Market Insights

July 2023

A Resilience Recipe for What Comes Next

Simon Gresham
Multi-Asset
Research Analyst

'Past performance is not indicative of future performance.' This financial disclosure may be more pertinent now than it has been in years. That's because the economic landscape continues to change due to a range of monetary and demographic factors that may lead to lower growth and stickier inflation, in turn impacting the investment regime and resulting in lower returns and higher volatility in the years ahead. Reassessing your investment lineup is crucial as such a regime shift would mean general market returns (beta) would be harder to come by, and finding excess market returns (alpha) would become more important in meeting return objectives.

The economic landscape is changing

Context matters, and a big question is whether the great moderation of declining interest rates and low inflation that has been a tailwind for the past 30 years has ended. Commentators have focused on whether we have entered a new period of sustained higher inflation but have perhaps glossed over the core driver of productivity. Returning the conversation to the drivers of productivity first — and then analysing the monetary response — gives a better perspective on the possible market outcomes.

The initial stages of the great moderation were fueled by G7 productivity growth that averaged 2% a year and continued until the turn of the century. Since then, we have reverted to a lower-productivity growth trajectory of around 1% a year. We point to an ageing demographic in higher income countries combined with a shift in the rate of the globalisation of trade and more recently the impacts of decarbonisation.

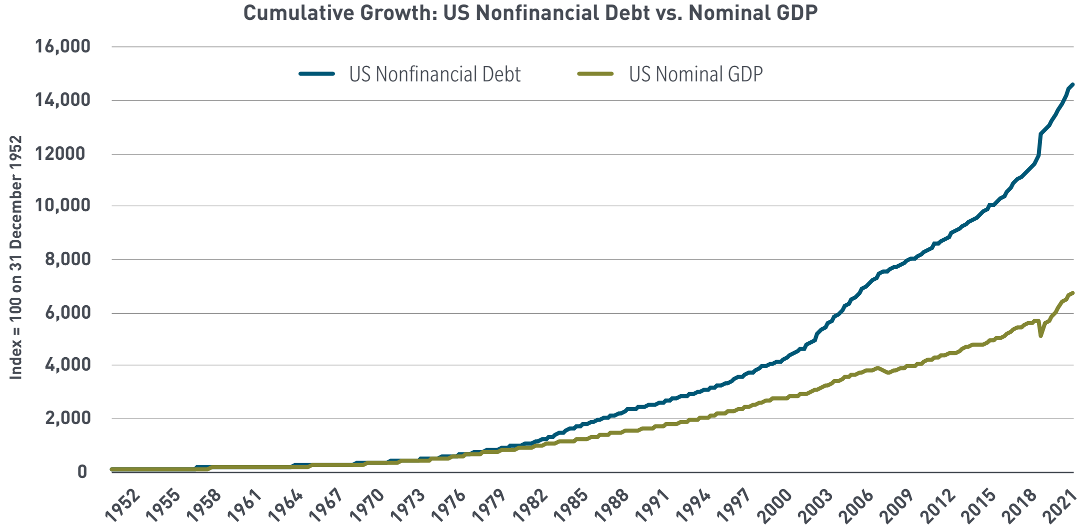
At the global level, the age-dependency ratio is forecast to increase significantly due to falling birth ratios and aging populations. This means countries will spend more on supporting people in their retirement years. This is particularly the case in high-income economies and will result in low productivity and low economic growth.

Globalisation as a productivity driver is disappearing, with increased onshoring or near-shoring as countries and companies seek more robust supply chains in the face of geopolitical stresses. Decarbonisation presents a challenge to growth due to the amount it will cost to fund the transition to net zero. According to the International Energy Agency, reaching net zero by 2050 will require 1% of GDP a year to rebuild the energy grid and generators.[1] This is effectively a 1% tax on global GDP as we do not get anything new; instead, in what appears to be the best-case scenario, we are investing 1% of GDP per year to decarbonise but without any other economic benefits.

All three of these drivers are set to further inhibit productivity growth in coming years. Technology is the potential counter to this headwind, but it has not been able to overcome the trend of lower productivity growth in the past two decades.

