Active Quantitative Equities

STATE STREET GLOBAL ADVISORS

Is the Trend Your Friend?

How we're thinking about equity markets as the investment cycle matures

Olivia Engel, CFA
Chief Investment Officer
Active Quantitative Equities

Correction or continuation?

While equities sailed smoothly through 2017, early 2018 has been marked by stormier seas. Equity markets in January benefited from the wind in their sails—the value of MSCI World equity markets climbed more than 5%,[1] following an annual return in 2017 of more than 20%. To put January's large positive return into context, a monthly return of more than 5% following a 20% (or greater) return in the prior 12 months has only happened in approximately 3% of all months since December 1971. But early February has brought choppier waters, driven by rising concerns of unexpected inflation. What insights can recent events provide for what will happen in the next 12 months? Are we more likely to see a correction or a continuation of 2017's trend? Historically, a single digit or a negative return occurred much more often than continued double digit returns in the 12 months following this kind of strong market.[2]

Regardless of recent choppy markets, we believe that the equity markets still have room to run in 2018, and we also see opportunities for active managers to deliver outperformance—even in the context of the second-longest U.S. equity bull market in history.[3] At the same time, however, the potential for macro uncertainties leads us to recommend that investors take a risk-aware approach to equity investing in the coming year to help protect against possible market dislocations, such as the market's reaction in recent days.

Continued earnings growth

Strong economic fundamentals set the conditions for 2017's equity-markets rally, alongside record-low volatility. Even though macro uncertainties remain in the background for 2018, we expect similar conditions to support equity markets into 2018.[4] Recent tax-relief legislation in the U.S. may provide a further boost, but we remain watchful for signs of unexpected inflation, which could lead to market reactions similar to recent events.

Corporate earnings have been a major driver of returns over the past year, with a relatively tight correlation between forward EPS growth and 12-month market returns. (See Figure.) As of December 31, 2017, earnings growth as measured by year-on-year forward EPS growth is the best and broadest we've seen in six years across regions and across sectors. Not only that, revenue growth is the strongest we've seen in many years—another reason we believe 2018 will be a supportive year for equities.

Uncovering opportunities

Under these conditions, where are we, as active managers, finding opportunities to outperform in this environment? In our view, the following sectors are particularly promising in 2018.

[1] As measured by MSCI World Index in USD terms, sourced from Bloomberg as of January 31, 2018
[2] 19 observations of 5%+ monthly return following 20%+ annual return in MSCI World index since December 1971. 11 out of 19 of these events were followed by a 12-month return less than 10%, and 6 of these 11 events were followed by an annual negative return.
[3] The S&P 500 has climbed since March 2009, making this the second-longest bull market on record (as of our press date). Matt Egan and Mike Tarson, "Obama-Trump bull market is now up 268%", *CNN MoneyInvest,* September 13, 2017.
[4] Christopher Probyn and Simona Mocuta, "Economic Outlook: Growth Broadens, Returning to Trend," State Street Global Advisors Global Market Outlook, December 6, 2017. (https://www.ssga.com/global/en/our-insights/publications/economic-outlook-growth-broadens-returning-to-trend.html)

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Healthcare. Even though this sector's top down valuation appears lofty, we see opportunities to outperform. For example, although healthcare stocks were bid up in 2017, a bottom-up view reveals dispersion (i.e., gaps between the best and worst stocks) and, therefore, opportunity. We favor the supplies and equipment segment of the healthcare market, where valuations not only tend to be reasonable, but earnings growth also tends to be stable—a result of the secular tailwind of an aging population.

Technology. The most well-known, high-growth technology and media stocks continue to be a force to be reckoned with in the US equity market. However, we think there are plenty of cheaper opportunities elsewhere in the technology and consumer sectors, which offer more realistic expectations for earnings growth over the longer term. We favor exposures in technology hardware and equipment over the glamorous names that are currently stealing headlines.

Financials. Stocks within this sector score well on many of the attributes we use to evaluate companies, and banks should experience earnings recovery when interest rates normalize. In terms of growth, we believe the market hasn't yet fully priced in the upside potential of a lighter-touch regulatory environment for U.S. financials.

