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TRANSCRIPT

Markets in Focus: Inflation Woes and Geopolitical Tensions

Featuring:

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Jenna Dagenhart:

In Q1, escalating tensions between Russia and Ukraine led to a major slump in equity markets around the world, adding uncertainty to countries already impacted by a surge in inflation and risk to economic growth. Joining us today from MSCI, to talk about how Ukraine rush attentions have impacted global financial markets, how factor indexes have historically performed during similar geopolitical events, what this means for investors, we have Mark Carver, Managing Director, Global Head of Equity Factor Products and Equity Portfolio Management, and Hitendra Varsani, Managing Director Global Solutions Research. Well, it's great to have you both with us. Mark, let's start by discussing market performance in Q1 with inflation and increased geopolitical tensions Ukraine, Russia, weighing heavily on global markets. How did these themes impact pre- and post-war market dynamics, and what are the implications for economies and economic growth?

Mark Carver:

Well, Jenna, with that backdrop that you just outlined, as you would guess, it was a tough quarter for equity investors. ACWI was down 5%, MCSI World, MCSI USA, also down, EMEA, excuse me, Europe down over 7%, and the emerging markets right around 7% as well. So it was a tough backdrop. But in many ways, it was a quarter of two tales, where we saw markets very weak at the start of the year, clients, very worried about inflation and economic growth, coming out of the Russia Ukraine crisis. Surprisingly, while we did see market weakness at the start of the crisis, markets firmed up much more in March, when we saw relative strength in equity market. So I think at the end of the day, it was a tough quarter, a very tough backdrop for equity investors, but it was a quarter of two tails. Now digging into that quarter of two tails, When we look at the factors specifically, Jenna, what we observe in our pure factors, is that the highest risk end of our factor structure performed poorly. Residual volatility was the weakest performing factor, momentum was also very weak. On the other end, the value dimensions, particularly earnings yield, performed very well. When we look at our index series, what we saw is that minimum volatility, enhanced value and high dividend yield were the standout performers across most regions. I don't think investors would be surprised at those results that value did well in that min vol. Surprisingly to some might be the weakness that we did observe in quality. was due to heightened valuations. But certainly that was maybe the surprise that we saw during the period. But overall, given the backdrop, relatively difficult quarter for equity investors, but certainly there were some spots with style indexes, factor indexes, that provided a little more resilience.

Jenna Dagenhart:

Thank you for that, Mark. Let's take a step back for a moment. In 2020, during the height of the global pandemic, investors chased high risk growth stocks. However, we started to see this trend reverse in 2021, as themes of reopening of economies, high inflation and proposed interest rate hikes began to emerge. Hitendra, could you talk to us about this rotation from high risk momentum and growth stocks to value stocks and what this meant for markets?

Hitendra Varsani:

Sure, as you pointed out, during 2020 at the height of the global pandemic, when there was surplus liquidity from central banks, investors chased high risk growth, momentum stocks. And put simply, the MSCI Crowding model, flagged this as a crowded trade. Now these high risk stocks sold off throughout 2021. And with the surges of inflation, rising rates, we've seen continued rotation away from these high risk momentum growth stocks, now to value stocks. In our latest research, disentangling market durations, we highlight that most of the staff factor returns have actually come prior to the start of the war. Since then, the strong rotation we've seen away from high risk stocks has actually reversed, perhaps indicating investors have higher risk appetite. Now, within industry groups, those that were positively exposed to inflation, and particularly exposed to commodities, such as oil and gas and metals, they rallied. In terms of country factors, there's been strong performance amongst countries that are exposed to oil production. So net exporters of oil, Norway, Canada, a majority of the countries in the Middle East, have outperformed. Now, this is broadly in line with our recent research using data over a much longer history, since 1975, where we show that countries that are net exporters of oil and gas have typically delivered positive, active returns. For those that are interested, that blogs title, "Which Factors Rose with the Price of Oil?”

Jenna Dagenhart:

And now the risk of deglobalization is a real one, amplified by Russia-Ukraine. How has this impacted markets? Hitendra, why don't you take that one?