In this context of the evolution of productivity growth, we turn to the monetary response. Despite an observable slowdown in the core drivers of economic growth, the monetary system has continued to expand. If we turn to the United States (Exhibit 1), there have been three major periods in which money growth has significantly outpaced real GDP growth: the 1970 to 1987 period that triggered inflation and ended with an asset bubble, the 2000 to 2008 period that ended with the global financial crisis and the COVID-triggered inflationary period we are in now.

Exhibit 1: Excess credit growth drives consumer price and asset inflation



Source: Haver Analytics. Quarterly data from 31 December 1952 to 30 June 2022 (latest available). Note: US Nonfinancial Total Debt includes general government debt, household debt and nonfinancial corporate debt.

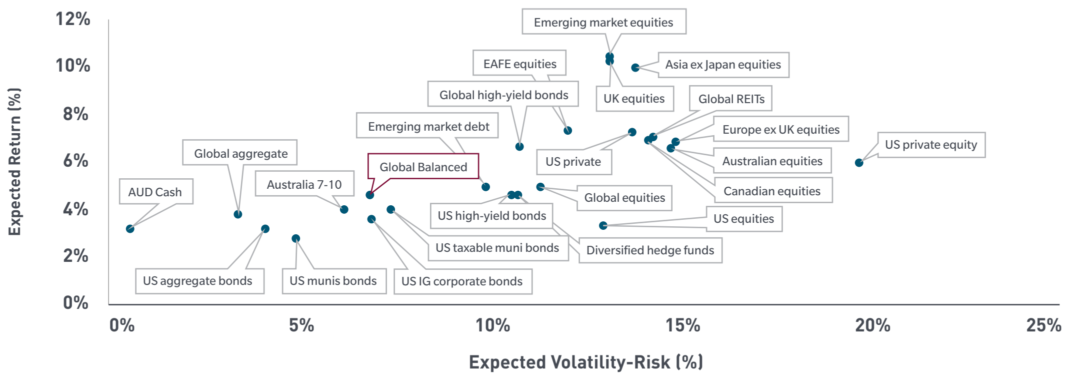
Also relevant is the level of outstanding debt we have today. Money stock has not declined after any of the excess growth periods and over the long run has compounded at a rate well in excess of the underlying economy. The result has been a lower return on assets and an ever-increasing level of debt as a proportion of the economy. Most higher-income countries now have total debt 2.5x GDP or greater. This lift in debt has been a rising tide for asset prices and consumption, but if it continues in a low-productivity growth era then it will result in either higher consumer price inflation or a lower return on assets, neither being the optimum outcomes for investors. However, without this rising tide of money growth, the core drivers of weak productivity are revealed. Essentially, we can't have our cake and eat it.

The investment regime appears more difficult as a result

This changing economic landscape takes on greater prominence given today's asset valuations, even with the pandemic-era correction. The Shiller CAPE compares current share prices to historical average inflation-adjusted earnings.[2] It shows that since the 1990s, cyclically adjusted P/E is 50% higher than it's very long-run average. This suggests room for further downside movement. Furthermore, it's not the actual P/E relative to this year's earnings that is the problem. A key issue is that the underlying profit margins of companies in the index are still high on an absolute basis and relative to their history.

So what does this mean for expected returns? If we take a mean-reverting model and revert P/E multiples and net profit margins, we get a long-term market expectation of 5% for global equities over the next 10 years.[3] This is higher than the forecast from two years ago but well below the almost 10% long-term performance. Overall, we believe expectations for future returns will moderate as the coming years are unlikely to resemble the high-return, low-inflation regime of the past couple of decades. Exhibit 2 shows our expectations for long-term returns across a variety of asset classes and regions.

