Commentary
Active Quantitative Equity (AQE)

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How We're Forming Our Investment Response to Coronavirus

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- The first order effects of the coronavirus shock have been acute, but the longer term will bring more widespread economic impact — likely an economic downturn and subsequent recovery, each of unknown timing, magnitude and duration.
- Our approach first focused on assessing our portfolios' exposure to the direct impact of the outbreak; as its economic consequences unfold, we will rely on our investment process, which has been designed to respond to changing economic conditions and refined through many years of research over many market cycles.

The extreme market environment connected to the coronavirus outbreak raises two key questions for investors: "How are we positioned?" and "What should we do about it?" As the impact of the coronavirus spread beyond the segments most directly affected to engulf the global economy, our first step in Active Quantitative Equity was to gauge our portfolio exposure to vulnerable companies. To decide what to do about those exposures, we continue to rely on our investment process. In this commentary, we'll outline our approach for gauging our positioning, and explain how we apply our investment process, in light of the coronavirus and its emerging consequences.

Assessing Our Portfolio Exposure as the Coronavirus Impact Unfolds

Over the past weeks, coronavirus has impacted markets with changing sentiment:

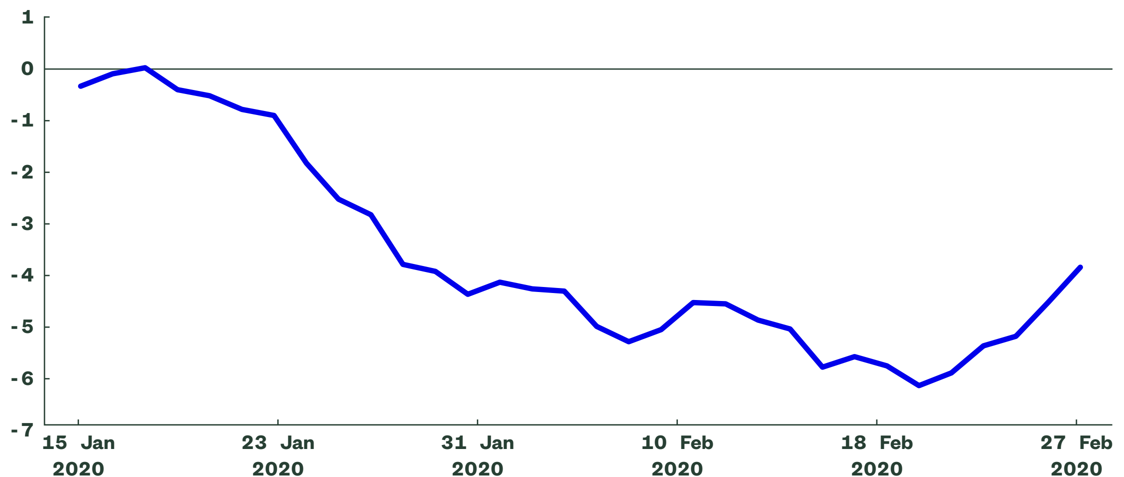
January 17–February 19	Curtailment of travel and shutdown of factories in China; hit to tourism stocks and companies linked to China's manufacturing supply chain.
February 19 and onward	Market sentiment flipping among concern over wider spread of the virus beyond China; concern over impact on global economy; and extreme market volatility.

During the first phase of sentiment (between January 17 and February 19), the AQE team moved quickly to establish a metric to measure our exposure to companies impacted most directly by the virus, using unique data sets to map the supply chain and analyze text statements by company management. Unsurprisingly, the most vulnerable developed-market segments were Automobiles, Household & Personal Products, Consumer Durables & Apparel, Tech Hardware and Semi-conductors. Using that metric, we evaluated our portfolios for concentrated or outsized exposures to those segments and determined they did not have outsized risk.

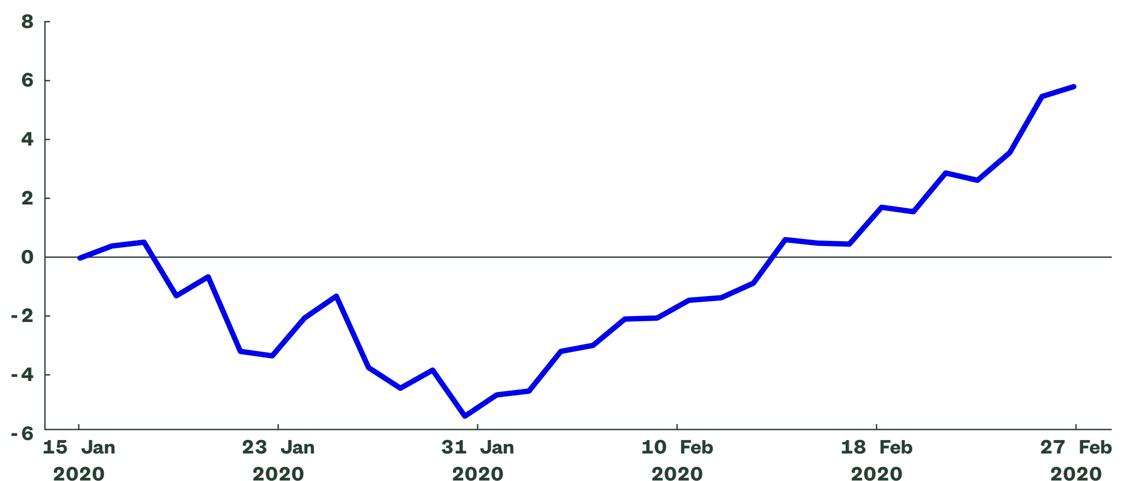
We also used the metric to calculate the performance of the companies most exposed to the direct impact of the coronavirus versus those least exposed, for developed and emerging markets (see Figure 1).

