

## MFS® WHITE PAPER SERIES

**Slowdown or recession?**

- Current economic conditions are influenced by ECB's tight monetary policy, Europe's austerity measures, and banks' balance-sheet trimming worldwide.
- The ill effects will probably be less severe than in 2008/2009, but markets are likely to remain volatile.
- Asia is at higher risk than Europe; the US is best positioned generally, but large, global companies — especially money-center banks — may bear the brunt.

**Seek income to mute volatility**

- Focus on stocks' dividend yield and, more importantly, underlying cash-flow generation.
- Consider high-grade bonds, which appear cheap by historical standards.
- Technology stocks now seem more "defensive" than utilities or consumer staples, while potentially positioned for a bright future.

**Takeaways**

- Even in this slow-growth environment, select companies around the world are building record cash flows and strong balance sheets.
- When interest rates are low, income streams become important generators of return.
- Look to fundamentals, especially consistency of cash flows.

# Strategies in a slow-growth world

## Seeking income streams for return enhancement

by James Swanson, CFA

**EXECUTIVE SUMMARY** Near the end of 2011, many economists were predicting a sharp slowdown — perhaps even a recession — for the United States and Europe. The current picture is more mixed. 2012's year-to-date gains across world stock markets belie underlying economic stress (as of February 29, even MSCI's Greece index was still up nearly 15%), and investors have grown more skittish over rising energy and commodity prices, as well as increasingly unstable political situations in Europe and the Middle East. Facing heightened tensions and potentially slower growth, investors inevitably wonder where to look for investment opportunities.

This paper lays out MFS chief investment strategist James Swanson's case that yield, whether from equities or debt, may offer some respite from a volatile market. Swanson examines some regional idiosyncrasies and how they might interact under further economic slowing. In his view, Asia may fare worse than expected, mainly due to issues in China. Europe may perform better than expected, given major banks' having reduced their balance sheet risk and Europe's new-found fiscal and monetary conservatism (potentially offset by political laissez-faire). The US may suffer least in a worldwide slowdown, at least in terms of gross domestic product (GDP), but large global companies and money center banks could take a substantial hit. Overall, though, the economic situation appears much more manageable than the 2008/2009 recession.

In a potentially volatile market, Swanson suggests looking to income streams to smooth what could well prove a bumpy ride. He makes the case for equities that provide a strong dividend, with an emphasis on seeking stable underlying cash flows, high-grade corporate bonds and, for their defensive operating margins as well as their potential for capital appreciation, technology companies.

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The paper concludes that, despite dire warnings of debt, duress, and political woe, return-enhancing income opportunities can be found, whether through dividend-yielding or defensive stocks or the potentially favorable risk/reward profile currently available via high-grade bonds. As always, investors should look to fundamentals and remember that, even in a low-rate and slow-growth environment, investors should be able to uncover companies with strong balance sheets that are generating substantial cash flows.

### Seeking income streams for return enhancement

Early on in 2012, European Union economies appear at risk of faltering. This weakening, evidenced in lower manufacturing and final demand, could signal the onset of economic contraction. By historical standards, however, it is a bit early for the region to re-enter recession, as the last downturn ended just two and a half years ago. The current slowdown results from the convergence of three factors:

- The prolonged, relatively tight monetary policy of the European Central Bank
- Fiscal spending reductions or “austerity measures” undertaken by heavily indebted countries
- Banks trimming balance sheets to brace for possible losses from sovereign credits

Europe’s economic contraction, now in its early phases, appears likely to be shallower and briefer than the 2008/2009 episode. The slowing may not compare in severity or trauma to the US- and Lehman-led housing/credit recession because, in terms of reserves and liquidity, developed market corporations and the banking systems are in better shape than they were last time around. Further, banks have less balance sheet leverage than in 2008. The European Union, despite current political concerns, thus seems better positioned today to absorb an economic shock.

Countries *outside* of the eurozone, however, would not be able to escape the impact of a recession. Asia would likely be the first affected because emerging countries of the region are more exposed to final sales to Europe than they are to final sales to North America. Asia’s trade and credit ties to Europe are more concentrated

and deeper than are Europe’s ties to other parts of the world.

China’s recent economic slowdown has also put a dent in the growth rates of Asian powerhouses Korea and Taiwan. While the combined effect of a slowing China and a recessionary Europe may not send Asian economies into outright reverse, it could further slow the expansion of exports from China and other Asian countries.

Because of fewer trade links to Europe, the economies of the United States and other North American countries are not likely to take as severe a hit as their Asian counterparts. Only 2% of US GDP is directly traded with European partners. Europe’s recessionary effects are far more likely to be transmitted to the United States through large, publicly traded companies and the banking system.