Exhibit 2: MFS long-term market expectations as at 31 January 2023



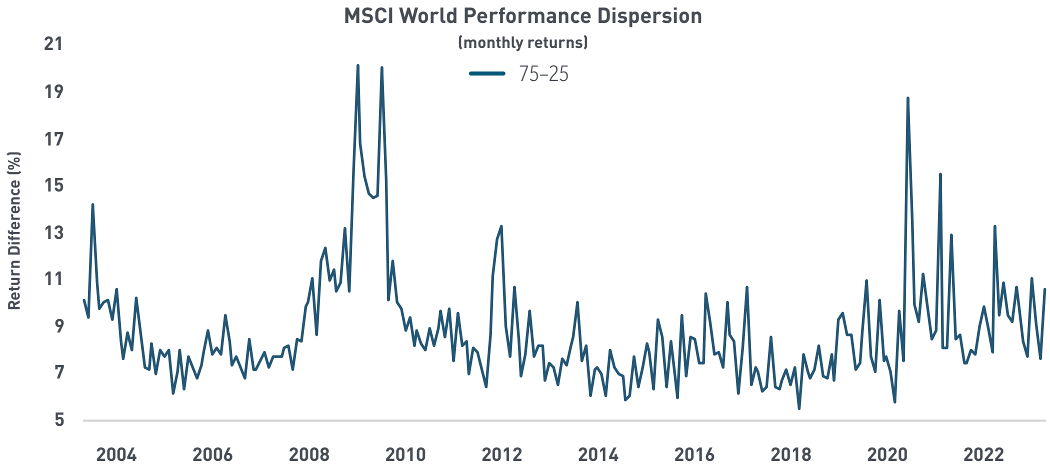
Source: MFS Long Term Market Expectations (Australia Edition) as of January 2023. Global balanced portfolio is 60% global equity, 40% global fixed income. Risk Volatility is represented by standard deviation. Capital Markets View is for informational purposes only and any general commentary on market activity, industry or sector trends, or other broad based economic or political conditions does not constitute a recommendation or investment advice. The expected returns presented are hypothetical in nature and are not representative of an actual account. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in calculating returns have been stated or fully considered. Projections and forward-looking assumptions are no guarantees of future performance. **The expected returns are not targeted or projected performance for any MFS portfolio or advisory service. Please see important disclosures for important information reguarding the assumptions used in these materials.**

Resilience is required to navigate the uncertain outlook

What does this changing investment regime mean? It highlights the importance of building resilience in a fragile environment. Given the lower-growth outlook driven by the headwinds of ageing, deglobalisation and decarbonisation, significant financial leverage in various parts of the global economy and higher-than-average starting valuations in key parts of the market, the consequences of getting this wrong would be serious.

Resilience begins with being aware of where you have come from compared to where you are now and adjusting your portfolios accordingly. This means moderating your return expectations and eschewing more risk to make up for the reduced market beta. Resisting FOMO is easier said than done. We also believe skilled active management has and can continue to deliver an attractive risk premium. Over the long run, Morningstar analysis shows the dispersion of offshore global mutual funds' 10-year net performance is greater between styles than within styles.[4] This means all active managers are not equal and the selection process can have a meaningful impact on returns.

Exhibit 3: Dispersion increases in downward corrections



Source: FactSet. Monthly data as of 28 February 2003 for MSCI World Index. Stock returns are ranked each month, and the difference between the 25th and 75th percentile stocks is shown above.

As highlighted in Exhibit 3, this is particularly important during downward corrections as performance dispersion has historically spiked during these and we see little reason for this pattern to change. This increased dispersion provides fertile ground for skilled active managers to generate alpha in order to fill the gap left by potentially decreased beta. The opportunity for alpha generation and above-average returns for active managers that invest over a complete market cycle could be substantial.

Moreover, in a more volatile environment that has us waiting for the other shoe to drop, we believe you should focus on risk management and mitigating downside risk, as active management does. For example, active managers select securities rather than 'owning the index' and can avoid companies or industries with low-quality, unsustainable earnings. In other words, what you don't own is just as important as what you do.

Attributes to look for in a skilled active manager

Identifying the attributes of a skilled active manager may be critical to driving long-term outcomes, so what to look for? We believe the following are signs of a skillful approach over long-term horizons and full market cycles:

- Ability to repeat the investment process, whoever is managing the portfolio
- Incentive structures aligned to ensure the process is repeatable
- High active share and long holding periods to demonstrate conviction
- Some advantage in a zero-sum game

At MFS, our active advantage is driven by an integrated and collaborative research platform that allows us to share information between analysts and portfolio managers across regions and asset classes. Our focus is on long-term expected returns and the risks around achieving those returns. Deep fundamental research by industry specialists combined with a collaborative testing of all scenarios allows us to focus on resilient investment opportunities across the investment spectrum. Often, this translates into us leaving the herd behind, which may seem lonely at times, but is usually because we have either identified a greener pasture or spotted a danger that the broader market is oblivious to.

