the U.S. Securities and Exchange Commission under U.S. laws, and MIL UK is regulated by the U.K. Financial Conduct Authority under U.K. laws, which differ from Australian and New Zealand laws.

MFSE-GMO-NL-8/14
20566.55