PORTFOLIO PERSPECTIVES

Practical applications for asset allocators // **Q2 2025**

Portfolio Perspectives

Practical applications for asset allocators

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SUMMARY

In this quarter's edition of Portfolio Perspectives, we cover key topics facing asset allocators today, including:

- Capital market expectations
- Risks of inflation volatility
- Potential catalysts for international equities
- Opportunities in core plus fixed income

After an action-packed election year, 2025 is shaping up to be just as unpredictable, with the Trump Administration signing a flurry of executive actions and upending many of the prior administration's policies in the first few weeks in office. The most consequential to the economy has been around **tariffs,** which will impact all major US trading partners to varying degrees. These actions will clearly result in negative long term consequences to a **global trade** system that was already undergoing change after a long-period of increasing globalization. While it is too soon to tell the ultimate scope and scale of the tariffs, it's clear we are rapidly approaching a new era with respect to global trade.

After just 100 basis points of rate cuts in 2024, **inflation** remains unacceptably high, causing the US Federal Reserve to slow walk its pace toward the neutral rate, holding steady once again in March. However, shaken confidence around tariffs and subsequent slowing growth could change this pace, with futures markets pricing in more cuts following the tariff announcements.

It's key to note that the persistently high inflation rates have been largely confined to the services sector, where a frozen housing market and rising insurance costs have kept prices rising, while inflation rates in the goods sectors have fallen to near zero. Should an escalating **trade and tariff war** persist, that could flow directly through to goods inflation and lead to a period of rolling inflation across sectors and time as trade relationships reorient.

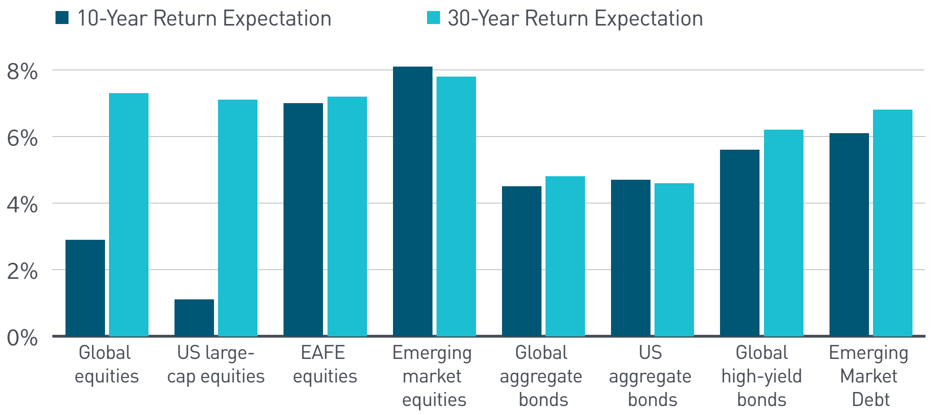
Global equity market volatility rose sharply following the tariff announcements after largely looking through the threat in the first quarter. In contrast to 2023 and 2024, developed global ex-US markets outperformed US markets during the first quarter in a welcome broadening to other regions, including Europe.

Global fixed income markets continue to offer compelling total yields across regions and fixed income asset classes such as corporate credit and mortgage-backed securities. Spreads widened in April and may further widen in coming months as markets digest the new state of global trade. However, with many corporate balance sheets in solid shape, this environment may provide fertile ground for core plus mandates.

