Insights
Active Quantitative Equity (AQE)

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Resilience Retested: What's Really Going to Drive Equity Returns in 2021 and Beyond?

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- The relentless market rally since March 2020 has been met with rise in speculative behavior, but will it continue to drive returns? If not, what will be the key return drivers over the next few years?
- In this paper, we assess the current market environment in the context of a 'typical market cycle'. We show that we are entering an environment where fundamentals are more likely to drive returns in 2021 and beyond
- This backdrop has implications for some of the major return drivers that we use to assess stocks — Value, Quality, Sentiment, and Risk

Four Phases of the Equity Cycle

Equity markets generally move in cycles. In order to develop a framework for this, we can examine the long term data available for the US equity market, and show that peak-to-peak market cycles can be divided into four distinct phases. We can describe these as: **Despair, Hope, Fundamental and Optimism.**

Below we outline what typically characterises each of the four phases within an equity cycle:

1. **The Despair phase** is defined as the period where the market moves from its peak to its trough. This correction is mainly driven by Price to Earnings (P/E) multiple contraction as the market anticipates and reacts to a deteriorating macroeconomic environment and its implications in terms of lower future earnings.

2. **The Hope phase** is typically a short period (on average 11 months), where the market rebounds from its trough through multiple expansion. This occurs in anticipation of a forthcoming trough in the economic cycle as well as future profit growth and is leading to a local peak in the trailing P/E multiple. We've chosen the end of the Hope phase to generally coincide with a local peak of the trailing P/E multiple.

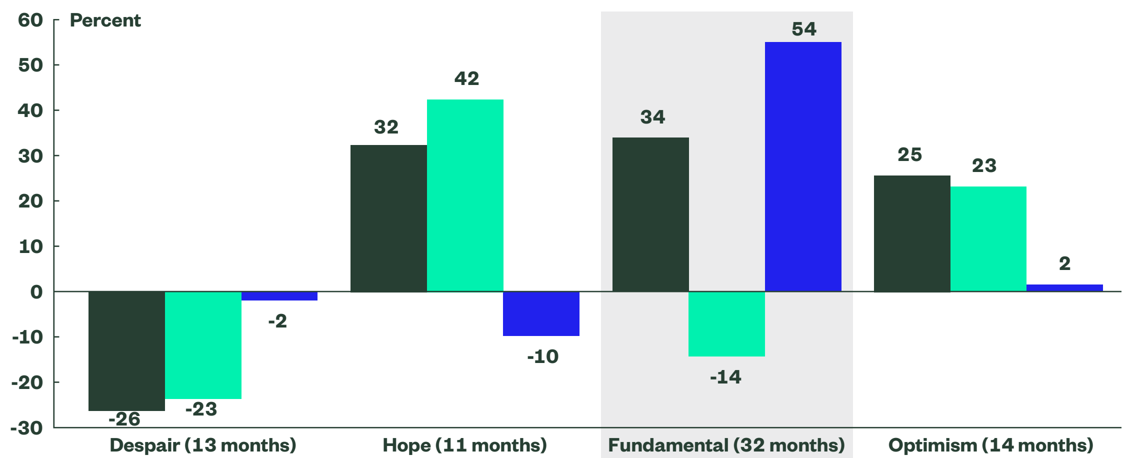
3. **The Fundamental phase** is a typically longer period (on average 32 months), where earnings growth drives returns instead of multiples expansion. We define the end of this period to be when multiple expansion again starts to provide a larger proportion of the returns than earnings growth.

4. **The Optimism phase** is the final part of the cycle, where returns driven by P/E multiple expansion outpace earnings growth, thereby setting the stage for the next market correction.

The four phases are related to the economy. Generally, the Despair phase is associated with a recession. The output gap troughs and the unemployment rate peaks during the Hope phase, while the Fundamental phase sees sharp improvements in both variables. In Figure 1, we can visualise the four phases through the lens of historical price and earnings data for the S&P 500 Index. Within each phase, we aim to decipher whether price returns are being driven by fundamentals (earnings growth) or valuations expansion.

