State Street Global Equity Fund

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Sectors that surprised in the coronavirus market drawdown

- Retailing and Autos as well as Software & Services generated unexpectedly elevated returns.
- Sector-level assumptions about potential resilience or weakness during a market drawdown are not always borne out.

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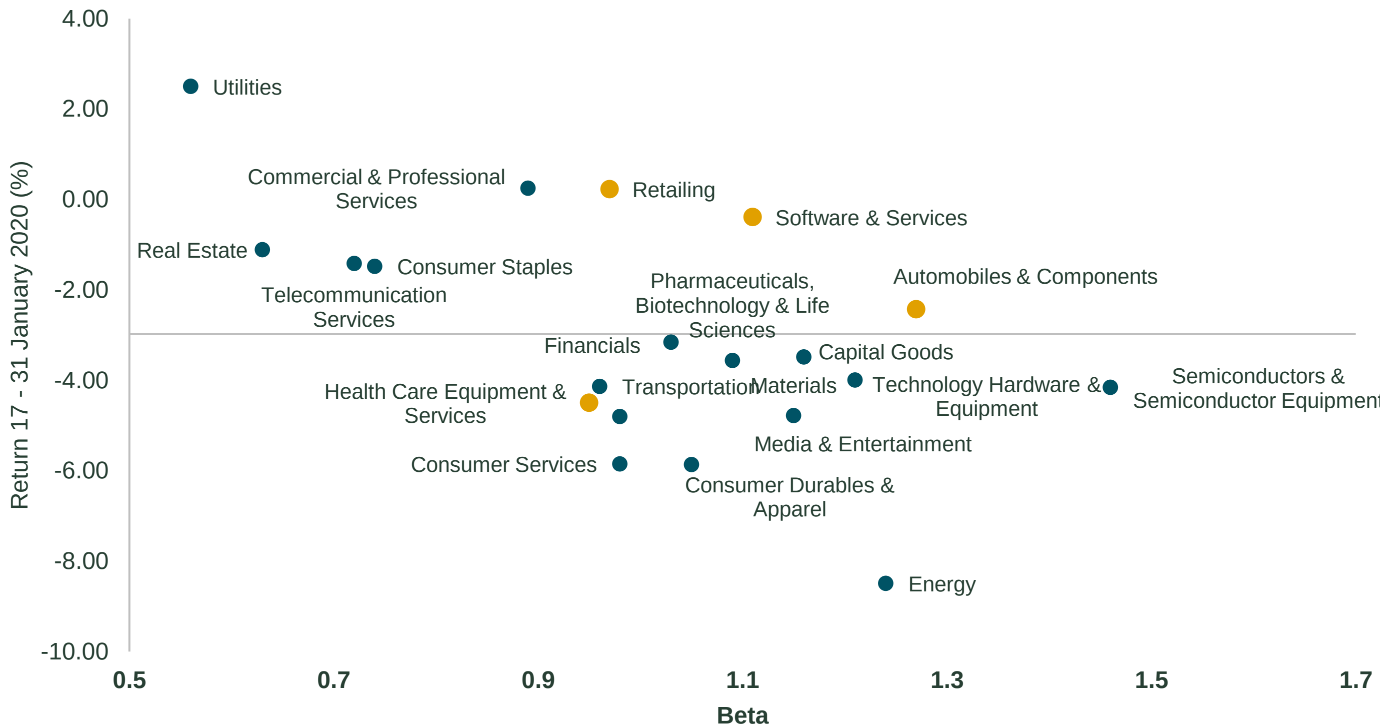
Between January 17 and January 31 2020, world markets fell 2.98% as news reports about the coronavirus saturated the media.[2] In this commentary, we'll compare actual sector performance during the January market drawdown with typical expectations for sector performance under these types of market conditions. For a few sectors that were particularly surprising, we'll explore reasons why expectations and performance diverged.

Performance across sectors during the drawdown

A review of GICS[3] segment performance as news of the coronavirus broke reveals a few surprises. Figure 1 on the next page plots sector returns during the January 17-31 period against beta.[4] The blue dots represent sectors in which the market reaction was in line with conventional expectations for a broad market selloff. The orange dots highlight sectors in which the market reaction ran contrary to expectations.

[1] CFA® is a trademark of the CFA Institute
[2] MSCI World Index.
[3] Global Industry Classification Standard.
[4] "Beta" measures the risk that arises from overall movement in markets. A portfolio of all investable assets has a beta of exactly 1. A beta value larger than 1 generally indicates higher volatility compared to the market.

