Perspectives
Global Equities

Rosenberg Equities Client Portfolio Management team

- **Economy and markets**: Vaccines and stimulus support investor sentiment
- **Factors**: After worst year ever, value’s best quarter since 1943
- **Valuation**: Interest rates the centre of attention
- **Earnings**: Signals crossed – when past performance really isn’t a guide to future returns

Economy and markets

Global equities continued to make gains in the first quarter of 2021 as the roll-out of COVID-19 vaccines across the world fuelled hopes of a swift economic rebound, despite supply constraints. A $1.9 trillion fiscal stimulus package in the US buoyed sentiment and helped the MSCI All Country World Index – a global equity benchmark – to reach all-time-high levels during February. Further support emerged in March as the US Federal Reserve upgraded its economic growth outlook for 2021. The pandemic, nevertheless, continued to cause bouts of unease, particularly as new strains of COVID-19 spread, and some countries tightened restrictions because of rising infections. Increases in government bond yields, as investors worried about growing inflation, added further pressure. Oil prices surged as they benefited from the improved economic outlook and from cold-weather-induced supply disruptions in the US. The brighter economic prospects also boosted the US dollar; gold prices, however, weakened as investors’ increasing risk appetite, the resurgent dollar and rising bond yields reduced the appeal of what has traditionally been considered a “safe-haven” investment. Against this backdrop, typically higher risk assets, sectors and factors continued to outperform, led by smaller, more economically sensitive and more lowly valued equities.

