Strategist's Corner
April 2024

A Different Paradigm

Author

Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist

In brief

- The return on capital drives equity valuation.
- The two tailwinds to prior capital returns are now headwinds.
- Discretion is advised.

It's returns (on capital) that matter

The market value of equities, whether public or private, represents a range of assumptions about future returns on capital. When profit forecasts change, market values adjust accordingly. The adjustment can be quick in public markets or slow in private ones, but they're inevitable.

Looking back at the remarkable period of wealth accumulation enjoyed by investors since the end of the global financial crisis, the catalyst was significant net income growth by companies regardless of region or style. While some materially outearned others, such as US large-cap growth companies, return on capital and stock prices were relatively high and faced minimal interruption.

Leaving aside the COVID-lockdown-stimulus-driven quarters, a global savings glut and falling fixed investment helped drive years of economic stagnation that weighed on corporate revenues. Yet many businesses around the world were still able to generate remarkable return rates thanks in part to falling capital and operating costs.

While that's how we got here, what matters now is where we're going. Since 2022, both capital and operating costs have risen. Below we explain why we don't expect them to revert to prior lows and what that could mean for risk assets.

Two important – and intertwined – factors

In a remarkable feat, the Bank of England has compiled a 5,000-year history of interest rates. In it, we're told that the year 2021 marked the all-time low for rates. To put that into perspective, for those, like me, born before the early 1980s, our lifetimes comprise a period when interest rates hit both 5,000-year highs and lows.

Three years later, and despite a tight labor market and a quarter-million new jobs being added monthly, market participants continue to discount a loosening of global monetary policy. While that may prove true, and I'm not suggesting otherwise, the more important consideration is what happens to yield curves and long rates down the road.

While overnight and short rates will likely fall before long, too many investors seem to be counting on a collapse in long rates and a resurgence in cheap capital costs. In my view, any reduction in short rates is more likely to result in more positively sloped yield curves than in precipitous declines in long-end borrowing costs. More important, I think borrowing costs, whether for the consumer, enterprises or government entities, are unlikely to revisit all-time lows because aggregate demand is too high, labor too scarce and the need for capital investment too strong.

A question I'm often asked when I share this view is, "In the event of market stress, won't policymakers want to manipulate yields curves?" Sure. However, wanting to do something and having the ability to do it are two different things, and it was a lot easier to manipulate yield curves when savings were high, spending was low, labor was plentiful (thus possessing little bargaining power), and growth and inflation were weak.

What's changed?

Today, what's changed is that household savings are now being spent on food, shelter and energy and companies are spending to shorten supply chains (more on this later) at a time when labor is expensive and in short supply. All this spending is growth- and inflation-accretive. Also, inflation today isn't only higher but more volatile than in the slow growth, low inflation paradigm, while budget deficits are far larger than in the recent past. This has led to policy constraint being dictated by the bond market, as we saw in the United Kingdom during the LDI crisis 18 months ago. This matters for risk assets because the hurdle rate to generating positive net income has gotten a lot higher.

Another factor is globalization. Globalization and just-in-time inventorying were tremendous catalysts for profit growth because warehousing goods is costly. Less inventory on hand means more working capital and higher operating and profit efficiencies. Low-cost manufacturing, particularly in Asia, meant many western conglomerates could slash labor expenses. The outsourcing of manufacturing meant that multinationals could decrease tangible fixed investment. All else equal, when capital intensity declines, profits rise. But when globalization allowed developed market companies to become asset-light businesses, it also ushered in a decade of economic stagnation in the 2010s. Thus, globalization isn't without risks, and more of those risks have been exposed during the pandemic and the ongoing Russia-Ukraine war and conflicts in the Middle East.

Changing face of globalization

A prerequisite for just-in-time inventorying and globalization was global peace. Ships got bigger and could hold more containers because the oceans were made safe by post-World War II alliances. Corporations needed to be sure goods would arrive exactly on time, and they were. As that confidence grew, and the benefits of economies of scale accrued, the percentage of the world's traded goods via the seas more than doubled. At the same time, shipping costs deflated and profits soared.

Shipping is still cheap, but its cost is rising. More concerning, a global pandemic, two hot wars and a cold one have reduced the certainty that a critical part will arrive just in time. Meanwhile, labor arbitrage with Asia has ended because manufacturing in Asia is no longer cheap and hiring people is difficult almost everywhere.

Globalization isn't over and neither is just-in-time inventorying. But I'm arguing supply chains will become less stretched, cost more or both.

It's time to be selective

Societies, like economies and financial markets, are cyclical. Throughout history, tough times have produced tough people. Those tough people, through the adversities they face, create soft times. Soft times create soft people. Those soft people ultimately produce tough times, completing the cycle.

