

Sector and Investment Themes to Watch in 2021: A Return to Fundamentals

- In 2021 we believe that equity prices will more closely tie to companies' underlying near-term earnings trajectory and financial strength.
- There are attractive stocks at both ends of the price-to-book valuation spectrum.



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The most confounding thing about financial markets in 2020 was that, in totality, the mood of the global equities market seemed completely different than the mood of everything else happening to humanity — i.e., millions of lives lost worldwide, ongoing concerns for health and employment, political instability, racial injustice, and the list goes on.

The MSCI World Index in the calendar year delivered a positive return of almost 16% (trading in a 46% range after a year-to-date low of -30% at the end of March) while the annual earnings of companies within the index are expected to have fallen by 7%. This represents a price-earnings multiple expansion of around 25%.

During 2020, the price appreciation of public equities reflected a high level of optimism about the ability of the global economy to recover from the pandemic and come out stronger than before. In 2021 we believe that the listed price of publicly traded companies will more closely tie to the underlying near-term earnings trajectory and financial strength of those companies.

While valuation is an important theme when we select stocks, we find attractive stocks at both ends of the price-to-book valuation spectrum. There are cheap stocks we like, and there are expensive stocks we don't like; expensive stocks we like, and expensive stocks we don't like. Among stocks that look expensive as measured by price-to-book ratio, we see a subset as attractive once we conduct a nuanced analysis of where they derive their value. For example, in developed markets tech hardware and semiconductors have average or slightly above average value scores according to our proprietary value measures, despite being extremely expensive on price-to-book alone. Figures 1 and 2 show that we expect high returns to be found among both cheap and expensive stocks.

Figure 1: Developed Market Sector Return Expectations, by Sector Valuation

	High Expected Return	Low Expected Return
Cheap	Traditional Autos Financials	Energy Real Estate
Expensive	Tech Hardware Semiconductors	Consumer Services Retailing Tech Software & Services

Source: State Street Global Advisors, as of 10 January 2021.

Figure 2: Emerging Market Sector Return Expectations, by Sector Valuation

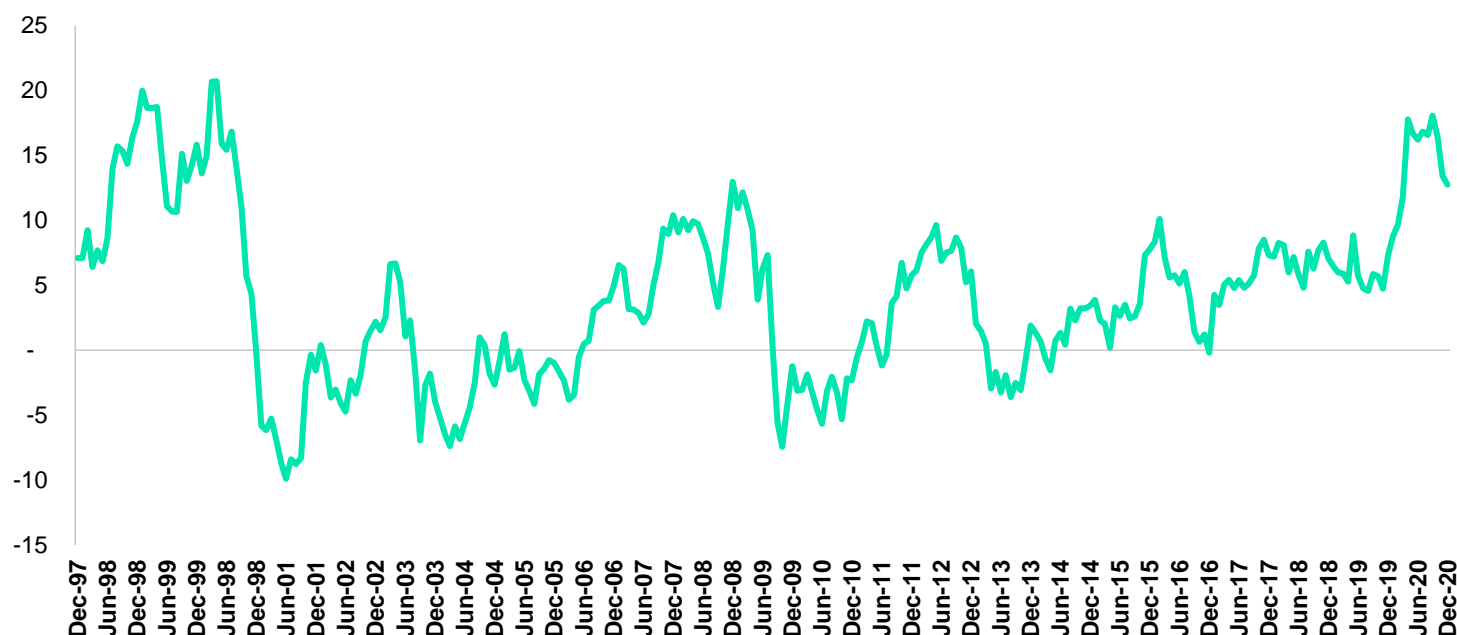
	High Expected Return	Low Expected Return
Cheap	Energy Financials Utilities	Real Estate
Expensive	Consumer Durables Health Care Equipment Software Semiconductors	Commercial Services Consumer Services Retailing Consumer Staples

