TRANSCRIPT

Markets in Focus: Positioning equities in a rising inflationary environment – What's your strategy?

Featuring:

Mark Carver, *Managing Director, Global Head of Equity Factor Products and Equity Portfolio Management, MSCI*

Hitendra Varsani, *Managing Director, Global Solutions Research, MSCI*

Jenna Dagenhart

In 2021, economies around the world began recovering from the pandemic and we started to see vaccination rates rise. Despite this progress, though, the Omicron strain reminds us that we're not yet out of the woods. If economic expansion continues in 2022, with a sustained period of high inflation, we could see rising interest rates across countries, potentially leading investors to reevaluate their equity portfolios.

Joining us today to recap the macro events that shaped the factor investing landscape in 2021, discuss factor index performance in different US interest rate and yield curve regimes, and explore how the recent surge in inflation may impact style factor and sector performance, we have Mark Carver, Managing Director and Global Head of Equity Factor Products and Hitendra Varsani, Managing Director, Global Solutions Research at MSCI. Let's start with a recap of 2021. Global equities were up in the fourth quarter after a decline in the previous quarter, and MSCI Quality Indexes led the way among the MSCI Factor Indexes. Mark, could you provide a macro level overview of 2021, and share how inflation impacted factor performance?

Mark Carver

Yes, sure. So, I think 202, in the bottom line is, was a good year for investors. The fourth quarter was a good year for global investors. However, was not a smooth year. There was at the beginning of the year, more optimism around economic re-openings. With the increasing vaccination rates that we saw around the globe, value stocks did great out of the gate this year. By the end of the year, there was more uncertainty. We had that uncertainty due to the COVID variants that you mentioned in your opening. Obviously, inflation that you also mentioned, we saw a surge in inflation, in fact, especially in the US. But global investors did quite well. And if we look at Q4, specifically, MSCI ACWI was up 6.8%, MSCI World almost 8%, and MSCI USA over 10%. So those are strong returns for global investors.

Pure factors, momentum was the standout performer. While on the other end, high risk stocks residual volatility was actually the worst performing factor in our global equity model in the fourth quarter. But the ultimate theme wasn't the performance of specific characteristics or factors, but rather the macro environment. And obviously, we mentioned a lot of the uncertainty; there was uncertainty to Central Bank tightening inflation, but something that maybe gets a little bit less risk, excuse me, less attention, is the risk to what's happening in the geopolitical environment. We saw a couple of years ago, in fact, we we've talked about it with you, Jenna, US-China tensions. Notably, these things are linked. Many of our listeners have experienced governments around the world taking a more populist stance.

A consequence of that is, in fact, equal mobilizations and as economies turn inward, this can drive up inflation due to potentially higher production costs. Now, many people, particularly sort of in the middle part of last year, toward the end of the year, were arguing that inflation was transitory. We're coming off a very low base in 2020, but the combination of rising demand as consumers were flush, wage pressure, that's so prominent and so well, I think documented, and this notion of deglobalization shifted that view. And for our clients, inflation seems to be the biggest topic on their minds now.

Jenna Dagenhart

Hitendra, building on Mark's comments regarding the outperformance of quality factor indexes, could you share what prompted this uptake across multiple regions and what correlations we saw between developed and emerging markets?

Hitendra Varsani

Oh, so the last quarter, we've seen a continued decoupling between developed and emerging markets, with MSCI World up 7.9% and emerging markets down 1.2% over the last quarter. And this reflects the strong performance that we've seen in USA Europe, and underperformance that we've seen in China and Asia. Now within developed markets, investors have been focused on how corporate fundamentals are reflecting the swift, the swift changes that we're seeing in the macro backdrop. Now Mark mentioned high inflation, these higher rates, and quality indexes has really led the way, as investors rotated away from high volatility stocks into ones that have strong profitability, high investment quality, and also high ESG exposures as well.

Now, I think a pivotal point was in December, when both US and global inflation numbers surged above the levels that we haven't seen for a couple of decades. And the 10-year US rates picked up much faster than short term rates, sometimes referred to as a bear steepening and fixed income. Now at that time, over December 2021, MSCI Enhanced Value Indexes outperformed in almost every region in the range of between 1% and up to 6%. Now, in our last quarterly factors and focus series, your equity styles ahead of the curve, we actually looked at these trends from a longer-term perspective, actually using data from 1994. And we found in similar bear steepening yield curve regimes as measured by US rates. We found within MSCI World, MSCI USA, Value Factor indexes outperform the market alongside smaller size and quality indexes. Now that may reflect a heating up environment, where markets expect stronger growth and inflation going forward. And so, these pro cyclical factors like value outperformed, and companies with stronger profitability, lower leverage were more resilient towards those interest rate rises.

Jenna Dagenhart

As inflation continues to rise and with CPI coming in at 7%, investors are looking to scenarios for economic growth. Hitendra, in your latest research, you explore how high inflation growth scenarios impact style factor and sector performance. Could you share more about your findings?

