Bulls May Have to Just Grin and Bear It

Featuring:

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Adam Bass:
This is MSCI Perspectives, your source for insights, for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass and today is July 14th, 2022. Today, we come to you with our regular look at how the market has performed over the past three months. Now, as all of you probably know, it's been a pretty quiet quarter. No huge draw downs, no tectonic moves in the market, and definitely no desperate attempts to fight inflation, if only that were so. Here's a quick actual roundup from our first guest and friend of the pod.

Hitendra Varsani:
I'm Hitendra Varsani, part of MSCI's Global Solutions Research team based in London. So global equities were down 20% in the first half of 2022, the worst six months start to the year on record since 1975. Now to put this in context, the first half of every other year, since the 1970s, besides this year, the worst of the worst had drawdowns of only around 12%. And you would've to go back all the way to 1982 to see that. Now the drawdown this year has largely actually occurred in Q2.

Lukas Smart:
So the second quarter, when markets were down, down about 16%, bonds weren't that different. In magnitude, yes, but directions similar.

Adam Bass:
That's our second guest for today.

Lukas Smart:
My name is Lukas Smart. I'm an MD here at BlackRock, and for the US, I head up for iShares Factors and Sustainable Businesses. The MSCI [inaudible 00:01:45], we was down about 15 and a half, so very similar to the US story for the quarter. Handful of major, major events, the increase in geopolitical uncertainty with the Russia Ukraine conflict. And we've seen is market increase in inflation overall, which has those two events I think are contributing overall to some of the under performance we've seen in the market and the increased volatility that we've seen in the markets.

Adam Bass:
But all that being said.

Hitendra Varsani:
The most fundamental concern amongst investors has been inflation.

Adam Bass:
Just today, as we were getting ready to record, we got word that the latest Consumer Price Index Report put US inflation at 9.1%. That's the highest in 40 years, and a 1.3% increase from last month's numbers. And those numbers don't get much better, when we look around the world.

Hitendra Varsani:
If we look across the globe, the OECD CPI inflation, as of May, was about 9.6. Food inflation was 12.6 and energy inflation was 35.4.

Lukas Smart:
One of the largest, most notable aspect of energy is fuel oil up 106.7%. So the cost of energy, the cost of food are clearly contributing to the overall level of inflation, certainly within the US. And that's understandable because these are core inputs to our lives and core inputs to our businesses.

Adam Bass:
And of course, when you have higher inflation, well, we know where this one's going.

Hitendra Varsani:
High inflation drives tighter monetary policy. Interest rates have been at record low levels and inflation is running at record high levels, and it's that gap, which has court central banks off guard. And now they're in catch up mode where they're needing to have a more tighter monetary policy, raise rates faster than expected, and that's creating more volatility in equity markets and also bond markets as well.

Adam Bass:
Okay. Yeah, that's an auspicious start to the episode, huh? How are we all feeling? Who besides me out there needs antacid, or something stronger, maybe? Okay. So let's start putting some of this market turmoil in context. And for that, we bring out our third guest.

Mark Carver:
I am Mark Carver, the Head of Equity Factors and Equity Portfolio Management here at MSCI.

Adam Bass:
I asked Mark for his reaction to the statement we heard before about how this was the worst six months start to the year on record since 1975 and his answer was not what you might expect.

Mark Carver:
That is a depressing stat, but as soon as I hear something like that, I think two things. One, why are people so fixated on the first six months of the year and two, how large is that drawdown relative to other periods of six month drawdowns and how anomalous is that relative to other starts of the year? And what we find is that for sure markets could have been a lot worse.

Adam Bass:
Go on.

