A Look Ahead to 2019
Shifting Emphasis From Return to Risk

December 2018

Author

Robert M. Almeida, Jr.
Global Investment Strategist

As 2018 draws to a close, the marketplace has become increasingly littered with years-in-review and return forecasts for the new calendar year. But forecasting is hard and forecasting market returns for a 12-month period is even harder.

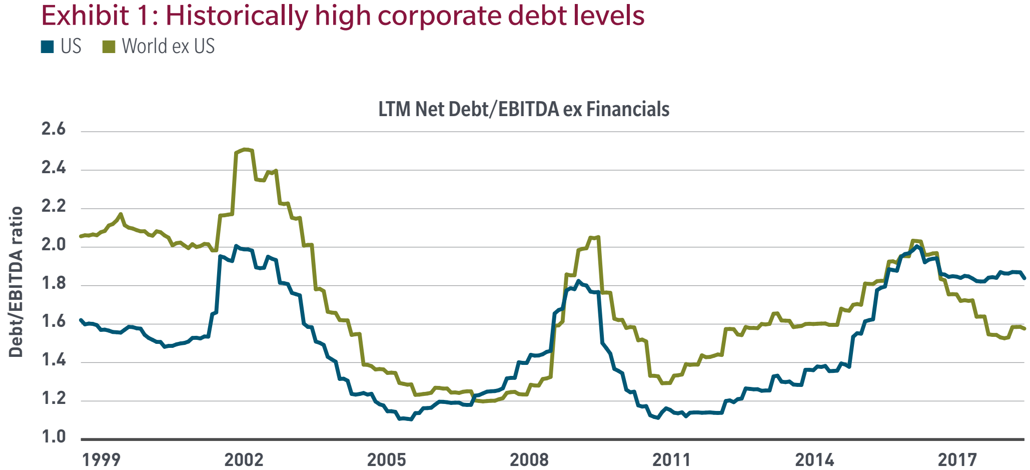
In their simplest form, investment markets provide a forum for capital seekers and givers to exchange monies today for the hope or promise of the later return of initial capital plus financial compensation for both risk and the time value of money. Asset prices, therefore, are ultimately a reflection of future cash flows. When those cash flows do not manifest themselves as hoped — or conversely, exceed expectations — the discounting mechanism of capital markets adjusts prices accordingly. Which begs the question, what drives cash flows?

In short, we believe there are four material factors: units, price, margin and earnings. How many units will the company sell over the next three to five years? At what price? What will the margin structure look like at maturity? Finally, what will earnings or free cash flow be and how much of that is already reflected by market pricing?

Over the long-term, we think fundamentals drive cash flows and cash flows drive asset prices. Day to day, however, the market's short-term orientation and overreliance on information that may prove to be less-than-material can lead to market long-term inefficiencies. For example, when legislative action will occur or how investors may interpret any such action is hard to predict. This makes successfully forecasting short-term market moves daunting at best, yet market strategists will undoubtedly try do so in abundance over the next few weeks.

However, what is certain today is the elevated level of worldwide corporate debt, particularly in the United States, where it has exceeded pre–global financial crisis levels (Exhibit 1).

