STATE STREET GLOBAL ADVISORS

Active Quantitative Equity

Lower-Risk Stocks Rallied in March. Here Are the Key Investment Themes to Watch Now.

- A recent uptick in bond-market volatility suggests that investors should be careful about their risk exposure across markets.
- Investors seeking to manage their risk exposure in developed-market equities should avoid cyclical-growth stocks in favor of defensive and secular-growth stocks, where valuations allow.

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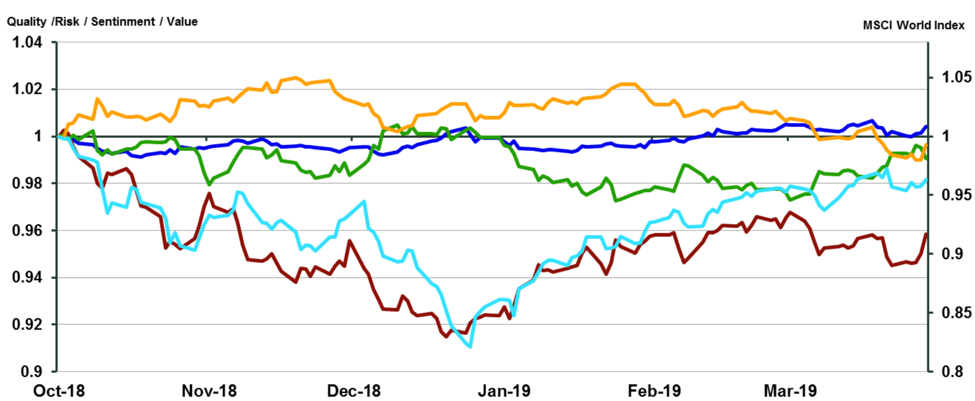
Upsets to interest-rate policy and moves in the bond market have been a major factor in the large equity-market moves over the last six months. In October 2018, increases in bond yields tied to robust economic results sparked an equity-market sell-off. Falls in bond yields due to softening global economic conditions and uncertainty about future Fed policy led to subsequent sell-offs in November and December. So far in 2019, equity markets have calmed down, and most of the market losses in Q4 have recovered in the first quarter.

Risk as a dominant theme

The theme that has dominated stock selection over this period has been risk. We can observe this phenomenon by building a portfolio that is long the quintile of stocks with the highest scores (representing the lowest risk) and short the quintile of stocks with the lowest scores (i.e., the highest risk), according to State Street Global Advisors' proprietary measures of security risk *(see Figure 1)*. This portfolio experienced a sharp decline during the period, in line with the broader equity market. Risk was a more significant driver of dispersion in performance across the global equity market than other investment themes, including valuation, sentiment and quality.

Figure 1 **Among key investment themes, risk was the most significant driver of dispersion in performance across the global equity market.**



Source: Bloomberg Finance L.P. and State Street Global Advisors analysis, using proprietary measures of each theme. "Quality" includes measures of financial strength (e.g., balance sheet stability, cash flows) and of sustainability attributes. "Risk" includes measures of volatility and market sensitivity (beta). "Sentiment" metrics include stock-price changes, trading volumes, changes in earnings and sales forecasts, and hedge-fund positioning. "Value" measures include multiples of book value, earnings, sales, cash flow, etc. In each case, our investment process relies on a wide range of robust, nuanced, sector-specific proprietary metrics, developed through rigorous research.

Figure 1

Performance of long/short portfolios of various themes alongside equity market performance, October 1, 2018 to March 29, 2019.

Legend

- Quality
- Risk
- Sentiment
- Value
- MSCI World Index (RHS)

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In general, high-risk stocks – particularly in the Technology, Industrials and Energy sectors – have been the strongest performers during the first quarter. In March, however, the rebound in high-risk stocks stalled, and market leadership shifted. In recent weeks, Technology stocks have remained at the top of the leader board, but Real Estate, Consumer Staples and Utilities stocks have also risen to the ranks of top performers.

An uptick in bond-market volatility

March has been marked with a rise in bond-market uncertainty, but not a rise in equity volatility, as seen in *Figure 2*. The MOVE index, a useful tool to measure bond-market sentiment, has risen sharply over the last weeks of March, but the VIX index – a measure of equity-market volatility – has not.

Figure 2

VIX and MOVE index values, October 1, 2018 to March 29, 2019

Legend

VIX Index (LHS)

MOVE Index (RHS)

Figure 2 **Bond-market volatility ticked upward in March, but equity-market volatility did not.**

Source: Bloomberg Finance L.P.
Past performance is not indicative of future results.

This is unusual. Bond- and equity-market volatility typically move up and down together, and we believe this clustering of volatility across asset classes is likely to continue to hold. So, given the recent uptick in bond-market volatility, we believe investors should prepare for a change in risk appetite across markets.

Key investment themes to watch

The best themes to have exposure to in an environment like this one, in which economic uncertainty is rising, are defensive and secular growth themes (as opposed to cyclicals).[1] The table shows our general sector preferences within these themes based on our proprietary stock-selection model and our risk forecasts for stocks. These preferences are powered by our multi-dimensional drivers of expected return, including value, quality and sentiment indicators and top-down macroeconomic drivers, as well as risk attributes such as volatility and market sensitivity.

Table

The Active Quantitative Equity team's most and least preferred sectors among secular growth and defensive stocks.

Investment Theme	Most Preferred Sectors	Least Preferred Sectors
Secular Growth	• Healthcare Providers • Pharmaceuticals • Technology Hardware	• Software and Services
Defensive	• Utilities • Food & Beverage • Diversified Telecoms • Insurance	• Real Estate • Household Products • Transport Infrastructure

[1] This is not, of course, to say that investors should categorically avoid cyclical stocks; indeed, a well-balanced equity portfolio is likely to require them even under current conditions. We see relative opportunity among cyclicals in the Consumer Services, Consumer Retailing and Commercial-Services sectors, as well as in Asia-Pacific Airlines. Our least preferred cyclical sectors include Durables and Apparel, US and European Airlines, Banks, Media and Entertainment, Materials and Energy.

Marketing communication

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Glossary

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

MSCI World Index. A stock market index of 'world' stocks

VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index call and put options. The index typically rises during periods of falling prices, sometimes sharply during more precipitous declines.

The Merrill Lynch Option Volatility Estimate (**MOVE**) **Index** is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options, which typically rises as concerns grow that interest rates are trending higher.

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