WISDOMTREE EQUITY OUTLOOK – THE THREE DIMENSIONS OF PORTFOLIO RESILIENCE

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In 2020, there was an unprecedented use of the word 'unprecedented'. Investors grappled with the human, economic, and financial costs of the pandemic. Various letters of the English alphabet were suggested to predict the shape of the recovery. Regardless of what letter ultimately described it best, for equity investors who were able to stay invested through the volatility in March, the subsequent recovery did indeed pay dividends.
The broad rally in equity markets, which has reached new heights in 2021, has been fuelled by three key forces. First, extraordinary (to avoid using the word 'unprecedented' again) levels of monetary accommodation have continued. Second, vaccine optimism, since November last year, has passed the baton to pent-up demand which is helping deliver strong corporate earnings this year. And finally, governments, introducing fiscal stimuli, have lent additional buoyancy to risk assets.

With many developed equity markets persistently reaching for new highs, what big picture themes might investors want to consider for adding resilience to their equity portfolios in the coming months?

Tantrums on the horizon?

We have heard of the boiling frog syndrome – the legend describing a frog being slowly boiled alive. The idea is that if the frog is suddenly put into boiling water, it will immediately jump out and save itself. If instead, it is put into lukewarm water, which boils gradually, it may not perceive the impending danger and end up being cooked to death.

How does the analogy apply here? Had monetary accommodation been introduced suddenly in response to the pandemic, the US Federal Reserve (Fed) may have been more eager to 'normalise' policy than it currently appears to be. Given that monetary accommodation has largely been the norm since the global financial crisis, the central bank appears less perturbed in an unsustainable situation.

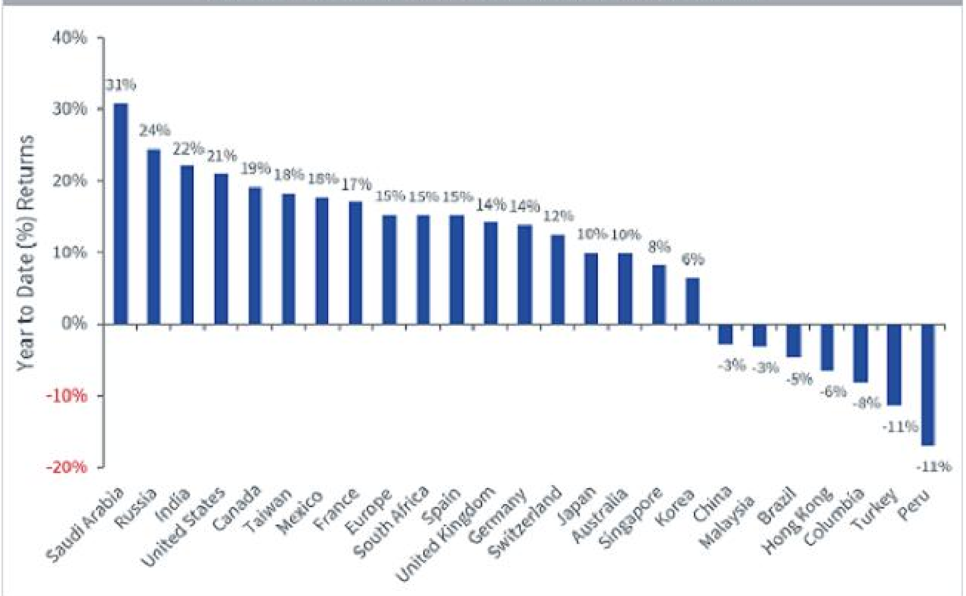
We currently have negative long term real yields in the US – an economy that is back up on its feet. Eventually, crisis levels of policy accommodation will need to be withdrawn. But the further the Fed kicks the can down the road, the higher the risk of a taper tantrum. We form this view based on the aftershocks of March 2020 market volatility, especially when markets anticipate a hawkish pivot from the Fed.

Equity investors can position themselves to better withstand such volatility with quality as a core portfolio exposure. Quality's balance between downside protection and upside participation makes it a favourable all-weather factor that can complement or replace a market cap exposure in the portfolio's core.

Regional snapshots – Winner takes it

Global equity markets have posted strong gains in 2021, powered ahead by the US and Europe, leaving behind China and the Asia-Pacific region. India and Japan have demonstrated a strong turnaround towards the middle of the year as their economies re-emerged from the recent peak of the Delta variant. We continue to remain optimistic on Europe, Japan, and Emerging Markets.