Exhibit 1: Historically high corporate debt levels

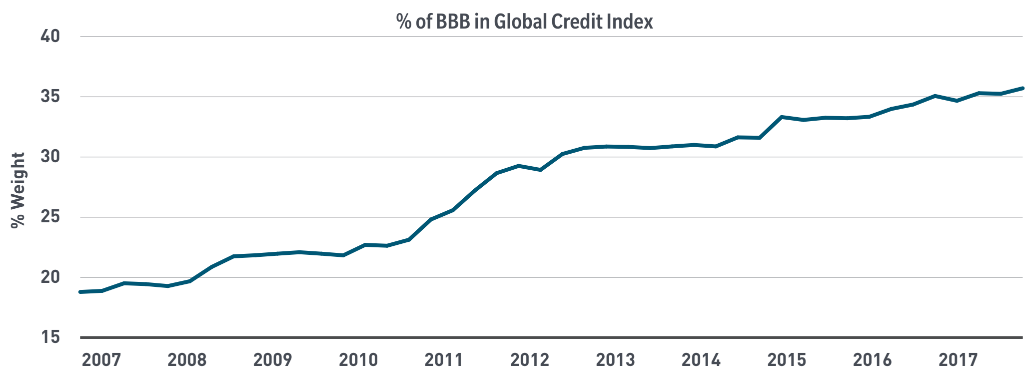


Source: Goldman Sachs Global Investment Research, Datastream, Worldscope as of 31 October 2018. LTM = Last Twelve Months. EBITDA = Earnings before interest, taxes, depreciation and amortization.

Coming out of the 2008 crisis, companies drove net margins higher due to falling input costs as capital became cheaper and labor was being shed. Yet three to four years into the business cycle the global economy was still dealing with the aftershocks of the financial crisis and revenue growth failed to materialize for many. While margins were unusually high, unit growth and pricing power remained modest. Many companies resorted to using their balance sheets to sustain free cash flow growth levels, and the credit markets were willing financers thanks in no small measure to unorthodox central bank policies like quantitative easing.

As the cycle matured, bond issuance and leverage ratios rose, covenants became less restrictive, collateral requirements fell and the overall quality of the corporate bond market deteriorated. As shown in Exhibit 2, the percentage of BBB-rated corporates in the Global Credit Index has almost doubled since the global financial crisis.

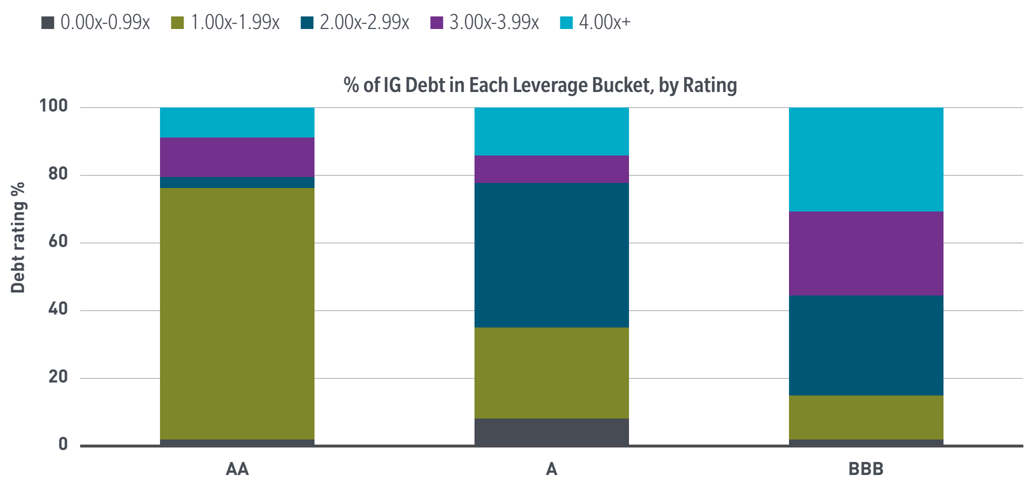
Exhibit 2: Credit quality deteriorating at the index level



Source: Barclays POINT as of 30 September 2018. Global Credit = Bloomberg Barclays Global Credit Index.

Leverage is most pronounced in the United States, where approximately one-third of investment-grade companies have a net leverage ratio of 4x or higher (exhibit 3). Nonetheless, a yield-starved bond market afforded the slow decay of credit quality.