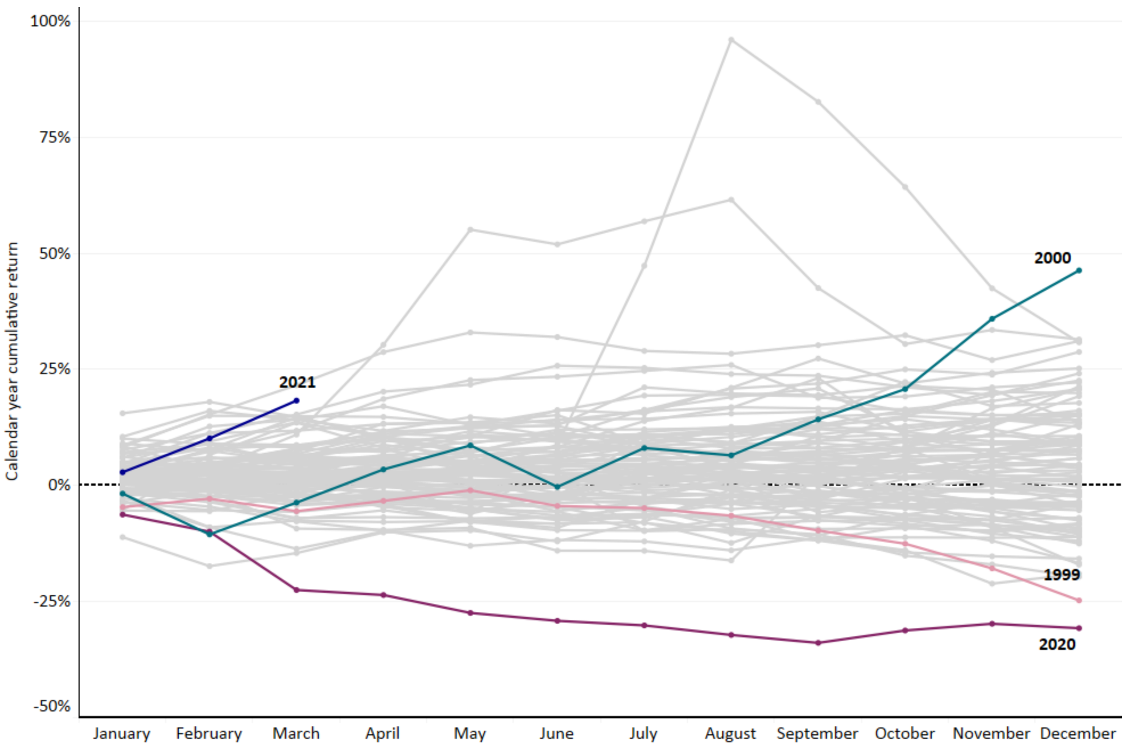
Factors

In last quarter's *Perspectives*, we highlighted signs of recovery in value after a particularly wretched stretch. Nonetheless, despite a better fourth quarter, 2020 still turned out to be the worst year for the value factor traditionally favored by academics – which focuses on the multiple at which stocks trade relative to their book values – since reliable data began in 1927. Fast forward to the first quarter of this year and the same factor posted its best return since 1943. This sharp shift in favour of value – and away from the factors currently least correlated to it, most notably growth and momentum – was the story of the quarter for factor investors.

The chart below tracks the value factor's cumulative returns each year since 1927. Analysing returns over such a long period of time gives us a sense of the historical distribution of outcomes for investors. It can also provide some context about the pattern of those outcomes, helping us to understand whether dramatic reversals like that seen in the first quarter are unusual.

Interestingly, we find that they are not. Throughout history, several of value's strongest years have followed its weakest periods. For example, on top of 2020 and 2021, the chart also highlights the returns to value in 1999 and 2000. Before last year, 1999 was value's worst year on record. As the tech bubble inflated, lowly valued stocks were left behind, resulting in deep underperformance. When the bubble burst in early 2000, however, the laggards of the past year were considerably more prized. As we see in the chart, the first year of the new century remains the best year for the value factor. Valuation-oriented investors who suffered through 2020 will be hoping that the factor's first-quarter comeback is a sign of history repeating itself.

Exhibit 1: Cumulative return for academic value factor by calendar year, 1927 to 2021, US stock universe



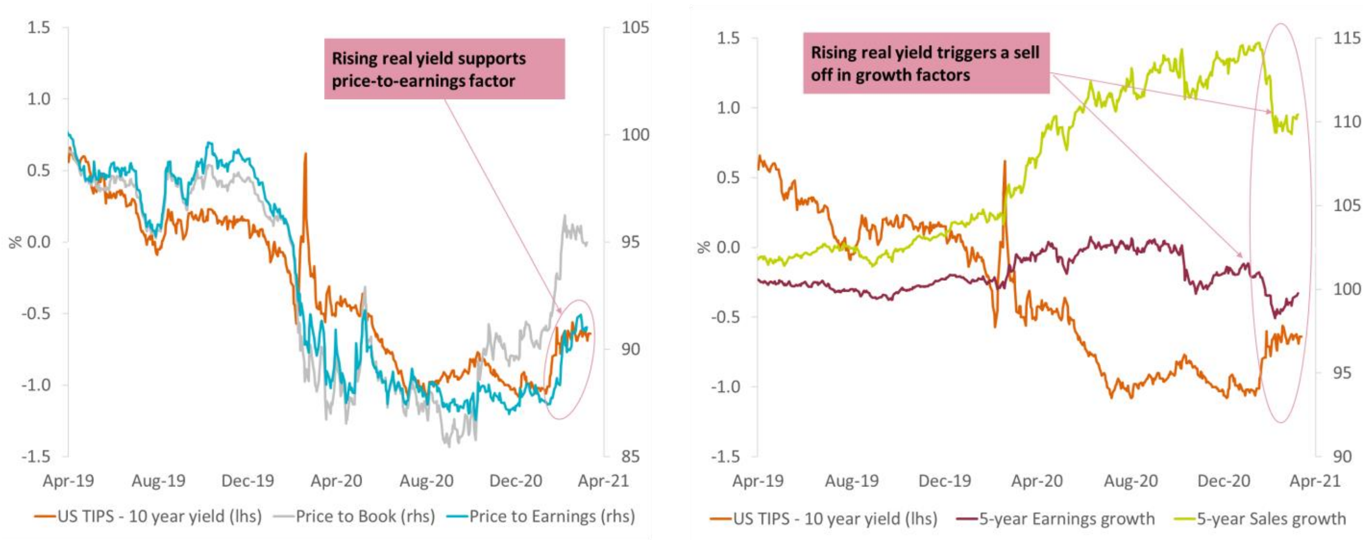
Source: Matthias Hanauer, Kenneth R. French Data Library. Data as of 31 March. Kenneth French Data Library includes all NYSE, AMEX and NASDAQ stocks for which data is available. Past performance is not a guide to future performance.