Mark Carver:
There were periods where we had six month drawdowns, particularly, in events that people probably remember, the global financial crisis, the tech decline, particularly the tech decline here in the US in the early 2000s, that saw six month periods that are much worse. But I think we're conditioned as investors to think about things on a calendar basis. So we focus on a quarterly result on a calendar, a half year result on a calendar, and because of that, we tend to fixate on that result relative to other periods and we extrapolate what that might mean going forward. And in some ways that's the wrong way to do it. It's a human instinct, but in truth, it's always important to think about how anomalous is this period. Look at periods like the global financial crisis, where we saw incredible market headwinds. Those markets were much more challenging from a drawdown standpoint where you might have seen periods of 40% draw downs versus the 20% drawdown that we're seeing today.

Lukas Smart:
If I think I dragged the data back at least two decades here, [inaudible 00:06:23] three significant drawdowns. Of course, there was a significant drawdown at the beginning of COVID. That number was around 33, 34% over a pretty short period and then pretty quick recovery over the course of the rest of the year. We saw about a 20% drawdown towards the end of 2018. And then, of course, the beginning of the global financial crisis, at the end of 2007 through 2008, that was around 44.7%. The one that's probably the most interesting, if we go back and look for some commonality here, is the 2018 drawdown. Although, I think it's fundamentally a bit different.

The similarity there is that in that same period, we saw for the year, the under performance of global equities, as well as the under performance of global bonds. There's only been one other instance, aside from year to date 2022 performance of that, and that was 2015. And this is going back to 1977, negative returns and equities negative returns in fixed income and across bonds, that's something that tends to be fairly uncommon. And that's what we're looking at right now.

Adam Bass:
And the reason we're looking at that right now is...

Mark Carver:
The conditions today are very unique. And let's think about three assets that every listener on this podcast knows well, equities, public equities, fixed income, and home prices, for instance, and what we have seen is extraordinary valuations across all of those. Equity markets started the year trading richly, fixed income was trading at high valuations, and then you could argue that certainly in many places in the US, home prices were extraordinarily high. The result of that means that clients have experienced shifts in their portfolio that don't allow them necessarily to diversify and find a buffer that they could have done in the past. And we're seeing the correlation between stocks and bonds as a positive correlation versus the historical negative correlation. So I can't move from equities to treasuries, for instance, and try to buffer my portfolio.

Hitendra Varsani:
Central banks have been raising rates from record low levels to combat this high inflation. Now, when they raise rates, that means falling bond prices. Now the rising rates has not only led to an increased cost of capital for corporates, it also makes equity investors more valuation sensitive. So you could think of it as them reducing their valuations on equities to account for lower earnings multiples. So overall, equities lower and bonds lower. And if central banks tighten too fast, that could lead to a recession. Now, recessions typically coincide with lower corporate earnings and higher market volatility, and we are starting to see that. We've already seen analyst revisions turn more negative than positive within the acqui universe. We've also seen selloff in the more risky segments of the market and so equity investors are turning more bearish on the outlook.

Mark Carver:
What is true today is that the drivers are different than what we have seen in other past periods of drawdown.

Adam Bass:
And one of those things driving today's wild ride in the market is a global reconfiguring of supply chains. And that as we've heard before, is due to the fallout from the COVID pandemic, as well as Russia's ongoing war Ukraine. Here's Luke, to explain.

Lukas Smart:
What the world is grappling with right now is the response to the Russian invasion of Ukraine, right? And the response, primarily by the West, is that we are weaning ourselves off of Russian energy. And that's not trivial, right? So Russia's the world's third largest energy producer. Accounts for about 10% of global oil supply, about 17% of global gas supply. That's according to the IEA data on December 2021. Russia is the EU's largest supplier of oil, coal, and gas at 27, 47, and 41% of imports, respectively. The US and UK, we're banning Russian oil imports. The EU has declared a fairly ambitious goal of reducing Russian gas purchases by about two thirds, by the end of the year. Germany has announced intentions to all but eliminate reliance on Russian gas supply by mid 2024, and become virtually independent of Russian oil, by the end of this year.