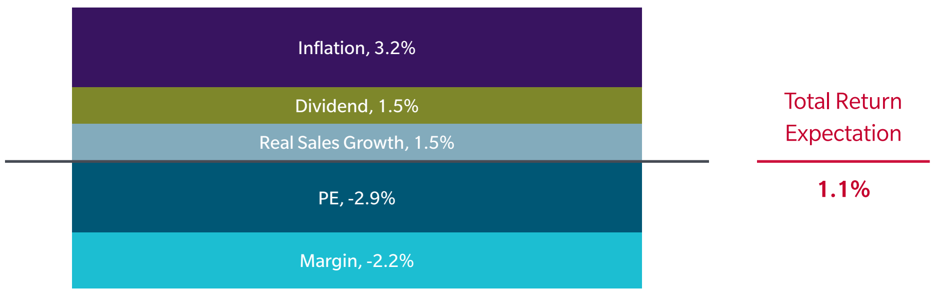
Global Market Expectations

Global non-US equities are expected to outperform US equities over 10 years

MFS Capital Market Expectations



US Equity Building Blocks



MFS® develops long-term capital market expectations for both 10-year and 30-year time horizons. While there is some variability across asset classes, the most notable are the 10-year global equity and US expectations, which are significantly lower than the 30-year expectations. Because US large-cap equities comprise a record high of 68% of the MSCI AC World index, global equity expectations are largely a reflection of the low 10-year US expectation.

So, what accounts for the mere 1% annualized US large-cap expectation? We use five building block components to develop our top-line forecast: real sales growth, profit margin, valuation, dividend yield and inflation expectations. US equities are currently trading at elevated valuations and companies have been the beneficiaries of extremely high profit margins. While valuations are a result of the collective market sentiment and subject to periods of exuberance on the upside and fear on the downside, profit margins are more fundamental to corporate operations, and reasons for their elevations are worth further exploration.

There have been several drivers that have kept profit margins elevated. First, the significant amount of fiscal spending in the system has kept companies and consumers flush with cash, which has kept spending elevated. Second, during the spike in inflation, many companies were able to pass on higher prices to consumers who were willing to pay them. Third, during the low-interest rate environment of 2020 and 2021, many corporations and households refinanced and termed out their debt, resulting in additional buying power.

In contrast to US equities, expectations for non-US equities, both developed and emerging markets, are expected to be higher on both 10-year and 30-year time frames and do not possess the same extended valuations and profit margins. This creates an opportunity for investors to consider how non-US equities fit in their portfolios from both a relative and absolute weight standpoint.

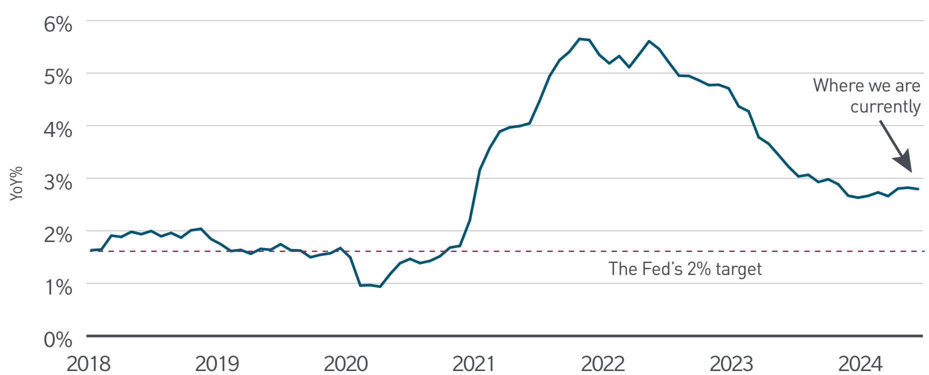
Source: MFS Long Term Capital Market Expectations (US Edition) as of January 2025. Risk-Volatility is represented by standard deviation. Capital Markets View is for informational purposes only and any general commentary on market activity, industry or sector trends, or other broad based economic or political conditions does not constitute a recommendation or investment advice. The expected returns presented are hypothetical in nature and are not representative of an actual account. The information presented is based upon hypothetical assumptions. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in calculating returns have been stated or fully considered. Hypothetical performance is developed with the benefit of hindsight (*i.e.*, actual knowledge of market conditions, results of similar strategies) and thus has many inherent limitations. Projections and forward-looking assumptions are no guarantees of future performance.