Exhibit 3: Leverage increasing in investment grade index



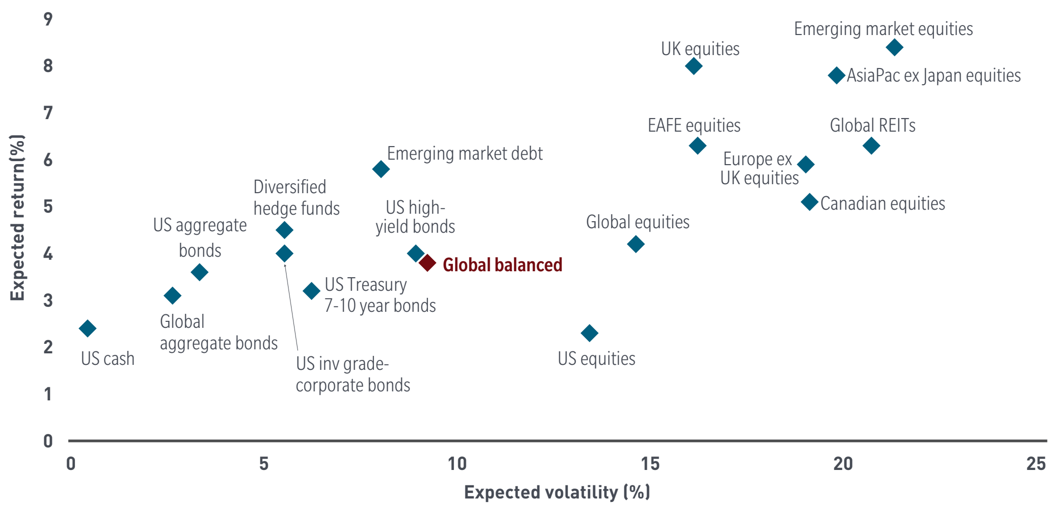
Source: Morgan Stanley Research, FTSE Fixed Income LLC, Bloomberg as of 31 October 2018. IG = Investment Grade.

Whether credit concerns manifest themselves in 2019 or much later, leverage is the common concern across our global research platform because, in our view, highly leveraged companies have less control over their own destinies. Without above-average unit sales growth or pricing power, margins and earnings will ultimately fall as input costs rise, as companies face higher interest rates when rolling over maturing low coupon debt.

Under more challenging market conditions, a scenario that is fairly likely in our estimation, companies that have become less competitive in a digital economy will no longer benefit from leniency on the part of credit rating agencies. And these companies' likely hunger for credit could come at a time when the bond market is experiencing indigestion. Funding rates, for some, may become operationally prohibitive, and many could become stressed. Under that scenario, asset selection will be critical, as differentiating between those companies with sustainable margins and those without will have a greater impact on portfolio returns than it has in recent years.

Longer term, our 10-year capital market expectations are for materially lower returns compared with what investors have experienced for the prior 10 years. Our forecast for a global balanced portfolio (60/40 global equity/bond) in Exhibit 4 for example, is slightly above 4% (in USD terms) before inflation. In general, we believe markets will decelerate from the above-average returns experienced the last three decades.

Exhibit 4: Muted return expectations



Source: MFS Long Term Market Expectations (US Edition) as of August 2018. Global balanced portfolio is 60% global equity (represented by MSCI ACWI Index (USD unhedged)), 40% global fixed income (represented by Bloomberg Barclays Global Aggregate Index (USD hedged)). 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. References to future expected returns and performance are not promises or estimates of actual performance that may be realized by an investor, and should not be relied upon. The forecasts are for illustrative purposes only and are not to be relied upon as advice, interpreted as a recommendation, or be guarantees of performance. The forecasts are based upon subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are not based on actual transactions, but are based on the models and data compiled by MFS. The results do not represent nor are indicative of actual results that may be achieved in the future. Individual investor performance may vary significantly. Please see end page for methodology.

Our market models are rooted in fundamentals because that's what matters for asset prices long-term: Units, price, margin and earnings. Please see our latest *Long-Term Capital Markets Expectations* for more detail, but in summary, the combination or high corporate leverage and margins, against elevated cyclically-adjusted earnings multiples, is the source of our below-average 10-year return forecasts.

In summary, we believe investors should reorient their portfolio emphasis from above-average return generation to risk assessment. Discretion and selectivity should become a priority at this point in the cycle.

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LTCME Methodology

The MFS Long-Term Capital Markets Expectations (LTCME) for 2018 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.

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