Russian energy production is something that it can't be really diverted elsewhere overnight, right? The world does need energy. So global energy supply right now because of some of these policies is effectively being reduced. And that in turn has driven big spikes in energy prices. So these price jumps this year, they reflect that supply shock in global energy markets, while we're seeking greater energy security. Russian energy routes sort of shift. Overall, the effect is stagflationary, that'll increase inflation, it'll help slow growth.

Mark Carver:
And that is weighing on the minds of clients, particularly as they see analysts revising down earnings estimates, they see weakening economic growth more broadly, and the result of that, is how do I deal with an economic environment that we haven't seen in many, many decades? Rising inflation, weakening growth. How do I allocate capital in that environment? The vast majority of clients who are running money have never faced an inflationary environment like we see today. And as a result of that, they're thinking deeply about the way they're allocating their equity capital. We have seen renewed interest in defensive strategies. We've seen renewed interest from clients around this notion of event driven risk, which is really about scenario analysis. Let me do stress testing on my equity portfolios. Let me do scenario analysis where I can look at even short periods that looked a bit like today. And what can I learn from that?

And the result of that is we are hearing from clients more demand to move toward, you might say those companies that are going to be more resilient. They are moving towards defensive strategies. We have seen a lot of clients asking about our minimum volatility indexes, both from a methodology standpoint but also what can we learn from our deep history in studying how that's done in periods that look as much like today as possible. And the result of that is we're seeing a shift in the way investors are allocating to their equity programs, which in some ways is how do I get defensive in my portfolio. And what we've seen, when we look at periods of heightened volatility, we have seen minimum volatility indexes that provide 20, 25% less volatility than their parent indexes. We often see that in periods of drawdown, minimum volatility indexes have drawndown less than their parent index. And what that means is that clients are able to buffer some of that equity drawdown by becoming more defensive in your equity position.

Adam Bass:
That matches up with something Luke said, based on data from iShares USA Minimum Volatility Factor ETF.

Lukas Smart:
USMV has outperformed very significantly year to date. It's outperformed the MSCI USA index, which is it's parent, by about 8.5%. The emerging min vol has outperformed by about 6.3%, the MSCI Emerging Index Net. So we've seen very strong performance in that, and that's sensible, given the economic environment that we're in. Overall, it gives you about 20% less risk. So it has a beta of around 0.8 and we've seen downside capture ratios in that 50 to 70% range. So this sort of exposure is perfect for investors that want to stay invested, that want to manage exposure to rates, that want to manage their overall risk by reducing it without necessarily dipping into a rising rate environment in bonds.

Adam Bass:
What else have you seen, in terms of not specific numbers around flows, but where are investors placing their bets so to speak, right now?

Lukas Smart:
So what started as a challenging year in factors switched basically in March. So we saw really strong inflows into factors overall, but specifically with the focus on min vol and dividend focus strategies. We've seen some interest in value as well, but min vol and those [inaudible 00:15:27] strategies have been sort of the dujour. I suspect some of that interest in dividend paying strategies is proxy actually for value. And the companies that pay dividends tend to look very value like, and they also tend to have, because they're dividend paying, they tend to be slightly higher quality within that overall range.

Mark Carver:
Well, I think it takes us back to market rotation.

Hitendra Varsani:
So if we go back all the way to 1998, the first quarter of this year, we've seen the strongest start for value of a growth. Now, in the first quarter, value outperform growth in the USA by almost 9%. And that point in time, you and I have discussed what the drivers of the out performance was. Now, this not only exceeded the out performance scene in 2001 post the dotcom bubble, but it also outperformed at 2021 when we talked about the reopening of economies post-COVID. Now, if we fast forward to this year, going up to the first half of the year, USA value has outperformed growth over 20%. So let's put that in context, the first quarter, 9%. And over the first half, more than 20%. No other year comes close to this on a historic basis.

Adam Bass:
Earlier in the show, we heard from both Hitendra and Mark, how we're seeing analysts revise earnings estimates downward lately. Mark went on to explain why this was important.

