MSCI

TRANSCRIPT

Markets in Focus: Who Let the Bears Out?

Featuring:

Mark Carver, *Managing Director, MSCI*

Hitendra Varsani, *Managing Director, MSCI Research*

George Bonne, *Executive Director, MSCI Research*

Mark Carver:

Hello, this is Mark Carver, Managing Director at MSCI, welcoming you to our quarterly Markets in Focus Round Table. Joining me as always, is my colleague from research, Hitendra Varsani, Managing Director of the Global Solutions Research team. We have a special guest this quarter, George Bonne, an Executive Director in our Equity Factor Research. So welcome George and Hitendra. All of our listeners know that global equity markets dropped sharply in the second quarter. In fact, MSCI I ACWI, we fell more than 15% in three month period and is down more than 20% year to date, marking one of the weakest returns for the first half of the year in history. US investors have been especially challenged with a combination of rising inflation, rising rates, weakening earning, and slowing economic growth, resulting in a a drop of almost 17% for the MSCI USA index, in a 21% decline year to date. As our listeners would probably expect, on a relative basis from the second quarter, we continue to see value yield and minimum volatility indexes outperforming across our ACWI World and USA markets range. On a model factor basis, again, the value dimensions did very well with earnings yield in long-term reversal, providing strong returns, while the highest risk factors of beta and residual volatility continue to show the weakest performance among our model factors. Now it's been well documented by many in the industry and talked a lot about, that the ballast of fixed income has not been there for equity investors. The headwinds of around high valuations, the inflation pressure, has also resulted in negative return for bond investors in the quarter. So Hitendra, let me bring you into the conversation, against that relatively, disheartening backdrop, can you provide us some details on the performance of the style factors in industry groups for both the quarter and maybe year to date?

Hitendra Varsani:

So overall, the key takeaway is, the rotation away from high risk stocks into value stocks. And we noted that in the first quarter and that trend has continued. In fact, it's actually accelerated. So over 2022, investors have favored stocks with strong fundamentals over ones that have risky growth outlooks. Our research has showed that the behavioral shift typically happens in a rising rate environment, as corporates face a higher cost of financing, investors become more valuation sensitive, expressed through multiples. And also there's a preference for companies with stronger earnings in the shorter term than those that have, or promise or expect earnings in the distant future. Now, looking back over the second quarter, the top rewarded stocks had strong earnings yield, stable earnings and high profitability. Stocks that had poor performance over the last five years had a turnaround in fortunes. We refer to these as the long term reversals. Now with the surge inflation across developed economies, oil and gas industries far well, alongside industries within consumer staples, namely, food and beverage, household and personal products. Our long term research has shown using data spanning over 40 years, that energy and consumer staples have done well over periods of rising inflation. This year's been no exception. And their performance typically, is even higher in stag environments, which is what investors are now concerned about going forward.

Mark Carver:

Hitendra, we've heard a lot about the comparisons of today's market to the 1970s, and may maybe even other inflationary regimes that are not quite as well known as the '70s. But what are the differences that you're observing today versus those periods where we saw rising rates and rising inflation?

Hitendra Varsani:

So when we look across the globe, the OECD CPR inflation numbers as of May, was around 9.6. So at 30 year highs. Food inflation was at 12.6, energy inflation was at 35.4. So clearly energy's been a major contributor to the inflation that we've seen. But this is amongst the OECD countries. We go down to individual countries, Turkey inflation being 74, in contrast to the USA around nine, and China at the lower end at two. Now the war in Ukraine and the early lockdowns in China, as well as the supply chain disruptions, have all added to existing inflation pressures, just coming out of the pandemic. Now, all the history doesn't repeat itself, it does rhyme. And when we look at the risk facing investors today, and you highlighted some of these marketing in your opening statements, the stubbornly high inflation, higher rates, quantitative tightening, potential recession risks. And now we're seeing downward revisions to analyst estimates. And all of these collectively, has led to higher market volatility. Now in our blog, our recent blog, "Keeping it Real and Defensive," we've looked at the performance of real asset indexes and defensive indexes over four distinct periods, facing one or more of these risks. Now, the details are in the notes, while highlight the key takeaway here. Minimum volatility indexes have been effective in reducing draw downs and dialing down risk during volatile markets. Value indexes have performed over rising rate cycles, and this year has been no exception. High dividend yield indexes have outperformed in most of these scenarios. And when we turn to real asset equity indexes, these have had outside gains versus the broader market when its inflation surged. Now, if we take, for example, the MSCI World Commodity Producers Index, that's outperform MSCI World by over 37% from November to the middle of this year. Now, no two time periods are identical, we know that. But that's why our research looks at several different time periods that do relate to the recent environment that we've experienced. And what we are suggesting or indicating in our research is, to think about a diversified approach to asset allocation using targeted index exposures as building blocks, and those that align to the investors' views going forward.