Figure 1
Typical Pattern of the Equity Market Cycle
S&P 500 Index — Returns, Earnings and Valuation Averages Across Cycles Since 1955

Price Return
PE Expansion
EPS Growth



Source: State Street Global Advisors, FactSet, S&P as of 31 March 2021. Past performance is not a reliable indicator of future performance.

History Never Repeats Itself, But it Does Rhyme

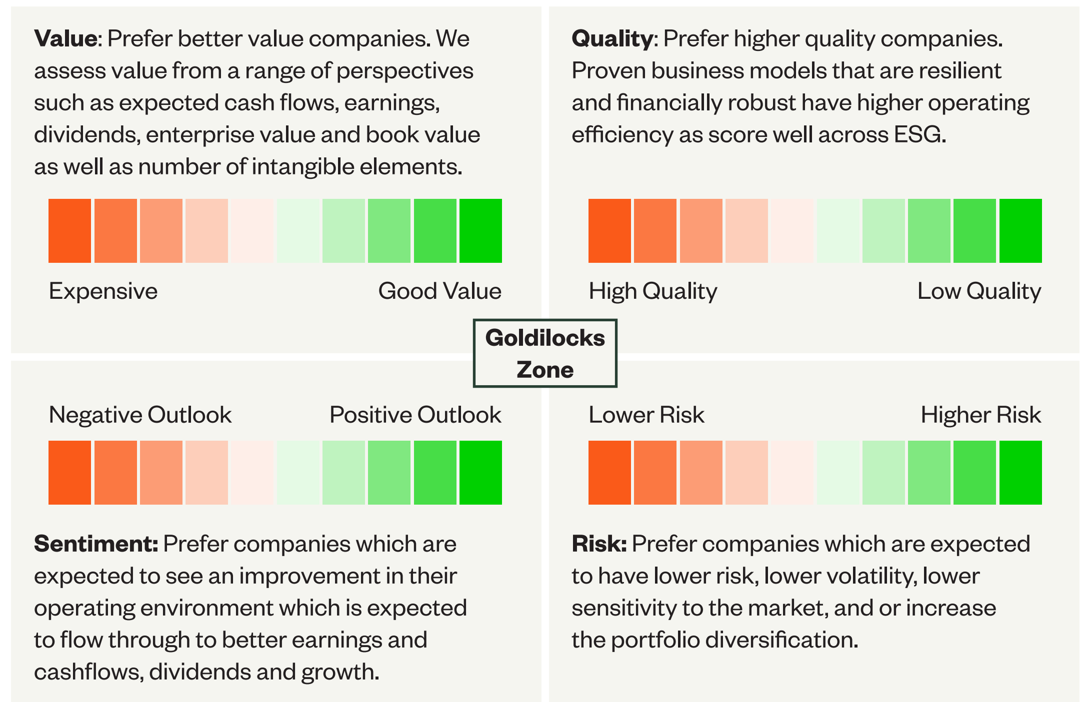
No two cycles are exactly the same, and there have been a few outliers. 2020 could be classified as one such outlier, as the global health crisis initiated a mass sell-off and rebound that was met with record speed and ferocity. The nature of the crisis saw an unusually short period of 'Despair' followed by a relatively short period of 'Hope'.

At the time of writing, we think markets have likely entered the 'Fundamental phase' — a period of higher real Earnings Per Share (EPS) growth alongside P/E contraction. We expect fundamentals and valuations will become important return drivers (as opposed to growth speculation) over the next few years, whether it comes in the form of higher profitability, stronger balance sheets, better earnings growth profile, more sustainable cash flow generation or more attractive multiples. In this environment, we prefer to own stable, defensive business with strong pricing power that can navigate a more challenging market environment.

What Constitutes an Attractive Buy for Us?

Below we outline the typical characteristics that we look for in a stock. Each characteristic can be thought of as being a fundamental driver of longer term excess stock returns. By actively trying to gain exposure to the 'Goldilocks Zone', we end up with a more balanced portfolio that allows for more consistent returns through the cycle.