Figure 1. **Sector-level returns versus beta from 17 January through 31 January**



- Blue dots = In line with typical expectations
- Orange dots = Contrary to typical expectations

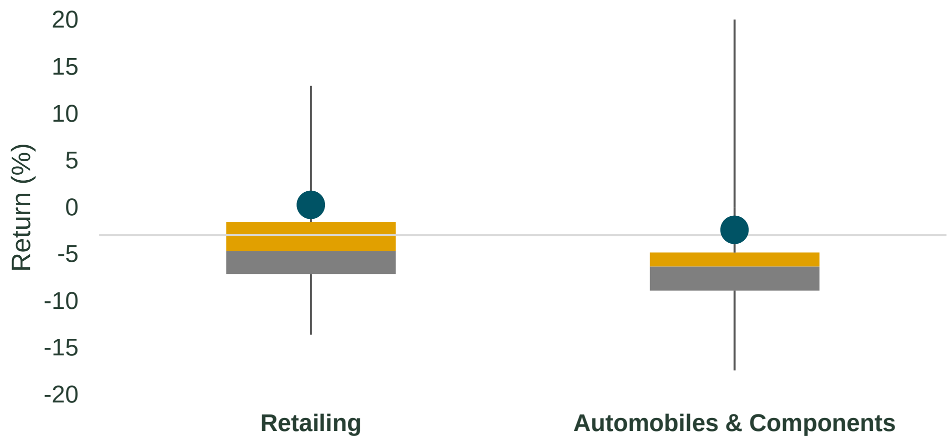
Source: Axioma, Bloomberg Finance L.P., as of 31 January 2020. GICS Sectors and Industry Groups in MSCI World Universe represented. Axis crosses at -2.98%, the aggregate return of MSCI World Index from January 17 through January 31. Past performance is not a reliable indicator of future performance.

In general, Figure 1 shows that performance of different segments turned out as expected. Traditionally defensive sectors such as Utilities and Real Estate did very well; cyclical sectors such as Energy, Consumer Durables, Consumer Services, Materials and Transportation did poorly. But a few sectors – Retailing, Automobiles, Software & Services, and Health Care Equipment & Services – defied expectations.

Retailing and Autos (cyclical sectors) as well as Software & Services (generally a high-beta sector) each generated unexpectedly high returns over the period. Digging deeper by sector illuminates the underlying reasons for these positive sector-level surprises.

In Retailing and Autos, megacap outliers lifted aggregate returns, while the rest of the segment suffered a large decline. Most Retailing companies, for example, showed returns worse than -5%, but one particular megacap internet retailer's stock surprised on earnings and lifted the overall average for the sector. Autos delivered relatively strong returns in aggregate, but the distribution of returns in Autos was skewed by one electric car manufacturer with off-the-charts returns (up 27%). The median return across the Autos segment was close to -6% (see Figure 2).

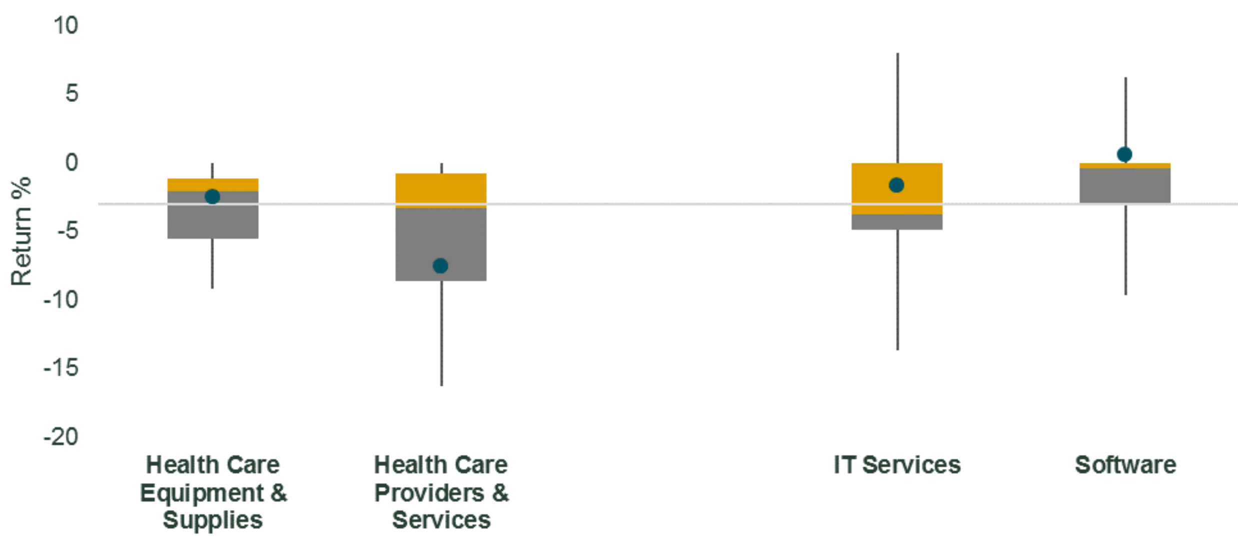
Figure 2. **Spread of security returns within each GICS Industry Group (box plot) and aggregate return for the group (blue dot)**