PLEASE SEE APPENDIX FOR IMPORTANT DISCLOSURES FOR IMPORTANT INFORMATION REGUARDING THE ASSUMPTIONS USED IN THESE MATERIALS.

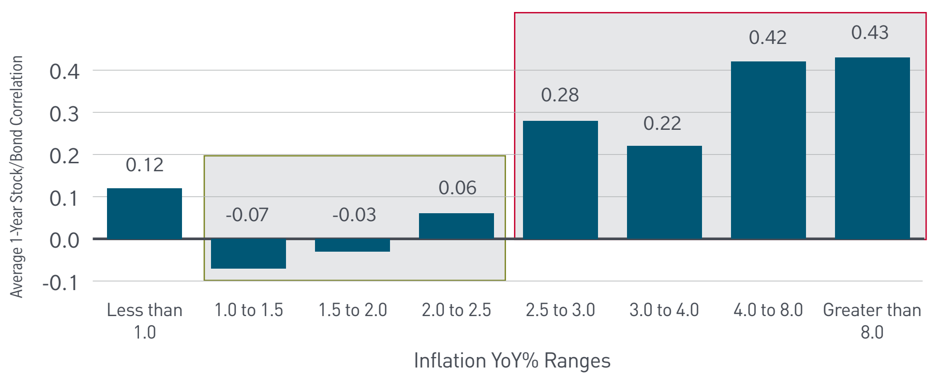
Inflation Volatility Impacts Portfolio Construction Decisions

Resilient portfolios will require higher allocations to inflation hedges in this new regime

US Core PCE



Correlations During Different Inflation Regimes



Source: Top chart - Bloomberg, Bureau of Economic Analysis (BEA). Monthly data from 31 January 2018 to 28 February 2025 (latest available). PCE = Personal Consumption Expenditures. Bottom chart - FactSet. Monthly data from 31 December 1975 to 31 March 2025. US Stock = S&P 500, US Bond = Bloomberg US Aggregate. 1-year correlations calculated using monthly returns (gross and in USD). Inflation YoY% = year-over-year change in the US Consumer Price Index. **Past performance is no guarantee of future results. It is not possible to invest in an index.**

We believe we are in the midst of a significant economic regime shift, which will result in a higher inflation and higher interest rate environment. In contrast to the prior regime of 2010 through early 2020, we also expect the volatility of inflation to remain elevated, with potential episodic spikes in inflation rates, which could migrate across the goods and services sectors, particularly as tariffs upend global trade relationships.

The US Federal Reserve is taking a cautious approach to easing monetary policy, cognizant of the lessons learned in the 1970's when the Fed chased inflation higher and then lower multiple times over the decade. However, if we see slowing growth due to changes in trade relationships and supply chains, we could find ourselves in another stagflationary environment. A tight labor market, a housing supply/demand mismatch and soaring insurance costs are pointing to continued higher services inflation.

Rising inflation can cause an increase in stock/bonds correlations as inflation erodes future cash flows of equities and coupons of bonds similarly, as shown on the lower chart where we see correlations well under 0.2, on average, during periods where inflation has been less than 2.5% but rising above 0.4 during periods of high inflation. This can be most acute in growth-oriented equities where cash flows are farther out in the future and most vulnerable to inflation eroding future value.

Fortunately, investors have a number of asset classes that offer reasonable hedges against inflation. Investors may want to consider an inflation hedge basket that encompasses several of these asset classes.

