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TRANSCRIPT

Investors Hope Something Changed on New Year-s Day.

January 12, 2022

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 January 12th, 2023. Happy New Year.

(00:21):

Today, we clear the slate after a volatile year in the markets, with both global equities and bonds declining against surge and inflation, waning economic growth, geopolitical tensions, and monetary tightening. Today on Perspectives, we take a look at market conditions and valuations, as well as investor allocations, all by assessing what might be most impactful for 2023. So, let's get to it with our first guest.

Hitendra Varsani (00:53):

I'm Hitendra Varsani. I'm part of the Global Solutions research team based in London. 2022 was a very challenging year for investors, with both global equities and bonds declining against the surge in inflation, waning economic growth and geopolitical tensions, as well as monetary tightening. Investors were caught between a rock and a hard place in their asset allocations.

(01:19):

If we look back at the year, MSCI ACWI Index, the all country world index, was down 18% over the year. That's the steepest decline since 2008, the global financial crisis. However, inflation, which has been the most significant concern amongst many investors, had started to soften as we went towards the end of the year, and that provided a relief rally in the final quarter.

Adam Bass (01:48):

Now, there were some brief rays of hope at various times last year, but the general tone of the markets was decidedly negative. That brings us to our second guest, who has some of the major storylines from 2022.

Mark Carver (02:04):

I am Mark Carver, the Global Head of Equity Factors and Equity Portfolio Management, here at MSCI. I think at the start of 2022, the market mood was much more positive. While today, many investors I think are approaching the equity markets with much more trepidation, uncertainty, concerns about heightened volatility. And there's been, I think, equal amount of discussion around the fall of the so-called Big Tech names.

(02:31):

Many hedge funds, for instance, began the year with big overweights to the technology names, and some long-only managers had these same overweights, and both were severely punished as value rotation gained speed in 2022. I think we can dig into the strong performance of value overgrowth, and in fact, on that note, I think it is really interesting to observe that in the US market, MSCI USA Value outperformed MSCI USA Growth by 26%. That is the largest calendar year outperformance that we've seen since 2000. That was the year that the tech bubble burst. And it's in fact the second largest calendar year outperformance of value overgrowth in the US market since the mid-1970s.

Adam Bass (03:28):

As we continued our conversation, Mark broke that down a bit more, telling us that...

Mark Carver (03:34):

What this really meant is that we observed a change in the correlation of exposures within factor portfolios. Our listeners often think that value and momentum, for example, will have negative correlation on average through time. But in The Rise and Fall of Big Tech, our team noted that at the start of 2022, the correlation of exposure of value to momentum was negative, just as people would expect and intuit. But by the end of the year, this exposure correlation was positive.

(04:11):

Conversely, growth and momentum, which are often I think wrongly conflated as the same thing, those started the year with positive exposure correlation. But by the end of the year, growth and momentum had negative correlation.

Adam Bass (04:29):

If you'll indulge me just a bit longer, I'd like to stick with this discussion about growth and value, which are often the protagonists in a continuous story of a battle for market leadership. And in this case, there may also be a very interesting valuation subplot to our hero's journey.

Mark Carver (04:49):

So, the thing that I think is unfolding before our eyes is the shift in the relative valuation of various factor strategies. So for example, we know that by definition value stocks will trade at a discount to the market. That's not controversial. However, that level of discount will shift through times, which is also not controversial. What this means is that sometimes value stocks look especially cheap, other times they don't look that cheap. And we can measure these things in two ways.

(05:22):

First, we can calculate a stock's or really an asset's exposure to a factor in the cross-section. We do this with our factor models and it's just an easy way to take a look. You can see the value exposure of a particular asset, and say, is it cheap relative to other stocks? But we can also do something else, which is to look at that same asset compared to its own history.

(05:49):

If we look at the start of the year, we saw the USA Value Index, for instance, was trading at a price-to-forward earnings at a roughly 27% discount to the US market. We saw similar levels across MSCI World, MSCI World ex USA, et cetera. But in the US market, the 10-year average discount is closer to 17%. So, we were talking last year at this time about value stocks being historically cheap, even after the rally in 2021.

