STATE STREET GLOBAL ADVISORS

Active Quantitative Equity

2018 Winners and Losers in the Equities Markets – Plus Themes to Watch in the Year Ahead

- Our expectations for strong performance in health care and our view that FANG stocks were over-valued were largely borne out in 2018.
- In the coming year, we believe valuation will continue to be an important consideration for equity investors.
- Additional themes we're watching in 2019 include increased market volatility and the changing interest-rate regime.

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As we move forward into 2019 after a year of increasing volatility and lower return expectations, it's time to review our assessment of the key investment themes we identified over 2018 – and to consider our expectations for the coming year.

Early in 2018, we anticipated positive earnings growth supporting developed equity markets throughout the year. At the same time, we recommended a risk-aware approach to guard against dislocations. Earnings forecasts continued to rise during the year, but started to falter at the end of the third quarter, impacted by geopolitical and macroeconomic events. Here are the investment themes that we saw as most promising in 2018, how those calls have panned out so far, and where we think they may go in the coming year.

Health care stocks

We have seen a lot of opportunity in the health care sector for some time. Health care brings together a lot of attractive themes, including such as stable and secular growth, reasonable valuations, improving outlook, and some defensive characteristics in the face of market volatility.

During 2018 we noted that the equipment and supplies segment was becoming the most attractive industry within the health care sector, due to the relative stability and consistency of their earnings growth. Toward the end of 2018, we started to see more opportunity in health-care providers, services and pharmaceuticals, and the equipment segment became slightly more expensive.

Since the start of 2018, the equipment and supplies industry has generated +9.8% total return, compared with a 8.2% decline in the MSCI World index. Since mid-year, the pharmaceuticals and providers industries have returned +4.7% and -0.9% respectively; MSCI World declined 8.9% in the same time period[1]. The earnings forecasts for the providers and services segment accelerated into year-end, improving by 6.5% in the fourth quarter.[2]

Heading into 2019, we still see many companies in healthcare with attractive attributes. Within the US market, many of the hospitals and the large pharmaceutical companies are attractive. Outside of the US, the most attractive health-care segment is European pharmaceuticals.

Technology and FANG stocks

In May 2018, we reiterated our concern for valuations in the FANG[3] stocks, and identified technology, hardware and equipment as the segment with more reasonable expectations for future earnings growth. We noted that the positive signs for the FANG segment in the near term were associated with extremely strong sentiment towards these stocks. Although the general quality of FANG stocks – based on our assessment of fundamentals including balance-sheet health, earnings, and solvency – had improved in the first months of 2018 compared to our earlier commentary in August 2017, we assessed these companies among the most expensive and highest risk across the entire global equity market.

FANG stocks reached record highs in June, returning more than 36% up to June 20. Since then, however, the FANG stocks have fallen 27% while the broad market index has declined 10%.[4]

Even in light of this substantial decline, we still see these stocks as a group among the most expensive in the global equity markets. The substantial decline in sentiment toward this group of companies further supports our already firm view that other opportunities in the technology and consumer segments are more favorable. More specifically, we still like some names in the technology hardware and equipment segment in the US and in Japan. In the consumer segment, some US restaurants have also started to look attractive on quality and risk attributes, and quite strong on sentiment – but they aren't particularly cheap.

Financial stocks

At the start of the year, we remarked on financials as a broad area of opportunity, noting banks as a segment that should benefit from earnings recovery with normalizing interest rates. We also revisited bank stocks in October 2018, noting US and Chinese banks more specifically. By then, we had started to see better earnings growth in US banks relative to banks in other regions, and attractive valuations for Chinese bank stocks.

Financials, including banks, were not a good source of equity market returns in 2018. In developed markets, banks have declined more than 20% in 2018 while the broader market has declined only 7.6%. US banks have declined 16.3%; Chinese banks have declined 10.1%. Although the broad sector didn't perform in line with our expectations of recovery, due to the impact of a sharply flattened yield curve, the relative attractiveness of US banks versus other banks across the globe was additive to performance.

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[1] As measured by MSCI World Index, MSCI World Health Care Equipment and Supplies Index, MSCI World Pharmaceuticals GICS Level 3 Index, and MSCI World Health Care Providers and Services Index over calendar year 2018, and the second half of 2018.

[2] As measured by change in 12-month forward EPS estimates according to Bloomberg Finance L.P. and measured within the MSCI World Healthcare Providers and Services Index.

[3] "FANG" stands for Facebook, Amazon, Netflix and Alphabet's Google; however, this group of companies is represented more broadly by the NYSE FANG+ Index.

[4] As measured by the NYSE FANG+ Index, and the MSCI World Index between June 20, 2018 and December 31, 2018.

In developed markets, we are not seeing as much opportunity in either the banks or the financials as we were a few months ago. Our current preference is for insurance stocks, where the expected price volatility is lower and the near-term sentiment is higher.

