Insights
Active Quantitative Equity

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Investment Themes and Sectors to Watch in 2022

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2021 was an extraordinary year for all three of Active Quantitative Equity's foundational investment themes. Here are our key expectations for 2022.

In January 2021, we wrote a letter to our investors stating our belief that our investment process was well positioned for the year ahead. We were confident that long-term economic relationships and human behavior would revert to well-established norms as vaccines were distributed. We also predicted that markets would revert to long-term, proven drivers of return — in particular, the themes that form the basis of our investment approach in AQE: Value, Quality, and Sentiment.

We're glad to report that even while equity markets continued to be volatile, this prediction became reality in 2021. Viewed in terms of our foundational themes:

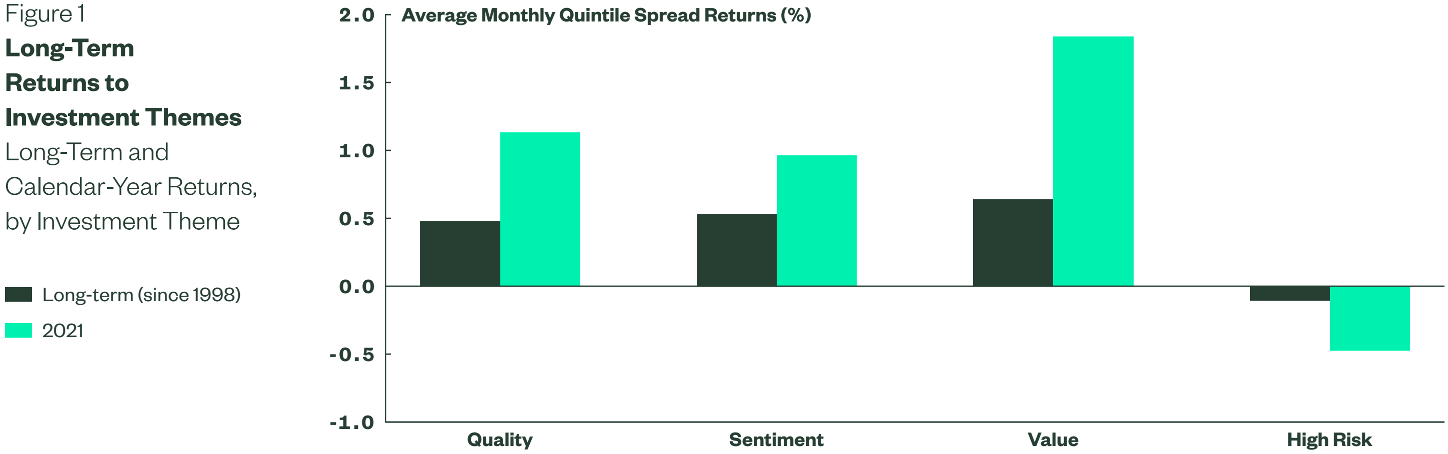
- Value and Sentiment both delivered returns in 2021. By contrast, 2020 saw a sharp drawdown of Value.
- The correlation of Value and Sentiment was more muted in 2021, as the two themes worked together to contribute to performance. In 2020, Value and Sentiment were extremely negatively correlated.
- Many dimensions of Quality were rewarded in 2021, including sustainability. Other, newer signals produced by our recent research, including financial-reporting quality and industry-specific signals, also performed well.
- Sentiment signals were very well rewarded in 2021. Some of our strongest results came from recently developed signals that use machine learning techniques to interpret the tone of company earnings conference-call transcripts.

In this month's commentary, we'll discuss key return drivers in 2021 from a factor perspective. We'll also look forward to 2022, to consider expected factor performance and the potential of our chosen investment themes over the next year, including our most- and least-favored sectors.

Factor Returns in 2021 and Looking Forward to 2022

Factor performance in 2021 was much stronger than long-term expectations — a marked contrast to 2020, which was one of the most challenging years ever recorded for factor performance (see Figure 1).

Figure 1
Long-Term Returns to Investment Themes
Long-Term and Calendar-Year Returns, by Investment Theme



Source: State Street Global Advisors analysis, as of December 31, 2021. This chart is based on Active Quantitative Equity's proprietary measures of Quality (including measures of balance-sheet stability such as cash flow), Sentiment (including measures such as momentum and hedge-fund positioning), and Value (including valuation measures such as price-to-book ratio); High Risk is defined as a combination of high realized volatility and high beta.

