January/February 2025

Market Pulse

Top-down and asset allocation perspectives over the next 12 months

Market Insights Team

KEY TAKEAWAYS

As we look toward 2025, many of us are setting resolutions while the market is resetting expectations:

- **Outperforming expectations** – Recent data support the narrative that economic growth has begun to outperform market growth expectations.
- **Mixed expectations** – The market has dialed back expectations for the number of Fed rate cuts next year while simultaneously adopting a "higher for longer" attitude toward longer duration.
- **Higher expectations** – The USD is expected to remain strong amid widening growth and interest rate differentials.
- **Lower expectations** – President-elect Trump is expected to lighten the regulatory burden, which could support SMID-cap companies given their sensitivity to compliance costs.

Economy & Markets

US Economy

ECONOMIC MOMENTUM IS ON THE RISE

Source: Bloomberg. Daily data from 28 March 2024 to 10 December 2024.

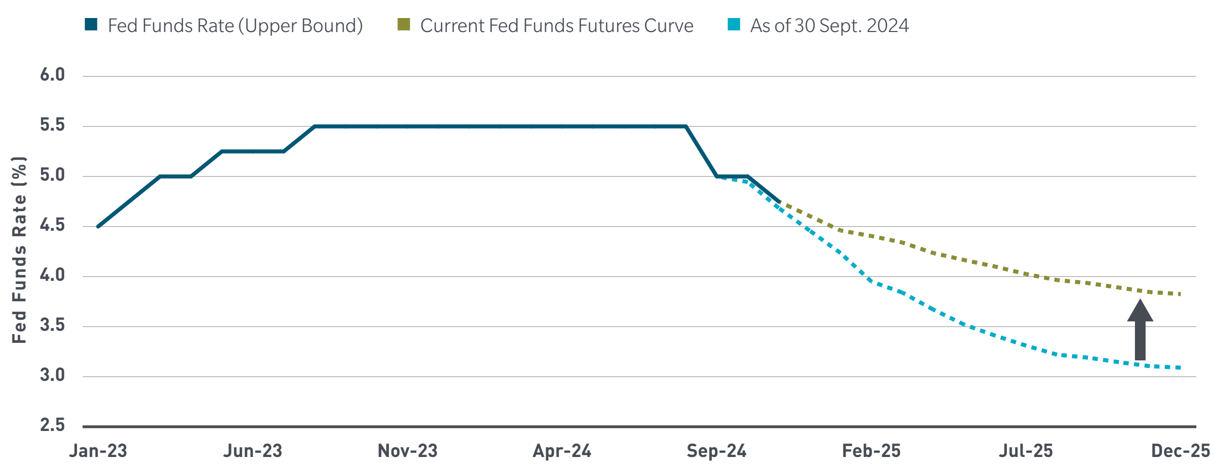
Trump 2.0 seen as pro-growth

MFS PERSPECTIVE

- The Citi Economic Surprise Index, which measures the difference between realized and forecast economic results, indicates that recent growth has been outperforming market expectations.
- President-elect Donald Trump's proposed policy mix of tax cuts and deregulation is expected to stimulate economic growth.

Fed Policy

MARKET EXPECTS FEWER FED CUTS



Source: Bloomberg. Monthly data from January 2023 through December 2024 (data as of 11 December 2024). Dotted line represents forward looking market expectations. Implied policy rates based on Fed Funds Futures monthly contracts from December 2024 to December 2025, adjusted by 0.125% to reflect upper-bound Fed funds

Recently, rate cut expectations have been reduced.

