A Year of Two Halves

Global equity markets bottomed out almost exactly a year ago. The sharp correction was caused by an economic slowdown, which was itself the result of government mandated lockdowns initiated to slow the spread of the Coronavirus. Since then, equity markets have recovered in a swift V-shaped manner. An abundance of monetary and fiscal stimulus, in addition to multiple vaccine rollouts have contributed to the robust economic recovery. If you split the past one year to the end of the first quarter, into two six-month periods, the equity market recovery was well-balanced between those two periods (Exhibit 1). However, as we observe in this paper, the factors driving the market strength could not be more different. There was a shift in market leadership creating almost a year of two distinct halves, whereby factors that worked in the first half lagged in the second half. We discuss some of these factors in this paper.

Exhibit 1. Balanced Market Performance: Six-Month Periods (in USD)

	Mar 31, 2020-Sept 30, 2020	Sept 30, 2020- Mar 31, 2021	Mar 31, 2020 - Mar31, 2021
Intl Dev Markets	21.5%	20.8%	46.7%
Emerging Markets	29.6%	22.6%	58.9%
ACWI ex USA	23.8%	21.3%	50.1%
USA	33.4%	20.4%	60.6%

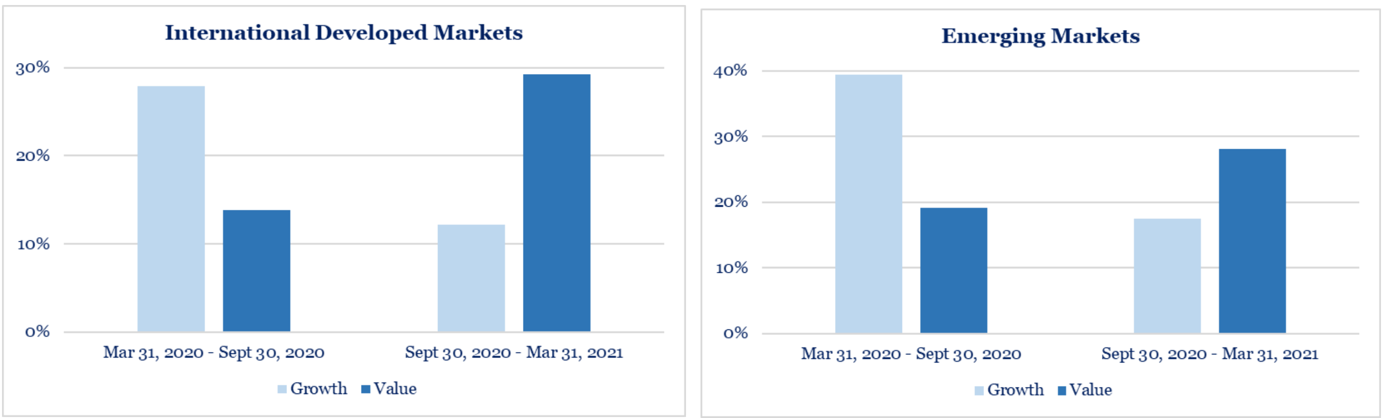
Source: Bloomberg, MSCI

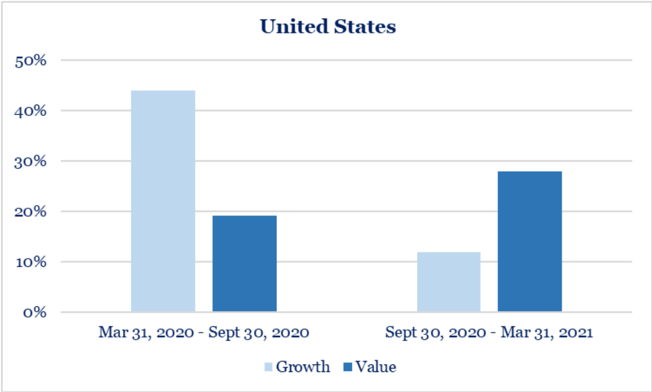
Value vs. Growth

In the October 2020 issue of Investment Insights, we analyzed the performance of growth versus value stocks in the global equity markets. We observed the significant outperformance of growth relative to value stocks as there was a synchronized slowdown in global growth in 2020. During the slowdown, technology companies that benefitted from people staying at home outperformed. Also, the slowdown in global growth led to a higher premium on growth companies.

However, several central banks around the world, including those in emerging markets such as India, Indonesia, Brazil, and Mexico, were quick to provide monetary stimulus to revive growth. The Federal Reserve Bank's balance sheet, which was at about $4trn in mid-March of 2020, expanded to more than $7trn by the end of June 2020. Similarly, the ECB's balance sheet has increased by 60% while the Bank of Japan has accommodated by almost 30%. In addition, the CARES Act in the US added trillions in fiscal stimulus. Similarly, there have been two fiscal packages in Japan totaling $2.2 trillion while the European Union has agreed on a €1.8 trillion fiscal stimulus package.

Exhibit 2. Growth versus Value





Source: Bloomberg, MSCI

These unprecedented levels of fiscal and monetary accommodation around the world have led to a swift global economic recovery. As Stanely Druckenmiller aptly described, “the recession was five times the average recession since World War II, but it did it in 25% of the time”. After multiple downgrades to global growth and a contraction of -3.3% in 2020, the IMF now expects the world economy to grow at 6% by the end of 2021. As global PMI bottomed in the second quarter of 2020, cyclical companies started to outperform leading to value dominance in global equity markets during the second half (Exhibit 2).