Figure 2
The Active Quantitative Equity Team's Preference for Stocks that Reside within the Goldilocks Zone



Source: State Street Global Advisors. The information contained above is for illustrative purposes only.

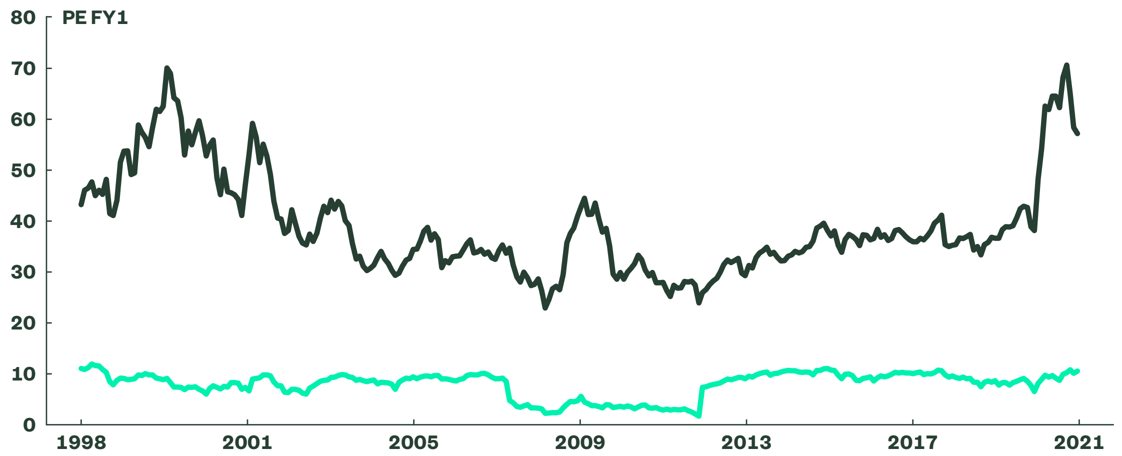
As we progress through the 'Fundamental phase' of the cycle, price action in most sectors are already reflecting sustained growth and reflation expectations. What will separate the winners from the losers going forward? Fundamentals and Valuations. As we will explore below, continued economic recovery and inflation pressures will continue to support active strategies that favour strong company fundamentals and maintain a strong valuation discipline. We view the recent rotation out of expensive growth names into value names as early days of a longer-term value recovery. Expensive growth companies face the pressure of higher interest rates and extended valuations, while economic sensitive value names — many of which have restructured and cut costs during 2020, are now in a much better position to grow earnings from cyclical lows. This is a trade that is being supported by ongoing fiscal stimulus from governments around the world.

But we are not simply advocating for a one sided bet on value names. In this environment, we believe higher quality, sentiment and lower risk are also important characteristics to own — because these are associated strong financial health of businesses. Our longer term data shows high quality companies have gone through an unusual period of underperformance since 2020, but conditions are ripe for a reversion back to its long-term upward trend.

Valuation Spreads and Inflation Pressures Signal Further Rotation into Value

Figure 3 shows that valuation of the most expensive quintile of the MSCI World Index (grouped by forward PE), reached an all time high in December 2020, surpassing the extremes of the dot-com bubble. However, the winds of change are now working in the other direction. The prolonged mispricing of growth — i.e. valuation spread between the most expensive segment of the market and the cheapest segment, has only retraced a little and are still a long way from historical norms.

Figure 3
Global Developed Market Equity Valuation Spread (MSCI World Index)



Source: State Street Global Advisors, FactSet, MSCI as of 30 April 2021. Valuation of the most expensive quintile of the index, grouped by PE FY1, reached all time high surpassing dot-com bubble. Beginning to see the trend reverse and some multiple compression, but still a long way from historical norms. Quintiles grouped monthly, harmonic average shown. Past performance is not a reliable indicator of future performance.

There has been a clear rotation into Value stocks since November 2020, after the announcement of the Covid vaccine. Investors quickly rushed to get into the 'reopening trade', which subsequently pushed up prices of the most beaten down industries of 2020 — including airlines, energy and financials. As a result, many of these cheaper, cyclical sectors have actually experienced quite a bit of valuation expansion — with some stocks now trading at higher multiples than pre-pandemic levels. Despite this, we think pockets of the "Value trade" have been underappreciated by investors and are likely to see further re-rating. We like to think of these names as 'cheap quality'. In other words, we don't just want cheap — because stocks are often cheap for a reason.

