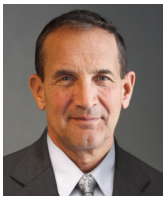

Strategist's Corner | September 22, 2011
by James Swanson, CFA
MFS Chief Investment Strategist

MFS INVESTMENT MANAGEMENT®

Obstacles abound en route to Q4

- **United States: Slow growth but not turning downward. Flight trajectory is close to the trees.**
- **Warning UXO[1]: Europe's finance leaders are playing with fire by refusing to produce a bank rescue plan on the scale required by the markets. The risks of transmission to the U.S. banking system are very real.**
- **Stocks in the United States are more vulnerable than credit markets, which have already underperformed. Many credit markets have priced in a moderate recession from here (high-grade bond and high-yield credit markets). Stocks have not fallen the usual amount for a recession.**
- **While this current crisis falls on the third anniversary of the Lehman Brothers bankruptcy, many conditions are better than they were then, and the scope of possible losses, while large, is not in the same league as those associated with U.S. mortgage problems in 2008.**

U.S. economic picture: Where do we stand?

Americans have lost some of their optimism and boldness about the future and their financial security. But they have not stopped spending. Retail sales and car purchases are stronger than at this time a year ago. Soft data (surveys and confidence polls) are down, but hard data indicate that the business cycle is not ending, as industrial production, capacity utilization, exports, and inflation all point modestly upward. At the same time, yields on AAA- and AA-rated bonds are near record lows, an indication of fear and distress in the system. Credit markets are functioning, but credit spreads are showing that the risks of default have risen. The stock market has moved sharply down over the summer but has not fallen as much as is typically seen at the outset of a recession. Companies continue to reduce debt (de-lever) and augment their liquidity as they harvest record cash flows. Capital expenditures have been slowly rising, and the jobs market has been holding steady without much growth. The U.S. consumer, without the aid of debt, is also de-levering and spending at levels in line with wage growth. The usual list of recession-causing suspects is small within the United States, and as of late September the situation was not deteriorating.

The U.S. economy has lifted off the runway but is flying too close to the trees. What I mean by that is that the margin of error for a mistake, a shock, or a policy error is small. That means the situation is somewhat fragile. Europe right now is the tallest obstacle in the U.S. flight path.

Continued on page 2

Continued from page 1

Europe's policy fumbles

The European finance ministers and central bankers appear to be getting dangerously close to a policy error. U.S. Federal Reserve Board Chairman Ben Bernanke has warned repeatedly that central banks and governments in the past have been too tight or too austere at just the wrong moment. While the eurozone problem countries (Greece, Italy, and Spain) have shown some willingness to cut costs, finance leaders in these countries have not put forward any plan with a size or scope comparable to the Fed's Troubled Asset Relief Program (TARP), which successfully ended the risk of massive systemic bank failures in the chaos of September 2008.

In fact, it is the markets, not the ministers, that seem to be leading the eurozone to a turning point. The funding costs of many big European banks have risen; the overnight lending rates are in some cases as high as they were in the Lehman crisis in 2008. Bond yields in the peripheral countries of Europe have become unsustainably high, making it too costly for many of these countries to refinance their spending or to roll over maturing debt payments. Because of various interbank cross-lending agreements, counterparty arrangements, and the outright ownership of European sovereign bonds, many major U.S. money center banks have part of their books of business tied to Europe. It is clear that the capital base and liquidity of both the U.S. and European banks is in good shape and perhaps in better shape than prior to the Lehman crisis of three years ago. However, losses in the European banks would cause many of them to shrink their balance sheets and rein in lending. As a result, business growth would be stunted.

The knock-on effect in the United States would be similar. The banks would not lose all of their capital, but loss exposure to European corporations and sovereign bonds in a European recession would bleed into many major U.S. banks. In turn, U.S. banks likely would curtail their commercial and industrial loans, which have just recently started to increase.

Because the U.S. economy is so close to stalling, any spillover from Europe would represent a very clear and present danger.

Emerging markets still offer growth potential

The developing countries are still growing but at a slower pace. The round of rate hikes in the developing world has subsided, and inflation pressures are moderating. But the long-term march toward more consumer-led economies is continuing, and any slowdown in growth during this period is probably temporary. Emerging market bond yield spreads have widened a bit in line with the eurozone crisis but are narrow when compared with historical levels of the past 20 years.

Emerging market stocks have also sold off this year, bringing P/E ratios to low levels not seen in many years.

Valuations and markets

Traders: Traders seem to be running the market up in short bursts when hopeful news comes out of Europe and then reversing course and sending markets down on the slightest disappointment.

Short-term investors: These investors face near-term market storminess as the system tries to absorb the risks that European policymakers are forcing the rest of the world to endure. Those with a three- to six-month horizon are very vulnerable to the chaotic newsflow that is the norm now.

Continued from page 2

Long-term investors: Those investors with horizons stretching years into the future who employ systematic value and growth strategies are beginning to sense opportunity. That confidence, despite near-term pessimism, is based on a torrent of better fundamental corporate news, led by rising cash flows, better profit margins, and stronger balance sheets. These fundamental strengths, paired with recent drops in market capitalization, have created value in many dividend-paying stocks. In a world starved for yield by central banks' easy-money policies, investors now look to the stock markets. There they can find current earnings yields, cash flow yields, and dividend yields, that are attractive when compared to the near record low rates offered in U.S. Treasury markets, cash, and deposit accounts. Also of note, technology companies continue to sell their ever-changing product lineup to an eager and awaiting world. They do so with virtually no debt, high profit margins, and high cash balances.

Conclusion: While it would be unfortunate to see a weak, but decent, business cycle terminated unnecessarily early by policy error or blunder, the scope of this problem is not as big as the U.S. mortgage mess of 2008. The potential losses and contagion effect are not of the scope of the Lehman/mortgage crisis. In fact, many of the monetary conditions are more favorable now. Corporations, flush with cash and liquid assets, have much greater capacities to absorb an economic shock now. The mess in Europe may also in some way be like an electric prod to U.S. policymakers, who still insist that the United States does not have a debt problem. The U.S. debt problem is now a balance sheet problem. In time, it could become a liquidity problem such as we are seeing in Europe. The United States is fortunate in that it has more time than Europe does to fix its problems. Time is running out for Europe, and as a result, it is perhaps running out for the whole world.

[1] A UXO is an unexploded ordinance.

MFS®
INVESTMENT MANAGEMENT

MFSE-SWANSON-NL-9/11
21490.9