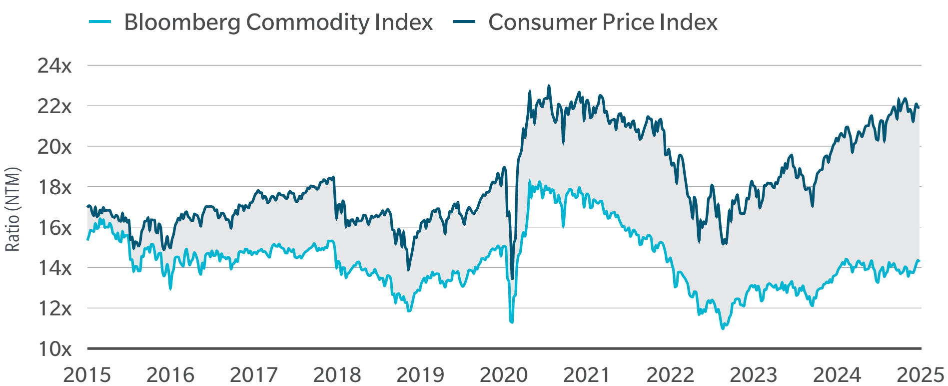
Asset classes for consideration:

- **Traditional value equities** tend to have greater sunk costs such as property plant and equipment that are less subject to inflation, whereas growth equities tend to have higher variable costs. They also tend to have greater near-term cash flows and offer higher dividend yields.
- **Inflation-adjusted bonds** provide a real yield and a CPI-linked yield, providing protection to investors concerned with persistent inflation. Due to the unique tax structure of these instruments, they are often best utilized in retirement or other tax deferred plans in the US or in other jurisdictions where taxes are a factor.
- **Commodities** are intertwined throughout the economy and are even components of inflation calculations, making them effective hedges against rising inflation.

The Catalysts for Global ex-US Equities Have Arrived

Low valuations, earnings growth upgrades and deal activity could lead to outperformance

Forward P/E



DXY Dollar Index

It is easy to understand why investors have grown frustrated after a prolonged period of global ex-US equities underperforming US equities. On the surface, the case for international equities has looked strong, with reasonable valuations and a growing gap between that of the S&P and the MSCI EAFE. However, while cheaper valuations may serve as a backdrop for the asset class, history has shown these gaps can persist for far longer than investors expect.

We see three potential catalysts that could drive developed international equities with their favorable valuations as a backdrop.

- Dollar strength has been a persistent headwind for US investors from a return standpoint. For longer-term investors, a strong dollar enables them to buy cheap equities which is beneficial as long as the dollar does not continue to rise. Indeed, there has been significant weakening of the dollar recently due to tariff-related disruptions, curtailing that headwind.
- US large-cap growth equities have been a magnet for flows over the past two years, particularly in a handful of technology names. However, the market has begun to broaden out over the past two quarters toward more value-oriented segments of the market. Global ex-US equities by sector composition are biased toward value-oriented industries such as financial services and industrials, so funding global ex-US equities with US equities will result in a more value-oriented portfolio.
- US protectionist policies could encourage European policymakers and businesses to enact measures to increase European competitiveness through deregulation and market-friendly reforms as outlined in the recently released "Draghi report." Financial services transactions, such as mergers and acquisitions in Europe, were up 22% in 2024 and are off to a fast start in 2025.

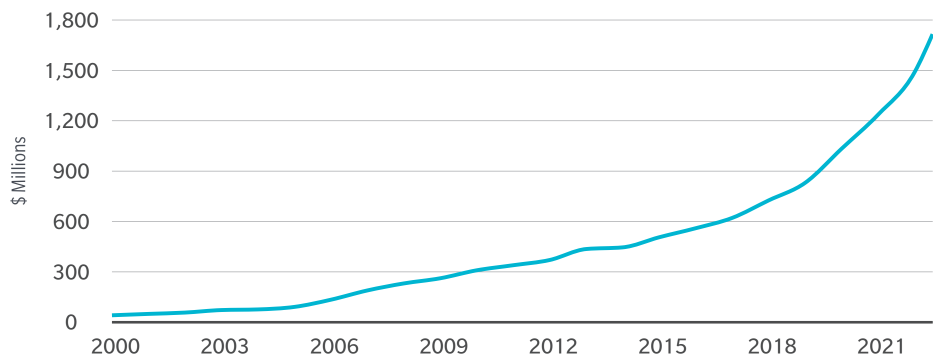
Perhaps the pervasive use in the press and industry of the term "US exceptionalism" should serve as a contra-indicator of what may come in the future.