Source: State Street Global Advisors, as of 10 January 2021.

Price Momentum

During 2020 we discussed concerns regarding market concentration in expensive and high-momentum stocks, and we are still concerned about companies that may, due to their size, impact market indices in aggregate if they pull back. Figure 3 shows that the embedded price momentum built into the S&P 500 over the past few months reached levels not seen since the height of the dot-com bubble.

Figure 3: Embedded Price Momentum in S&P 500 Index (11-month return, lagged one month)



Source: State Street Global Advisors and S&P, as of 11 December 2020.

Opportunities in 2021

Since market concentration in expensive, high-sentiment stocks reached all-time highs last August, some out-of-favor stocks are showing some signs of improving sentiment — and creating better opportunities for us to find companies that tick all the boxes. In aggregate, the following segments are where we see the greatest opportunity with a nine- to 12-month horizon.

	Most Preferred	Least Preferred
US	Household Personal Products Consumer Durables and Apparel Autos	Real Estate Consumer Services Pharma & Biotech
Europe	Autos Telecom Services Insurance	Software & Services Pharma & Biotech Consumer Services
Japan	Tech Hardware & Equipment Autos Capital Goods	Software & Services Household Personal Products Consumer Services
APAC ex Japan	Banks Health Care Equipment & Services Telecom Services	Transport Software & Services Consumer Services
Emerging	Autos Semiconductors Telecom Services	Transport Household Personal Products Consumer Services

Source: State Street Global Advisors and S&P, as of 10 January 2020.

The Bottom Line

After a year of high optimism in equities markets — an optimism that often seemed disconnected from the year's many challenges — we believe that equity prices will increasingly reflect underlying fundamentals in 2021. Multiple expansion will not be enough. Our nuanced assessment of value in context with other key investment themes, including sentiment and quality, points to opportunity among both cheap and expensive stocks. Although market concentration in stocks benefiting from extraordinarily high price momentum remains high, some out-of-favor stocks are displaying improving sentiment, widening the range of stocks that are attractive across multiple themes and dimensions of investment performance.

We stand on the threshold of a new investment reality as COVID vaccines roll out and monetary and fiscal conditions change in response to a global economic recovery. In 2021, we believe our investment process, which uses a balanced set of attributes to select stocks, will be well positioned to capture the opportunities that markets will offer in this new environment.

Portfolio Attribution and Performance¹

Global markets were slightly down in AUD terms in December 2020. From a sector perspective, Utilities and Real Estate fell the most while IT and Discretionary was marginally positive. The rotation into Value stocks that began in November took a breather in December, although the intensifying 'blue wave' in the US is setting the scene for further rotation into cyclicals and value.

The State Street Global Equity Fund outperformed the broader index in December. From a sector perspective, positive contributions from Industrials and Utilities were more than offset by negative stock selection within Staples and Discretionary. Currency hedging gained +2.3% as the AUD rose 3.5c to \$0.77 on higher commodity prices and risk-on sentiment. Over the past 2 years, underperformance has been driven by investor's preference for "growth at any price"; and detractors came largely from two cohorts – the very expensive (where we are underweight) and the very cheap (where we are overweight). Having a lower risk bias also hurt performance, as investors tried to front run the 're-opening trade' post COVID-19 sell-off and post vaccine announcement. The strategy aims to minimize total portfolio volatility and as part of achieving that objective we have avoided the riskier, most expensive, high sentiment segments of the market that harbor higher valuation risks.

¹ Source: Factset, SSGA as at 31 December 2020. Past performance is not a reliable indicator of future performance. 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. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

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Equity securities may fluctuate in value and can decline significantly in response to the activities of individual companies and general market and economic conditions.

Quantitative investing assumes that future performance of a security relative to other securities may be predicted based on historical economic and financial factors, however, any errors in a model used might not be detected until the fund has sustained a loss or reduced performance related to such errors.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

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