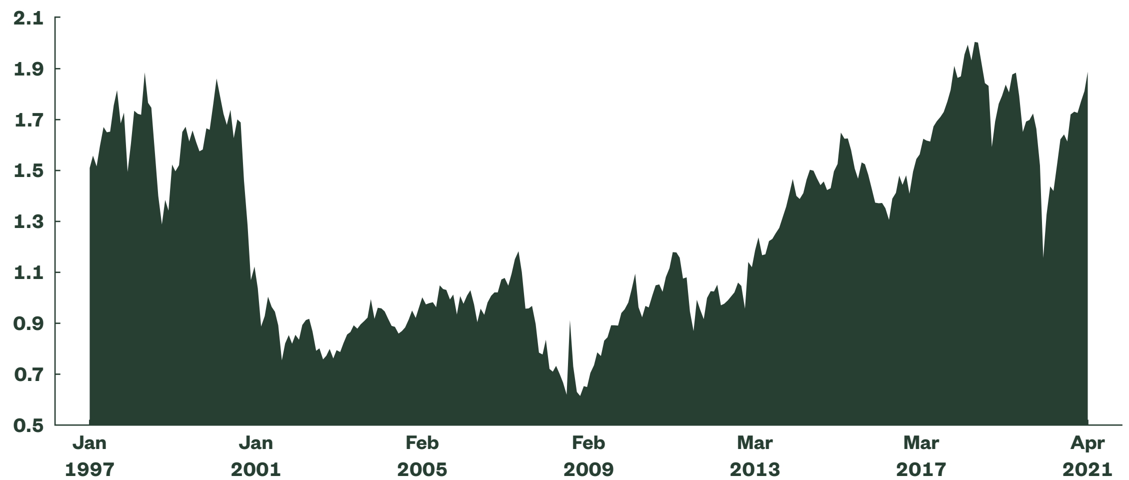
Rising inflation expectations and a steepening yield curve also provide important tailwinds for these high quality names trading at attractive valuations. In such environments, there is a premium attached to the pricing power of companies (their cash flows provide a hedge against inflation). Stocks that provide some level of inflation hedge can often be found within a segment of the market where Quality and Value characteristics intersect. These types of companies come from various sectors, including:

- Telcos (less impacted by inflation)
- Health Care
- Real Estate (positively exposed to consumer price rises and not negatively impacted by producer price rises, retail REITs have inflation linked leases so revenues are insulated)
- Utilities (revenues can often be determined by regulation which are often based on Consumer Price Index (CPI) or cost of debt)

Mean Reversion Suggests Better Opportunities in Lower Risk/Higher Quality Names

Since the pandemic began, equity markets have shown an unusual appetite for riskier stocks that are more volatile — thanks partly to unprecedented government stimulus, greater level of retail participation and increased margin lending. Preference for higher risk stocks in 2020 has been associated with high levels of speculation in markets. Figure 4 shows that US margin debt (as measured by FINRA & NYSE debit/credit balances) rose at its fastest pace since 2000 — with leverage ratios now nearing all-time highs.