Quality

As presented in Exhibit 3, a value rally also led to an underperformance in quality stocks in the second half. MSCI defines quality by three measures: Return on Equity, Debt to Equity and Earnings Variability. Based on these measures, companies with higher ROE, lower debt to equity and less earnings variability lagged in the second half when cyclical companies, many of which have variable earnings and lower ROE outperformed (Exhibit 3).

Exhibit 3. Divergence in Quality Performance

	Mar 31, 2020-Sept 30, 2020	Sept 30, 2020- Mar 31, 2021	Mar 31, 2020 - Mar31, 2021
Intl Dev Markets	24.9%	13.3%	41.6%
Emerging Markets	30.2%	21.0%	57.9%
ACWI ex USA	29.7%	16.4%	50.7%
USA	31.5%	14.3%	58.5%

Source: Bloomberg, MSCI

Market Breadth

As the growth and value rally reversed, accompanied by quality underperformance in the second half, market breadth narrowed in the international developed markets. In the first half, approximately 54.6% of companies outperformed the broader markets, while only 47.5% outperformed in the second half. By contrast, in the more growth and technology heavy US and Emerging Markets, market breadth increased. In EM, the number of stocks that outperformed improved from 42% in the first half to 44% in the second half. The US (Russell 1000) saw an even bigger improvement from 40% to 62%.

Sector Performance

The shift in market leadership between growth and value can also be observed in the divergence in sector performance. While the Information Technology sector is identified as growth, the representation of cyclical sectors such as Financials, Energy, Materials, and Industrials are higher in value stocks - as discussed in the October 2020 Investment Insights. Hence, the IT, Consumer Discretionary and Communications Services sectors outperformed in the first half of the year ending Sept 30, 2020, while cyclical sectors outperformed in the second half, as presented in Exhibit 4.

More specifically, the cyclical outperformance in the second half was driven by the Energy and Financials sectors, especially in the US and international developed markets. By the same token, growth sectors such as Information Technology and Communications Services lagged in the second half. However, it is interesting to note that the Materials sector, which tends to be cyclical, did not perform in line with its value peers. We believe that the weak dollar in the first half may have been responsible for the Materials sector outperforming in the first half. As the dollar traded flat in the second half, there was less of a tailwind for commodities.

Exhibit 4. Sector Performance

		Mar 31, 2020 - Sept 30, 2020			Sept 30, 2020 - Mar 31, 2021		
		DM	**EM**	**US**	**DM**	**EM**	**US**
Growth	**Communications**	18.0	26.6	30.8	21.1	17.8	23.0
	Discretionary	30.1	55.1	52.8	29.9	4.2	12.4
	Info Tech	38.2	45.6	46.3	19.1	40.7	14.1
		28.8	**42.4**	**43.3**	**23.4**	**20.9**	**16.5**
	Staples	15.1	18.4	19.3	4.1	13.6	7.6
	Health Care	17.7	40.2	20.2	0.7	13.8	11.4
		16.4	**29.3**	**19.8**	**2.4**	**13.7**	**9.5**
	Real Estate	12.2	7.6	15.4	18.0	12.2	14.4
	Utilities	16.3	5.9	9.0	11.2	23.8	9.6
		14.2	**6.8**	**12.2**	**14.6**	**18.0**	**12.0**
	Industrials	30.7	20.4	30.1	22.1	24.8	28.8
	Materials	40.1	39.0	42.8	21.2	41.9	24.8
		35.4	**29.7**	**36.4**	**21.7**	**33.3**	**26.8**
Value	**Energy**	-7.5	22.8	4.8	45.1	18.3	67.2
	Financials	13.6	7.4	17.1	38.4	28.5	42.9
		3.0	**15.1**	**11.0**	**41.8**	**23.4**	**55.1**

Source: Bloomberg, MSCI

This begs the question: why did the Energy sector perform differently from Materials? After all, oil is also a commodity, much like iron ore, copper, etc.? We believe that restricted activity outside the home reduced oil demand in the first half. Hence, oil stocks underperformed in the first half, even as the US dollar declined. As oil demand improved in the second half, Brent crude rose from $44 to $65 thus lifting oil stocks. Looking forward, as the members of OPEC+ have agreed to a gradual increase in production by 350,000 barrels in May, 350,000 barrels in June and 441,000 in July along with Saudi Arabia easing their voluntary cut, we believe that oil prices are less likely to continue to rise, especially because, we believe that the market has already priced in a demand recovery.

What next?

Given that the last 12 months have been a year of two halves, the question then is what next? In our view, where we go from here in terms of market leadership depends on three things. First, we believe the current equity markets are dependent on the continuation of expansionary policies, and thus the extension of accommodative fiscal and monetary policies remains a necessity. The Federal Reserve has maintained target interest rates at near-zero and reiterated its commitment to continue its aggressive asset purchases. However, the Fed has acknowledged that the economic recovery is progressing faster than what had been expected a few months back due to the stimulus payments and a faster rollout of vaccinations.

The second factor is whether or not inflation remains in check. The Fed believes that the inflation rate will rise above 2% in the next few months due to a low base effect and supply chain disruptions. However, this is expected to be transitory. In the event that the rate of inflation persists above 2%, then the Fed plans to use the tools at its disposal to lower inflation. The third factor is the speed of the global vaccine rollout and whether there is a significant rise in the variants. Several countries are currently experiencing another wave of infections thus pushing the number of daily cases above previous peaks. About 40% of these cases are currently in India, where the situation remains dire. Hence, the race between the vaccine rollout and new variant-based infections remains crucial for the health of global economy.