Mark Carver:

George, I think this is a good time to bring you into the conversation. You and I have heard an awful lot from clients about event driven risk. And we know that clients often use our factor models to forecast and attribute portfolio level risk. Together, you and I introduced some new equity factor models on Asset TV late last quarter. And one of the features of those models was the adaptive co-variance feature. How could this help investors understand the changes in risk or even event driven risk itself?

George Bonne:

Sure. So, as you mentioned, we've introduced something, we call adaptive co-variance, which is designed to make the model smarter to the market regime. For example, in the pandemic period of two years ago, the relationships and drivers between different segments of the market: industries, styles and countries, were quite different from what we've seen more recently. But in the standard factor model framework, those pandemic relationships may still have an undesirable large influence on the factor model today. And this is rather common to see that the relationships change when there is a major event or crisis driving a regime shift. And the performance around such rotations can really make or break a portfolio, so it's something we really want to get right. So to address this, we have basically a regime indicator in the model that tells us when we are in a different regime. And when we see that, it basically tells the model, "Hey, we're in a new regime now. Don't let the unusual relationships of the past have so much influence on the estimate of the relationships and drivers today." And as you might expect, we find this to be most valuable around strong regime shifts, such as crisis periods, both entering and exiting.

Mark Carver:

And so George, that sounds to me, like a very unique feature that would help our clients make sure that they're capital efficient in the way they're allocating capital. But maybe we should take a step back, and talk about the models more broadly, right? So if you could, maybe describe the changes in these new models relative to our previous generations.

George Bonne:

Sure, there are quite a few changes in fact. We're making improvements to the existing factors, we're adding new factors, and we're adding new methodologies. Some of the improvements to the existing factors are of course, designed to improve their performance, but others are designed to improve coverage, stability or interpretability of the factors. And we've also made changes to make our factor structure more consistent across the different models, like US, global and so on. With regard to new factors, we're introducing four: an ESG factor, a climate factor based on carbon emissions, a machine learning factor and a crowding factor. We know that ESG and climate are topics that are getting more and more attention among investors, and they need solutions to create and manage ESG and climate aware portfolios. And now they'll have one. The machine learning factor is designed to capture evolving non-linear relationships that are missed by the traditional linear model. And the crowding factor identifies securities that are behaving unusually, potentially driven by crowding or price bubbles, or at the other extreme, unusual neglect. In terms of new methodologies, we already discussed the adaptive ovarian framework and we're adding another enhancement to address something we're calling cluster risk. And that is the risk that there may be small clusters of companies that behave like their own little industry and co move together like the Fang socks. But these clusters can evolve over time, and the companies in them may span multiple industries or even sectors, hence, the risks driven by these clusters, may not be captured well by the traditional factor model framework. So we're adding a methodology to capture them.

Mark Carver:

So, Hitendra, let me end with you. In this setting, we often talk about our adaptive multifactor model. What is that model telling us today?

Hitendra Varsani:

So adaptive multifactor model is a framework that's designed to highlight indicators of factor performance. And it's based on four pillars: the macro cycle, the valuations of the factors, the performance of factors in terms of trends that we're seeing, and also market resentment, which is based on implied volatility and credit markets. Now, as at the end of June, the model was overweight minimum volatility and overweight momentum. Now, in contrast, it's been overweight valued for the first half of this year. And so that's a change in the positioning that we're seeing based on data as at the end of June.

Mark Carver:

Thank you, Hitendra. I think the big takeaways that we have here is that MCI has been prolific in publishing on many of these topics, including some of the things you were highlighting earlier, Hitendra, around the performance of factors and factor indexes, in particular, in various regimes, both inflationary regimes and obviously increasing rate regimes. For all of you who want to follow that information, please visit our website, and specifically the MCI insights gallery, that has a whole host of research topics related to factor investing, factor crowding, and obviously, links to our specific indexes in models. So with that, let me say, thank you, Hitendra and George for joining this quarter, and to all of you for listening. And we look forward to speaking to you in our next quarterly installment.

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**.