Commentary
Active Quantitative Equity (AQE)

January 2020

Sectors and Investment Themes to Watch in 2020

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- Health Care and Technology are our most preferred sectors globally.
- Value and low volatility will be key investment themes in the year to come.

2019 was an eventful and fruitful year for equity investors, with the MSCI World Index delivering a massive 25% return. It was the strongest calendar year for equities in a decade, and strong returns were accompanied by relatively low volatility. This massive move upward was largely unsupported by earnings growth, which was only about 1% for MSCI World in 2019. As multiple expansion continues in these early days of 2020, I'd like to share some thoughts about key areas that we are watching for the new year.

Sectors to Watch in 2020

Health Care stocks rose 21% in 2019, as measured by the MSCI World Health Care index.[1] This represents underperformance compared to the broad markets; however, health care stocks' reliably strong earnings make them a sector to watch in 2020.

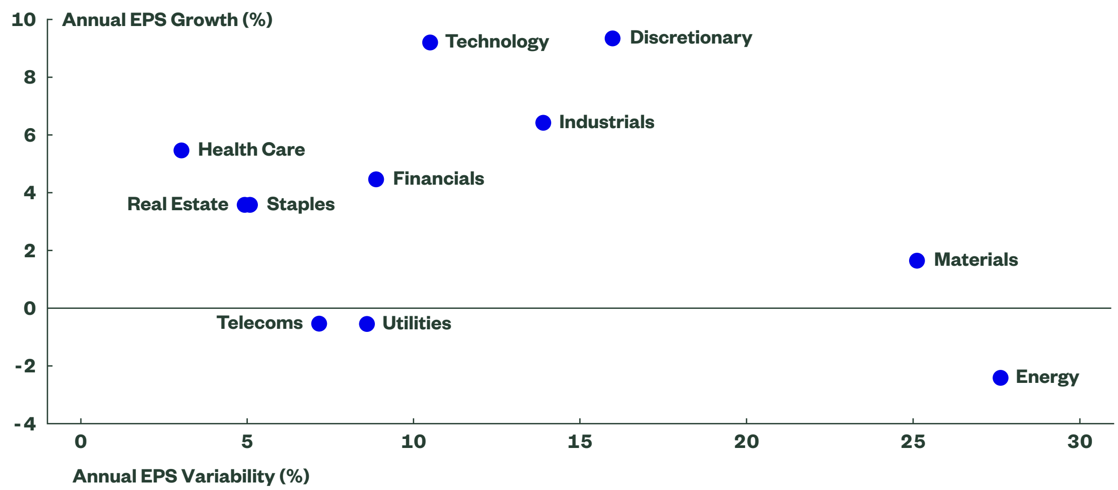
Last year Health Care firms continued a 10-year trend of reliably strong earnings. Health Care earnings per share (EPS) rose 8.4% in 2019; multiple expansion in health care was the lowest of any sector.[2] Over a long term, ten-year time horizon, health care firms show relatively strong annual EPS growth with relatively low variability compared to other sectors (see Figure 1). In addition, Health Care stocks are relatively cheap; the average price to forward earnings (P/E) ratio for Health Care stocks was only 7% above its long-term average in 2019.[3] Other segments exhibited a 15% to 30% P/E premium compared to long-term averages.[4]

With equity prices still largely connected to earnings, health care is our most favored global developed-market sector — subject of course to potential price volatility during a US election year. In the fourth quarter, the market seemed to relax about the US political concerns, resulting in a strong sector rally. Political concerns could easily arise again as the election cycle plays out.

We find attractive companies across North America and Europe in the Health Care Equipment & Supplies segment, as well as selectively in Health Care Providers & Services. Equipment & Supplies companies are not a value play, but their strong, stable, and improving growth characteristics make them appealing.

At a regional level, we generally prefer health care firms in developed markets to those in emerging markets. Although there are many health care companies in emerging markets, particularly in China, Korea and India, we generally find the volatility of EM health care stocks is too high. In addition, health care valuations are elevated compared with other segments in EM.

Figure 1
Health Care and Technology Firms have Experienced Relatively High EPS Growth with Relatively Low Variability Over the Past 10 Years
Long term EPS characteristics, 2009–2019



Source: Bloomberg Finance L.P as at 31 December 2019.

Technology is our second sector to watch in 2019, due to strong fundamentals. Technology stock prices as measured by the MSCI World Information Technology index were up a staggering 46% in 2019.[5] As Tech earnings continue to soften, multiple expansion for the sector is being carried to extreme levels. Technology firms are also very expensive; the P/E ratio for Tech is now 35% above long-term averages.[6] Despite these warning lights, fundamentals for the Tech sector are still quite strong, with earnings growth, sentiment and quality all signaling strength.

Despite rosy fundamentals, stretched valuations and high volatility constrain the broad attractiveness of this sector. However, we do find specific areas of the US Tech sector attractive. The IT Services segment, though a little overpriced, has some very strong growth and quality characteristics that bode well for future returns. And in the Technology Hardware and Equipment segment, which includes some well-known large caps, there are attractive pockets with strong quality and growth characteristics — although these remain expensive.

In Japan, there are Tech hardware names that are very attractive on valuation but have suffered greatly during the escalating trade war. Since August 2019, these names have had a positive turnaround in market sentiment, and we like some of them. In emerging markets, our forecasts peaked for semiconductors in the third quarter. EM semis have been cheap over a long time horizon, but sentiment regarding EM semiconductors seems to be reaching an inflection point and turning more positive. EM semis outperformed broader EM equities by around 20% over the fourth quarter,[7] making them another segment to watch in 2020.