Valuation

Rising interest rates were among the key culprits that commentators seized upon to explain the market shift. Indeed, after several years of steadily falling rates, yields picked up in the first quarter amid expectations of a rebound in global economic growth and the potentially inflationary effects of unprecedented stimulus measures designed to counter the COVID-19 crisis. Though still at historically low levels, increases in both nominal and real yields appeared to leave their fingerprints on the major factor dynamics that played out in the first quarter.

The charts below show the pick-up in real rates – highlighted by the yield on 10-year US Treasury Inflation Protected Securities (TIPS) – and the subsequent performance of well-known value (left) and growth (right) factors. As yields moved higher in February, the value rally broadened beyond the price-to-book factor that was the major beneficiary of vaccine euphoria late last year to include earnings-based measures of value; at the same time, firms with the fastest growing sales and earnings saw a sharp sell-off.

Exhibit 2: The path of real yields and value and growth factor returns over the past two years



Source: Refinitiv, MSCI, AXA IM as of 31 March 2021. Factor returns shown are multivariate returns for each factor in the GEMLTL risk model for the periods shown. Past performance is not a guide to future performance.

This relationship between interest rates and value/growth dynamics makes intuitive sense, and will be especially familiar to bond investors already well schooled in the concept of duration. Put simply, as yields rise, the discount rate applied to companies' future cash flows increases, making those cash flows less valuable today. This affects different companies differently, with growth stocks – for which investors are generally focused on cash flows far into the future – more susceptible to de-ratings alongside other so-called "long duration" stocks. By contrast, value stocks tend to be less vulnerable as more of their value is typically seen as being captureable in the short to medium term.

While this script played out perfectly in the first quarter, it is worth noting that the longer-term correlation between interest rates and returns is not necessarily as strong in equity markets as it is for bonds. While further increases in yields could be expected to have similar effects, neither the expected increases, nor their effects, are guaranteed. The good news for growth investors is that interest rates have stayed stubbornly low for years, defying most commentators' projections. For now, the Federal Reserve seems focused on avoiding another "taper tantrum". The good news for value investors is that history shows that value stocks don't need rising rates to outperform.

