



Moving past the pain

The market has recalibrated in the last couple of months. Investors are no longer pricing in a 20% chance of total bank failure and an ensuing collapse of the financial system. The possibility of a second Great Depression seems to have faded from the market's consciousness.

Instead we are faced with the aftermath of moderate economic growth cycle, derailed by excessive risk-taking of the American consumer. We are left with a recession that is deeper and longer than any of the post-World War II recessions but somewhat similar to the episodes of contraction in the early 1970s and early 1980s.

I expect that we are headed out of recession by the end of 2009. But then what?

Growth, albeit at a slower pace

After slowing for two years, it is likely that U.S. economic growth will pick up in 2010. In the end, the contraction will result in a peak-to-trough decline of probably close to 4% or 5%, far short of a 10% decline, which would characterize a depression.

While expansion will resume it will likely be at a slower pace — perhaps less than 2% — than in the previous growth phase, during which time the economy experienced real growth of between 2.5% and 3.0% annually. This time around growth should be bolstered by stimulus money and spending programs. Those government and central bank efforts should offset the debt reduction and increase savings programs of U.S. consumers. However, high debt repayment schedules and higher taxes to pay for the recovery programs will remain a drag on growth and prevent the expansion from being as robust as it was in the last recovery.

International growth picks up as the U.S. economy stabilizes

China's strong growth should resume as the U.S. economy stabilizes. Expansion in other emerging economies should soon follow. More developed economies are likely, however, to languish under high borrowing costs and elevated levels of unemployment.

Bank lending is likely to resume in a more constrained and conservative fashion. The credit-driven bond markets are improving dramatically and should continue to do so into 2010.

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Corporate earnings poised for a rebound

Earnings of companies in the Standard & Poor's 500 Stock Index are now depressed, but low capital spending and production and labor cuts have set the stage for a new round of profit sharing going to owners of capital. Also, a depreciating dollar could boost U.S. exports. The outlook for earnings is thus brighter than is the outlook for the economy as a whole.

Inflation accelerating

A wave of money has flooded the market and world economies. While some experts expect this liquidity to have an immediate inflationary effect, we expect the money will be absorbed. We will have to see excess capacity and labor used up before inflation will again rear its head. In our view, inflation's return should be expected, not in the near term, but more probably in mid-2010 and 2011.

Inflation and stocks

Inflation's return need not hurt stocks. History shows that rising prices are more harmful to certain bondholders. In fact, stocks can flourish during episodes of inflation. In the past inflation between 2% and 7% has proven to be good for the stock market.

Historical data support the notion that dividend-paying stocks do well and are better inflation hedges than non-dividend-paying stocks. Right now large dividend-paying larger-size companies have a historical advantage in valuation (price/earnings ratios) than smaller non-dividend-paying companies.

Source: MFS research

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