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MFS Long-Term Capital Markets Expectations Webcast Summary

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Kim Hyland: There's a lot impacting markets of late: the unwinding of the yen carry trade, a correction of overvalued mega-cap US stocks and uncertainty about US economic strength. What happened?

Rob Almeida: We've had a lot of disorder, but I'd argue that disorder is just order misunderstood. We've all seen explanations about the recent market volatility, and what you described largely captures it. But perhaps there is a bigger message from the market. The VIX, a measure of volatility, jumped from a spot of 10 to 50. Last time you saw jumps like that was the attack of an unknown virus and the global financial crisis (GFC). I'm not sure that those three market events compare to a global shutdown or the GFC. So perhaps the market's telling us it's more than just those three things.

Hyland: Is this the beginning of a paradigm shift in the markets? Is this the catalyst for change?

Almeida: It's hard to know what match will light a fire and if it will get put out. The short answer is that we don't know. The larger concern is what's the tinder? Over the past 15 years, the two primary drivers of epic highs in profitability were low interest rates and globalization. Companies all over the world, especially in the United States, were able to generate massive profits and margins largely through suppression of costs. Interest rates have now normalized, and globalization has changed. Revenues, as we're seeing in this earnings cycle, are fading, probably to pre-COVID levels, and that's a different earnings outcome. I think that's what the market might be focusing on.

Hyland: Any signs of stress or liquidity issues that we're worried about?

Almeida: From a liquidity standpoint, it's been surprisingly orderly, particularly in fixed income where it matters most. When you look at this earnings cycle, companies that are missing estimates or maybe just guiding expectations down are getting hit hard. I think that's the beginning of a normalization. The more important question is why are companies missing? Units are down, prices are falling and costs are rising. While we've had this in our models, the street hasn't. Volatility is just the market adjusting to an incorrect assumption that elevated profit would be sustained.

Hyland: Before we pivot to our long-term capital markets expectations, how do we build them?

Jon Hubbard: Many market expectations are put together from a macro top-down or complex statistical models. We do it differently, from a fundamental bottom-up perspective informed by our investment team. I think that gives us an edge. On the equity side, we start with sales, valuations, profit margins and dividends and then we fold in our inflation expectations. We bring those together in a quantitative framework across 26 different countries and roll that up into regional expectations. We take a similar approach on the fixed income side. Our fundamental building blocks are starting yields, credit spreads, expected credit losses as well as yield curve shape and hedging impact. These building blocks allow us to isolate why expectations might be higher or lower relative to each other and relative to history.

Hyland: What are the latest long-term capital markets expectations telling us about global equities?

Hubbard: Our return expectation for global equities is about 3.7% over a 10-year annualized period. While that's low relative to history, we've had plenty of rolling periods where 10-year returns were lower or even negative. We're not expecting negative total returns, but high valuations and likely unsustainable profits margins point to lower returns.

Hyland: What are some of the risks and opportunities our investment teams are seeing right now?

Almeida: What's the purpose of capitalism in markets? Take capital away from a not so good idea and put it into a good idea. But for the last 15 years, every idea was a good idea. Our focus is and has always been looking at what a company does. How do they do it? Is it viable through a potential downturn? At the same time, we're evaluating how new technologies, like artificial intelligence, will affect a company. Will it be competitive in a potentially new type of environment? We're working through that.

Because of low interest rates, there was a ton of M&A, resulting in a tremendous amount of goodwill. Is that goodwill appropriately marked? We're also thinking about what type of costs might stress the balance sheet or the income statement. Do they need to hire more people? Will labor costs increase? Do they need to spend to reshape their supply chain? It's walking through all these things and deciding what multiple we want to pay. Increasingly, there are fewer businesses where we're willing to pay the multiple that the market's offering.

Hyland: What are the bright spots outside of the US that maybe investors should be thinking about?

Hubbard: US equities account for 65% of global equities, up dramatically in the last decade.[1] About 37% of the S&P 500 is concentrated in 10 companies, up from 17% to 18% a decade ago.[2] Investors need to ask if they're comfortable allocating the next incremental dollar to a portfolio with 37% in the top 10 stocks. Market expectations are far higher outside the US. Our developed non-US market return expectation is 6.7% overall. Emerging markets look a little better at mid-8%, albeit with more volatility. While your risk return profile is a factor, it makes sense to look outside the US for new opportunities.

Almeida: Why is the index so concentrated? Why is the US 65% of the global market capitalization while roughly only 10% of global GDP? That's where the earnings expectations are. AI has generated a tremendous amount of enthusiasm. There are 5,500 data centers in the US, 20 times more than any other country. There has been a tremendous amount of spend in AI to buy the chips and equipment needed, but the return on investment is four years out, not four months. This could unwind quickly if the funding for capex goes away. I'm not saying it will, but we've seen overbuilding happen before: too many houses in the 2000s, too much fiber optics and hardware to support the internet in the 1990s and too many railroads in the 1860s. Getting back to market volatility, what is the market really telling us?

Hubbard: With the cost of capital higher, high amounts of capex can come with a cost. When the cost of capital is zero, there's little cost to mistakes, but now there's a much higher cost if mistakes are made. How that plays out remains to be seen.

Hyland: Going back to non-US opportunities, do you think Japan's stock market will continue to rebound?