This was especially notable because we would generally expect some factor themes to perform well, and others less well, in a single year. 2021 was unusually positive because all themes did well and contributed to performance.

In 2022, market moves likely will continue to be heavily influenced by an uncertain macroeconomic backdrop. Monetary policy moves will be particularly influential. If current consensus expectations for growth, inflation, and monetary policy response hold, these conditions should continue to provide a tailwind for the combined characteristics of Value, Quality, and Sentiment in our stock selection model.

Our Value theme experienced a strong comeback in the first half of 2021 in the reopening scenario, losing some steam when the Delta-variant spike appeared halfway through the year. Value went on to renew its forward surge in December, even as the Omicron variant picked up steam.

Quality performed well in 2021, fueled in part by our comprehensive sustainability signal (which is included within our Quality theme). Last year this sustainability signal experienced its strongest factor return in both emerging and developed markets since its introduction to our stock selection model in 2018. Even though Quality performed well on its own last year, it's worth noting that we tend to think about Quality and Value together when identifying truly undervalued companies; the two themes generally need to work together.

We believe that high-quality Value again rallied into the end of 2021 because investors trusted that central banks would strike the right balance between supporting economic growth and controlling inflation, and they believed that the global economy would recover and life would return to normal.

We believe this pattern will continue into 2022. The most risk-seeking investors will likely prefer deep-Value stocks; others will likely pay strong attention to Quality and risk when choosing stocks. But there are risks to this scenario. If interest rates hikes are unable to keep inflation under control, or interest rates rise too much and economic growth suffers, then deep Value will not be rewarded, and high-quality, defensive, low-volatility stocks will be the most resilient.

Sentiment has been a strong theme over the past decade, and it performed well through most of 2021. Mainstream economic conditions continue to support our Sentiment theme, but we control our exposure to this potentially volatile theme. This helps to avoid the damage that can be caused by extreme market reversal, such as the one that took shape in November 2020.

In developed markets, high-risk stocks were strongly rewarded during the first part of 2021; high-beta stocks strongly outperformed. The latter part of the year saw a dramatic pullback in high-beta, high-risk stocks, particularly in emerging markets, where investors started to get nervous about inflation and interest-rate increases. We don't expect a strong risk-taking stance by investors in 2022 in the mainstream economic scenario, but, due to the potential for monetary policy mistakes, we do think it's a good idea to avoid high-risk areas of the market.

Current Sector Preferences

Some of the extreme behaviors that characterized 2020 certainly normalized in 2021, but we believe there are still excesses in markets that could unwind sharply in the coming year. In particular, the high concentration of benchmark indexes, the extraordinary flows that have piled into them in a single year, and the aggregate valuation multiples of some very large parts of the market — with the tech sector comprising 25% of MSCI World index — could be the source of some disruptive reversals in the coming year.

With that backdrop in mind, Figure 2 lists our current most and least preferred sectors as we head into 2022.

Figure 2
Active Quantitative Equity's Current Sector Preferences
As of 31 December 2021

		Most Preferred	Least Preferred
Developed Markets	US	Food and Staples Retailing Tech Hardware and Equipment Health Care Equipment & Services	Software and Services Media and Entertainment Consumer Services
	Europe	Energy Banks Pharmaceuticals	Transport Retailing Consumer Services
	Japan	Insurance Pharmaceuticals Autos	Transport Retailing Media and Entertainment
	APAC ex Japan	Resources Health Care Telecomm Services	Diversified Financials Industrials Consumer Discretionary
Emerging Markets	China	Energy Utilities Banks	Consumer Services Retailing Software
	Ex-China	Energy Semiconductors Tech Hardware and Equipment	Retailing Consumer Services Real Estate

Source: State Street Global Advisors analysis.

The Bottom Line

2021 was an extraordinarily positive year for Active Quantitative Equity — one in which every foundational theme in our investment approach worked well and contributed to performance. We had strong reasons to believe that this would prove to be the case, and we believe that conditions remain in place for continued strong performance. That said, we recognize that the macroeconomic and policy conditions that have provided the backdrop for this strong performance may change. In that case, we believe that our multi-dimensional approach to investing, designed to perform in a wide array of conditions, will serve us well. We're looking forward to working through the unique set of investment challenges that 2022 will offer.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion 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.

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