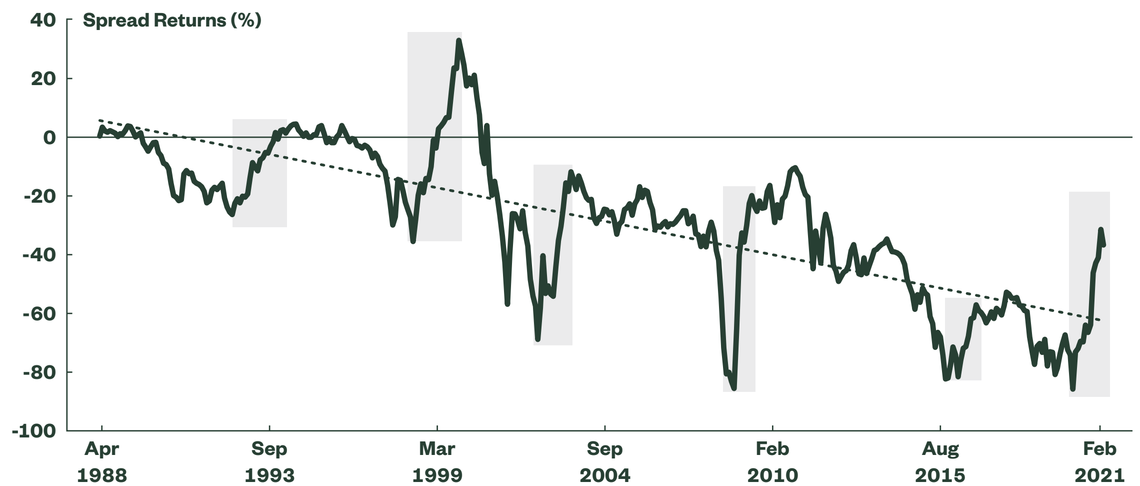
Figure 4
NYSE & FINRA Leverage Ratio (Debit/Credit Balance)



Source: FINRA, State Street Global Advisors as of 30 April 2021.

The financial conditions that have dominated 2020 represent an aberration rather than the norm. In fact, risk data over the very long term tells us that owning higher risk companies (often more cyclical too) destroys value over time. This is a pervasive phenomenon; true both globally and in Australia. Figure 5 shows the cumulative returns achieved by buying the riskiest quintile of stocks and short selling the least risky quintile of stocks available in the global developed markets over a 30+ year period (i.e. a systematic strategy based only on risk). As evident, risk-on rallies have historically been fast and sharp, but have always reverted back to a downward trend over a longer timeframe.

Figure 5
Long/Short Quintile Spread Return to the Risk Factor
Factor Return to Higher Risk Securities — Global Developed Markets



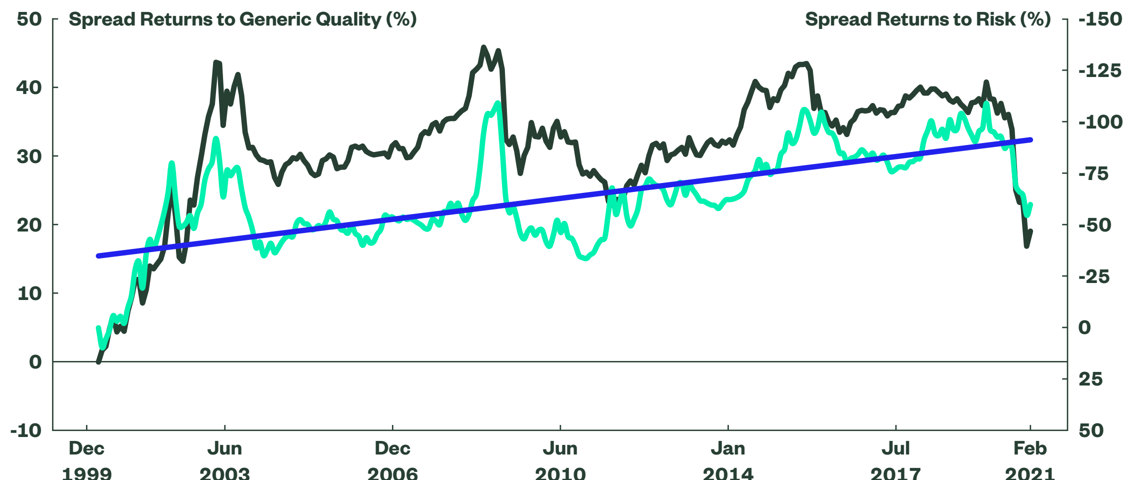
Source: State Street Global Advisors, FactSet, MSCI as of 31 March 2021. Quintiles grouped monthly. Universe is Developed Market Large Cap. Past performance is not a reliable indicator of future performance. **The above information is for illustrative purposes only and is not indicative of the past or future performance of any SSGA product.** The results shown represent current results generated by our G5 model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street Global Advisors decision making. The results shown were achieved by means of a mathematical formula (i.e. going long the top quintile of stocks and going short the bottom quintile of stocks as ranked by G5 on a particular dimension), and are not indicative of actual performance which could differ substantially.

