

MFS INSIGHTS: THOUGHTS ON A CRAZY COUPLE OF WEEKS

By Robert M. Almeida

Portfolio Manager and Global Investment Strategist, MFS Investment Management

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Amid a deepening public health crisis that has had a dramatic impact on families, communities and markets, here are a few observations that I hope might help.

Change your focus

Many investors focus on the upside in rising markets and the downside in falling markets. Perhaps, the focus should be exactly the opposite.

For the past several years we've focused on the near-systemic misallocation of capital by companies fixated on goosing stock prices by returning capital to investors via stock buybacks and dividend hikes — funded by historically low interest rates and tight credit spreads — while sidestepping productive long-term capital investments. That misallocation resulted in all-time high profits, margins and near-record valuations. But companies were engineered to win a sprint. They didn't have the legs necessary to win a marathon. It took COVID-19 to expose the fragility of those overstated profits and the global economy.

Now, the focus should be on opportunities. Which companies will survive and which will be better positioned on the other side of the crisis if half of their competition is gone? We believe companies with something people need or want, that are not dependent on short-term funding and that have seen their stock prices arbitrarily decimated may prove attractive, in hindsight, once the crisis is behind us. That's where we're focused.

Liquidity remains awful but may improve

Investors may struggle to take advantage of opportunities until liquidity improves as it remains difficult to either buy or sell in the present environment. The US Federal Reserve's actions in recent days are beginning to ease strains in the money markets. The health of short-term funding markets is critical to the smooth operation of all other financial markets. The consistent functioning of these markets is the number-one priority. Central Banks can't fix a pandemic or an oil crisis, but they can make sure the plumbing of the financial system is in order.

Operationally, Wall Street firms has gone virtual, with trading desks and portfolio management teams at disaster recovery sites or working from home. At MFS, our investment teams are able to meet by video conference, and visits with company managements are taking place virtually, as are roadshows. While happening remotely, these meetings are taking place, more or less, as usual. We have increased the frequency of our risk reviews during this period of greater volatility.

The crystal ball is cloudy

Forecasting earnings when large parts of the developed world are subject to lockdowns is challenging enough. But the challenge is compounded when you add the oil supply shock to the equation. Markets are being forced to absorb two shocks at once against a backdrop of markets coming off of peak, puffed-up profits at a time when central banks have few monetary tools left in the shed. In my view, the effects of the oil price war, on top of the coronavirus crisis, won't be linear. The combination will be something greater than either in isolation. That makes forecasting 2020 earnings particularly challenging at the index level, but we're constantly performing fundamental analysis at the company level, looking for long-term opportunities among high-quality assets.

The Portfolio triage

From an investment perspective, something like triage is taking place as investors sort through portfolios and ask themselves if certain companies can carry on amid a global liquidity drain, a deep recession and sub-\$30 oil prices, to name a few new realities. For those left standing, how long will they be impaired? Will they need to raise capital, diluting existing shareholders? Will EPS be impaired for years to come? Are we spawning a new generation of zombie companies?

It will be key to make those sorts of assessments in the months ahead; focusing on who we believe will be the survivors and then doing the analytical work necessary to take advantage of opportunities.

IMPORTANT INFORMATION

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