Hitendra Varsani

Sure. So higher inflation could have profound impact on style factor and sector performance. And in our recent blog, hotter inflation set some styles and factors on fire. We presented two scenarios that our clients are most interested in at this point in time. The first is stagflation, reflecting higher inflation, slow growth, and heating up, reflecting higher inflation, and higher growth. Now using MSCI World and Sector Factor Index data since the 1970s, there's three real key takeaways here. The first is quality and momentum were two factors, fairly unique, that actually outperformed in both scenarios. In a heating up scenario, value lead alongside IT materials and financials. And in stagflation, it was minimum volatility that led alongside defensive sectors like healthcare, consumer staples, utilities and energy. Now, we recognize that while some investors have a particular view on the state of the world going forward, others may not well do so. They may prefer to diversify exposure, say to value in a heating up scenario or quality in a in a more defensive scenario. And combining these two factors in this way, perhaps would have had a more balanced, positive outcome, irrespective of the growth environment in a high inflation environment.

Jenna Dagenhart

At the end of 2021, what did MSCI Adaptive Multi Factor Model show?

Hitendra Varsani

Yeah, so those that are not familiar with the Adaptive Multi Factor Model, this is a framework that's designed to analyze indicators that may reflect factor performance going forward. It's based on the macro cycle. It's based on valuations of the factors, market sentiment, and trends in performance. Now as at the end of December last year, our indicators on aggregate pointed towards an overweight to value and low size, reflecting a procyclical stance in the market, supported by economic expansion. But these two factors also have very low valuations relative to the other factors as well. But having said that, we do recognize that investors may have different outlooks going into 2022. And for that reason, our recent research has really relied on scenario-based analysis; around inflation, around growth, and also around changes in interest rates as well, and how that has implications on their portfolio allocation decisions.

Jenna Dagenhart

Finally, looking ahead, Mark, could you share a few key takeaways for investors as they look to reallocate their equity portfolios while also hedging against inflation?

Mark Carver

Yeah, sure. So, I think there's a couple of key takeaways. One that Hitendra mentioned quite well, which is, thinking about inflation, you need to also think about economic growth. Because what we've seen in the data is that certain factors will do better in a heating up environment where you see rising inflation, but also positive economic growth. That can be good for factors historically, like value. While on the other hand, you know, as stagflation airy environment is a quite a different environment. And I think a key for investors this year is that there's not uniformity. That we may see one environment, one economy that's heating up, while another may feel a bit more like a stagflation area environment. So, it's really important to be very, very deliberate in the asset allocation choices. And we've heard clients think in this term.

Something that we maybe haven't talked about here that I think's another really interesting takeaway from 2021, is maybe a hidden dimension of the work at home environment. What we saw in 2021, which may be influences markets in ways people haven't thought about, is that as people work at home, they also invest at home. And that stay at home armchair investor did influence markets in 2021. A lot of people think about this with the volatility we saw in some of the mean stocks. But in fact, one of the lesser known issues is maybe around the crowdedness of certain factors. Our research team noted last year, that factor like residual volatility, which had been a standout performer, and in fact, a driver of some of the macro themes that gained such prominence in 2020, early 2021, were actually exposed to this residual volatility, which was the most crowded factor. Subsequently, we saw a drop down.

So, the big takeaway that maybe investors are starting to think about this year is to go back to first principles. Know what you own, what are you exposed to? And are those consistent with your investment beliefs, your investment thesis, and the objectives obviously, that you have. So, obviously, be aware of inflation and economic growth, get back to first principles and ensure you're allocated to the things that are consistent with your investment objectives.

Jenna Dagenhart

Mark, Hitendra, always great to have you with us.

Mark Carver

Thank you.

Hitendra Varsani

Thank you very much.

Jenna Dagenhart

And thank you for watching. Once again, I was joined by Mark Carver, a Managing Director and Global Head of Equity Factor Products, and Hitendra Varsani, Managing Director, Global Solutions Research at MSCI. I'm Jenna Dagenhart with Asset TV.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. or its subsidiaries (collectively, "MSCI"), or MSCI's licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the "Information Providers") and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or redisseminated in whole or in part without prior written permission from MSCI.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, "Index Linked Investments"). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on www.msci.com.

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.'s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.'s company filings on the Investor Relations section of www.msci.com.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI's products or services are not intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Issuers mentioned or included in any MSCI ESG Research materials may include MSCI Inc., clients of MSCI or suppliers to MSCI, and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor's. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and Standard & Poor's.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data, reports and ratings based on published methodologies and available to clients on a subscription basis. We do not provide custom or one-off ratings or recommendations of securities or other financial instruments upon request.

Privacy notice: For information about how MSCI ESG Research LLC collects and uses personal data concerning officers and directors, please refer to our Privacy Notice at https://www.msci.com/privacy-pledge.