We believe owning low-risk companies is integral for any long-term investor who pays attention to risk-adjusted returns, particularly if the end investor has an aversion to sharp drawdowns due to sequencing risk. But simply having an exposure to low-risk is not enough. As we repeat over and over, fundamentals drive excess returns over the long-run; and superior risk-adjusted returns are conditional on having exposure to fundamentally strong companies — ones that are profitable, and are able to sustainably generate profits through the ups and downs of an economic cycle.

Interestingly, a strategy built on owning low-risk companies is also consistent with one built on owning high quality companies. Over the long-term, the returns to a systematic low risk strategy[1] is 0.8 correlated to the returns of a simple systematic strategy of owning high quality[2] stocks. In other words, higher quality names — defined as companies with superior levels of profitability, balance sheet strength and operating efficiency, tend to be less risky as well. Figure 6 shows the hypothetical cumulative return series to these two systematic strategies — Quality and Low Risk. Note the Quality line here is just one of the many quality factors we use within our investment process.

Figure 6
Long/Short Quintile Spread Returns to Risk and Quality
Factor Return to Higher Risk Securities — Global Developed Markets

Generic Measure of Quality
Risk (RHS, Inverted)
Linear (Risk (RHS, Inverted))



Source: State Street Global Advisors, FactSet, MSCI as of 28 February 2021. Quintiles grouped monthly. Universe is Developed Market Large Cap. Past performance is not a reliable indicator of future performance. **The above information is for illustrative purposes only and is not indicative of the past or future performance of any SSGA product.** The results shown represent current results generated by our G5 model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street Global Advisors decision making. The results shown were achieved by means of a mathematical formula (i.e. going long the top quintile of stocks and going short the bottom quintile of stocks as ranked by G5 on a particular dimension), and are not indicative of actual performance which could differ substantially.

Looking ahead, we think the risk-on rally of 2020 and early 2021 have largely played out. The outperformance of high risk (i.e. more volatile securities) has been highly correlated with the outperformance of less financially stable businesses. Just as we expect the risk rally to reverse course after a sharp rally, we expect companies with stronger fundamentals to also do better in subsequent periods — and Quality as a factor is likely to benefit from a mean reversion in risk. As explained before, inflationary pressures are also likely to benefit high Quality companies as they tend to come with stronger pricing power and are better placed to pass on higher input costs.

The Bottom Line

We would argue the market environment of the past two years — which has been quite unhospitable to systematic (or quantitative) strategies, has likely past a turning point. As we enter the 'fundamental phase' of the cycle, earnings and cash flows will increasingly drive returns rather than re-ratings. The valuation expansion of long-duration growth companies is now the story of yesteryear, and long-term fundamental drivers of returns will likely once again become the dominant driver.

In the short-term, inflation expectations and bond yields will continue to be a key factor determining the extent of the value rotation that we've seen year to date. However, at this point in the cycle we think simply buying into deep cyclical value names is no longer a compelling way to generate excess returns. What will be more important going forward is an appreciation for strong company fundamentals coupled with a strong valuation discipline. In this environment, we advocate active strategies with exposure to reasonably valued, stable, defensive business that have strong pricing power. These types of businesses are better positioned to navigate the fundamental phase of the market cycle; one where we can expect central banks to have limited ammunition to combat unwanted inflation without causing severe disruptions to an already overleveraged market.

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- Build from breadth
- Invest as stewards
- Invent the future

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* This figure is presented as of March 31, 2021 and includes approximately $60.33 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.

Endnotes

1 A systematic strategy of buying the least risky quintile of stocks and short selling the most risky quintile of stocks.

2 A systematic strategy of buying the highest quintile of 'Quality' stocks ranked based on Piotroski F-Score and short selling the worst quintile of Quality stocks.

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