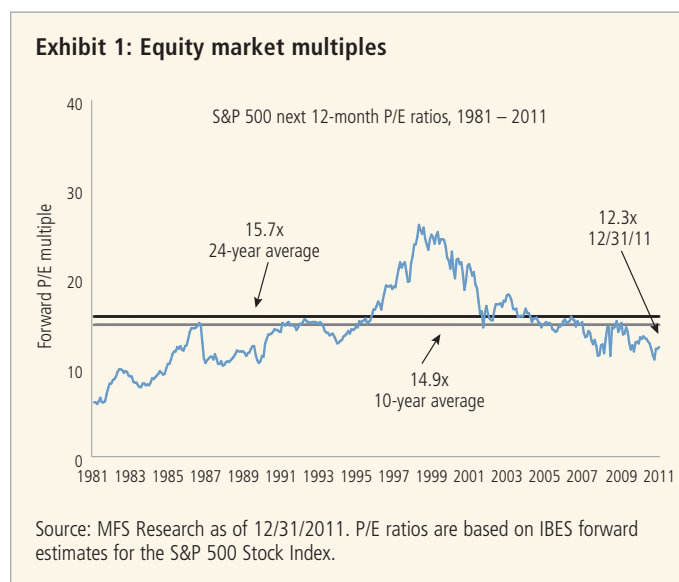
The largest companies of the US-focused S&P 500 Stock Index have far more exposure in terms of sales and earnings than the general economy’s 2% GDP effect might suggest. Our research indicates that some 10% to 12% of their US sales and earnings are the direct result of trading with Europe and countries in the European Monetary Union. This exposure suggests that the recent robust earnings and margin growth among top US-based companies may subside to a certain degree in the early part of 2012 as a slowdown in purchases of US goods and services begins to hit reported results.

Major money center banks in the United States represent the most significant transmission links to Europe. US banks are closely tied to Europe though their bond holdings (the value of which could be written down), credit-default arrangements, and overnight lending facilities, with temporary surpluses flowing to higher-yielding European banks.

A perception of increased risk of loss would likely cause many US banks, like their European cousins, to reduce the size of their balance sheets and, in effect, curb credit expansion. In other business cycles, such tightening monetary conditions might have been lethal; however, expanded business lending is doing little to drive the current US business cycle, so any pullback of credit is not likely to be widely felt.

Memories of the deep and prolonged downturn of 2008/2009 are still fresh. We need to keep in mind that the possible losses from sovereign default in Europe are not anywhere near the magnitude of — nor as hidden as — those experienced by the banking and housing sectors in 2008, when the levered nature of the financial system created a historically intense recession. This time, neither US nor European bank leverage compares.

In other words, potential losses from the current situation seem a bit more manageable than those of the last recession. It follows that investors need to be vigilant and cautious, but not paralyzed by fear. In fact, the effects of potential losses may have already run their course in world markets: Historical comparisons suggest that a recession of moderate magnitude may have already been priced in by European and emerging markets. Historically, global stock markets fall an average of roughly 15% to 25% before the onslaught of a recession, a drop similar to what we saw in 2011. In addition, forward price/earnings (P/E) ratios and other valuation metrics show equities as inexpensive relative to historical norms and as having already priced in real signs of distress.



Recent US stock results have not suffered the declines of other world stock markets. While this trend may not be evidence of US “decoupling” (the idea that certain

economies, especially among emerging markets, have developed some independence from US markets), it may be a sign that US companies are well positioned to weather a slowdown. In the years since the Lehman debacle, US firms have deleveraged; further, they now have high cash flows, high cash balances, robust sales, and access to high-growth markets. These characteristics have placed the US economy in a stronger position from which to begin a slowdown and suggest a certain resilience lies ahead.

Although European leaders have responded to the sovereign debt crisis with delays and half measures, they nevertheless have succeeded in preserving the euro, at least for the time being. However, their behavior is not preventing a recession. Credit rating agencies seem to be sending the message that more decisive, long-term action is needed to assure the world that the European debt crisis can be solved. Anxious investors may not want to pounce on European markets just yet, despite their seemingly inexpensive offerings. History would back up this caution: Markets tend to rally when they sense that the end of a recession (rather than its beginning) is within view, perhaps some six to nine months away.

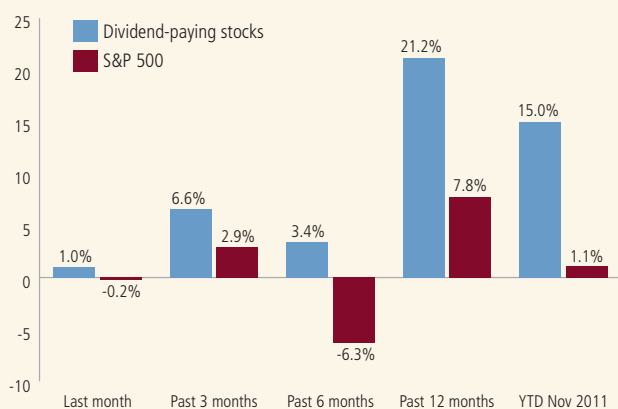
### So, how does one invest or think about investing in this global economy?

