Strategist's Corner
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Emphasize the Essentials

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In brief

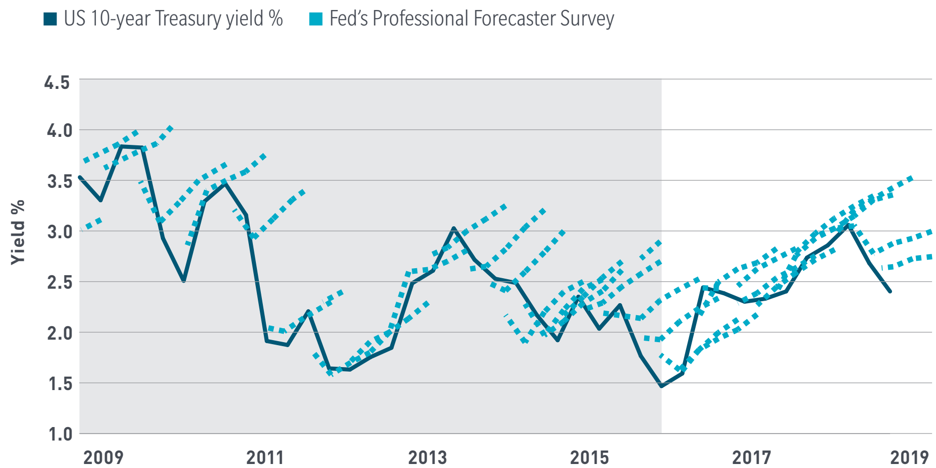
- Investors often pay outsized attention to binary outcomes while focusing too little on the importance of material factors such as free cash flow generation and intellectual property.
- The ongoing technological revolution has made historical economic comparisons less relevant.

Financial markets place a great deal of emphasis on binary outcomes: Will the Fed lower rates? Will there be a resolution to the US–China trade war? Many a short-term investment thesis has relied on predicting the answers to these sorts of questions.

But predicting the unpredictable is hard, and odds are you'll be wrong as often as you're right. Instead, we think investors would be better served by focusing on fundamentals, on what's material to long-term investment outcomes. In my view, it's better to look closely at what makes companies unique — their competitive advantages, ability to generate free cash flow and intellectual property — than it is to guess whether their cost of capital will decline by 25 basis points.

As illustrated below, analysts consistently forecast a rising interest rate environment (the light blue lines) well in advance of the turn in the rate cycle in mid-2016. This supports why I believe focusing on company fundamentals rather than macro variables may have been a better use of investors' time than guessing the path of interest rates.

Exhibit 1: Forecasters often miss the mark

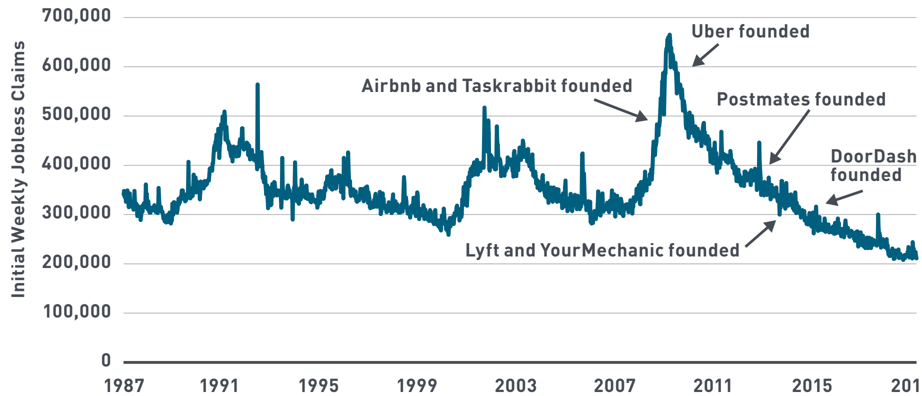


Source: Bloomberg, as of 3/31/19.

That isn't to say that investors should ignore economic and political conditions, only that they should keep them in perspective. Macro data often send false signals, even more so today given structural shifts in the global economy via digitalization, as seen in the illustration below provided by MFS strategic solutions analyst Sean Cameron.

In years past, if you suffered a job loss you'd quickly file for unemployment benefits. Now, rather than report to the unemployment office you might instead download an app to your smartphone and begin driving for one of the ride-sharing services or deliver takeout ordered online. You might even rent out a spare bedroom on Airbnb.

Exhibit 2: Weekly unemployment insurance claims since 1987



Source: Bloomberg, as of 3/31/19. The companies referenced are used for informational purposes only, and do not necessarily represent holdings in any MFS portfolio .

Macro: What you see may not be what you get

So, for example, analyzing weekly jobless claims data through a historical lens, you might assume that labor markets are historically tight and that inflationary pressures are likely to build. But, as Sean notes, people are finding financial lifelines that didn't exist a decade ago and are managing to stay afloat without creating outsized wage or price pressures on the broad economy. This has contributed to a lower structural unemployment rate that, when coupled with low inflation, has fostered a benign investment environment characterized by low interest rates and low volatility.

To sum up, in my view it's better to focus on the signal – in this case, that jobless claims are low because there has been a fundamental shift in the economy thanks to technological innovation – than on the noise. Because the noise, even more so than in the past, is less relevant. Simply stated, concentrate less on macro signals and more on what's truly material to financial market returns: fundamentals and cash flow.

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