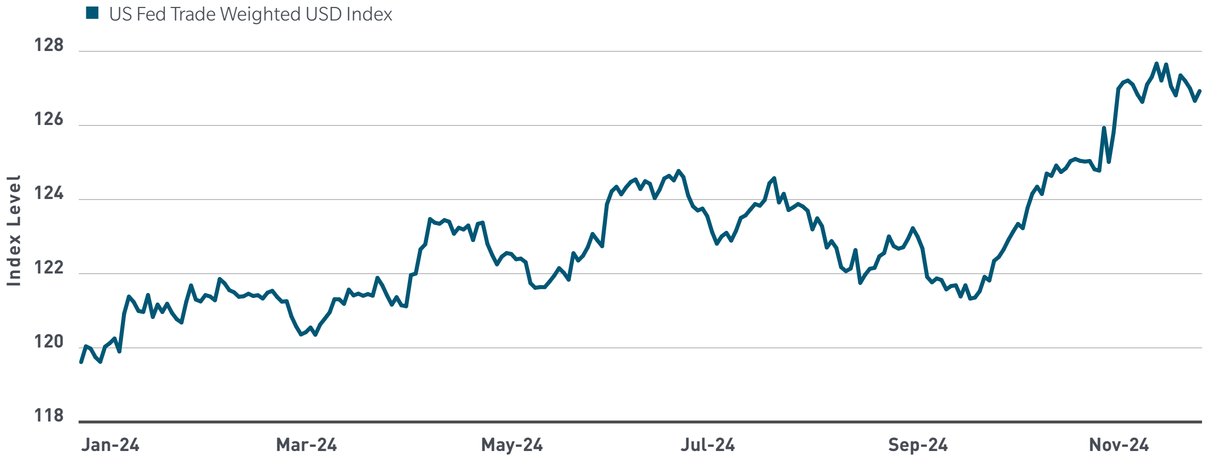
MFS PERSPECTIVE

- Stronger growth, stickier inflation and concerns that future policies may raise prices have contributed to the rethink.
- Higher-for-longer is back: Rates have corrected higher and the case for long duration has weakened.

Economy & Markets

US Dollar

THE DOLLAR HAS STRENGTHENED SIGNIFICANTLY



Source: Bloomberg. Daily data from 2 January 2024 to 6 December 2024.

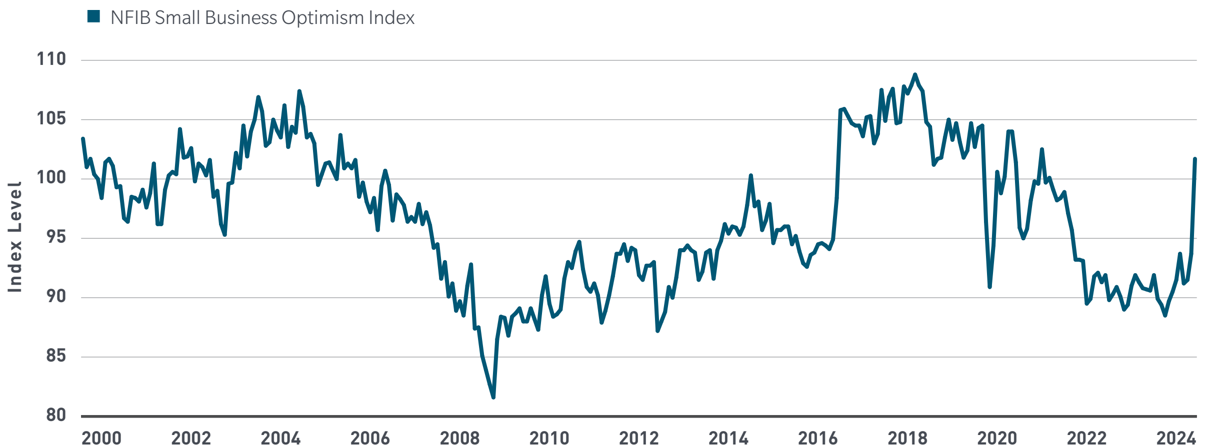
Stronger US growth and potential tariffs are driving up the USD.

MFS PERSPECTIVE

- A stronger dollar should lessen the impact of tariffs on US consumers.
- Higher-for-longer interest rates are dollar supportive.
- Uncertainty remains high amid mixed messages from the incoming administration on FX policy.
- A strong dollar tends to restrain imported inflation but hurts US exporters.

Small-Business Optimism

SMALL BUSINESS OPTIMISM IS ON THE RISE



Source: Bloomberg, National Federation of Independent Business. Monthly data from 31 January 2000 to 30 November 2024. NFIB Small Business Optimism Index surveys small business owners for their outlooks on the economy, sales, hiring, inflation and uncertainty, among others, to gauge business conditions for this segment of the US economy.

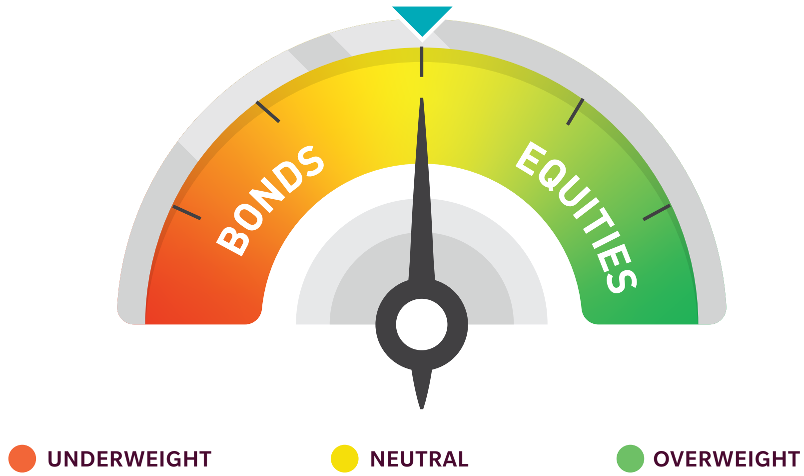
SMID-cap companies stand to benefit from future policy.