Source: Top chart - FactSet. Weekly data from 13 February 2015 to 4 April 2025. NTM = next-twelve-months.
Bottom chart – Bloomberg. Daily data from 3 January 2023 to 11 April 2025.

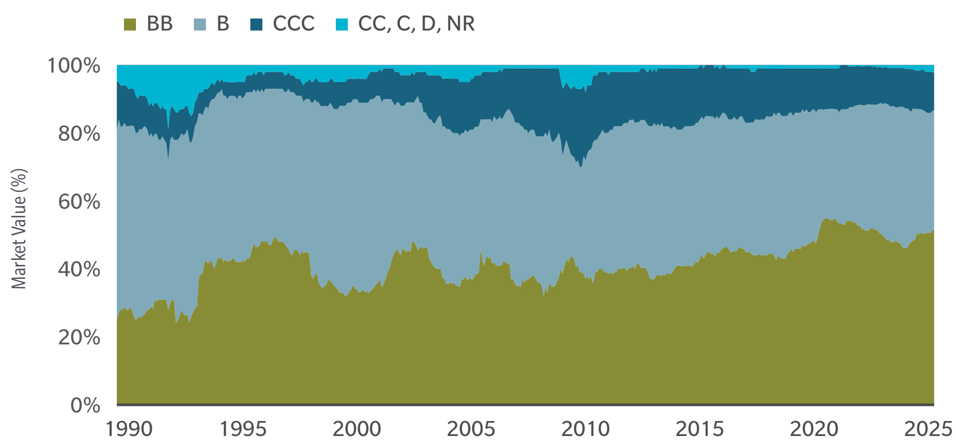
Credit Quality Upgrade Heightens Appeal of Core "Plus"

Meaningful pickups in yield are available outside core fixed income

Private Debt Assets Under Management



US High-Yield Credit Quality



The growth and evolution of the private debt market has been nothing less than extraordinary in recent years. Following the global financial crisis, regulatory reforms to the banking sector and unfavorable credit conditions resulted in an environment where private lenders could provide credit where traditional lenders were unwilling or unable. As a result, some borrowers who would have traditionally utilized the syndicated markets have migrated over to private debt markets. This migration, in addition to overall strong corporate balance sheets related to a strong economy, no doubt contributed to the move up in credit quality of the high-yield universe.

Today, over 51% of the high-yield universe is rated BB and more than 85% are B or higher. Recent spread widening in the high-yield market presents a compelling opportunity, considering the overall quality upgrade that has taken place in the index.

Within emerging markets debt, many countries have improving fundamentals or have adopted more flexible currency regimes, which could mitigate impacts from potential US tariffs. In addition, they currently offer solid total yields which can boost the overall yield to a core plus strategy while also providing diversification away from the US across countries, credits and currencies.

An effective way to take advantage of the higher yields available across a spectrum of global credits while also mitigating risk is through non-dedicated exposure such as a core plus fixed income strategy. This allows managers to take advantage of higher yields and shorter-term credit dislocations at their discretion without the need for a dedicated high yield or emerging markets debt allocation.

Source: Top chart – Prequin, data pulled from Federal Reserve: Cai, Fang, and Sharjil Haque (2024). "Private Credit: Characteristics and Risks," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, February 23, 2024, https://doi.org/10.17016/2380-7172.3462. Annual data from 31 December 2000 to 29 June 2023 (latest available). Bottom chart – Bloomberg. Monthly data from 31 January 1990 to 31 March 2025. US High Yield = Bloomberg US Corporate High Yield Index.

