MFS®

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THOUGHTS TO KICK OFF 2016

QUICK POINTS

Our approach is analytical, not attitudinal — almost like fundamental company analysis.

We look for the facts to win out, and the fact is that the US consumer has been doing well.

Someday the consumer — like a football quarterback — will be sacked, but is that day coming soon?

The complexities of the world around us — and the many choices faced by investors in 2016 — may feel overwhelming. But if we go back to the basics and consider the outlook for the largest economies in the same way we would analyze the prospects of individual companies, then we may shed light on the facts that matter most.

Looking at the fundamentals

When looking at a company, we want to know the quality of its products or services and their attractiveness in the marketplace. We need to assess the firm's competitiveness: What costs go into making the product or delivering the service? Does another firm have lower costs? Who are the buyers and how much can they afford to buy?

We also want to determine whether the company is living on too much debt and whether the management is motivated to increase shareholder value over the long run. Measuring a few key numbers, such as profit margins and return on equity (ROE), can help us put the longer-term picture together.

Analyzing the US economy

In 2015, demand rose again for US products other than commodities. At the beginning of 2016, the biggest source of world demand is still the US economy — not China, Europe or Japan. If the United States were a company, we could say that it makes technology, pharmaceuticals, automobiles, airplanes and entertainment. Because the US does a pretty good job at all of them, world demand grows.

Is the US a high-cost producer? The biggest cost of all is labor, and for more than 10 years the unit cost of labor has been falling in the US relative to most other countries. The second big input is energy — used by many companies to make products such as chemicals, plastics or automobiles — and the cost of energy is lower in the US than nearly anywhere else in the world.

The cost of capital is another factor. One way to keep this cost down is to use the existing capital base wisely or "turn it over" more frequently. The numbers show that US companies are good at applying technology to keep capital usage lower and asset turnover higher than for other companies around the globe. So I think we can say that the US is competitive with its costs.

Who are the buyers of US products? What the US exports to its neighbors, emerging markets and the eurozone amounts to about 13% of US GDP. These exports have been weak for two years but haven't collapsed. Most of what the US sells is bought by consumers within its own borders. And for them, the workweek has been lengthening over this business cycle, wages have been rising in all job categories and their numbers have been increasing in line with the gains in employment.

This three-way multiplication generates much of the buying power that we have witnessed during this cycle. And that combined buying power continues to push upward.

Meanwhile, rising costs haven't become a burden. Unlike the 1970s and 1980s, when buying power was being eaten up by rampant inflation, the early part of this century has seen contained inflation. In fact, the only thing that seems to be on a downtrend for the US consumer is the basic cost of living, as the prices of food, clothing and energy have all been falling. This means that real buying power has been lifted.

What about the US balance sheet, margins and ROE? Debt levels of this company called the US are high, and that is a worry, but who has been borrowing? The consumer debt burden has actually been falling for six years, while corporations have been tapping the debt markets — but less than in other cycles. And US government debt has not been rising as much as in most other countries.

Published returns on equity from publicly traded stocks indicate that ROEs in the US are now higher than in almost any other region. US profit margins have held up extremely well. Even in the most recent quarter, when revenues lagged along with lower global demand and weaker oil prices, the profit share of US GDP remained at levels rarely seen since World War II.

So in our view, the analytic elements — product, cost, demand, balance sheet, profit margin and so on — all line up in favor of longer better growth for the US economy.

Sacking the quarterback

The US football season is entering the playoffs, and during every fiercely contested game, the commentators shout dramatically in anticipation of the quarterback being knocked down before passing the ball.

It's much the same with market watchers and the US economy. The end of the business cycle is predicted almost every day. Understandably, with memories of the terrible 2008–2009 recession causing wariness, someone will foretell the onset of the next recession after each spell of weak economic news.

Given all the talk about an aging business cycle that is ripe for collapse, recession seems just around the corner. Unfortunately, many investors have heeded these warnings of doom and largely stayed out of the US stock market during the past six years.

But I think the facts of history tell us another story: Business cycles don't suddenly occur or die for no reason. Economic growth is a function of the number of people working, their ability to be productive — that is, add value — and the system's ability to pay them for their work.

The last 15 recessions have all been triggered by something that robbed consumers of their jobs and their spending power. The most common culprits have been rising interest rates, excessive inventories, peacetime demobilizations and skyrocketing costs of living — especially energy.

In January 2016, the US worker and consumer may look vulnerable to the defensive line coming in for a tackle. Yet wages have been rising, and cost-of-living increases appear negligible. The forward path of interest rates may be upward, but at a moderate pace — hardly a risk since no one seems to be borrowing. There has been neither runaway inflation, with crude oil prices so low, nor demobilization from war. As I see it, all three drivers of economic growth are still positive.

Then how will the US economy's quarterback be sacked in 2016? This sack — or recession — must come from somewhere, yet there is no rush underway. Those elements that can destroy US consumer buying power are either almost absent now or even helping, not hurting.

The way may also be clear for weak global economies to fare a bit better in 2016. Why? Because their input costs have fallen — the costs of capital, commodities and energy remain historically low. The world's population is still growing, and many consumers in both developed and emerging markets are net users of energy.

Standing on the sidelines

I expect that in 2016, we may see rolling recessions in isolated industries and in certain national economies. But the big players on the global field — the US, China, the eurozone and Japan — could all continue to benefit from lower energy costs.

The net result would be better buying power for three-quarters of the world's consumers. For investors who have so far remained on the sidelines, that could turn out to be a good signal to enter the game.

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