MFS PERSPECTIVE

- Small-business optimism soared following Trump's election as the regulatory environment has historically been more favorable under Republican administrations.
- Medium-sized firms bear the highest regulatory cost burden and could benefit the most from a friendlier regulatory backdrop and lower corporate taxes.

Asset Allocation

Relative to investor's strategic asset allocation



There is plenty to be hopeful about, but also plenty to be wary of. The degree of uncertainty surrounding policy and the potential for market turbulence keeps us neutral.

MFS PERSPECTIVE

1 There is cause for excitement around US equities. Trump 2.0 could extend US exceptionalism, a strong dollar, a bear-steepening yield curve and pro-growth policies.

2 Equity exuberance has been tempered by lofty valuations, stubborn concentration and disbelief that S&P companies can continue to post mid-teens earnings growth. Policy expectations are optimistic for US equities, but the balance between growth and inflation will be critical.

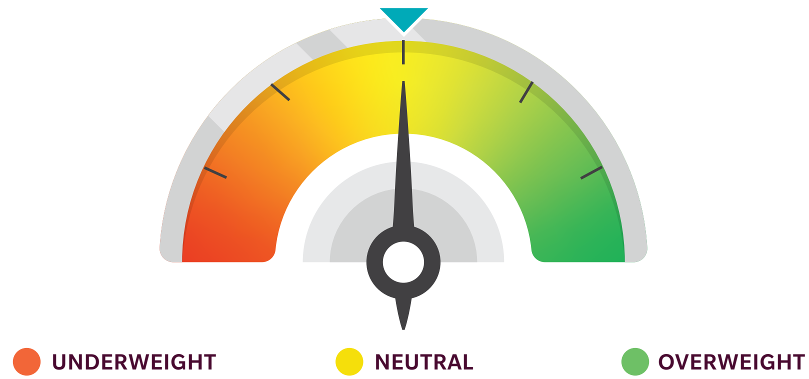
3 For bonds, the pain from 2022 continues to manifest in high all-in yields today. Absent a 2025 recession, bond spreads could remain at or near their current rich levels for an extended period.

4 If bond spreads remain range-bound, the greatest risk to the outlook would be rising inflation expectations (and subsequently, interest rates) sparked by pro-growth Trump 2.0 policies.

Approach and methodology: The *Market Pulse* provides an outlook over a 12 month investment horizon for major asset classes as well as considerations of the prevailing market conditions. Views are driven by both quantitative and qualitative inputs including, but are not limited to, macro-economic data, valuations, fundamentals and technical variables.

The views expressed herein are those of the MFS Strategy and Insights Group within the MFS distribution unit and may differ from those of MFS portfolio managers and research analysts. These views are subject to change at any time and should not be construed as MFS' investment advice, as securities recommendations, as portfolio positioning, or as an indication of trading intent on behalf of MFS.

US Equity



- Expectations for pro-growth policies such as lower corporate taxes and a lighter regulatory burden are driving multiple expansion.
- While valuations remain above long-term averages, the Fed is set to ease further, and recession signs are scant.
- We expect the earnings gap between big tech and the S&P 493 to continue to narrow.
- However, we're mindful of potential volatility from a looming tariff threat.

MFS CONSIDERATIONS			
LARGE CAP	**SMALL/MID CAP**	**GROWTH**	**VALUE**
▪ Valuations remain elevated but are supported by forecasts for 14% EPS growth in 2025. ▪ We expect increased volatility and remain cautious on further multiple expansion until there is greater clarity on Trump 2.0 policies. ▪ Sticky inflation and higher growth could raise 10-year Treasury yields, which would be a concern.	▪ Small caps are becoming more appealing as sustained positive economic data and strength in the services sector point to a soft, or no, landing. ▪ However, SMID-cap earnings will need to show signs of recovery through 2025 to justify the improved outlook.	▪ Growth remains supported, with cyclicals significantly outperforming defensives. ▪ Amid policy uncertainty, we expect higher- growth cyclicals to take a breather near term. ▪ Megacap tech continues to do well, but concerns are being raised over the disconnect between AI capex and revenues.	▪ RFK's nomination has impacted both health care and staples and is likely to drive further volatility. ▪ Higher long-term bond yields are a potential headwind for utilities and REITS, counterbalanced by a stronger economy and growing electricity demand. ▪ Financials remain poised to benefit from economic growth, deregulation and increased capital markets activity.

