SAVVY INVESTOR

The long-term view: Equities, bonds, and economic growth

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A fast-arriving future

Prem Panesar
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Savvy Investor

Short-term views proliferate in periods of uncertainty and transition, and it is all too common in these conditions to overvalue novel investment themes that, to an investor, seemingly flip the narrative. MFS's paper, "Long-Term Capital Market Expectations" for 2025, the subject of this Special Report, offers a forward-looking assessment of global investment conditions, asset class performance, and economic trends.

With global markets navigating diverging monetary policies, geopolitical events, and supply-side changes in the economy, investors face an evolving landscape requiring strategic adaptation. In the first month of 2025 alone, the U.S. has seen regime change with the inauguration of Donald Trump, international tariffs proposed and an undermining of the "Magnificent 7" from Chinese competition

The backdrop for the future therefore remains complex. U.S. equity markets remain vulnerable due to consolidation and sky-high valuations. Meanwhile, global equity markets remain mixed and as credit spreads remain tight, fixed income markets are increasingly driven by carry. By assessing these factors with a wide-angle lens, MFS highlight the importance of diversification, risk management, and identification of opportunities across asset classes and regions.

Alongside a two-page report summary, this Special Report also includes an interview with Jonathan Hubbard, Managing Director & Lead Strategist for the Strategy & Insights Group at MFS Investment Management, and the lead author of the paper.'

Report Sponsor

About MFS Investment Management

For a century, MFS has aligned our active investment approach and how we serve clients with a sole purpose: to create long-term value responsibly.

Through our global investment platform, we combine collective expertise, thoughtful risk management and long-term discipline to uncover what we believe are the best investment opportunities.

Jonathan W. Hubbard, CFA
Managing Director
MFS Investment Management

Jonathan W. Hubbard, CFA, is a managing director within the Investment Solutions Group for MFS Investment Management® (MFS®). In this role, he focuses on client portfolio topics, including asset allocation strategy, portfolio structure, and global investment trends and developments.

In addition, he works closely with the various investment teams at the firm in determining MFS capital markets expectations and asset allocation views.

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Featured Paper from MFS Investment Management

Long-Term Capital Market Expectations

View the full paper

“China’s growth outlook remains subdued despite stimulus efforts, grappling with weak domestic consumption and a faltering property market.”

A year of global shifts

The global economy in early 2025 reflects a blend of strong past performance in certain regions and persistent challenges in others.

U.S. equities posted another exceptional year in 2024, despite concerns of concentration and elevated valuations. Markets saw a healthy rotation into small and mid-cap stocks with solid earnings reported beyond the technology and communication sectors. Meanwhile, Trump’s re-election has brought significant hurdles into place for emerging markets, including trade tensions and a strong U.S. dollar, which may alter the dynamics of existing demand as emerging economies face increased competition. China’s growth outlook remains subdued despite stimulus efforts, grappling with weak domestic consumption and a faltering property market. In developed markets, Europe continues to struggle with economic softness and political turmoil, while Japan stands out with its recovery supported by wage growth, interest rate hikes, consumer spending, and favorable corporate reforms.

Inflation has eased globally, though it remains sticky in the U.S., influenced by robust economic activity and Donald Trump’s protectionist trade agenda, which could influence global supply chains. While global markets exhibit resilience, they remain susceptible to risks such as inflationary pressures, policy missteps, and geopolitical uncertainties, underscoring the need for strategic investment approaches attuned to these dynamics.

Fiscal policy and central bank divergence

Central banks are charting increasingly divergent paths in response to varying regional economic pressures. The Federal Reserve has adopted a cautious easing strategy, having trimmed rates by 100 basis points in 2024, in part due to persistent inflationary concerns stemming from services across housing, insurance and financials.

The European Central Bank (ECB) and the Bank of Canada (BoC), however, have pursued more aggressive rate cuts to counter sluggish growth and declining inflation. The Bank of Japan maintains the lowest interest rates in developed markets, benefiting from its first consistent inflation and wage growth period in decades.

Fiscal dynamics are heavily influenced by the U.S. administration’s pro-growth policies, including proposed tax cuts that could deepen the federal deficit, which already stands at 130% of GDP. Protectionist trade policies, including tariffs, add another layer of complexity, with potential consequences for global trade relationships. These measures may bolster domestic industries in the short term but risk retaliatory actions and supply chain disruptions. As central banks grapple with inflation and growth, MFS believes that monetary policy remains a critical tool in addressing regional disparities. However, the scope and timing of these interventions are pivotal to ensuring market stability while fostering sustainable growth.