Source: MSCI, Bloomberg Finance LP, as of 31 January 2020. MSCI World stocks; axis crosses at -2.98%, the aggregate return of MSCI World over that period. Box plot crosses at the median return for all stocks in the segment. Past performance is not a reliable indicator of future performance.

Drilling deeper into the underlying GICS segments is necessary to understand performance in the Software & Services and Healthcare Equipment & Services sectors. In the Software sector, many stocks in the cloud computing segment delivered very strong earnings that surprised the market, driving returns upward. Software stocks and their intangible assets also seemed to be unaffected by concerns tied to the very tangible effects of the coronavirus. The weakness in Healthcare was driven by substantial declines for Healthcare Providers, including Health Insurance companies, which suffered amid expectations of increasing costs related to treating patients with the virus. Healthcare Providers, including Insurers, returned -7.6% over the period, while Healthcare Equipment & Supplies firms slightly outperformed the market on average, but still experienced negative absolute returns of -2.5%.

Figure 3. **Spread of returns within each GICS Industry Group (box plot) and aggregate return for the group (blue dot)**



Source: MSCI, Bloomberg Finance LP, as of 31 January 2020. MSCI World stocks; axis crosses at -2.98%, the aggregate return of MSCI World over that period. Box plot crosses at the median return for all stocks in the segment. Past performance is not a reliable indicator of future performance.

Our current views of these segments

Retailing
Some Retailing stocks are attractive, but in general this is not a key sector for us right now. The megacap stock dominating the sector is too expensive on all valuation angles.

Software & Services
In aggregate, both the Software and IT Services segments are much more expensive than other segments of the market. Investors have been rewarding these companies, and earnings forecasts are being revised upward, so sentiment is very positive. We find better quality characteristics in some of the more mature companies in the IT Services segment and have found select names there to invest.

Autos
As a whole, autos are relatively cheap, but sentiment on this segment has not improved much beyond the small turnaround caused by last year's relaxation of trade tensions. Therefore we hold positions in only select names in this sector.

Health Care Equipment and Services
We prefer Pharma over Providers and Services, but we also like some Health Care Equipment companies. We've been reducing our position in Healthcare Providers due to elevated risk connected to upcoming elections, so our portfolios have relatively little exposure there.

The bottom line

When seeking defensive equity positions, it's wise to avoid relying solely on sector-level assumptions about potential resilience or weakness during a market drawdown. We believe careful stock selection which takes value, quality, and sentiment into account is much more likely to be effective over the long term.

Portfolio positioning and performance[5]

Global Markets initially rallied hard through most of January on positive trade deal momentum, before selling off sharply on coronavirus fears to end in slightly negative territory (local currency terms). With China's market closed due to Chinese New Year and the closure extended due to the coronavirus, the Hang Seng (-6.7% local) was the worst performer due to its high China exposure. Riskier markets lagged, with MSCI Emerging Markets index down 3.3% (local). Among Global Developed Market sectors, Utilities, IT and REITs outperformed, while Energy, Materials and Financials underperformed the most.

The State Street Global Equity Fund underperformed its benchmark during the month. January was characterised by strong returns of growth and momentum stocks, and corresponding underperformance of value stocks. Having a lower exposure to Energy and Materials added value, but was more than offset by our lower than benchmark weight in IT (not holding Microsoft and Apple) and negative stock selection within Discretionary (not holding Amazon). The fund underperformed over the past 12 months; having a lower exposure to IT was the single biggest detractor, taking away 3.3% from benchmark relative performance (again, not holding Apple and Microsoft). On the other hand, having a lower than benchmark exposure to Energy and good stock picking within Materials contributed positively.

[5] Bloomberg Finance, L.P. SSGA as at 31 January 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.

Disclosure

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