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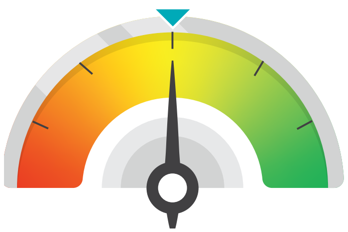
Source: All data on page, FactSet, 7 November 2024.

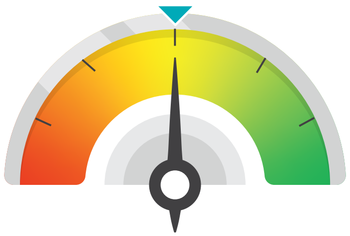
International Equity

DEVELOPED INTERNATIONAL EQUITY



- Core Europe continues to struggle, driven by weak sentiment and political uncertainty.
- European valuations look reasonable and reflect the pessimistic outlook.
- Japanese domestic demand growth remains strong on the back of rising wages.

EMERGING MARKET EQUITY



- USD strength is expected to be an ongoing headwind, along with rising trade tensions.
- China's stimulus measures have helped steady markets, but investors await detailed plans on boosting consumption and stabilizing property prices.

MFS CONSIDERATIONS

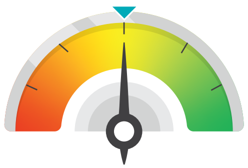
- We expect German industrial production to continue to struggle in the face of stiff Chinese competition.
- Potential catalysts for European re-rating include a Ukrainian peace deal, German fiscal stimulus and improving Chinese consumption.
- Widening interest rate and growth differentials imply continued euro weakness.
- Tariff impacts on European earnings are not expected to be dramatic.
- Faster than expected BOJ policy normalization could be a risk if rates rise faster than expected.

- Against an uncertain international backdrop, selectivity is especially important.
- Valuations remain undemanding, and further Chinese stimulus should be supportive for SE Asia.
- North Asia is facing a semiconductor slowdown. Korean political instability is unlikely to have longer-term ramifications.
- India's long-term structural drivers remain intact, but expect further consolidation as earnings grow into valuations.
- Mexican uncertainty is expected to continue until the tariff picture becomes clear.

UNDERWEIGHT NEUTRAL OVERWEIGHT

Fixed Income

DURATION



- The macro backdrop and Fed outlook are somewhat less supportive of duration over a 12-month horizon.
- There is a risk that rate volatility may rise because of Trump 2.0 policies and more cautious Fed policy.

MUNICIPALS

- Fundamentals, including state finances, remain adequate while the valuation backdrop looks favorable.
- Any tax cuts could undermine tax advantages munis provide.

SECURITIZED (MBS)

- The outlook for agency MBS remains positive in view of strong fundamentals and an improving technical backdrop.
- A combination of compelling relative valuations and a return of institutional buyers to the marketplace could support MBS.

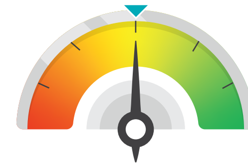
US INV-GRADE CORP

- The macro environment remains positive for credit, and the fundamental backdrop is broadly satisfactory.
- However, the valuation landscape is challenged, mainly reflecting the impact of rich spread valuation.

US HIGH YIELD

- Fundamentals remain solid, helped by historically low levels of leverage and strong earnings.
- Other positives include low projected defaults, attractive breakeven yield valuation and a solid macro outlook. While spread valuation looks rich, we don't see a catalyst for major spread widening.

EMERGING MARKET DEBT



- Fundamentals have shown increasing signs of weakness, especially on the fiscal front.
- On the positive side, the valuation picture still looks adequate, while technicals appear robust.

MFS CONSIDERATIONS

Duration

- The case for duration has weakened. Hence our neutral bias.
- The yield curve is likely to bear steepen further, which should help support the relative attractiveness of the long end.

Municipals

- Given their low credit risk and favorable tax treatment, municipals represent a great alternative to the elevated amount of cash still on the sidelines.

Securitized (MBS)

- Agency MBS offers diversification and defensive benefits as well as attractive spreads over Treasuries, with improving valuations and technicals. A favorable stance is appropriate.

US Inv-Grade Corp

- We have turned more cautious owing to the historically low spread level. Nevertheless, expected returns are likely to remain robust, helped by the impact of rate cuts and the attractive carry.

US High Yield

- We believe the risk/reward for total returns is favorable, especially relative to other asset classes.
- Security selection will continue to be a critical part of the investment process, given the credit risk involved.

Emerging Market Debt

- While total yield valuation remains compelling, higher-rated country spreads are tight and EM remains exposed to global risks. Hence, our cautious stance.
- There remain attractive opportunities within EM, but sovereign credit selection is paramount.

UNDERWEIGHT NEUTRAL OVERWEIGHT

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MFS Investment Management