(06:26):

Now, we come to the end of the year, and what do we see? Well, the relative valuation of value stocks, again measured by MSCI USA Value, is closer to the 10-year historical average. So, the rally in value stocks last year meant that, on a relative basis, we saw a reversion to the mean.

(06:45):

The same is true of another star performer in the factor realm in 2022, which was high yield equities. Their relative valuation at the start of the year was cheap. By the end of the year, closer to the historical average. If we contrast this with growth stocks, on a relative basis, growth stocks were trading at huge premiums to their historical averages at the beginning of 2022. But by the end of the year, reverted closer to the mean. Still trading at a premium, but closer to the mean.

(07:18):

US Momentum stocks and World ex USA Momentum stocks, we actually saw something even more interesting. Which is that these stocks, which traditionally trade at a premium to the market, are now trading at a discount to the market.

Adam Bass (07:37):

Mark mentioned the star performance of high yield equities. Let's pull that one apart a bit.

Hitendra Varsani (07:43):

So, when central banks raise interest rates to combat inflation, investors preferred short duration assets over long duration assets. So in fixed income, short-dated bonds outperformed long-dated bonds. And in inequities, value outperform growth, high yielding assets outperform low dividend yielding assets.

(08:05):

Now, with the prospect of an economic recession, we have looked at previous cycles and found that during those economic recessions, they typically coincide with earnings recessions, and analysts typically revise downwards the expectations for earnings going forward. That's not something that we've seen on scale yet.

(08:25):

However, what we've found is that earnings growth tends to be negative or slower, while dividend growth tends to be more sticky, and investors may prefer high yielding assets as rates may continue to rise, and economic conditions may continue to remain fragile.

Mark Carver (08:45):

When you see a year like we saw with US Treasuries, for instance, trading down so strongly, investors were trying to find yield outside of bonds. And that led to investors buying bond proxies in the equity market, which tend to be high yield indexes. And we saw that with the incredible amount of flows that went into yield ETFs, equity income or high dividend yield ETFs that is.

(09:14):

But we also saw that meant that those strategies, those stocks that had been beaten down so much over the last 10 years where investors had been favoring growth stocks, rallied strongly in the valuation, reverted closer to their normal averages. That reversion to the mean meant today yield stocks are not quite as cheap as they were a year ago.

Adam Bass (09:39):

So far, we've been pretty firmly focused on the US markets. And while what happens in the US doesn't always stay in the US, just look at the impact of a strong dollar for example, investors considering how they're going to allocate their portfolios in 2023, well, they'll likely look at other parts of the world. And that includes Emerging Markets.

Hitendra Varsani (10:05):

So, the overall MSCI Emerging Market Index was down around 19.7% in 2022, and there were significant headwinds. One of those was the strength in the dollar, as you mentioned. But that has turned in recent months.

(10:23):

Now, historically, the end of the US rate hike cycle could have significant implications on Emerging Markets. It could reduce pressure for other central banks to raise rates to protect their currencies from depreciating or limiting capital outflows. Now this weaker dollar, in theory, could reduce the price of imports, particularly those that are more commodity-sensitive in the imports. These are typically priced in dollars. It could also reduce the financing cost of foreign US-denominated debt. And so, a weaker dollar could be a tailwind based on these two factors.

(11:06):

Having said that, within Emerging Markets, we have seen a strong degree of dispersion across the various regions. So, although the broad Emerging Market was down 19.7, MSCI Emerging Market, LATAM America was up 9.5%, largely due to Brazil and its commodity exposure. Whereas, Emerging Market Asia was down 20.8% and that was driven by the weakness in China, somewhat related to the real estate crisis and Zero Covid policies for majority of the year.

(11:43):

And within Emerging Markets Asia, India is expected to be the fastest growing economy in '23 and '24, and become the world's third largest economy by 2027. And there is a number of key trends or drivers propelling India's growth prospects.

(12:03):

And these five points are digitalization. For example, the government initiative to roll out India Stack, which is the world's largest open API, revolutionizing access to finance. The second is the rise of the India office, so many multinational companies continue to allocate more office headcounts in India. Third is the growing manufacturing hub to the world. Fourth is rising domestic consumption. As wealth standards increase, there's increased spending, and so increased consumption. And the fifth is de-carbonization and the big energy transition.