Investment Themes to Watch in 2020

Value stocks underperformed in 2019, mainly due to continuation of the trade war and a flattening-to-negative treasury yield curve. In September, the yield curve started to steepen and trade war tensions began to ease, reversing the prolonged losing streak for value stocks. Despite the 2019 underperformance, value remains a core driver of our stock return forecasts. Its importance in long-term investment strategies is undiminished; a year of rampant multiple expansion doesn't change the long-term value of the value theme.

Right now, the cheapest stocks are autos, banks and telecoms in most developed market regions. In Japan, energy, materials, insurers and utilities are quite cheap. In the US, there aren't many cheap stocks except for airlines, autos and banks. In Europe, food retailers have become quite cheap.

But cheapness is only half of the value equation, and the most deeply attractive value stocks are not necessarily poised for a quick turnaround. Since the third quarter, market sentiment toward autos has improved, but not in the form of real earnings forecast improvement — only in terms of market prices. Banks are cheap, but the impact of yield curve changes is not yet enough to improve earnings and market sentiment. And while many Telecommunications names are cheap, the better opportunities for returns are in Japanese stocks, which have a strong earnings forecast trend.

In emerging markets, Energy, Telecoms, Tech Hardware and Semiconductors are the cheapest areas of the market on our measures. However, they also happen to be some of the most attractive value segments overall due to their high quality characteristics (in the case of semiconductors and telecoms) or improving sentiment (in the case of both tech hardware and semiconductors).

Low Volatility companies experienced very solid and steady total returns in 2019. Viewed in isolation, the results were outstanding: a total return of more than 20%, with daily volatility one-third lower than the stocks in the broader MSCI universe.[8] Low vol did underperform the broader market, but the sector achieved its returns with a much smoother return trajectory. This overall performance, relative to the market, strongly coincided with the Treasury yield curve (see Figure 2).

Figure 2
Low Volatility Stock Performance has Strongly Coincided with the Treasury Yield Curve
Cumulative excess returns of MSCI World Minimum Volatility index versus the MSCI World index; 2 yr/10 yr Treasury Yield Spread

Low Vol versus Market
Yield Curve (Inverted)

Source: Bloomberg Finance L.P. as at 31 December 2019.

We believe that, looking ahead, the stretched valuation of equities generally will add to the attractiveness of low vol stocks. The 2019 year-end rally extended the broad market valuation to an almost 20% P/E premium versus the average of the past 15 years;[9] any negative earnings surprise in the coming quarters could represent substantial vulnerability.

Over the past 12 months, low vol equities[10] have actually become relatively cheaper. Using the price-to-12-month forward earnings ratio, low volatility equities were around three multiple points higher than the broad equity market (16.5 versus 13.5) at the start of 2019. This spread contracted meaningfully over the fourth quarter. Now low vol equities are only 1.7 multiple points higher than the market (18.8 versus 17.1).[11] Interestingly, in emerging markets, the valuation spread between low vol equities and the broader market index has contracted to its lowest level since data was available in 2012. Twelve months ago, the spread was three multiple points, and now it's just 0.9.[12]

We think low vol equities can have a vital role to play in a portfolio that seeks to manage both return and standard deviation of returns. Traditionally, the lowest volatility segments are utilities, real estate, insurance, telecoms, staples retailing and food and beverage. In developed markets, we continue to find good low vol equities on a selective basis in these segments. But we also find equities with low vol characteristics outside of the traditional segments, in areas such as commercial services, consumer services and household and personal products, where better value and earnings growth add to overall attractiveness.

Figure 3
Our 2020 Outlook

Region	Most Preferred	Least Preferred
US	• Health Care Equipment and Services • Consumer Services • Food Retailing	• Energy • Software • Media and Entertainment
Europe	• Insurance • Pharmaceuticals	• Materials
Japan	• Telecom Services	• Food and Beverage
Asia-Pacific ex-Japan (Developed)	• Telecom Services • Health Care Equipment and Services	• Household and Personal Products
Emerging	• Technology (not Software) • Energy	• Healthcare Equipment and Services • Retailing

Endnotes

1 Bloomberg Finance L.P., State Street Global Advisors Analysis, as of 31 December 2019.

2 As measured by 12-month forward EPS estimates, sourced from Bloomberg Finance L.P. as at 31 December 2019.

3 As measured by Price to 12-month forward EPS estimates, sourced from Bloomberg Finance L.P. as at 31 December 2019 compared with average between January 2005 and December 2019.

4 Average measured between January 2005 and December 2019 for all MSCI World GICS Sector Indices except for Financials an Real Estate. Sourced from Bloomberg Finance L.P.

5 Bloomberg Finance L.P., State Street Global Advisors Analysis, as of 31 December 2019.

6 Average measured between January 2005 and December 2019, sourced from Bloomberg Finance L.P as at 31 December 2019.

7 As measured by the MSCI Emerging markets Semiconductors Index versus the MSCI Emerging Markets Index between 30 September 2019 and 31 December 2019. Sourced from Bloomberg Finance L.P.

8 Bloomberg Finance L.P. as at 31 December 2019.

9 Average measured between January 2005 and December 2019, sourced from Bloomberg Finance L.P as at 31 December 2019 MSCI World index, price-to-next-12-month earnings (P/NTM E), as of 31 December 2019, sourced from Bloomberg Finance L.P.

10 As measured by MSCI World Minimum Volatility Index.

11 Bloomberg Finance L.P., as of 31 December 2019 and 31 December 2018.

12 As measured by the MSCI Emerging Minimum Volatility Index and the MSCI Emerging Markets Index between 31 December 2018 and 31 December 2019.