Index Returns

As of March 31, 2025

BENCHMARK	10 YEARS	5 YEARS	3 YEARS	1 YEAR	YTD	3 MONTHS
EQUITY						
S&P 500	12.50%	18.59%	9.06%	8.25%	-4.27%	-4.27%
Russell 1000® Growth	15.12%	20.09%	10.10%	7.76%	-9.97%	-9.97%
Russell 1000® Value	8.79%	16.15%	6.64%	7.18%	2.14%	2.14%
Russell 2000®	6.30%	13.27%	0.52%	-4.01%	-9.48%	-9.48%
MSCI EAFE	5.40%	11.77%	6.05%	4.88%	6.86%	6.86%
MSCI Emerging Markets	3.71%	7.94%	1.44%	8.09%	2.93%	2.93%
MSCI ACWI	8.84%	15.18%	6.91%	7.15%	-1.32%	-1.32%
FIXED INCOME						
Bloomberg US TIPS	2.51%	2.36%	0.06%	6.17%	4.17%	4.17%
Bloomberg US Aggregate	1.46%	-0.40%	0.52%	4.88%	2.78%	2.78%
Bloomberg Global Aggregate	1.94%	0.42%	1.55%	4.59%	1.17%	1.17%
CASH						
Cash	1.90%	2.69%	4.42%	5.17%	1.10%	1.10%

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Source: FactSet, SPAR. Monthly data ending 31 March 2025. Returns are in USD. Equity returns are gross for US indices and net for Non-US indices. Fixed income returns are gross and hedged in USD.

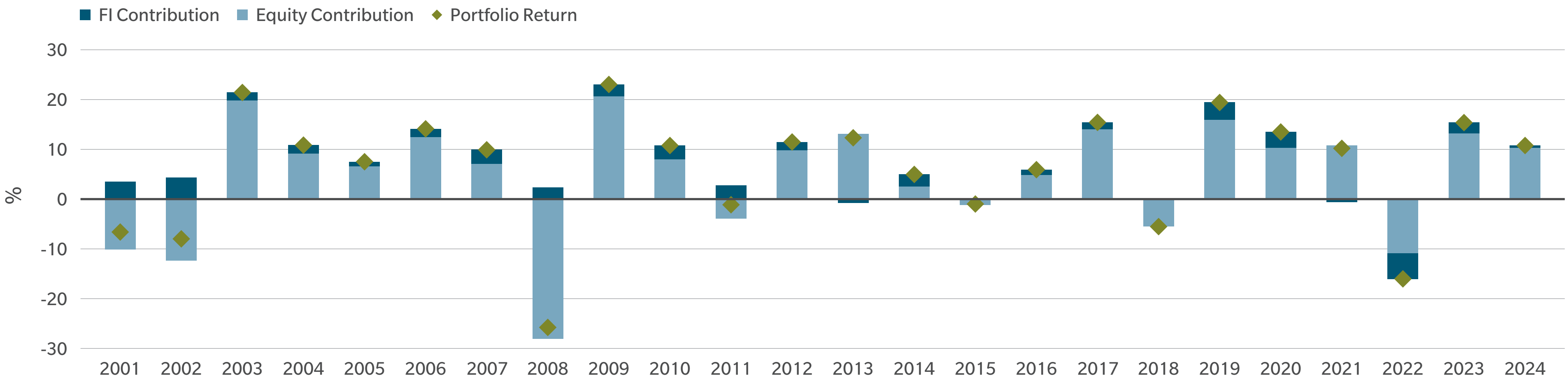
Cash is based on returns for the FTSE 3-month Treasury Bill Index.

The historical performance of each index cited is provided to illustrate market trends; it does not represent the performance of a particular MFS® investment product. It is not possible to invest directly in an index. Index performance does not take into account fees and expenses. **Past performance is no guarantee of future results.** You should consider your client's financial needs, goals, and risk tolerance before making any investment recommendations.

Reference Portfolio's Statistics

Return, risk and contributions to return

60/40 Calendar Year Returns



Source: Hypothetical returns presented herein are for illustrative purposes only, do not represent actual trading or the impact of material economic and market factors, and are based on analysis designed with the benefit of hindsight.