Adam Bass (12:46):

And of course, I'm sure that Hitendra and our legal team, well, they would want me to remind everyone listening that while these five trends are notable, there are also definitely risks involved. And all of this, in no way, represents investment advice.

(13:06):

Now, we spoke earlier about central banks raising rates around the world in an effort to tamp down inflation. But investors have been captivated by central bank actions, as well as their language, as they try to anticipate future moves. And at times, they haven't anticipated it very well.

Mark Carver (13:28):

I think the market is looking at that data to anticipate any potential pivots of central banks, with the belief that if employment data weakens, that then central banks may not raise rates at quite the level of intensity.

(13:49):

Now, will we see that to be true or will we see inflation continue to be resilient? I think that's a story that's that's going to unfold throughout the course of, not only the first quarter, but probably much of 2023. And what we did note is that the US market, in particular, was hypersensitive to central bank expectations, and there was almost this divide between the policy statements that the Federal Reserve was putting out and the interpretation of those statements by investors.

(14:30):

There was a belief that maybe the Fed would slow down the rate increases, and the result is the market started to rally, but then when a statement got clarified or some data came out that said maybe inflation is a bit more sticky, then obviously markets fell fairly dramatically.

(14:52):

And so, what it's telling you is that investors are very sensitive to the macro environment. What's curious about that is the macro environment, when we look around the globe, the macro environment is not the same even within developed or within Emerging Markets.

Hitendra Varsani (15:13):

If we look back at higher rate environments, many factor indexes had delivered outperformance. So whether it be quality or value or yield or other factors, they've typically generated positive returns in higher rate environments. So, many questions on investors' minds is, in this new rate environment, should they be thinking about a more diversified allocation to several factor indexes, as opposed to tactically adjusting to one or two-factor indexes?

Adam Bass (15:45):

And those questions extend beyond equities to all areas of portfolios.

Hitendra Varsani (15:52):

So for multi-asset investors, fixed income is a yielding asset again. When we look at the yield on MSCI Investment Grade Corporate Bond Indexes, they finished the year around 5.4% for US dollar, 5.6% for Sterling, and 4.2% for Euro-denominated investment-grade bonds. These are levels that we haven't seen for decades.

(16:20):

For equity investors, this higher cost of borrowing for corporates could mean that corporates borrow a lot less, earnings could grow at a slower rate, and this is all against a backdrop of slower economic activity.

(16:35):

Now, in light of the continued monetary tightening and potentially further rate rises, our research has highlighted indexes with value, or high yield, or quality stocks, alongside minimum volatility allocations as an alternative for straightforward market cap index allocations to navigate this challenging environment.

Adam Bass (17:01):

Now, we're really getting down to it. All right, where else have investors focused as they try and contend with inflation, low growth and continued volatility?

Mark Carver (17:11):

There are countries in regions within the developed or the emerging world that will not perform the same, based on the levels of inflation in those countries or regions, or the potential or the forecast GDP growth of those same countries or markets. What does this mean for investors?

(17:30):

This means there's an opportunity to be more deliberate in your asset allocation. Knowing how you want to be exposed, potentially the macro environment of those exposures, will take on heightened sensitivity. This means, for some investors, they may want to take a more defensive position in one market and a more pro-cyclical position in another market.

(17:57):

I often say, the first principle is know what you own. Are you aware of your exposures? You need to look beyond the headlines because sometimes a portfolio will be called one thing, but its exposures will be something else. You need to look at the underlying factor exposures and how those have shifted, not just at a single component of your portfolio, but the portfolio more holistically.

(18:20):

What's really interesting is that today more and more investors are sort of model-centric. We often think this is true mostly in the wealth markets, but the truth is that there are many institutional investors that are building diversified model portfolios and then implementing. And sometimes, you'll build a model which you think is well-diversified, but then when you implement by hiring active managers, by allocating to specific index type strategies, that might actually shift the intended exposures.