Equity and fixed income building blocks

U.S. equity markets saw robust gains as 2024 came to a close, with the S&P 500 delivering over 20% returns for the second consecutive year. Key drivers included earnings growth beyond technology and communication sectors, though elevated price-to-earnings ratios suggest limited room for valuation-driven returns. If tax cuts, deregulation and productivity gains related to AI materialize, earnings could grow into the heightened P/E multiple, and MFS anticipates that a relatively low 10-year expectation (1.1%) for US large-cap equities would contrast a solid 30-year return expectation (7.1%).

Japan's equities are expected to outperform, supported by improving corporate governance and a weak yen boosting tourism and exports. Meanwhile, European and emerging market equities face headwinds, including political uncertainty and trade policy risks, though they present value opportunities for long-term investors.

MFS believes that fixed income markets, on the other hand, are expected to see returns dominated by carry, as higher all-in yields provide a compelling entry point for investors. With global investment-grade bonds yielding 4.8% and high-yield bonds offering 7.5%, carry emerges as the key contributor to returns, particularly in a spread-compressed environment. Credit spreads have remained tight due to strong technical demand, healthy corporate fundamentals, and subdued default rates, limiting their potential to add to returns.

Moreover, the gradual easing of monetary policy by major central banks supports the case for sustained carry returns, as rate cuts stabilize bond prices.

Portfolio considerations for 2025

MFS believes that strategic asset allocation remains essential in navigating the evolving market landscape. Historically, a 60/40 global balanced portfolio has performed well, sustained by strong global equity returns and stabilizing bond contributions dampening volatility. It makes the case that a pivot toward international equities, particularly in emerging markets and Europe, may offer attractive long-term return potential despite near-term challenges.

MFS presents a selective view on emerging economies, anticipating that the protectionist stance by the new U.S. administration may have greater impact on export-heavy nations, such as Mexico and China. Tied with a strong dollar, there could be opportunity in global trade shifts toward favored emerging markets that shoulder the deficit in lower-value manufacturing once held by China.

"MFS believes that fixed income markets, on the other hand, are expected to see returns dominated by carry, as higher all-in yields provide a compelling entry point for investors."

Ask the Expert with MFS Investment Management

The long-term talk

Jonathan Hubbard, CFA, Managing Director & Lead Strategist for Capital Markets at MFS shares some of the thinking that went into his stance for this year, along with a host of further insights.

Interviewer
Gary Adams
Deputy Head of Investment Content
Savvy Investor

Jonathan W. Hubbard, CFA
Managing Director
MFS Investment Management

What assumptions underpin your relatively lower 10-year return expectations for US large-cap equities, especially when compared to your expectations over 30 years?

Jonathan: Sure. To take a step back and explain how we construct these expectations for equities, we focus on four fundamental building blocks and one macroeconomic variable. Then, we consider how these might evolve over the next decade—our time horizon. We use 10 years because it's long enough to encompass a typical business cycle, which generally lasts 7 to 10 years.

The four fundamental building blocks are: real sales growth, valuation (as measured by P/E ratios), profit margins, and dividend yield. The macroeconomic variable is the inflation forecast. We determine a future target level for each of those building blocks and compare that target to today's level, which allows us to calculate not only a top line expectation, but also determine expected contributions from each building block.

Currently, profit margins and valuations are at extremely elevated levels relative to history, particularly in the U.S., which represents just under 70% of the global equity market. Over the next decade, we see these elevated levels normalizing and moving toward historical averages, particularly in the first five years. Beyond that, when we extend the horizon to 30 years, we expect better returns. Once the initial correction occurs, the equity market should approximate long-term returns closer to 8-10% annually. That's what accounts for the differentiation between the 10-year and 30-year expectations.

Do you believe that the potential returns from the Chinese economy outweigh the geopolitical risks that foreign investors face when investing there?

We're fairly cautious on the Chinese economy right now. From a macroeconomic standpoint, they're facing significant challenges. They're undergoing a deleveraging process and attempting a metaphorical "controlled demolition" of their property market. Domestic consumption is extremely weak, and deflation is a real concern. And this is before you consider the risk of geopolitical shocks and the potential for significant tariffs from the U.S. and its allies.

China's economic growth was barely 5% last year, and their bond market reflects growing distress. For instance, China's 10-year yield has dropped from about 2.9% a year ago to 1.6% now. This is signaling tougher times ahead. What's more, potential geopolitical risks are compounded under the current U.S. administration. We do urge caution for investors considering China as a potential investment opportunity.

