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Quality Matters, Especially Now

- Equity Markets are overdue a correction
- Sectors and themes in a down market
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Equity Markets are Overdue a Correction

At the time of writing both local and global markets were down for the month of September. Might this be the start of a correction? Statistically speaking we expect monthly returns of less than 5% about 10% of the time, or about 1 in every 10 months. As at the end of August we haven't had one for 17 months so it could be argued it is a bit overdue. In this monthly note we take a closer look at both the increasing uncertainty in markets as well as sector performance and themes during market corrections and why we think quality matters more than ever.

Figure 1: Earnings Uncertainty Builds in Outer Years

Sectors	12 Month Return to 31 July 2021	12 Month Earnings Revisions to 31 July 2021	Earnings Changes Since Reporting Season 12 Months Forward	Earnings Changes Since Reporting Season 24 Months Forward
S&P/ASX 300 Index	25.9%	37.3%	-1.5%	-1.4%
Utilities	-22.7%	-14.7%	-9.4%	-5.6%
Telecoms	28.3%	-0.2%	-0.6%	5.5%
Staples	8.3%	2.3%	1.1%	2.0%
Health Care	5.3%	9.7%	-1.3%	-1.7%
Materials	39.8%	84.8%	-2.2%	-3.4%
Industrials	12.8%	10.5%	-6.1%	-0.6%
Energy	6.7%	82.4%	-3.7%	-3.2%
Financials	33.6%	29.3%	1.5%	1.0%
Technology	31.2%	4.7%	-7.8%	-2.5%
Discretionary	45.6%	28.7%	-3.4%	-0.2%

Source: State Street Global Advisors, Factset as of 10 September 2021. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Figure 1 Highlights the stellar returns experienced within the Australian equity market in the 12 months prior to August 2021. It also highlights the massive improvements we have seen of corporate earnings for the 12 months to August 2021. Perhaps most concerning is the declining outlook for earnings over the next 12 and 24 months. Post reporting season we are now seeing downgrades across the S&P/ASX 300 Index as a whole and for most sectors. Telecommunications, Staples and Financials (mostly insurance) are the only sectors that are bucking this negative trend. Adding to uncertainty are a range of delta disruptions impacting global demand and supply. We are observing supply bottlenecks, and rising input costs reducing corporate profits as well high rates of inflation increasing the likelihood of eventual tapering and a tighter set of monetary conditions. Increased regulation across a range of industries in China and in the United States also adds to the uncertainty.

Best and Worst Sectors and Themes During Negative Monthly Returns

Should we see an equity market correction emerge this month or in coming months, it is worth assessing your portfolio sensitivity to various sectors and themes. Figure 2 examines the performance of a range of MSCI World sectors and themes during MSCI World down months of different percentages (negative months down more than 5% and negative months down more than 10%). The Consumer Staples and Healthcare sectors are the most defensive sectors followed closely by the themes of lower volatility and quality. As you would expect more cyclical themes tend to underperform the most in down markets.

Figure 2: Excess Returns to Various MSCI World Sectors and Themes in a Range of Negative Months

	State 1: When MSCI World monthly returns are negative	**State 2: When MSCI World monthly returns are less than-5%**	**State 3 : When MSCI World monthly Returns are less than -10%**
Staples	2.1%	4.2%	6.2%
Health Care	1.7%	3.7%	5.2%
Low Volatility	1.6%	3.3%	3.1%
Quality	**0.7%**	**1.3%**	**2.8%**
Momentum	0.6%	1.2%	1.9%
Telecom	0.0%	1.6%	1.6%
Utilities	1.6%	3.5%	1.3%
Discretionary	0.0%	-0.3%	1.3%
Growth	0.0%	-0.1%	0.9%
Technology	-1.2%	-2.4%	0.0%
Value	-0.1%	0.1%	-0.9%
Smaller	0.0%	-0.3%	-1.8%
Energy	-0.2%	0.2%	-3.0%
Industrials	0.0%	-0.7%	-3.3%
Materials	-0.3%	-0.8%	-3.4%
Financials	-0.8%	-2.0%	-4.3%

Source: State Street Global Advisors, Factset as of 31 August 2021. In figure 2 we calculate the excess returns vs the MSCI World of each sector or theme under 3 different types of down months. State 1 occurs when the MSCI World has a negative monthly return. State 2 occurs when the MSCI World has a negative monthly return of less than 5%. State 3 occurs when the MSCI World has a negative monthly return of less than 10%. In each state we calculate the average monthly excess return of that theme or sector. For example, the average monthly excess return for Quality is +0.7% when the MSCI World has a negative monthly return. The average monthly excess return for Quality is +1.3% when the MSCI World has a negative monthly return of less than 5%. The average monthly excess return for Quality is +2.8% when the MSCI World has a negative monthly return of less than 10%. All calculations are based on the last 20 years using monthly data of MSCI sectors and themes.

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Quality, the Quiet Achiever, Outperforms Year to Date

Amidst all the discussion over Value vs. Growth you might be forgiven for missing the quiet achiever this year – Quality. Quality has been the best performing theme in the 8 months to 31 August 2021. The MSCI World Quality Index has outperformed the MSCI World Index by 4.0% YTD. Compare this to the MSCI World Growth Index only up 0.9% and MSCI World Value Index down -1.2%.

As shown in figure 2 Quality tends to generate excess returns during down markets but importantly tends to outperform during rising inflation. Quality can be viewed from various perspectives but the one most relevant to inflation relates to the ability for a company to sustain high levels of profitability and high margins in the face of competitive and difficult trading conditions. Highly ranked quality companies tend to have greater pricing power – having the ability to pass on rising input costs to the end customer and maintain margins. In recent times many companies have been tested with rising input costs. The higher quality companies have been able to pass these costs on to the end customer and have maintained profitably and held high margins. During the most recent reporting season the better ranked quality companies have navigated this environment better and have outperformed.

The Bottom Line

With increasing risks and earnings uncertainty we can expect more volatile equity market returns. Classically defensive sectors may well outperform in this environment but quality appears particularly well placed especially if cost and inflation pressures remain.

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