Conclusion

We are in a fragile environment with lower productivity growth, higher leverage and high profit margins. This means inflation events and recessions are likely to occur more frequently and be more severe. While the years ahead may be tougher than those just gone, there will still be opportunities for skilled active investors to outperform. This will require being more cognisant of risks and having the ability to steer away from benchmarks to take advantage of the opportunities presented by wider dispersion. Not all active managers are equal, so it's vital to seek out trusted investment partners that can help navigate the volatility and actively take advantage of opportunities.

Endnotes

[1] Source: International Energy Agency (IEA), Net Zero by 2050 — A Roadmap for the Global Energy Sector, P154, May 2021.

[2] The Shiller CAPE compares share prices to average inflation-adjusted earnings over the previous 10 years to even out the effect of the economic cycle.

[3] Source: MFS Long-Term Capital Market Expectations (Australia Edition) as at January 2023.

[4] Source: Morningstar Database using Offshore Global Mutual Funds, 10-Year annualised performance (after fees) as at November 2022.

MFS® Long-Term Capital Market Expectations

Important Disclosures

Information in this slide describes the source data, methodologies and assumptions used by MFS Investment Solutions Group to prepare the attached analysis. Different source data, methodologies and assumptions would result in differing analysis.

The MFS Long-Term Capital Markets Expectations (LTCME) for 2023 includes return and risk expectations for equity, fixed income and alternative asset classes across country, regional and global markets. The focus of these expectations is to provide a strategic, long-term, forward-looking view of various global markets. We use a proprietary top-down approach by employing quantitative, country-based models as the foundation for our expectations and then integrating bottom-up fundamental views from our global equity and fixed income investment teams to inform our final expectations.

Our expectations are developed across 26 countries comprising 18 developed countries and 8 emerging market countries.

Equity expectations MFS equity market expectations are displayed in unhedged, nominal total return and are developed using a building-blocks approach. Elements of market history and mean reversion are incorporated into our models. Reversion speed and target levels are calibrated based on our analysis of historical data and forward-looking expectations. Any return figure should be viewed as the mid-point in that range of outcomes.

Fixed income expectations MFS fixed income market expectations are displayed in nominal total return, hedged to the investor's home currency. As with our equity model, our fixed income model employs a building-blocks approach. And, again like the equity model, the fixed income model derives its reversion speed and target level parameters from careful historical research as well as forward looking expectations. In our forecast, we focus on the returns from carry, yield change, roll-down and credit loss (where appropriate). Using this framework, we develop expectations across a range of sovereign, global credit and regional credit markets, while being careful to tune our models in accordance with the unique attributes of the various fixed income markets.

Alternative Expectations Due to the unique characteristics and varying drivers of return in alternatives, we vary our approach for each category. Our equity and fixed income capital market expectations serve as key variables in our alternatives models.

Currency Expectations We use a mean reversion approach to calculate currency expectations. Currency expectations represent the nominal excess returns which are nominal total return less domestic carry. Nominal total return is calculated as nominal prices change plus foreign currency carry. Domestic and foreign currency carry comes from the MFS Long Term Capital Expectations cash forecasting model. Nominal price change is real price change plus inflation differential between currencies.

The expected returns presented are hypothetical in nature and are not representative of an actual account. The information presented is based upon hypothetical assumptions. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in calculating returns have been stated or fully considered. Hypothetical performance is developed with the benefit of hindsight (i.e., actual knowledge of market conditions, results of similar strategies) and thus has many inherent limitations. Projections and forward-looking assumptions are no guarantees of future performance.

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. No forecasts can be guaranteed. Past performance is no guarantee of future results.

Distributed by: Australia/New Zealand – MFS International Australia Pty Ltd ("MFS Australia") (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.

MFSI_FLY_1927055_7_23
54770.1