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Making Sense of the Extreme Relationship Between Value and Sentiment

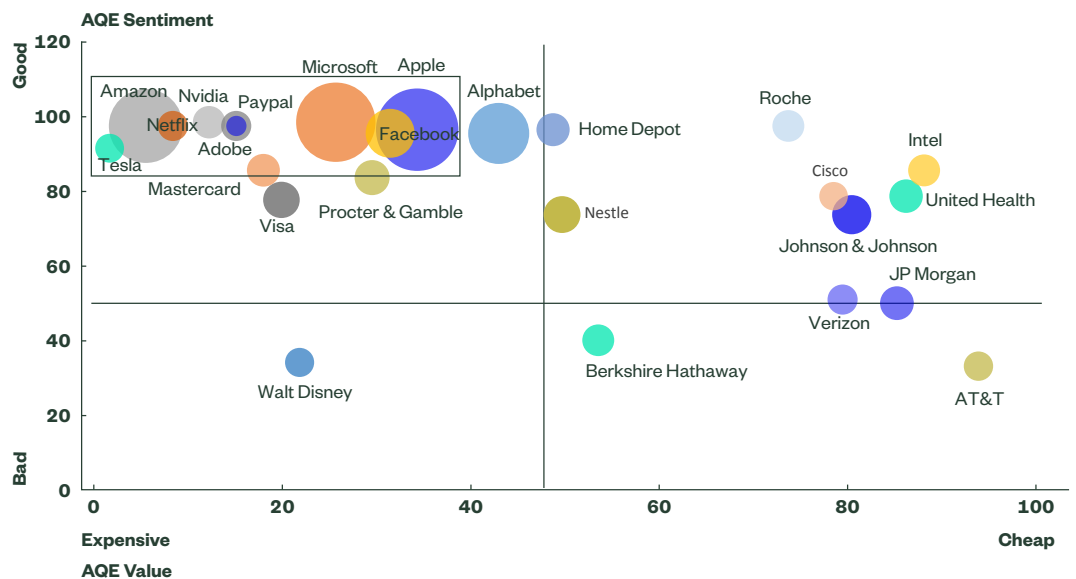
- Correlation between value and sentiment has reached its lowest point since the dot-com bubble.
- When extremes like this occur, it's important for investors to be wary.

There's a lot of disagreement in the market right now about what is cheap, and what has positive market sentiment. These themes represent important complementary characteristics that we look for when building equity portfolios. When there's a lot of disagreement between these themes, the pool of companies that are attractive in aggregate becomes smaller.

This disagreement can be expressed as cross-sectional correlation (i.e., the degree of alignment) between the two themes. On average, this relationship has a correlation of around -0.1, and since 1998 we have observed a range of -0.2 to 0 in most periods.¹ Right now, the correlation is -0.4. The only time in the past that we've observed such low correlation between value and sentiment was during the dot-com bubble.

To help visualize market concentration on the dimensions of value and sentiment, we plotted our proprietary value and sentiment assessments of the 25 largest companies in MSCI World Index (see Figure 1). Companies have migrated into the top left quadrant of this chart, where we find expensive companies with good sentiment.

Figure 1
AQE Value versus AQE Sentiment for the 25 Largest MSCI World Stocks

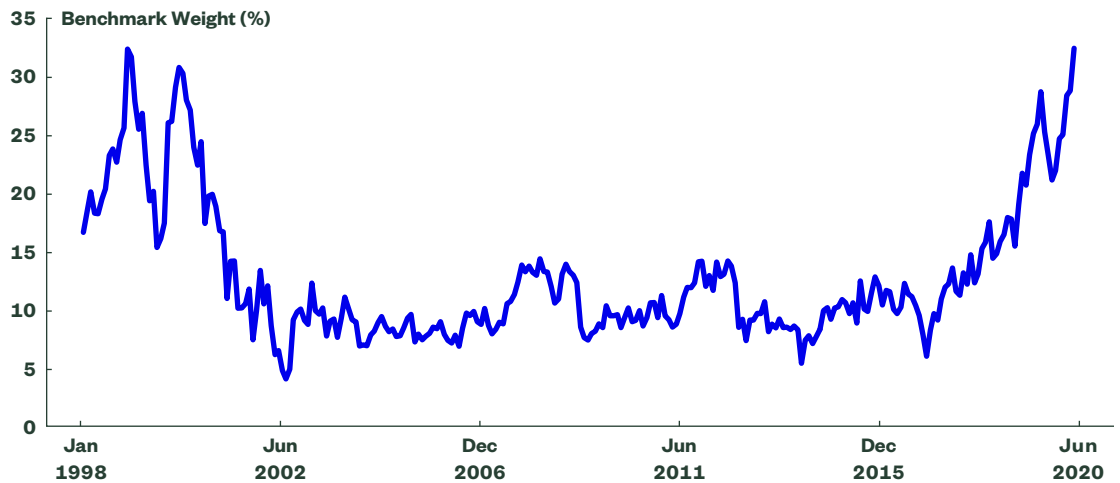


Source: State Street Global Advisors, MSCI, as of 31 July 2020. Based on AQE's proprietary measures of value and sentiment. Circle size = relative market cap.

At the same time, companies in this quadrant have grown in market capitalization. The combined market cap of the companies in the boxed area on the top left has grown by 60% in 12 months.² This time last year, the market cap for some of these companies was just a small fraction of what it is today. The corresponding earnings of the same group of stocks has only grown by about 7% over the same period.³

If we take the benchmark index weight of this group of companies in the top left box, and plot that through time, we see a startling pattern. The proportion of the benchmark index that is in the group of companies that are very expensive *and* have very strong sentiment is as large as it has been since the dot-com bubble (see Figure 2).

Figure 2
**Weight of Expensive,
High-Sentiment
Stocks in the
MSCI World Index**



Source: State Street Global Advisors, MSCI, as of 31 July 2020. Based on AQE's proprietary measures of value and sentiment.

The Bottom Line

We're observing extremes in the equities market right now that haven't been seen since the Global Financial Crisis and the dot-com bubble. When these extremes occur, it's important for investors to be wary of the potential that these extremes could revert to more normal levels. For us, that means allocating our portfolios away from these concentrated names toward companies with more balanced characteristics that make them attractive.

Endnotes

- 1 Two variables are negatively correlated if one decreases when the other increases; they are positively correlated when they tend to move up and down together. A perfect negative correlation is represented by the value of -1, while a perfect positive correlation is represented by a value of 1.
- 2 The companies in the box are Apple, Microsoft, Amazon, Facebook, Procter & Gamble, Mastercard, Nvidia, Netflix, Adobe, Tesla and PayPal. 12 months ago, their combined market cap was \$4.2T and as of 31 July 2020, it is \$6.8T.
- 3 As measured by change in 12 month forward estimates of Net Income between 31 July 2019 and 31 July 2020, sourced from Refinitiv.

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Marketing communication

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