Model Matters

As we entered 2023, market expectations were not rosy. Calls for dismal performance, and even recession, were abundant. But the market defied the odds by delivering better-than-expected earnings, albeit weak in the absolute sense. As of June 30, 2023, the S&P 500® Index delivered 16.89% year to date, but the impressive half-year return is somewhat skewed if we look under the hood. Pick your perspective for the index's return drivers on a percent basis. As shown in the following chart, the top quintile of companies by market cap contributed 89%; the Technology sector contributed 62%; companies designated as large-cap growth contributed 69%. This is a far cry from a balanced market rally, but it is reasonable to believe that the markets will normalize some of these extremes. At this point, the Investment Solutions Group (ISG) thinks that the markets are demonstrating sequential weakness, but opportunities still abound.

First quarter year-over-year (YoY) earnings were -1.81% and second quarter earnings are looking weaker at -9.37% YoY with 89 companies reporting. However, market sentiment, as measured by ISG's proprietary Market Regime Indicator (MRI), has shown strong risk asset buying — a trend that investors ignore at their peril. The team's equity models are still showing a strong preference for equities, although in a slightly weakened state, as higher interest rates take their toll.

The moderate State Street Active Asset Allocation ETF Portfolio currently expresses a 7.5% overweight to equities with most of the concentration in the US, but the US overweight has seen recent reductions. Within fixed income, the models are not constructive in the short term. The team expects higher rates, a steeper curve, and wider spreads. To circumvent this, the portfolio is conservatively positioned via the fixed income complex with respect to duration and credit. In the coming months, the allocation will be different, but whether the shift will be based on a soft or a hard landing is another question.
The secret sauce to any investment strategy depends on the investment time frame chosen to pursue alpha, which can be difficult to detect. Investors often use turnover as a proxy for the time frame for investments. But other indicators exist such as the underlying factors, or the manner which the factors are combined. The operative term used in investments and academia is “factor decay,” which is a fancy word for how long a strong factor signal works. Market participants do have an intuitive sense of the factor decay and research confirms this intuition. For example, factors involving macro and value have longer shelf lives than factors involving momentum. State Street’s Active Asset Allocation ETF Portfolios use a combination of short- and long-term factors, such as macro, momentum, sentiment, quality, value, and risk sentiment. The combination of these factors affects the shelf life of an aggregate asset class attractiveness score.

Macros Factors with Longer Shelf Lives

Higher inflation and higher interest rates typically lead to economic slow downs.
The Value of the Views

As their name implies, the State Street Active Asset Allocation ETF Portfolios are truly active models. Unlike managers who purport to be active but only trade once or twice a year, these portfolios average 12–20 trade events per year. This allows the team to take advantage of a shorter view, often one to three months out. If any of the following occurs, ISG is poised to position the models accordingly to help improve portfolio outcomes:

- an unexpected monetary policy event
- a major change in investor risk aversion
- changes in model alphas
- policy changes or political events
- a decoupling of valuation relationships between assets

These shorter-term views can deviate from longer-term views and, at times, may seem counterintuitive. The reality is that pockets of opportunity still exist in the short term, even when longer-term market direction seems clear. For example, State Street’s Midyear Global Market Outlook (GMO) is less constructive on equities and more constructive on fixed income. This is the opposite of ISG’s current view, but is easily reconciled by considering time frames, and more specifically, the anticipated shelf life of the underlying factors employed. ISG’s process uses faster moving indicators — like the MRI, momentum, sentiment, and curve factors — that produce different forecasting outcomes than the GMO which can be more focused on longer-term signals such as the macro environment and valuation variables. The views are not in opposition to each other. Both can be correct, and both can show convergence at a later time.

Understanding the direction of the overall economy and the expected major pockets of value as well as the shorter-term temperature of the markets and investors’ appetite for risk assets is paramount to navigating difficult markets. There is no right or perfect approach, as long as alpha production and client satisfaction are at the center.
Endnotes

1. FactSet, as of June 30, 2023.

2. FactSet, as of June 30, 2023.