Why do you think the Chinese government is willing to let its property market deflate?

That's a good question. The Chinese government has been reluctant to use the kind of fiscal stimulus the U.S. employed after the global financial crisis. One reason for this might be optics. In China, the government played a significant role in encouraging property sector investment. Admitting this might look as though they're taking responsibility for inflating the bubble. In contrast, the U.S. government was able to blame private banks and Wall Street broadly. While China has engaged in some fiscal stimulus and likely will do more in early 2025, it really hasn't been to the level needed to deleverage the market effectively.

Your paper presents an optimistic view of emerging market equities over the next 10 years. Are you working with a specific scenario regarding tariffs, reshoring, or other geopolitical factors?

Our 10-year expectations are informed by a quantitative approach, but they're also shaped by our deep understanding of market fundamentals. Predicting specific geopolitical factors over a decade is difficult, but we do believe tariffs and shifting trade flows will play a key role in capital markets.

We anticipate a trend toward "reglobalization"—not deglobalization, but a realignment of trade relationships. For example, in the U.S., we expect more reshoring and friend-shoring. Critical industries, such as semiconductors and medical equipment might return to this country, while lower-value manufacturing may shift from China to other emerging economies, such as Indonesia, Thailand, and Vietnam. I would also suggest that India looks like a pretty interesting country that is well-positioned to take some of those trade flows from China.

In terms of equity expectations, U.S. profit margins and valuations are elevated, but emerging economies, and international equities in general, don't face this same issue. This provides room for positive total returns in these markets over time.

Speaking of India, what is meaningfully different now compared to the past 10-20 years, during which time it has often been touted as being the "next China"?

Yes, India has often been referred to as the next China, but it never really materialized. I think that things are different now. The first reason is global companies are now actively seeking alternatives to China due to tariffs, the supply chain issues that emerged as Covid occurred, and geopolitical risks, such as Russia's invasion of Ukraine. Second, Prime Minister Modi is very eager to take advantage of this opportunity by making significant infrastructure investments in airports and energy grids.

However, challenges do remain. India's democracy can slow progress compared to China's centralized, command-and-control system. But there is clearly genuine momentum now.

Additionally, many Indian businesses have begun aligning with global trade shifts by investing in high-growth sectors, such as technology and pharmaceuticals. This shift could significantly boost India's economic trajectory over the next decade.

Your forecast for emerging market debt is strong. How should investors assess risks in this space?

There are a couple of things going on within emerging market debt. If you take a look at your starting 10-year time horizon, your starting yield to maturity within fixed income is a pretty good indication of what you're going to get over that next 10 years. Today, emerging market debt offers attractive yields, currently in the 6-7% range. Many emerging economies are in reasonably good shape, with inflation coming down and central banks cutting rates faster than seen in the U.S. While tariffs and global trade shifts may pose risks, the overall macroeconomic backdrop looks supportive for emerging market debt.

And what about Japan? Do you think recent central bank moves and changes to corporate governance are enough to drive growth?

Reflation has returned to the economy, encouraging spending. And Japan is an economy made up of savers, who should benefit from higher interest rates. Meanwhile, various corporate governance reforms, such as disentangling cross-shareholding structures and increasing dividends, make Japan equities more shareholder-friendly and attractive to investors.

Japan's aging population presents a unique challenge, though. Consumer behavior may take time to adapt after decades of low inflation and near-zero interest rates. However, higher wages and structural reforms could gradually shift spending habits, which would support long-term growth. We think there are some really interesting dynamics in place for Japan's economy and equity market.

How do potential AI-driven productivity gains factor into your growth assumptions? Do these vary by region?

We haven't directly incorporated AI-driven productivity gains into our forecasts. While AI is certain to have a great impact on how businesses operate, it's not entirely clear to us how developments in AI are going to flow into productivity gains, in what why they will materialize, and who the winners will be. This is reminiscent of the early Internet days, where expectations were

high but practical applications took time to emerge. AI may need a catalyst, like how Covid effectively forced and accelerated remote work technology adoption. Companies are eager to invest in AI but are struggling to determine what to do in terms of key performance indicators and other measurements of productivity.

Given the divergence in global monetary policy, what adjustments should investors make to their fixed-income portfolios?

