
Why We Maintain a Balanced Approach to Stock Selection Amid Interest Rate Volatility

STATE STREET GLOBAL ADVISORS

- Interest rates have been a major macroeconomic driver of equity returns since mid-February – but the path of macro drivers is difficult to predict.
- In Active Quantitative Equity (AQE), our stock selection preferences are not particularly biased toward or against stocks with extreme interest rate sensitivity, because we rely on a diverse set of bottom-up inputs to evaluate stocks.



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In recent weeks, market perception of a strong recovery has led to a corresponding sell-off in bond markets. This has led a fresh theme to take shape in equity markets: interest rate sensitivity has become a more important explanation of returns than risk, or value, or COVID-19 winners versus losers. When these types of top-down, macroeconomic influences on stock returns start to overshadow the influence of bottom-up stock selection, it's important to understand a portfolio's exposure to these top-down trends. In Active Quantitative Equity, our portfolios are not exposed to extreme interest rate sensitivity.

Interest Rate Sensitivity as a Major Driver of Returns

When selecting stocks, we focus on three important themes – value, quality, and sentiment. We look for companies that are reasonably priced, profitable, solvent, efficient, and with improving outlooks. We don't explicitly prefer stocks that are positively or negatively impacted by moves in interest rates; however, the characteristics we do affirmatively seek can have a relationship with interest rate sensitivity.

Interest rate sensitivity has been the major driver of equity market returns since rates started moving in mid-February. Figure 1 below shows that returns are currently highest for the interest rate sensitivity factor compared to other explanatory factors such as value, beta, and return on equity. Valuation multiples, especially book-to-price ratio, are positively correlated to interest rate sensitivity and have also been performing strongly.

Deep value strategies with a lot of exposure to cheap price-to-book stocks have undoubtedly performed well during this period. We prefer to take a more balanced approach to selecting stocks. By introducing sentiment and quality themes, we reduce the sensitivity to interest rate moves.

Figure 1: Interest Rate Sensitivity Has Been the Major Driver of Market Returns Since Mid-February

Explanatory Factor-Based Returns as Measured by Information Coefficient (12 February 2021 through 8 March 2021) versus Correlation to Interest Rate Sensitivity (as of 26 February 2021)

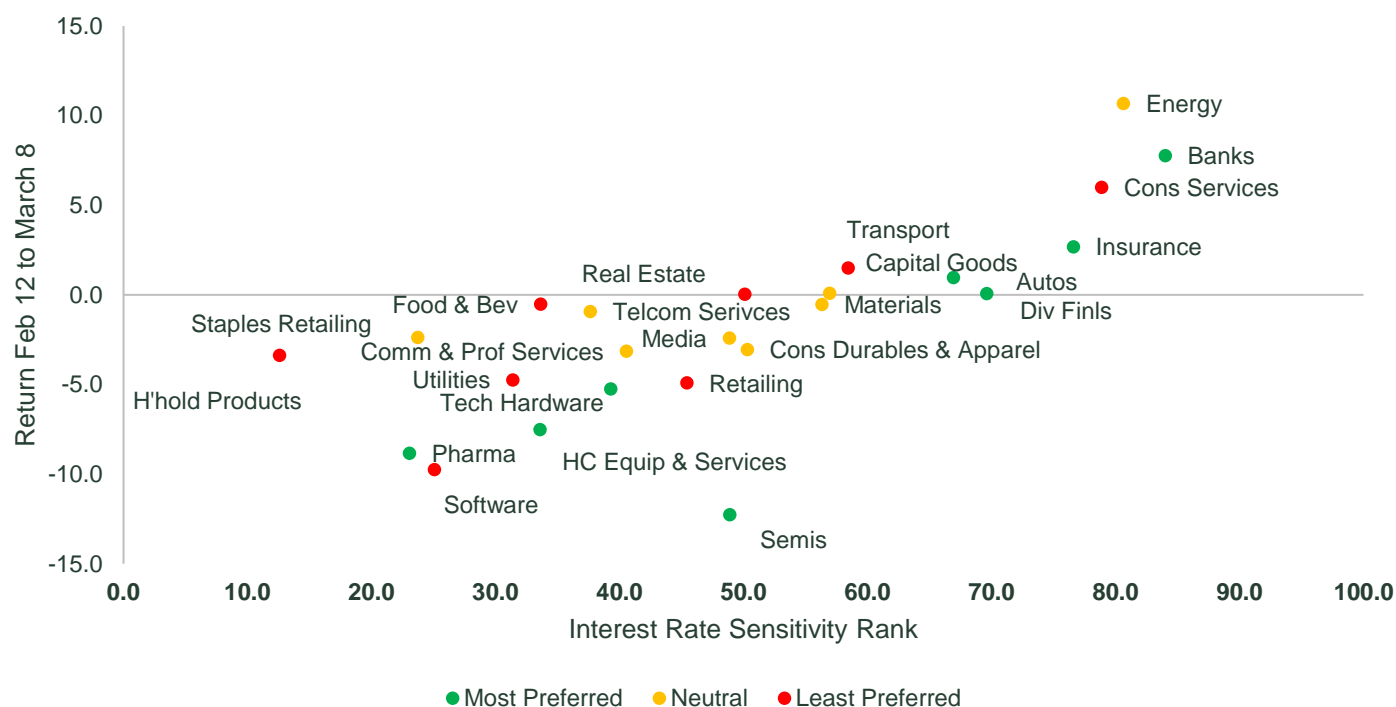


Source: State Street Global Advisors, Refinitiv. State Street Global Advisors proprietary composite measures; MSCI World investment universe.

This phenomenon has also manifested itself among sectors, as seen in Figure 2 below. Here, we show the sensitivity of various industry groups to interest rates versus the returns to each group since February 12, overlaid with our most- and least-preferred segments based on our assessment of expected returns. Cheap segments like Banks and Energy currently have a positive exposure to interest rate increases, while high-growth and expensive segments, like Household Products, Software, and Pharmaceuticals have a negative exposure. Because of our balanced approach to selecting stocks, our preferences in AQE do not overly favor or avoid stocks with positive or negative interest rate sensitivity.

Figure 2: Our Most Preferred Segments Are Currently Both Negatively and Positively Exposed to Rising Rates

Equity Returns Versus Interest Rate Sensitivity Rank (12 February 2021 through 8 March 2021)



Source: State Street Global Advisors, Refinitiv.

The Bottom Line

Our stock selection model's preferences are not particularly exposed to extreme interest rate winners and losers. This stems from our use of a diversified set of inputs to evaluate stocks. Our most preferred segments include pharma (which has a negative exposure to rising rates) as well as banks (which are positively exposed to rate increases). Our least preferred segments include household products (negative sensitivity) as well as consumer services (positive sensitivity).

We prefer to keep our portfolio exposure to interest rate sensitivity in check rather than bet on macroeconomic influences that are less predictable than the bottom-up stock characteristics. Not only are the macroeconomic events difficult to predict themselves, but the way the stock market reacts to these events can change.

Important Disclosures

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