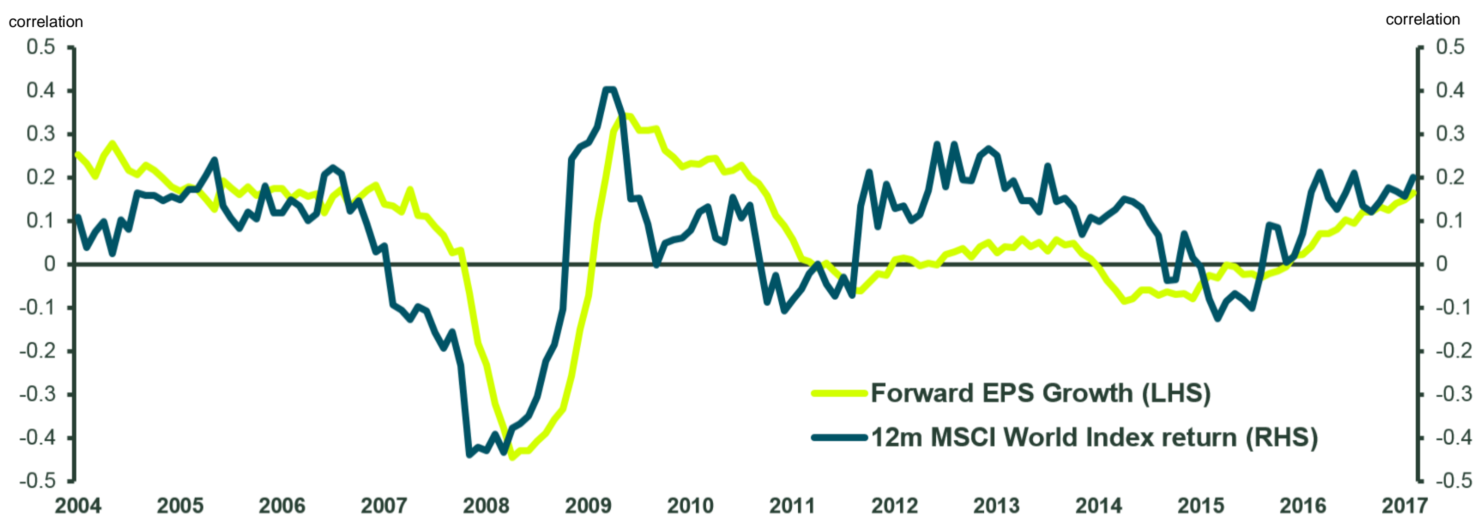
Cyclicals. We believe cyclical sectors may offer deeper value plays in 2018. Our preference in this segment is in the industrials, rather than the energy and materials sectors, once we consider the additional layer of expected risk of these companies.

Balancing opportunity and risk

Despite prospects for steady economic growth and earnings improvement, the potential for significant market dislocations still exists. It's unclear whether expectations for further economic stimulus and deregulation will be realized in the United States. Geopolitical instability (with its locus in Washington D.C.) adds to uncertainty and an overall atmosphere of unpredictability. And more than eight years into the current economic recovery in the U.S., managing economic-cycle risk is an increasing focus. As market valuations continue to climb, investors are understandably worried about the prospects for a significant correction.

In this context, finding ways to take advantage of the opportunities available in equity markets while managing against the risk of loss will be an increasingly high priority. We believe that an active investment approach that has the advantage of drawing on a very large universe of stocks is uniquely suited to accomplish this aim. In this late-cycle environment, we believe that a long-term approach which balances both return and risk will be particularly relevant, as investors seek to take advantage of the opportunities offered by the equity markets, while remaining focused on risk.

Figure. **Earnings have been the primary driver of returns in the past year**



Source: MSCI, Thomson Reuters/DataStream, State Street Global Advisors. As of December 31, 2017. Returns and earnings measured in local currency. Index returns reflect capital gains and losses, income and the reinvestment of dividends.

Marketing communication

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