Hitendra Varsani:

So overall, we've seen a strong stark drop in correlations; be it between regions, between countries. This is adjusting further decoupling amongst the major economic blocks. Now some of the underlying forces driving deglobalization and decoupling have been the strategic reevaluations of global value chains, supply chains throughout the COVID pandemic. You've seen reassuring and relocation of manufacturing hubs, software development, and now with the Russia-Ukraine tensions and broader geopolitical risks, that's actually added to further deglobalization. Now, what does it mean for investors? There's a greater need to revisit global factor allocations. There's growing importance to be thinking about regional factor allocations. And our research suggests that exposure to companies that have high quality, could potentially withstand less trade blows between countries. Given more volatility amongst single countries, strategies like low volatility could help dial down risk. Exposure to companies that have dramatic exposure, such as robotics or innovation could also benefit if there's a shift towards domestic production.

Mark Carver:

And Jenna, maybe I can just build a little bit on a sentiment underlying what Hitendra is saying is that, when we think about geopolitical risk, we're often thinking about the risk to the downside. And what he's really highlighting is that, with this deglobalization that we're observing, it also means that there's a change in correlation. And that allows investors to actually diversify their portfolio. So you can think of, maybe a hidden benefit of deglobalization as the opportunity to diversify and reallocate capital. And we've talked about this theme a few times in the past, but I think it's becoming more plain to see it more evident based based on the way the markets have transitioned in the quarter. And as a result, we are seeing clients who are starting to allocate to regions or countries with specific style or theme mandates, to try to express their view and diversify the overall portfolio. So that's maybe a side benefit, a hidden benefit if you will, of this trend toward the de-globalization that we're observing.

Jenna Dagenhart:

Hitendra, we're going back to you. Could you share what MSCI's Adaptive Multifactor Allocation model showed as of March 31st?

Hitendra Varsani:

So the MSCI Adaptive Multifactor Model, going into this year, was actually overweight value. And as it turns out, value was one of the best performing style factors over the first quarter. Now, as at the end of March this year, the adaptive multifactor model points to an overweight to momentum, value and lower size stocks. And this reflects economic expansion, and the lower relative valuation that these factors hold in a historical context.

Jenna Dagenhart:

Finally, Mark, could you share a few key takeaways for investors?

Mark Carver:

Yeah, of course. I think the big takeaways from the quarter, I think are three things. First, I think it's important to go beyond the headlines. We've had a lot of narrative in the industry about this growth to value rotation, and in truth, there is a growth to value rotation, but it's too simplistic to define what we're observing as growth to value. Instead, what we're really observing, is more of a high risk to cheap rotation, where those growth stocks, Hitendra referred to them as the most high momentum stocks, or you could think of it as the highest end of the growth stocks, the most risky end, have really suffered. We see that in our factor structure with residual volatility, those are stocks with the highest idiosyncratic risk. To find it simply, that's been the weakest performing factor where value price to earnings, price to book have been better performing. And the rotation is really more about risk to cheap. You have got to go sort of beyond the headlines to see that. The second big thing that I think is that, our research shows that while the Russia Ukraine conflict, as terrible it is for reasons that are obvious to everybody, what we observe in past conflicts, conflicts is that generally the market trend that was present before the conflict, tends to persist after the conflict. The reason I mention this is in more and more client conversations that we're having, they're telling us that today, their biggest worry are those macro risks of inflation and economic growth. Those are the things we were thinking about, prior to the crisis, to the conflict. Those are the things that are back to the forefront of investors' minds. The third thing is something that Hitendra also mentioned, which is the way clients started to reallocate capital toward the end of the quarter. Yes, there's been this reallocation away from the high risk stocks at the beginning of the quarter, but what we're observing now, is some clients are stepping back into those risk trades. We can see that in the performance shift, in the factors, we can also see that with the flows to specific mandates. So to me, the big quarters are the big themes for the quarter, go beyond the headlines, understand historical precedent and see the way assets behave in periods of conflict and periods of inflation. And third, look at what the market's telling you, both from the way assets are performing, and the way investors are allocating money.

Jenna Dagenhart:

Well, Mark Hitendra, we appreciate those insights into the major themes of the first quarter. And thank you to everyone out there watching. Once again, I was joined by Mark Carver, Managing Director, Global Head of Equity Factor Products and Equity Portfolio Management, and Hitendra Varsani, Managing Director, Global Solutions Research at MSCI I'm Jenna Dagenhart with Asset TV.

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