In my view, the policy response to the global financial crisis and the pandemic purposely created a soft- business operating environment that produced high returns for owners of capital. Life, business and investing aren't easy. Yet investing was recently made easy by the overwhelming policy response.

Conclusion

- We believe the primary driver of capital returns over the past several years has been falling costs, not growth.
- Costs are no longer falling. They're inflecting upward while growth isn't keeping pace.
- Risk premia, across stocks and corporate bonds, is relatively low and leaves little room for error.

Portfolio returns will likely become more leveraged to business fundamentals as the aforementioned dynamics play out. We believe securities of companies positioned to successfully navigate the new higher-cost paradigm should comfortably outperform those who aren't ready.

As the societal, economic and market cycle works to completion, the current, soft business operating environment will change. Adversity will rise but the new paradigm is not likely to allow policymakers to soften the blow this time. And that's why I think discretion regarding what portfolios you own is advised.

Strategist's Corner

April 2024

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.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S. -** MFS Investment Management; **Latin America -** MFS International Ltd.

Please note that in Europe and Asia Pacific, this document is intended for distribution to investment professionals and institutional use only. In Canada, this document is intended for distribution to institutional clients only.

Note to readers in Canada: Issued in Canada by MFS Investment Management Canada Limited. **Note to UK and Switzerland readers:** Issued in the UK and Switzerland by MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS®, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore -** MFS International Singapore Pte. Ltd. (CRN 201228809M); **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.; **Hong Kong -** MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO").; **For Professional Investors in China –** MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan -** MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments ; **Bahrain -** This document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally. The Central Bank of Bahrain assumes no responsibility for the accuracy and completeness of the statements and information contained in this document and expressly disclaims any liability whatsoever for any loss howsoever arising from reliance upon the whole or any part of the contents of this document. The Board of Directors and the management of the issuer accepts responsibility for the information contained in this document. To the best of the knowledge and belief of the board of directors and the management, who have all taken all reasonable care to ensure that such is the case, the information contained in this document is in accordance with the facts and does not omit anything likely to affect the reliability of such information.; **Kuwait -** This document is not for general circulation to the public in Kuwait. The information has not been licensed for offering in Kuwait by the Kuwait Capital Markets Authority or any other relevant Kuwaiti government agency. No private or public offering of the information is being made in Kuwait, and no agreement relating to the information will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the information in Kuwait.; **Oman -** For Residents of the Sultanate of Oman: The information contained in this document does not constitute a public offer of securities in the Sultanate of Oman as contemplated by the Commercial Companies Law of Oman (Royal Decree 4/74) or the Capital Market Law of Oman (Royal Decree 80/98). This information is being circulated on a limited basis only to corporate entities that fall within the description of sophisticated investors (Article 139 of the Executive Regulations of the Capital Market Law). The recipient acknowledges that they are a sophisticated investor who has experience in business and financial matters and is capable of evaluating the merits and risks on an investment.; **South Africa -** This document has not been approved by the Financial Services Board and neither MFS International (U.K.) Limited nor its funds are registered for public sale in South Africa.; **UAE -** This document, and the information contained herein, does not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The information is only being offered to a limited number of exempt investors in the UAE who fall under one of the following categories of non-natural Qualified Investors: (1) an investor which is able to manage its investments on its own, namely: (a) the federal government, local governments, government entities and authorities or companies wholly-owned by any such entities; (b) international entities and organisations; or (c) a person licensed to carry out a commercial activity in the UAE, provided that investment is one of the objects of such person; or (2) an investor who is represented by an investment manager licensed by the SCA, (each a "non-natural Qualified Investor"). The information and data have not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority, the Dubai Financial Services Authority, the Financial Services Regulatory Authority or any other relevant licensing authorities or governmental agencies in the UAE (the "Authorities"). The Authorities assume no liability for any investment that the named addressee makes as a non-natural Qualified Investor diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document you should consult an authorised financial adviser.; **Saudi Arabia -** This document may not be distributed in the Kingdom except to such persons as are permitted under the Investment Funds Regulations issued by the Capital Market Authority. The Capital Market Authority does not make any representation as to the accuracy or completeness of this document, and expressly disclaims any liability whatsoever for any loss arising from, or incurred in reliance upon, any part of this document. Prospective purchasers of the securities offered hereby should conduct their own due diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document, you should consult an authorised financial adviser.; **Qatar -** This material/fund is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such material/fund. The material does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). The fund has not been and will not be registered with the Qatar Central Bank or under any laws of the State of Qatar. No transaction will be concluded in your jurisdiction and any inquiries regarding the material/fund should be made to your contact outside Qatar.

MFSE_FLY_2681898_4_24
58064.1