MFS Chief Investment Strategist Corner: Proceed with caution

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- We are heading into a turbulent summer.
- Company earnings are under increasing pressure; the consumer is stretched and oil is disturbing the world economy.
- Prices of other commodities, especially food, are rising as well.

Let's hope these price increases are indicative of a temporary, speculative bubble. In the case of oil, it does seem as if speculation may be playing a part, given that oil prices are up more than 88% from a year ago while demand has risen only 3%.

If the price increase is not a bubble, however, we are moving closer to recession.

Let's take a look at where we are now and where we might be heading as the long days of summer approach.

- **U.S. economy:** The economy is not collapsing. It is growing slowly. In other words, the steady hand is winning. The "gloom gatherers" have not received their disaster nor the bulls their boom. **What's next?** We expect weak growth for the second and third quarters, but the U.S. economy should pick up in the last few months of year — unless, of course, oil and commodity prices stay at these elevated levels.

- **World economy:** World growth will soften but will remain at a faster pace than U.S. growth. I do not foresee a recession. Emerging market economies now contribute as much growth to the world economy as does the United States. And, while inflation is raging in many of these countries, the emerging economies are growing at a 6% pace. **What's next?** World growth chugs along a bit slower than last year but exceeds 4% and remains faster than the U.S. growth.

- **Inflation:** Inflation is accelerating as prices of commodities, especially oil and food, rise. **What's next?** The slowing of the U.S. economy should help temper inflation. Energy and food make up 18% of the inflation indices, whereas housing and indirect labor costs compose about 40%. The most recent numbers suggest labor costs are restrained and housing prices continue to fall. Both trends should help moderate the rise in inflation.

- **Markets:** Bond markets have stabilized but are still pricing in a recession. Stocks are down 4% to 5% for the year 2008 and down 9% from the October 2007 peak. Thus, by historical standards, stocks have not yet priced in a recession given that a typical peak-to-bottom drop is about 20% to 27%. **What's next?** We are likely to see more turbulence, more down days for the stock market, and margin pressures for companies. Seasonal trends, oil prices, and the housing slowdown will weigh on the market. But remember, election years and periods when the U.S. Federal Reserve Board is cutting rates are typically good for investors. Those benefits, however, are likely to be seen later in the year. As we have said in the past, this year is likely to be a tale of two halves.

- **Earnings:** First-quarter earnings are in, and we have seen 8 out of 10 sectors report profit growth. And, after subtracting the drag of financial services, overall median earnings were up over 9%. **What's next?** Earnings should be weaker but remain positive in this

quarter. **What to watch?** When nominal U.S. economic growth falters, as it has, performance of different sectors becomes more varied. We say there is more "dispersion" of results. Whenever we see this trend, stock-pickers seem to have the advantage over index investors, and long only and long/short players tend to lead other investors.

- **What's cheap?** ***Some stocks and...*** From a historic market perspective, large-cap multinationals are inexpensive, and key sectors of the "value indices" also seem undervalued on the basis of their price-to-earnings (P/E) ratios. Overall P/Es are in ranges that we would consider normal on a historical basis. ***Most bonds.*** Municipal bonds and short-term, high-grade corporate bonds still are undervalued on the basis of their yield spread to the taxable market. **What's next?** Valuation disparity persists. More sectors become inexpensive. Some remain rich. Now is the time to tilt toward research.
- **Oil:** I do not believe oil is exempt from the law of economic gravity, which, as I have observed, states that supply (not so magically) appears when profits are easy to be had. Think: Oil companies react to rising prices by bringing on more reserves. Additionally, consumers know how to cut back on energy when prices rise. **What's next?** I foresee market forces will drag oil below $100. Why do I say that now? The stock market may hold the clue. Stock prices for oil companies are trading at a level that is pricing in oil closer to $80.
- **Housing:** We still have the same old problem: Too many empty houses for sale. **What's next?** Expect the housing market to remain in a slump for another year.
- **Interest rates:** Interest rates are moving in a tight range. **What's next?** The Fed's most recent minutes suggest its will keep its target unchanged.

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