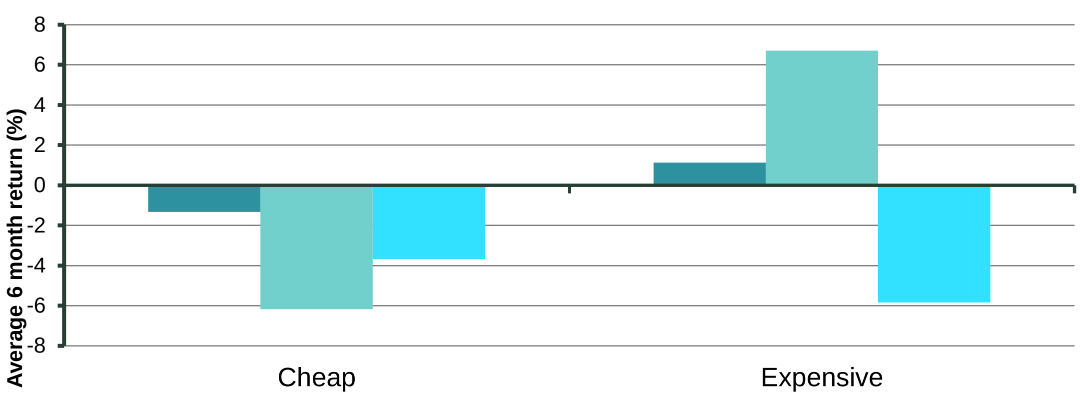
Value

In 2018 we looked at valuation from a number of angles, particularly in the middle of the year when value stocks were deeply underperforming the high-growth, expensive parts of the equity market. We noted the long spell of underperformance for the long-term value premium – at least as defined by the most common valuation ratios, such as book value to market, cash flow to price and earnings to price. This, in turn, highlights the importance, in our view, of evolving the way one measures value across equities, to include more robust, nuanced metrics.

In general, the value premium rewards both the high- and low-growth segments of the market; cheap growth stocks generally perform better than expensive growth stocks. But this was not the case through the first half of 2018, when value exhibited a near-zero return spread in low-growth stocks and an extreme negative spread in high-growth stocks (based on a long portfolio of cheap, low-growth companies and a short portfolio of expensive, low-growth companies).

An interesting adjunct to this theme is the contrasting performance of high-growth versus low-growth companies in the first half of 2018 compared to the second half. In the first half, we saw high-growth companies perform very strongly compared to low-growth companies in the most expensive part of the market (based on a long portfolio of high-growth, expensive companies and a short portfolio of low-growth, expensive companies). By contrast, in the second half of the year, the returns for all high-growth companies experienced a major reversal, in both the cheap and expensive pockets of this category. (See Figure.)

Figure. **The growth theme experienced a major reversal in the second half of 2018.**



Source: State Street Global Advisors, MSCI, Factset. Portfolio returns shown above are hypothetical and are based on the returns of the underlying market index. Results are unmanaged and not subject to fees and expenses, which would lower returns. As of December 31, 2018.

Figure

Average six-month percentage return of a portfolio that is long the highest-growth quintile of stocks and short the lowest growth quintile, within cheap and expensive groups in the MSCI World Index.

Legend

1995-2018

1H 2018

2H 2018

The value theme was rewarded more in the second half of 2018, particularly during September, October and November, but the theme that played out more strongly was that of high-growth stocks underperforming, rather than cheap stocks outperforming. Indeed, the highest-earnings growth segments – the technology and consumer discretionary sectors – strongly underperformed the rest of the market.

We will continue to see valuation as an important consideration when buying stocks in 2019 and beyond. It’s important not to overpay for companies with a strong growth prospects, and we believe investors should carefully balance these themes, applying a value lens to growth stocks.

At the same time, it’s also important for investors to apply a quality lens to value stocks. The cheapest parts of the market aren’t necessarily the best places to invest right now. For example, autos and materials stocks all look quite cheap, but the near-term outlook for these segments is negative, and risk attributes are high. We find better opportunities to capitalize on value in insurers and telecoms.

Additional themes to watch in 2019

Volatility

Market volatility has picked up in recent months, highlighting the need to consider portfolio exposures that can withstand this renewed market pattern. Taking defensive positions in the portfolio can help, but it’s important not to overpay for safety and not to think about positions in isolation. The contributions each position makes to the overall portfolio are also an important consideration; the correlation of positions in the portfolio is just as important as the positions themselves.

Interest rates

Defensive positions are important in this environment. At the same time, we have entered a new interest rate environment in which synchronized, interest-rate increases are likely to continue for the next few years (albeit slowly). The impact of rising rates on equity positions will impact defensive parts of the market, including utilities and REITs. Looking at defensive positions through the lens of interest-rate sensitivity can help investors to weather the storm of volatility in this new interest-rate regime.

Glossary

Earnings per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Earnings Growth is the annual rate of EPS growth

Growth stock A company that in anticipated to grow at a rate above the average for the market, rather than yield high income.

Value stock A company with solid fundamentals (e.g., dividends, earnings and sales) that tends to trade at a lower price than its peers.

REITS Real Estate Investment Trusts own and typically operate commercial real estate.

FANG stands for Facebook, Amazon, Netflix and Alphabet’s Google; however, this group of companies is represented more broadly by the NYSE FANG+ Index.

MSCI World Index A stock market index of ‘world’ stocks.

Marketing communication

State Street Global Advisors Worldwide Entities

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