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TRANSCRIPT

Investors Stick the Landing in Q1 '23

Adam Bass (00:03):

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 April 6, 2023.

(00:19):

After a difficult year for the markets in 2022, the first quarter of 2023 could be described as occurring in fits and starts. The year started strong, and then investors tried, somewhat unsuccessfully, to gauge central bank language and rate intentions. Then came the banking crisis, or kerfuffle for regular listeners. That seemed to stabilize and markets marched higher to end the quarter. It's a lot to cover, so let's get at it with our first guest.

Hitendra Varsani (00:53):

Hello. I'm Hitendra Varsani, and I'm part of MSCI's Global Solutions Research Team based in London.

(00:59):

So global equity markets rallied in the first quarter of this year with the ACWI Index up 7.4%. Now, the year started with the second-highest January return of around 7.2% over the last 36 years, so it was a very strong start to the year. But it pulled back on inflation concerns and fears around the collapse of Silicon Valley Bank, Signature Bank, and also the rescue of Credit Suisse by UBS. Interest rate volatility reached levels that we haven't seen since the global financial crisis in 2008, and options listed on the US exchanges reached record volumes.

(01:39):

Now overall, high-quality outperformed low- quality. We saw unwinding in what our models show as crowded stocks, particularly in high beta, developed markets outperformed emerging markets, Europe outperformed USA, large-cap outperformed small-cap, and technology outperformed financials, healthcare and energy, which is a reversal of a trend that we saw last year.

(02:04):

Now, given the recent events around the banking crisis, investors have started to recalibrate their expectations of future rate hikes going forward.

Adam Bass (02:14):

As I mentioned at the top, it's been quite an eventful quarter from many different investing perspectives. But there are always elements that diverge from the main storyline and some that boil under the surface. So we'll put on our scuba gear for those unseen issues later in the program. For now, we turn to our second guest with some initial thoughts around the concept of divergence.

Mark Carver (02:42):

My name is Mark Carver. I'm the Head of Equity Factor Products here at MSCI.

(02:47):

So by divergence, what I'm really referring to here are, you can think of it as gaps in the returns among things you would expect to perform sort of closely together. You can think about this in a couple of ways. First, if we were looking at our factor models, we would see that through the end of the quarter, the earnings yield factor fell 50 basis points based on monthly returns, but the book-to-price factor increased or jumped 70 basis points. That's 120 basis points spread on pure value dimensions, things that people would assume move somewhat together, not necessarily in magnitude. But it's quite surprising to see that kind of spread from just one quarter.

(03:35):

We could observe a similar pattern in divergence in things like volatility dimensions where the beta factor was actually the best performing factor year to date. It rose about 2.38% while residual volatility, think of that loosely as the unique risk of a stock, fell by 111 basis points. Where we don't see that divergence are in the quality factors or the quality dimensions. These have all been positive across the board. So things like profitability, earnings quality, investment quality, all positive for the quarter. The things you'd want to be negative on the quality side, you don't want a lot of leverage, you don't want a lot of earnings variability, those factors were negative for the quarter. So many quality investors would be positioning their portfolios to have low leverage, low earnings variability so they would've been on the right side of that trade. So that's what I mean by divergence, and it's quite striking.

Adam Bass (04:34):

Hitendra pulled on this thread as well.

Hitendra Varsani (04:37):

So in our global equity factor models, value has three signals. So we have earnings yield, we have book-to-market ratios, we have long-term reversal. Now, book-to-price has been more relevant for certain sectors, particularly that trade on assets. And what drives performance is usually abnormal earnings. Earnings yield is often seen as an income state measure. It's forward-looking from analysts, so it's different to book-to-price, which is often seen as backward-looking, and it helps investors avoid value traps.

(05:18):

The third signal is long-term reversal that captures tendency for mean reversion over say around five years or so. The fact that the performance of these factors have diverged recently suggests that investors are differentiating between the sustainability of earnings going forward versus abnormal earnings. And long-term reversal has delivered a relatively stronger performance of these three metrics over the last two years, and that suggests that investors have been taking profits on long-run winners and buying into long-run laggards.

Adam Bass (05:58):

And how did that play into regional differences?

Hitendra Varsani (06:01):

So within equities, as I highlighted earlier, Europe outperformed USA. It also outperformed world. And this could be due to Europe having relatively low valuations entering into 2023. Now, if we look within

Europe, Netherlands, France, and Germany led the performance in Europe. And looking into these countries in particular, they had either high exposure to technology, but they also had exposure to the China reopening theme as well.

(06:32):

Within emerging markets, although this is a segment that's lagged the broader equity markets, there are particular hotspots. Some countries have actually delivered very strong returns. Mexico has had a tight monetary policy from its central banks and has been very proactive in raising rates ahead of most other central banks, and currently its rate stands at 11.25%. It's also benefited from trade deals and capital inflows from USA and China.