Mark Carver:
If you're making the decision between growth and value allocations, earnings estimates probably matter a lot. We've seen valuation of markets come down because prices have fallen faster than earning. So if I'm doing a simple price to earnings metric of valuation or price to forward earnings, I'm seeing prices fall faster than earnings reported or forecast and so consequently markets seem cheaper. But if we see earnings revisions down, you might see market valuations go back up. So depending on your perspective there, you would choose between growth allocations and value allocations, interestingly. And looking at some of the big ETFs that are against growth or value indexes, you did observe some big allocations to some growth strategies in the quarter. That is indicative of the clients who might have the mindset that growth has fallen enough and I want to take advantage of those lower prices.

Clearly, a lot of clients we're talking to are taking the counter argument, which is that the economy is still favoring value. That growth had such a long period of out performance that value is going to continue to outperform. These are questions that just looking at the simple headline that values beating growth won't tell you the full picture. Beyond that headline, we see a continuation of something, that you and I, Adam, talked about last quarter, which is that it's not as simple as value beats growth. Value's beating the riskiest growth stocks by the widest amount. And that is something that maybe is also a consideration for those investors who are weighing that rotation and how they're going to play that rotation.

Adam Bass:
And with that as backdrop, curious about how this is playing out for hedge fund managers in particular. How are they navigating through all of this?

Hitendra Varsani:
So hedge funds overall have not been immune to the recent market shocks. While macro or CTA hedge funds have weathered the storm and delivered positive returns, given we've been in a very macro driven environment. On the other hand, equity hedge funds are under water year to date. Now, using MSCIs hedge fund Intel data, equity hedge funds are typically have higher allocations to IT, industrials, and consumer

discretionary sectors, and they also chase stocks that are liquid, higher growth, higher risk and momentum stocks.

But we've seen the change in sentiment here as well. If we look at recent trends, they've cut their equity exposure, their net long exposure, down from 50% at the end of last year to around 33% at the end of April. So in effect, de-risking from equities. Now, from a factor perspective, over the last year, we've also seen them reduce their exposure to growth, they reduce their exposure to high risk stocks, and they've also turned less negative on stocks that have high yield and also have value exposure. And as we know, yield and value has been performing well over the recent past.

Adam Bass:
I don't want to attempt our compliance team to break out the razors and start cutting things out, so let me preface this with the obligatory announcement that nobody has a crystal ball and this is not investment advice. My question is this, where might perhaps could the market potentially be going, according to our model?

Hitendra Varsani:
So each quarter we do turn to the adaptive multifactor framework. And as you rightly called out, it's a model and it's designed to highlight indicators of factor performance. And just to recap how this works, it's based on four pillars. First, the macro cycle, second, the valuations of factors, third, trends that we're seeing in factor performance, and fourth, market risk sentiment. As at the end of June, the model was overweight minimum volatility and overweight momentum. This is a change in its stance. Over the first half of the year, it was overweight value but that has now turned negative.

Adam Bass:
And as for what clients are asking about?

Mark Carver:
The three things that they are asking about are event driven risk, and that is regime and scenario analysis. They want to understand how their portfolios might respond. They are asking about what those events tell us, particularly when we think about inflation. Inflation is the number one issue on the minds of most of our clients. And I might say, inflation and economic growth, we'll just sort of marry the two. And in truth, this growth to value rotation. What I think investors are looking at is not unlike what investors looked at the tech crisis, tech bubble back in the early 2000s. And in that regard, they're looking at companies that have resilient businesses, real businesses that will produce strong, fundamental results on a go forward basis.

Adam Bass:
That's all for this week. A big thank you from Joe and me to Hitendra, Luke, and Mark, and to all of you for listening. For more insights, putting markets into focus, you can register for the upcoming webinar Who Let The Bears Out. You'll find a link on this episode's page right on msci.com. Until next time, I'm your host Adam Bass, and this is MSCI perspectives. Stay safe, everyone.

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