Investors should look globally for value. This is often an overlooked lever in fixed income markets. Investors tend to have home country bias overall, but I think this is particularly pervasive within fixed income. Non-U.S. central banks are cutting rates more aggressively than we expect the Federal Reserve to, offering opportunities in regions like Europe and Canada. Credit markets also look attractive despite tight spreads, as all-in yields remain high. Understanding that all-in yields are what you take home as an investor is really critical. And currently, even though credit spreads might be tight, all-in yields are very high relative to historical levels. While its critical to be mindful of risk, spreads can remain tight for long periods of time, particularly when corporate balance sheets are in such good shape, as they are today.

However, considering the inflation backdrop, we do suggest that investors should be cautious with duration. Inflation might not only remain higher than it was in the decade following the financial crisis but might also be more volatile.

What factors contribute to your idea that carry will be the primary driver of fixed income returns over the next decade?

If I can go back to the 10-year period following the global financial crisis, we had extremely low inflation. We also had extremely low interest rates, which was really an anomaly. At that time, the global financial system was on the brink. Banks needed to disentangle from each other, consumers needed to deleverage, and financial institutions had to de-risk. As a result, interest rates were kept near zero in many countries and regions—like the U.S., Canada, and Europe—for almost a decade. In some cases, yields were even negative in parts of Europe and Japan.

After the Federal Reserve and other central banks began raising rates in 2021 and 2022 to combat inflation, the expectation was that we would eventually revert to a low-rate environment when the rate-cutting cycle resumed. However, we don't believe that this kind of significant rate-cutting cycle will occur as many expected a year or two ago.

Inflation has proven far more persistent and less predictable than it was in the post-crisis period. In the U.S. particularly, it has been challenging to control inflation. This raises doubts about how much total return can be achieved from rate cuts and I mentioned before, credit spreads are quite tight, diminishing the likelihood of further spread compression. As a result, we think the focus should shift to carry. It's going to be the primary driver of fixed income total returns, and that's where we believe clients should concentrate their attention.

One last question: Do you believe President Trump has had a more significant impact on markets than previous modern U.S. presidents?

While equity market performance is often not heavily impacted by who holds the presidency, some administrations—like Reagan's—have had large and lasting economic impacts, in Reagan's case, due to significant deregulation. Trump's administration may leave a significant and lasting legacy, particularly through the change his administration is making in the realms of regulatory policy, energy independence, and tariffs.

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Our top pick of outlook papers

2025 6 Key Themes

03 January 2025 | MFS

Forward-looking snapshot of what we believe will be relevant and may influence the markets and economy

What Matters for Markets in 2025

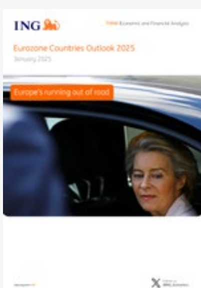
21 January 2025 | State Street Corporation

State Street CEO Ron O'Hanley discusses with host Tim Graf the risks and opportunities in macroeconomics and financial markets in 2025, and what they mean for State Street.

Global Fixed Income Strategy Report - January 2025

04 February 2025 | Invesco

Trump delivers on his campaign promises—what does it mean for macro and markets?



Europe's Running out of Road: Eurozone Countries Outlook 2025

04 February 2025 | ING Bank

If Europe doesn't show clear and tangible signs that it's moving in the right direction, the risk of being stuck in stagnation is high.

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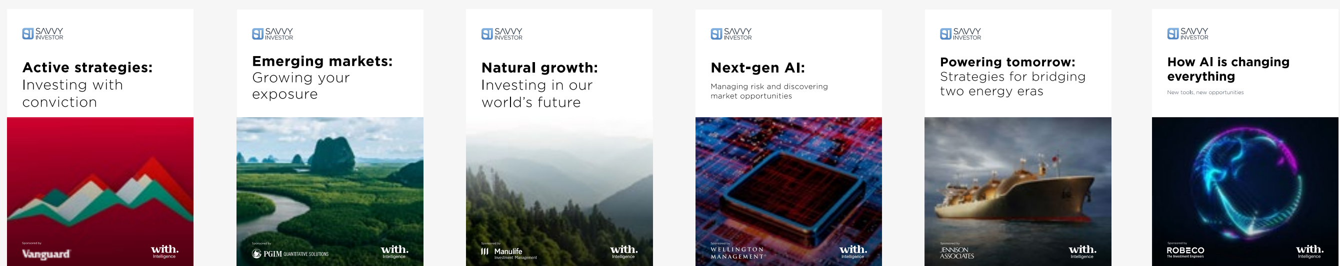

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