#### Defeat volatility through the compounding of income.

This long-established investment tool can help smooth the violent churn of a risk-on/risk-off trading environment (that short-term pattern wherein when investors are confident, money flows to risky assets such as stocks and when they are worried, to the perceived safety of guaranteed returns, *e.g.*, bonds, US Treasuries, and the US dollar). Our research shows that in Europe, over long periods of history, approximately 60% of total return from equity shares has been derived from associated dividend streams. In the United Kingdom, that number is 55%, and in the United States, dividends account for 40% of stock returns. Some researchers put the full figure even higher. Compare, for example, the 2010 article by GMO’s James Montier, “A Man from a Different Time.” Combining dividend yield and real dividend

growth, Montier states that, for the US S&P 500, “on average, over the very long term [1871-2009], dividends have accounted for some 90% of total return,” and that in Europe, “80% to 100% of the total returns achieved since 1970 have come from dividends.”

**Exhibit 2: Absolute returns of dividend-paying stocks vs. S&P 500 (as of 30 NOV 2011)**



Source: Bank of America Merrill Lynch Quantitative Strategy.  
Data as of 11/30/2011.

Cash flow is a necessary ingredient in the creation of future dividend payouts. Despite all the turmoil over sovereign debt, we can find companies operating in Asia, North America, and even Europe that are generating near-record cash flows. So, when considering dividend yield, do not neglect cash flow generation as the underpinning of a dividend-yield purchase strategy. Yield matters, but consistent cash flow to support that dividend flow matters even more.

Also, history shows that dividends are about 70% less volatile than company earnings because, in most circumstances, companies are loath to cut dividends unless under great duress. In sum, we need to think more about dividend streams and less about the day-to-day churning and bouncing of various global indices.

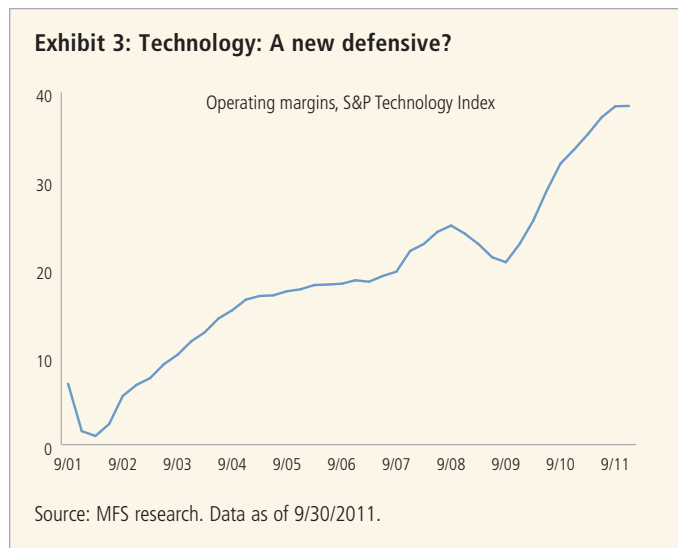
**High-grade present another value option.** In terms of excess yield (*i.e.*, bond yield minus a risk-free rate), recent high-grade bond markets in Europe seem cheap compared with their prices in past cycles. As credit rating agencies continue to downgrade the few remaining AAA sovereign credits, the menu of “high-grade” bonds available to institutions with “high-grade” mandates is dwindling. Meanwhile, many corporate bonds look safer than the bonds of certain heavily indebted countries.

Spreads in the US high-grade corporate bond markets have been pricing in recessionary outcomes that we believe may be exaggerated. Corporate-credit defaults are running below normal, and balance sheets and cash flows are strong. If no recession is expected, high-grade corporate bonds may represent a sensible way to compound an income stream at favorable reinvestment rates.

#### **Seven reasons we like information technology (IT).**

We see five major fundamental factors regarding the technology sector worth serious consideration:

- Three product revolutions under way: Virtualization, migration to the public cloud, and the dissemination of data and entertainment to smaller devices.
- Significant exposure to growth outside the developed world: The growing consumer classes there continue to buy software and hardware.
- Very little debt: Technology is the most conservative sector from a balance sheet-safety point of view; these companies are awash in cash.
- Pent-up demand: Corporate tech spending has run well below normal over the past two cycles, implying that just to bring systems up to date, companies are going to have to resume IT spending.
- Perhaps most important: IT companies are generating two to three times the cash flow and earnings margins they were a decade ago. Tech companies around the world are very profitable.



#### About the author

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In addition, we see two nonfundamental reasons to consider technology companies:

- The sector's relative volatility, or beta, has fallen over the past three to five years, meaning that the sector has become less sensitive to general market moves.
- Valuations, in terms of forward price/earnings ratios, are low by historical standards. In the United States, Europe, and Asia, multiples are running well below 20-year averages for forward P/Es. Some companies are now trading at 11 times forward earnings, whereas 10 or 12 years ago, P/Es of 20 to 30 times were not uncommon. Current tech valuations are similar to those seen in the utilities or consumer staples sectors, which are now experiencing lower earnings growth and product excitement.

In conclusion, flash headlines warning of debt, duress, and political woes can prove bewildering. But investors should remember that, even in slow-growth environments, select companies around the world are demonstrating an ability to generate record cash flows alongside strong balance sheets. Investors should always look to fundamentals and never forget that, when interest rates are low, income streams, whether from stocks or bonds, become important generators of return.

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 from the Advisor.

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