(07:04):

Taiwan and Korea, that have high-tech exposure, have also fared well. And on the other hand, within emerging markets, India has lagged despite having long-term growth prospects. It did come into the year with premium valuations, and that's been somewhat of a headwind in the first quarter of this year.

Adam Bass (07:24):

That leads us to those potential risks under the surface I mentioned. And now this is a theme we've discussed before, but what does it mean in the context of 2023?

Mark Carver (07:36):

If we went back in time and we looked at the tech bubble in the late 90s and the tech burst in the early 2000s, then again at the global financial crisis, we saw these same two factors, book-to-price, i.e. value and earnings yield move in opposite directions. For much of the last decade where we've had relatively stable financial conditions, sort of ignoring the last year, those two factors had been moving in a relatively steady positive correlation until what we've seen in this quarter.

(08:11):

For sure, and it reminds us that methodology and investment process matters. It's a familiar refrain probably from me on this podcast, but investors benefit from digging into the selection and construction process of their funds, of their indexes, of their managers so that they can understand and see the differences beneath the surface and explain return gaps in things that they would normally equate as substitutes or things that are fungible for one another. It's often not the case when you dig in and see things underneath the surface. You'll find the reasons for why you might not see the same types of performance in things that you previously would've expected to see more similar returns.

Adam Bass (09:04):

Some of the risk that is bubbled over lives within the banking sector. We covered this in depth in our last episode, which, I should say, you can always listen to again at msci.com or wherever you listen to podcasts. But to not discuss it with Mark and Hitendra in the context of the performance this quarter, that would be a huge oversight. In this case, we took it from the perspective of again looking to the global financial crisis.

Hitendra Varsani (09:35):

So when we came out the global financial crisis in 2008, there was significant amount of regulatory reform across the globe. Since then, banks have been more capitalized, holding more liquid assets compared to the GFC era.

(09:51):

Now this time, central banks were also swift to handle the situation both in the US and in Switzerland. However, recent events do remind us of concentration risk in revenues, the need to search for sustainable profits. And the collapse of SVB and Signature Bank in particular, which are regional US banks, could lead to tighter financial conditions. Now, if that is the case, in theory, while that could help lower inflation, it could also reduce economic activity and thus the need for the Fed to hike rates less aggressive.

Mark Carver (10:28):

Yeah, I mean, I think the distinction between the global financial crisis and what we're seeing with the current banking crisis, if you will, perhaps is the speed of which we saw a bank that was well-known, well-established, a couple banks, unwind. And the impact of depositors moving money out in a incredibly tight window that forced action to try to, one, protect the depositors who remained, and then ultimately ensure a stability of the bank and the banking system. And of course, we don't know because this is all happening in real time what could be the longer-term impact if we see other banks come under stress.

(11:20):

What I do note is that it is making investors renew some debate around what central bank behavior will be. As we've talked about in this podcast, there have been periods in 2022 and even in the first quarter of 2023 where investors were almost betting that the Fed wasn't going to follow through on what it said it was going to do, that maybe they would pause or pivot their rate hike. And then when the Fed comes out with a statement and says, "Hey, we're going to fight inflation," we saw a lot of volatility introduced in the market. But what it is certainly making us all aware is that there are macro sensitivities to the way investors are pricing assets in the equity space. And in fact, that has led to a lot of the rotation we've seen in markets.

(12:14):

Curiously, what we talked a lot about last year was the incredible strength of value over growth. This year we've seen the opposite happen where, again, I'll just use the example that is become popular on this podcast, when we look at MSCI USA Growth, our style index, that index was up 17% in the quarter, value was down 1%. That's an 18% move in three months, 18% gap. That's an incredible return, resurgence of growth, and a lot of that was based on the strong performance of the technology space in the US market where investors took advantage perhaps of low valuations of those stocks, they bid them up. A lot of the valuation is based on the terminal value of those companies, not the more near-term cash flow. And the result of that is greater volatility and uncertainty when interest rates go up. All right. So you change your discount rates on those stocks and that's collapsed the valuation.

(13:19):

What we saw at the end of 2022 was growth stocks valuation reverted closer to the 10-year average. What I mean by relative valuation, if we look at growth stocks relative to the broad market that we might build that growth portfolio from. So USA growth stocks relative to the USA market, world growth stocks relative to the world market, et cetera. You saw those valuations come closer to the 10-year average. The result of that was maybe investors felt comfortable that the growth stocks themselves were trading at a level that they could then reenter.

Adam Bass (14:02):

Mark mentioned the effects of macro sensitivities on equities. I asked Hitendra if he could expand on that point, particularly what the current level of interest rates might tell us about equity factors, as well as the idea of equity duration. Now, as Hitendra reminds us.

