Insights
Systematic Equity-Active

September 2023

Lessons from Summer Returns

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After the stock market euphoria of the first half of the year, the summer ushered in a slowdown and a pivot to a more cautious stance. We consider how returns and fundamentals unfolded across sectors, while looking for clues that will shape the outlook for the rest of the year.

As a summer of record heat has drawn to a close and as the Northern Hemisphere returns to work and school, we take stock of what we have learned from equity markets and how companies have fared over the summer months. After the impressive market returns over the first half of 2023, investors were looking for signs during the July and August reporting season to support consolidation, or a pivot, in market direction. The Systematic Equity-Active[1] team considers both hard numbers, such as the reported earnings, as well as signals from guidance on company conference calls to build a more nuanced picture.

Returns and Earnings Expectations

In the first half of 2023, through the end of June, global equity markets had staged an impressive recovery from the weakness witnessed over the course of 2022. The MSCI World Index, for example, returned 15%, with notable strength coming from the technology-led companies within the Consumer Discretionary, Information Technology (IT), and Communication Services sectors. Although market returns were very concentrated, most sectors delivered a positive return.

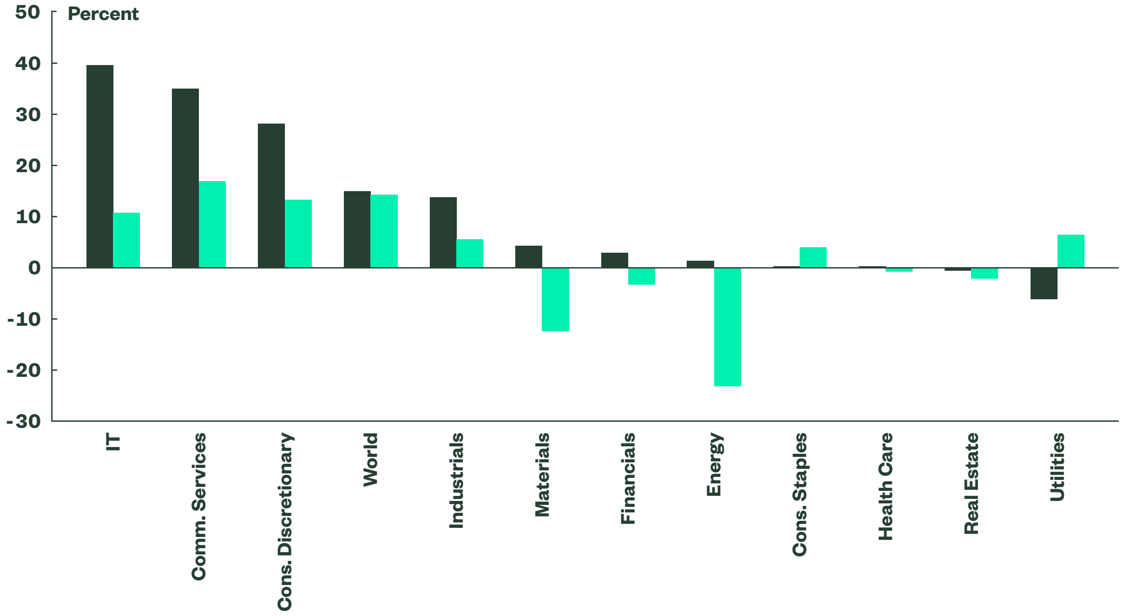
The summer vacation months started by continuing this theme, with the broad index rising in the month of July by almost another 3%. August, however, ushered in a wobble with the MSCI World Index falling by 2% and registering its worst monthly return of the year.

At face value, the strength in equity markets over the first half of the calendar year seems to contrast with the revolving narratives around slowing global growth, inflation, interest rates, and a potential for recession. Over the first half of the year, earnings forecasts for the next twelve months were nudged up by only 1% on average. Yet, the average hides significant dispersion across sectors, as IT, Communication Services, Consumer Discretionary, and Energy sectors received increases in earnings estimates of 15–29%. In contrast, Utilities and Consumer Staples saw expectations falling (Figure 1).

