Insights

Active Quantitative Equity (AQE)

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Understanding the Recent "Junk" Rally in Equities

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- The recent market rebound has been strongly skewed to companies whose earnings have been hardest hit by the COVID-19 crisis.
- Our investment process charges us to avoid focusing on near-term rebounds, even if they may have some short-term momentum, in favor of a longer-term view.

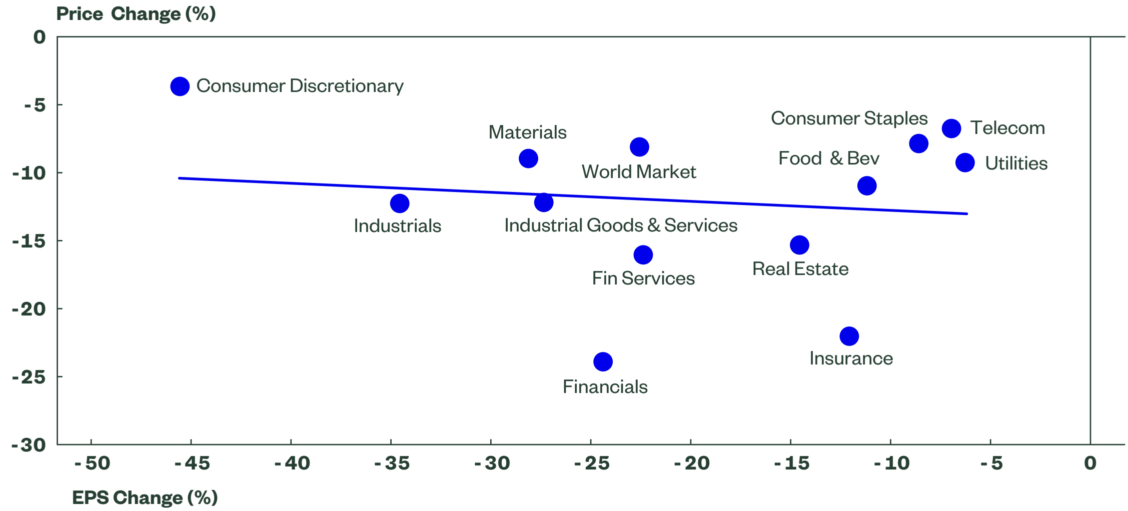
In the months since the March 2020, COVID-19-related drawdown, price action in many segments of the equities market has become almost completely disconnected from the earnings shock that companies are expected to experience in 2020 and 2021. Between April 28 and June 10, a massive rally took shape among a very narrow subset of stocks that were suffering from substantial earnings challenges — the so-called "junk" rally.[1] In this commentary, we'll explore this recent rally to uncover where some of the deepest disconnects between prices and earnings are appearing, and where we see better opportunities.

Alignment in the Extremes; Disconnects in the Middle

At the extremes of earnings performance, prices and earnings have been reasonably well aligned. The Travel and Energy sectors, which have been the hardest hit from an earnings standpoint, have also experienced the most negative price movements. Meanwhile, the Technology and Health Care sectors, where earnings have been most resilient, have also had the strongest prices.[2]

Between these extremes, however, there are some disconnects. If we compare some other sectors using year-to-date results through the end of June, the Materials and Energy sectors have each shown total returns of around -10%. Earnings forecasts for the Materials sector dropped by more than 25% over the period, while earnings forecasts for Utilities fell by only 6%. Meanwhile, year-to-date total returns for Consumer Staples have fallen by around 8%, in line with an 8% drop in earnings. But Consumer Discretionary stocks are down only 5% year-to-date — even though their earnings are expected to be down 45%.[3]

Figure 1
Prices and Earnings are Reasonably Well Aligned at the Extremes of Earnings Performance — but There Are Disconnects in the Middle
Price and Earnings per Share (EPS) Change, Year to Date



Source: Refinitiv Datastream, as of 30 June 2020.

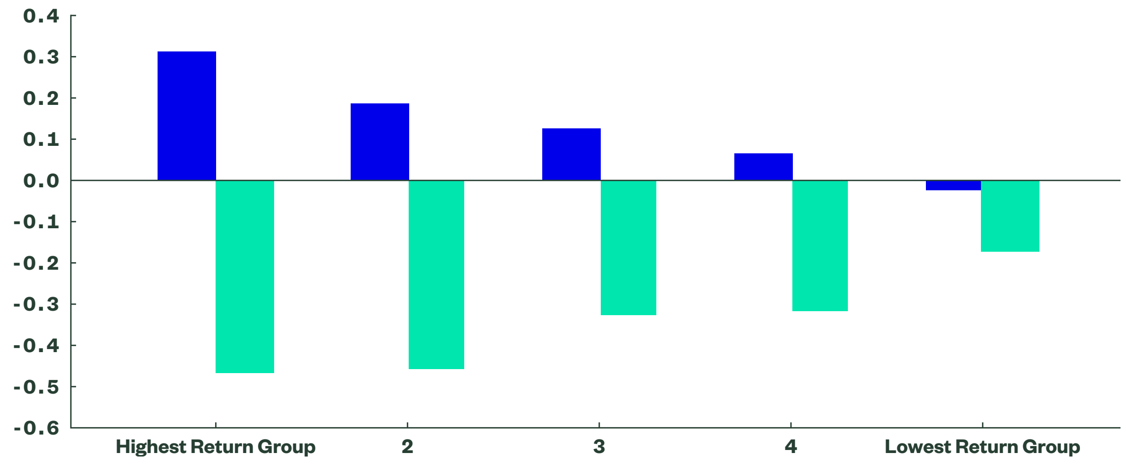
When viewed alongside both earnings and valuation perspectives, stock prices in the Materials and Consumer Discretionary sectors seem much more at risk compared with Utilities and Consumer Staples, year-to-date:

	Price Move (%)	**EPS change (%)**	**Price to Equity Ratio versus 5-Year Average**
Materials	-10	-25	4% more expensive
Consumer Discretionary	-5	-45	28% more expensive
Utilities	-10	-6	2% cheaper
Consumer Staples	-8	-8	16% more expensive

Source: Refinitiv Datastream, as of 30 June 2020.

If we look at the investment universe on a stock-by-stock basis by grouping companies according to their price moves over the past two months, and comparing that to the corresponding year-to-date earnings decline in 2020, it becomes clear that the recent market rebound is strongly skewed to companies whose earnings have been *hardest* hit by the COVID-19 crisis.

Figure 2
Prices Have Moved Opposite to Earnings Recently
Change in Stock Prices versus Change in Forecast Earnings

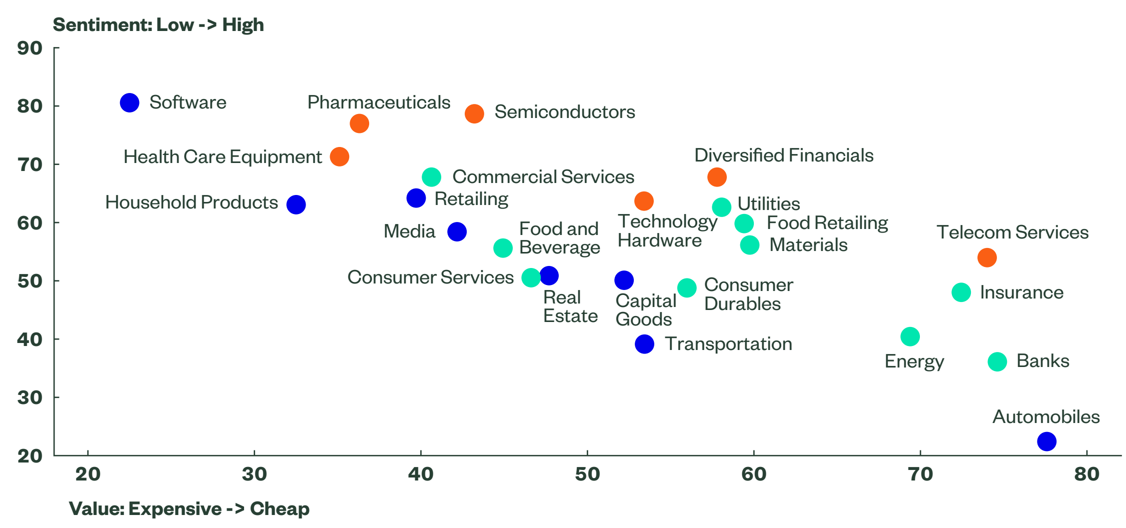


Source: Factset Research Systems as at 30 June 2020. Price change over two months, earnings forecast change over 12 months.

So investors today are faced with a challenge: Are the stock prices wrong? Or are the fundamentals wrong? How do investors walk the tightrope between current sentiment trends (which may be enduring), and finding stocks that are not trading on nose-bleed price multiples?

Our most preferred segments of the market, based on our multi-dimensional view, are Technology Hardware and Semiconductors, Health Care (Pharmaceuticals and Services/ Equipment), Insurance, Diversified Financials, and Telecom Services. Our least preferred segments are Software, Retailing, Household Products, Media, Real Estate, Capital Goods, Transportation and Autos. In Figure 3, we've laid out the dimensions of value and sentiment and color-coded various segments based on our overall preference.

Figure 3
Value and Sentiment Relationship
Ranks out of 100



Source: State Street Global Advisors as at 30 June 2020 based on proprietary measures. Orange dots indicate our most-favored segments. We are more neutral on segments indicated by green dots. Blue dots indicate our least favored segments.

The Bottom Line

Our investment process charges us to avoid focusing on near-term rebounds, even if they may have some short-term momentum, in favor of a longer-term view. Underlying company fundamentals are a critical anchor when selecting stocks. For that reason, our most-preferred names are in segments where earnings have been more stable, and we tend to favor companies that have suffered a much smaller earnings decline than average.[4]

Endnotes

1 As measured by earnings depreciation.

2 As measured by positive total returns, year to date.

3 Refinitiv Datastream, as of 30 June 2020.

4 The average security in the MSCI World universe has experienced a drop in earnings forecasts of around 35% in the last 12 months (as of 30 June 2020), whereas the securities we prefer in the strategies we manage with a risk-adjusted return mandate have experienced an average earnings decline of only 12.5%.

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Marketing Communication

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