Hitendra Varsani (14:22):

This is a relatively less talked about concept compared to fixed income counterparts. Now, the hike in US interest rates over 2022 coincided with one of the greatest rotations from growth to value stocks. And value stocks are often seen as short duration and growth stocks are often seen as long duration. Now, interest rates not only impact valuations of equities via discount rates, but also through the higher cost of financing that could potentially slow down earnings growth.

(14:58):

In our recent blog, Markets in Focus, we looked at the relative valuation based on forward PE. So based on analyst expectations of various MSCI USA Factor Indexes relative to the USA Index. We looked at value, quality, size, low vol, yield, growth target and momentum, and found that a majority of these factor indexes had valuations significantly below where they had been when the US 10-year yields were at similar levels over a history of around 20 years.

(15:35):

So just to give you an example here, the MSCI USA Enhanced Value Index would need an active return of around 25% for it to be in line with the yields in the context of historical levels and valuations assuming earnings estimates remain unchanged.

Mark Carver (15:54):

But the clear winner so far this year has been quality. We've seen strong performance of MSCI Quality Indexes outperforming their parent across our flagship regions, with the exception of the emerging market space.

Hitendra Varsani (16:10):

If we look at how quality indexes are constructed, they select companies that have high profitability, low earnings variability, and low leverage. And in the current environment, investors have been rewarding these companies in the first quarter across both US markets, regional markets, and more broadly, global equity markets.

Adam Bass (16:33):

What about investors themselves? For that, we can look at fund flows where we saw similar stories playing out.

Mark Carver (16:41):

When we look at flows to public ETFs, we saw outflows in most of the big dividend and equity income ETFs this year. Quality has been the beneficiary of that where a lot of investors have started to position portfolios toward quality. But interestingly, that's been more toward the end of the quarter. What's really, I think, notable is that at the start of the year, we went out and we talked to a lot of our clients, these clients specifically who build model portfolios or are responsible for asset allocation policy for their respective firms. And what surprised me at the time was their appetite for risk.

(17:26):

In 2022, many clients held more defensive positions across their equity program. This meant bigger allocations to things like minimum volatility. But coming off the weakness of last year, many firms moved out of those defensive equities to, I'll call it risk-on positioning, favoring more beta 1 products.

(17:45):

The result was we saw outflows in minimum volatility products this year, especially things like emerging markets minimum volatility, but in favor of broad emerging markets. And this proved to be modestly helpful for those model allocators in emerging markets. IMI Index rose, let's call it 4%, where EM Min Vol was up 3.1%. But the general sentiment was one of risk on. So taking the lower beta equities and moving them to beta 1 type portfolios or more market-cap, broad-beta exposures.

(18:26):

At the end of the quarter, the story and particularly exacerbated by the concerns around the regional banks, we saw a move toward quality. What we saw is that investors were looking for positions in the equity space that represented more durable businesses, higher profitability, lower leverage. The result of that was strong flows in March to quality ETFs, as those represented that more resilient business models or fundamentals that investors wanted coming toward the end of the quarter.

Adam Bass (19:05):

Before letting Hitendra go, I figured why not take a chance and see if he'd give us a sneak peek into some related research he's currently working on in terms of the options market. Fortunately, this chance paid off.

Hitendra Varsani (19:22):

So there's around five key questions that we tried to address. The first is is fixed income volatility leading equity volatility? The second is there are various options selling programs in the market. The question is is this artificially dampening equity volatility? The third is are US investors becoming much more short term given that we do see a gravitation in volumes towards from monthly to weekly to now daily or single-day options? Then within emerging markets, there's been a pickup in hedging activity, particularly in deep out of the money puts. In other words, tail risk hedging. What could be the rationale for that? And finally, the fifth question is are EFA investors becoming more concerned about downside risks? We do see increased volumes in puts versus calls on the listed options market.

Adam Bass (20:25):

He's a good salesman. I'm definitely looking forward to reading that piece. And of course, no quarterly recap would be complete without taking a look ahead, using our models that is.

Hitendra Varsani (20:38):

So the MSCI Adaptive Multifactor Allocation Model is based on four pillars, the macrocycle valuation, momentum, and market sentiment. Now, based on data at the end of the first quarter, the model shows an overweight to value and an overweight to low size. It's neutral on quality and momentum and underweight to low-volume yield.

Mark Carver (21:07):

We've seen in periods where we see divergence, we see increased cross-sectional volatility, that active investors will often do very well in those types of environments. So we're hearing from clients more willingness to look at active portfolios, factor-based portfolios so that they can take specific bets against the general market and they can reflect their investment views given these macro conditions.

Adam Bass (21:42):

That's all for this week. A big thank you from Joe, Phil, and me to Hitendra and Mark, and to all of you for listening. You'll find the full Markets in Focus report at the bottom of this episode page at msci.com. Until next time, I'm your host Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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