Portfolio Statisics for Various Asset Mixes

MORE FIXED INCOME ↑ / MORE EQUITY ↓	GLOBAL EQUITY WEIGHT (%)	US AGG WEIGHT (%)	10-YEAR RETURN	EQUITY 10-YEAR CONTRIBUTION	FI 10-YEAR CONTRIBUTION	VOLATILITY	SHARPE RATIO
	0%	100%	1.46%	0.00%	1.46%	5.02%	-0.09
	20%	80%	3.05%	1.83%	1.22%	5.92%	0.20
	40%	60%	4.58%	3.67%	0.91%	7.71%	0.35
	60%	40%	6.06%	5.46%	0.60%	9.92%	0.42
	80%	20%	7.48%	7.18%	0.30%	12.33%	0.45
	100%	0%	8.84%	8.84%	0.00%	14.84%	0.47

Source: FactSet. 60/40 portfolio is 60% MSCI AC World (Equity) and 40% Bloomberg US Aggregate (FI). Returns are net for MSCI ACWI and gross for Bloomberg US Aggregate, and in USD. Returns are rebalanced monthly. Top chart –Annual data from 31 December 2001 to 31 December 2024. Bottom chart – Monthly data ending 31 March 2025. **Past performance is no guarantee of future results. It is not possible to invest in an index.** Information on this page describes the source data, methodologies and assumptions used by MFS Strategy and Insights Group to prepare the attached analysis. Different source data, methodologies and assumptions would result in differing analysis.

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The MFS Long-Term Capital Markets Expectations (LTCME) for 2025 includes return and risk expectations for equity, fixed income and alternative asset classes across country, regional and global markets. The focus of these expectations is to provide a strategic, long-term, forward-looking view of various global markets. We use a proprietary top-down approach by employing quantitative, country-based models as the foundation for our expectations and then integrating bottom-up fundamental views from our global equity and fixed income investment teams to inform our final expectations.

Our expectations are developed across 26 countries comprising 18 developed countries and 8 emerging market countries.

Equity expectations
MFS equity market expectations are displayed in unhedged, nominal total return and are developed using a building-blocks approach. Elements of market history and mean reversion are incorporated into our models. Reversion speed and target levels are calibrated based on our analysis of historical data and forward-looking expectations. Any return figure should be viewed as the mid-point in that range of outcomes.

Fixed income expectations
MFS fixed income market expectations are displayed in nominal total return, hedged to the investor's home currency. As with our equity model, our fixed income model employs a building-blocks approach. And, again like the equity model, the fixed income model derives its reversion speed and target level parameters from careful historical research as well as forward looking expectations. In our forecast, we focus on the returns from carry, yield change, roll-down and credit loss (where appropriate). Using this framework, we develop expectations across a range of sovereign, global credit and regional credit markets, while being careful to tune our models in accordance with the unique attributes of the various fixed income markets.

Alternative Expectations
Due to the unique characteristics and varying drivers of return in alternatives, we vary our approach for each category. Our equity and fixed income capital market expectations serve as key variables in our alternatives models.

Currency Expectations
We use a mean reversion approach to calculate currency expectations. Currency expectations represent the nominal excess returns which are nominal total return less domestic carry. Nominal total return is calculated as nominal prices change plus foreign currency carry. Domestic and foreign currency carry comes from the MFS Long Term Capital Expectations cash forecasting model. Nominal price change is real price change plus inflation differential between currencies.

The expected returns presented are hypothetical in nature and are not representative of an actual account. The information presented is based upon hypothetical assumptions. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in calculating returns have been stated or fully considered. Hypothetical performance is developed with the benefit of hindsight (i.e., actual knowledge of market conditions, results of similar strategies) and thus has many inherent limitations. Projections and forward-looking assumptions are no guarantees of future performance.

Source: January 2025 MFS Long Term Capital Market Expectations – US Edition.

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