Hitendra Varsani (19:05):

So, one of the biggest concerns amongst investors' minds in 2022 was the decline of both equities and bonds, and that presented significant challenges for a 60-40 strategic mix. Investors are now reevaluating if other alternative ways to construct portfolios that can be more defensive replacement for bonds.

(19:26):

From a global economic point of view, the OECD is forecasting slow economic growth, and as much as one-third of the global economy going into recession, softer inflation and continued monetary tightening. So, as we enter this new regime, our research has looked at a wider toolkit to help investors reposition their portfolios and capture medium to long-term horizon opportunities across many dimensions. Be it factor investing, single country investing, particularly in Emerging Markets with our growth opportunities, thematics, as well as climate overlays across the portfolio.

(20:06):

So climate conscious investors, they often aim to capture more than one objective through their capital allocation, be it financial risks and opportunities, or incentivizing companies to change or steering capital towards, say, solution providers, Greentech companies for example. But beyond climate considerations, investors also have other financial objectives, such as managing risk or seeking active returns by investing in stock selection strategies such as value investing, or high yielding equities, or identifying quality companies.

Adam Bass (20:43):

There was one other approach Hitendra referenced, thematic investing, which is...

Hitendra Varsani (20:49):

Characterized as a top-down investment approach that aims to capitalize on opportunities created by macroeconomic, geopolitical and technological advances. These are not short-term swings, but long-term structural transformational shifts. Now, some institutional investors are thinking about innovation or thematic investing as a strategic asset allocation as part of a diversified portfolio.

Adam Bass (21:17):

In fact...

Hitendra Varsani (21:19):

Knowing how much innovation is in your portfolio could become an integral part of the investment process over the months and years to come. Thematic investing is distinct from style investing, such as value or growth, sector investing, be it technology or other related sectors that are often associated with innovation, or traditional forms of allocation. Exposure to a wide set of thematics, over a recent sample period spanning November 2016 to May 2022, would've resulted in improved risk adjusted returns of a broader MSCI ACWI Index.

Adam Bass (21:58):

No year-end recap would be complete without talking about the coming year. To help us out, we asked to Hitendra to talk through MSCI's Adaptive Multifactor Allocation model and what it showed as the ball dropped on New Year's Eve.

Hitendra Varsani (22:14):

So, the Adaptive Multifactor Allocation model is based on four pillars, the macro-cycle, valuations of factor indexes, momentum and factor indexes, and market sentiment driven by volatility and credit spread indicators.

(22:33):

At the end of 2022, a combination of indicators showing an economic slowdown, low valuations, trending performance, as well as mixed readings from risk indicators, led to an overweight in momentum and value relative to an equally weighted mix.

(22:53):

Now, in terms of what the derivatives market is saying about volatility, if we turn to the VIX, it currently has an upward sloping position. But I think, more interestingly, it's structurally higher than we were during pre-Covid levels. And this indicates that a higher volatility regime might be here to stay over 2023.

Mark Carver (23:15):

Last year, it was about inflation, de-globalization, and as we mentioned, the fall of Big Tech. But really, it was about inflation and de-globalization. This year, I think we'll have more focus on earnings, and relatedly, employment, and the third big pillar will be risk management.

(23:38):

We all know how sensitive the market was to central bank policy in 2022. And in fact, there was a lot of talk about in the US, for instance, if the Fed pivots from a strong stance to combat inflation to a softer stance, that the market would rally. And we saw a few sort of head fakes, mid-summer we saw a rally, believing that the Fed might reduce the intensity of rate increases. There was that debate again in the fall where that pattern played out again. The market rallied.

(24:13):

But we also observed that stocks, which missed their earnings targets, were severely punished, and especially those that had these high valuations. So I think, in 2023 we'll see a continuation of this focus on central banks, but an increased focus on earnings, employment, and risk management.

Adam Bass (24:42):

That's all for this week. A big thank you from Joe, Phil, and me, to Mark and Hitendra, and to all of you for listening.

(24:50):

Over the course of 2023, we'll see if and how the themes that we discussed today play out. And of course, we'll help answer the questions on investor's minds. Until next time, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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