Figure 1
Our Proprietary Measures Suggest that EM Companies that are Especially Vulnerable to the Direct Impact of the Virus are Rebounding More Quickly than their DM Counterparts
Active Quantitative Equity's Proprietary Metric[1] Measuring Coronavirus-related Portfolio Risk Exposure

Cumulative Spread, Most Exposed vs. Least Exposed — Developed Markets



Cumulative Spread, Most Exposed vs. Least Exposed — Emerging Markets



Source: State Street Global Advisors analysis, Revere, EDGAR, FactSet Research Systems, as of 3 March 2020.

Interestingly, emerging markets quickly rebounded as new cases of the virus in China seemingly came under greater control, as evidenced by a slowdown in daily new cases. China had the strongest equity market in the world in February (up 3%).

Applying Our Investment Process

As more cases of the virus appeared outside of China, the exogenous shock swiftly moved from its initial stage — impacting equity markets on a first order, direct basis — to broader concern about the virus's impact on the economic cycle.

Our investment process is based on the knowledge that economies go through different cycles, and different company characteristics are rewarded at different times in the cycle. While the first order effects of the coronavirus shock have been acute, the longer term will bring more widespread economic impact. This will likely take the form of an economic downturn and subsequent recovery, each of unknown magnitude and duration.

In the face of that threat, we expect the core themes that form the foundation of our investment process will be impacted as follows:

Value Given that the cheapest parts of the market right now are cyclicals and financials, we don't expect that cheap stocks will be rewarded at the start of an economic downturn.

Quality This will likely be the most resilient pocket of the market. Strong companies do best in a market downturn and defensive characteristics are generally rewarded.

Sentiment Right now, companies with the strongest sentiment are technology and other secular growth segments as well as traditionally defensive companies. These should do well through a downturn, and we've also observed this as markets moved beyond the initial stages of the outbreak's impact. As sentiment shifts, our process will also adjust depending on changes in earnings forecasts for 2020, hedge fund positioning, how much company management are talking about the outbreak during earnings season, and other measures of investor sentiment.

With that backdrop in mind, our most preferred equity sectors — which in our view are generally relatively cheap, exhibiting good quality and improving sentiment — are US Food & Staples Retailing, and Japanese Telecom Services and Tech Hardware. Our least favored sectors are Japanese Household and Personal Products and Retailing, and European Retailing and Consumer Services. (See Figure 2) Of course, the degree to which a given sector exhibits these traits influences its desirability — so we do not favor Japanese Consumer Services on the grounds that they are extremely expensive, but we do favor Japanese Semi-conductors, as their valuation does not dominate other positive quality and sentiment characteristics.

Figure 2
Current Preferences of the Active Quantitative Equity Team's Stock Selection Model

Most Preferred
Least Preferred

Value		Good Quality & Improving Sentiment	Neutral	Poor Quality & Falling Sentiment
	Cheap	US Food & Staples Retailing	European Insurance	US Energy
		Japan Telecom Services	Asia Pacific ex-Japan Consumer Durables	US Autos
		Japan Tech Hardware	Asia Pacific ex-Japan Retailing	European Food & Staples Retailing
	Neutral	US Health Care Equipment		US Materials
		US Diversified Financials		Asia Pacific ex-Japan Consumer Services
		European Pharmaceuticals		
	Expensive	Japan Consumer Services	Asia Pacific ex-Japan Semi-conductors	Japan Household & Personal Product
		Japan Semi-conductors	Asia Pacific ex-Japan Pharmaceuticals	Japan Retailing
		European Semi-conductors		European Retailing
		Asia Pacific ex-Japan Health Care Equipment		European Consumer Services

Source: State Street Global Advisors, as of 3 March 2020.

The Bottom Line

We're investors, not epidemiologists. Our forecasts of the actual spread of the virus would not likely be as accurate as official reports issued by the WHO or the CDC. Even those organizations are less focused on forecasting the spread of the virus and more focused on what to do to contain and treat the illness. So, rather than speculating about the trajectory of the coronavirus pandemic, we believe we're better off relying on our investment process to respond as it was designed to, through many years of research over many different market and economic cycles.

Endnotes

1 Formed by aggregating scores on a) revenue exposure to China, b) supply chain input exposure to China-based suppliers, for disruption from factory closures in China, c) the initial week's news of the outbreak's impact on returns across the equity market, and d) how often the virus was mentioned in company conference calls.

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