Almeida: Over the past two to three years, Japanese corporate attitudes about returns on capital, employment for life and keiretsus have changed. Less about doing business with less efficient partners to more about improving returns on the business. That's why Japanese stocks have done so well. I think what's happening with the yen is unrelated to this new structure.

Hyland: What are our expectations telling us about the fixed income markets, moving forward?

Hubbard: Our expectation for global returns is around 5% over the next 10 years, due to a higher rate environment. When looking at the credit space, our expectations are even better. In terms of high yield or emerging market debt, we expect returns in the mid 6% over the next decade. Thinking about the building blocks, a lot of the return contribution is coming from the underlying yield — carry — and potential return from rate drops. However, credit spreads are so tight across credit markets, so we don't expect much total return from credit spreads. When you look at the equity versus fixed income expectations on a risk-adjusted basis, fixed income looks pretty good right now.

Hyland: Where are our investment teams finding value across fixed income sectors?

Almeida: Spreads are tight, so we're trying to avoid credits that may be stressed. That's always been part of our fixed income philosophy, but in a zero-interest rate environment without consequences, I think some investors lost sight of this. In this tight spread environment, there's less enthusiasm because you might not get paid, and collateral might be insufficient. It's about identifying troubled assets with enterprise value problems, cash flow problems or where those spreads aren't sustainable at these tight levels. While fixed income is still attractive, you have to be more careful than you were before.

Hyland: Over the past five to seven years, clients have increased their exposure to private credit. What are your thoughts on the private credit market and how did that impact your expectations?

Hubbard: Private credit became popular after the global financial crisis when yields were very low, and banks and lending organizations curtailed lending. Private credit firms offered higher yields. Fast forward to today, private credit assets have massively ballooned. Both private and publicly traded debt are loans. But on the traded side, it's generally a syndicated loan with different folks holding the loans in the form of bonds. On the private side, it's more of one-on-one relationships, in many cases with just a single lender, which leads to underwriting risk. As yet, we haven't seen how the private performs during a period of prolonged stress. The COVID drop was a very short period which saw massive liquidity. Many firms didn't have to mark down their assets. There are also different objectives and elements of transparency, tradability and liquidity, all things that investors need to incorporate when assessing allocations, especially if they can get the same amount of return with less risk in public markets.

Almeida: Also, private firms aren't immune to the same risks that public companies face. Labor and capital costs are going up. They've got to reshape their supply chain.

Hyland: How are our investment teams thinking about AI? Who will be the winners and losers?

Almeida: What does technology do? It removes frictions from society, and frictions are usually tethered to cost. New technology generally makes life better and/or cheaper. Software replaced hardware, the cloud replaced on-premises software and AI disintermediated a combination of the two. It's not a coincidence that software companies missed estimates in the last two earning cycles. They missed because AI can give you more efficient functionality at a lower cost. Chief technology officers are likely shifting their IT budgets away from software to AI. Some companies are at risk from AI, but not all. I think AI is an area for future differentiation at the business level, and ultimately at the stock level.

In terms of AI ecosystem suppliers, they're priced for sustained massive capex. What happens if spending goes away or is just less than expected? This ecosystem is contributing to index concentration and, given that US stocks are 65% of the market, that is a huge at-risk factor right there.

Hyland: What are our investment teams seeing outside of the technology sector?

Almeida: Many, but not all, consumer-facing companies have reported some levels of household stress. We're also seeing stress from consumer cyclicals and capital goods with indirect exposure to cyclicals. Again, we're looking at what does a company do? How do they do it? Will they be able to manage an inevitable sort of economic reset, not a recession, but something different than what we've been in?

Hyland: How should investors think about the US election and what could the investment implications be?

Hubbard: Right now, it looks like a coin flip between the two candidates. The October surprise was pulled into July; we had an incumbent who dropped out of the race on top of an assassination attempt. Regardless of who wins, high fiscal spending will likely continue, and deficits may remain high or continue to grow. Government debt is $35 trillion, an all-time high. Unless we have fiscal austerity or a tax structure change, it will likely remain high. I don't think either will happen. In addition, tariffs may move higher. Many of the tariffs put in place by Trump in 2017 still exist. For example, tariffs on steel and aluminum were kept by the Biden administration, which also put 100% tariffs on Chinese electric vehicles. Over time, tariffs can be inflationary, and higher tariffs are rarely good for the economy. They generally restrict global trade and push prices higher.

The one difference between the candidates is spending. With Trump, expect more tax cuts, discretionary spending and defense spending. With Harris, expect higher benefits, taxes and tax benefits on those earning under $400,000.

Hyland: What will the bond market allow the federal government to do?

Almeida: The Federal Reserve's balance sheet is around 30% to 35% of GDP. One out of every three cents of US money velocity is the government, and new debt comes with lower and lower ROI. Look at what happened in England in 2022 when former Prime Minister Liz Truss tried to introduce tax cuts and stimulation. Thirty years ago, central banks controlled the yield curve and the cost of capital, even more so in the last 15 years. I think that now switches. The bond market is in control. The yield curve has been inverted for a year and a half, despite Fed jaw boning. The market will likely discount real growth and real inflation. As to what politicians try to do, we'll see if the bond market allows it, but I don't think so.

Endnotes

[1] FactSet: MSCI All Country World Index as of 6/30/24.

[2] FactSet: S&P 500 Index as of 6/30/24.

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