With modest increases in earnings forecasts, and double-digit equity returns, we conclude that a significant proportion of the returns realized for much of the market came from price-to-earnings (P/E) expansion rather than actual fundamentals. While earnings growth was robust in the highest performing sectors, returns were even stronger as multiple expansion amplified the returns.

Figure 1
Returns and P/E Expansion and Contraction by Sector — H1 2023

Returns
P/E

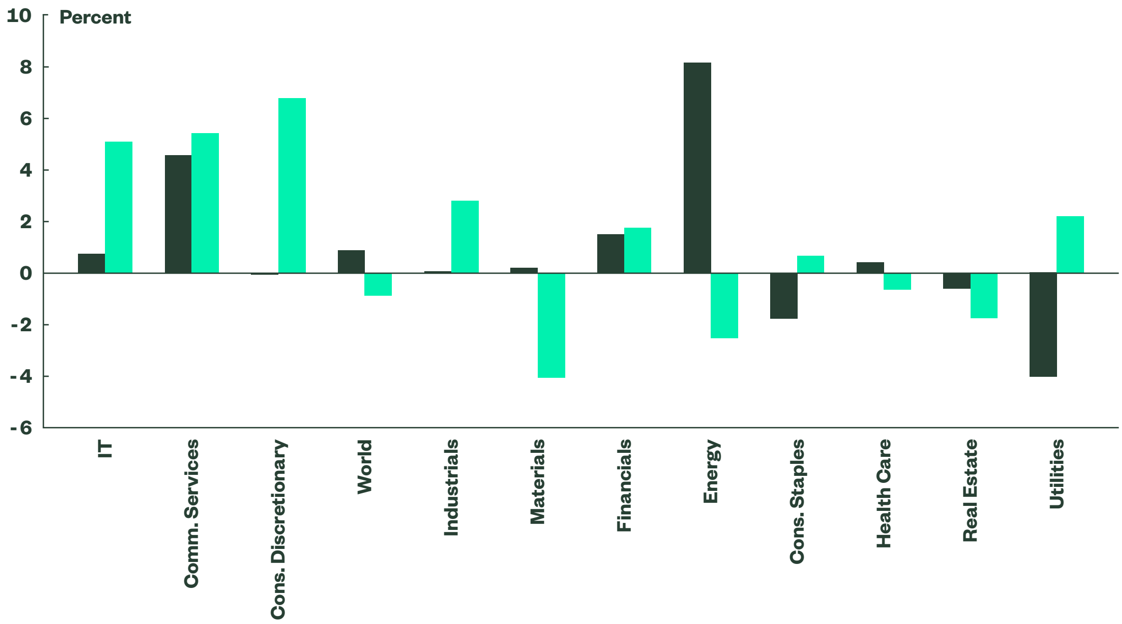


Source: MSCI, FactSet, State Street Global Advisors, as of June 30, 2023.

More recently, however, the story has evolved. Aggregate earnings were revised up by a further 1.8%, over July and August, but of the previous high-flyers only Energy names continued to gain while the market darlings of the first half of the year, namely IT, Communication Services, and Consumer Discretionary sectors, saw earnings forecasts fall (Figure 2). The picture was more mixed across the market; however, returns were once again supported by multiple expansions especially in the market darling sectors.

Figure 2
Returns and P/E Expansion and Contraction by Sector — July and August 2023

Returns
P/E



Source: MSCI, FactSet, State Street Global Advisors, as of August 31, 2023.