Earnings

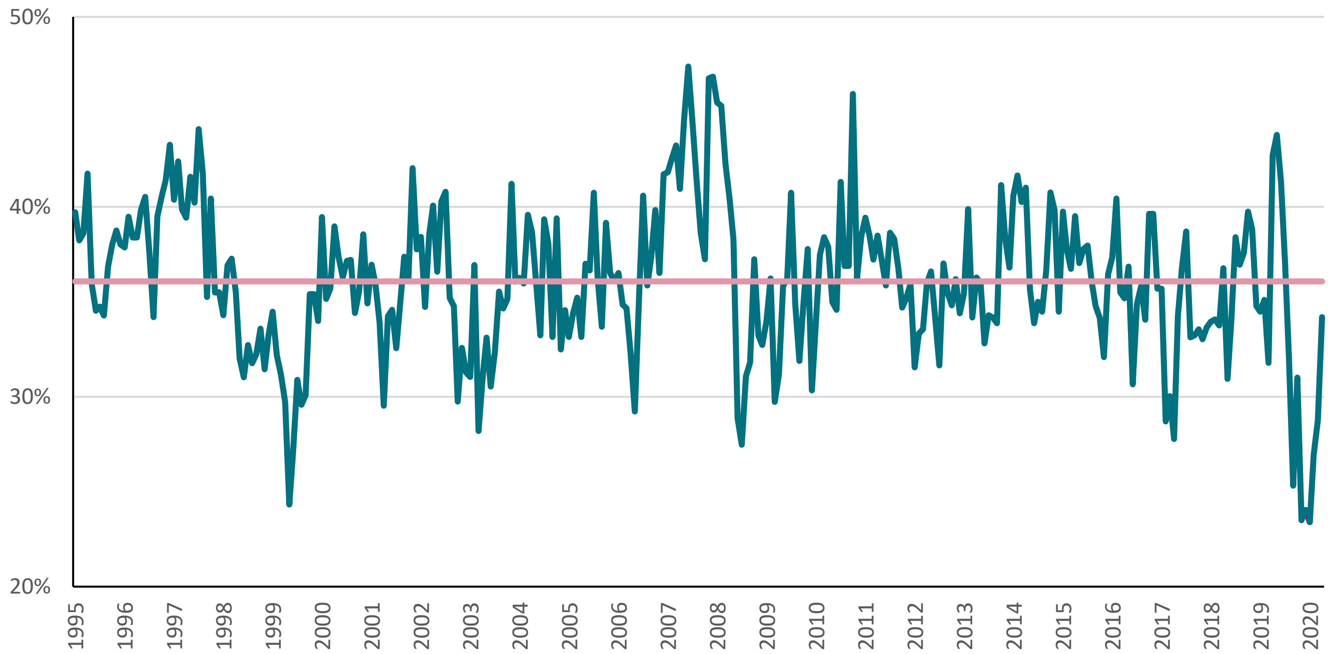
Given the shift in market environment, price momentum was one of the worst-performing factors across global equity markets in the first quarter. Part of the reason for momentum's woes was a temporary breakdown in the factor's ability to perform its key task as a result of the increased market volatility seen over the past year.

Momentum's fundamental role is to identify firms on an upswing. While value factors have historically outperformed in spite of their failure to capture near-term earnings growth, momentum factors have thrived largely because of their skill in doing so. This relationship makes sense: price momentum typically aligns with fundamental momentum – investors analyse companies' prospects and bid up those that appear to deserve it. By buying stocks with positive momentum, investors are buying companies that the market believes are likely to outperform.

However, when this relationship breaks down, companies' past performance suddenly becomes a much less effective guide to future returns. Major macroeconomic events have often been the source of these breakdowns and have revealed the Achilles heel of strategies based on trailing price momentum – their sluggishness in reacting to regime changes.

The chart below is one way to understand this effect. It illustrates the overlap between the top quintiles of trailing price momentum and short-term analyst earnings revisions in the MSCI World Index over time. Since 1995, on average about 35% of the stocks in these categories have featured in both buckets. While this may not seem high, comparing it to the intersection between the top quintiles of price momentum and other, non-sentiment, signals demonstrates that it is. For example, over the same period, the average overlap between the top quintile of stocks in the price momentum and low volatility, value and quality factors was markedly lower, with the value overlap barely above 10%.

Exhibit 3: Degree of overlap between stocks in the top quintiles of price momentum and near-term analyst earnings revisions, MSCI World Index



Source: AXA IM, Rosenberg Equities, MSCI. Data as of 31 March 2021, based on Rosenberg Equities' trailing 12-month price momentum and short-term earnings revisions signals for its MSCI World Index universe.

The far right side of the chart, however, shows a recent sharp decline in this relationship between trailing price momentum and fundamental momentum. After peaking in April last year, the market turbulence caused by the coronavirus outbreak led to a fall in the number of stocks appearing in both the top quintiles of price momentum and near-term earnings revisions. This overlap bottomed out at 23% at the end of last year – the lowest since shortly after the tech bubble burst in 2000. Although the overlap rose again in the first quarter, by the end of March it remained noticeably below its long-term average.

With trailing price performance a poor guide to how analysts viewed the future, price momentum and earnings revisions delivered starkly different returns in the first quarter – the latter outperforming and the former strongly underperforming. These two views of investor sentiment should realign when market volatility begins to ease and as equities settle into a new trend. But until then, investors should tread carefully.

Important Information