Valuations and Outlook

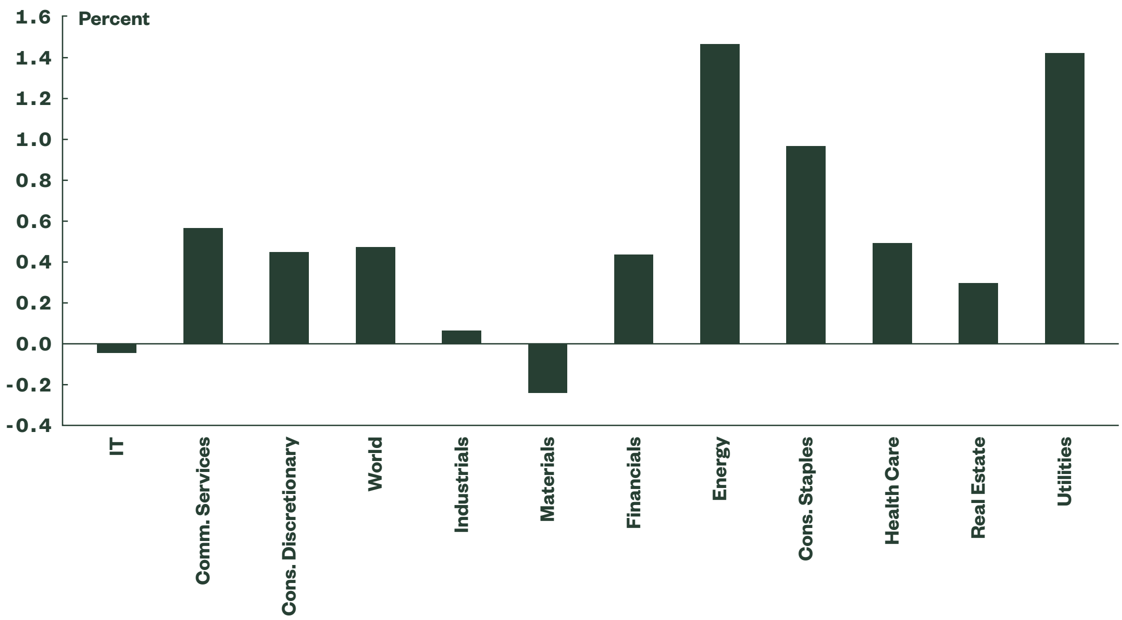
As a result of this multiple expansion, the aggregate 12-month forward P/E of the MSCI World Index has recovered from its lows of 13.7x in September 2022, to a level of 16.8x, which is higher than the long-term averages. The more popular segments of the markets sit at a premium to the average with IT sitting at 26x next year's earnings and Consumer Discretionary at 20x, for example. These full, although not extreme, valuation levels suggest that investors in aggregate are confident in the outlook for equities.

As part of our assessment of expected returns for stocks we routinely analyze communications between company management and investors. One example that we have discussed before in a prior commentary (Extracting Complex Investment Insights from Earnings Calls) is company conference calls, which provide a critical tool to collect information on management's confidence in the outlook. Aggregating these analyses provides us an informed view on the overall corporate outlook.

In the post-COVID period, the tone of company management was at its weakest in December 2022, following a chastening year of market returns and slowing growth. Over the course of 2023 to the end of July, management teams sounded more and more confident, before a slight dip in August. At the end of August, company management teams exuded more confidence in their long-term averages.

To make a more granular assessment, we can remove the long-term median tone to account for any potential positivity-bias within different sectors. Here the picture becomes more varied: Communication Services and Consumer Discretionary management teams are more confident than they typically are over the long-term, but they do not stand out relative to other sectors. IT managers are one of only two sectors that are slightly more bearish than they usually are. Energy, Healthcare, and Consumer Staples companies are among those that appear the most upbeat (Figure 3).

Figure 3
Relative Tone of Company Conference Calls by Sector



Source: State Street Global Advisors, as of August 31, 2023.

The Bottom Line

After a blockbuster start to the year for equity markets, the summer months have brought a more sober assessment of the outlook and a focus on fundamentals. Much of the outlook for stocks will be determined by the final path of the US economy as it flits between narratives of recession or a softer landing. With full valuations still within markets and mixed messages coming from company management teams, we think this is an environment where it pays to be cautious. We believe there is merit to not simply follow the crowd into the more expensive areas of the market, but rather to build diversified portfolios to help navigate the ever-evolving narrative and environment.

Endnote

1 As of May 2023, the former Active Quantitative Equity (AQE) team has been renamed the Systematic Equity-Active team. These monthly commentaries will continue but under the name of Systematic Equity-Active.

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* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of June 30, 2023 and includes approximately $63 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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ID1785800-5806250.2.1.GBL.RTL 0923
Exp. Date: 09/30/2024