Figure 1: Year to Date performance returns amongst primary global indices



Source: Bloomberg, WisdomTree. Please note the Year-to-Date percentage returns are from 30 December 2020 to 9 September 2021.

Historical performance is not an indication of future performance and any investments may go down in value.

The **Eurozone** economy appears to be firing on all cylinders. In the second quarter, the Eurozone's growth measured by gross domestic product (GDP) expanded by 2% quarter-on-quarter, outpacing the US and China. While growth amongst global markets is on course to slow next year, the pace of the slowdown is much lower for Europe compared to the rest of the world since Europe was at a very nascent stage of its recovery prior to the pandemic. Eurozone GDP is still 3% lower than its pre-pandemic high, while US second quarter GDP was 0.8% higher.

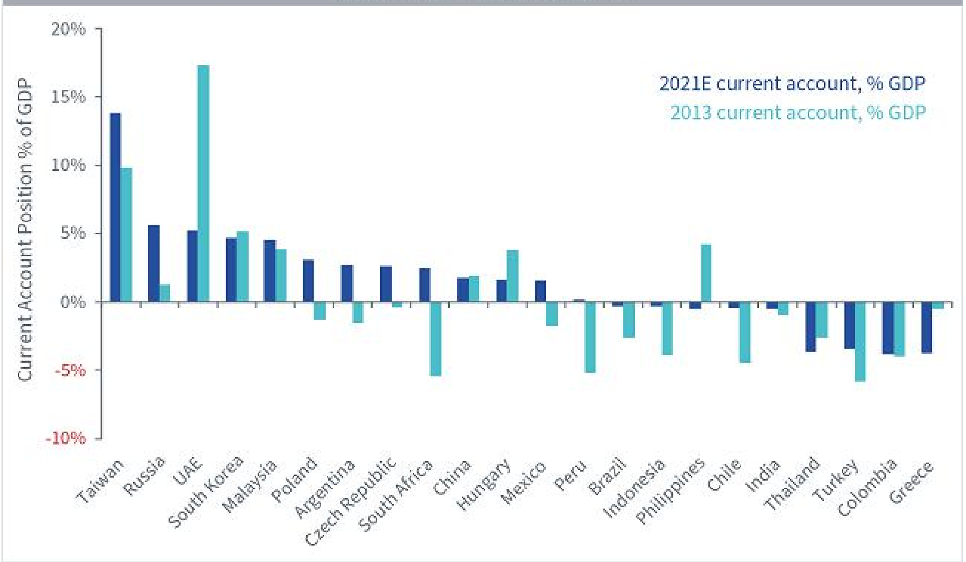
Consumption demand, aided by the economic reopening, helped unleash excess savings that had been accumulated during the pandemic. Increases on the production side have been led by the services sector as the manufacturing sector still faces supply shortages on numerous production inputs. Delivery delays are driving manufacturers' input costs higher, leading to a record increase in the average selling price for goods and services. We expect this to translate into higher inflation over the second half of this year before easing into 2022. Monetary policy is likely to remain accommodative and we expect the pace of net purchases under the Pandemic Emergency Purchase Programme (PEPP) to slow down and eventually terminate by March 2022, contingent on the coronavirus crisis being contained.

The EU's Recovery and Resilience Facility (RRF) should also enable the implementation of economic reforms by member states. Looking at the grants alone, the RRF will cover nearly 20% of Germany's recovery plan and 30% of Italy's, 39% for France and 50% for Spain. In Germany, the left-leaning Greens are polling strongly in advance of the federal elections in September. The most likely outcome looks to be a coalition between the Greens and the Social Democratic Party of Germany (SPD), in which the Greens are likely to push for more expansionary fiscal policy. On the earnings front, European equity markets are benefitting from one of the strongest earnings revision upgrades. Amidst Europe's record-breaking second quarter earnings season, buyback announcements now stand at a four-year high and could provide a further tailwind for European equities.

Japanese equities are poised to benefit from the recovery in developed markets, as the large cap segment derives nearly 56%[1] of its revenues abroad, of which the largest regions are the US and Europe. Covid-19 dynamics have been a key factor in the underperformance of Japanese equity markets versus global markets. Another source of uncertainty that is unique to Japan stems from its political landscape. Prime Minister Yoshihide Suga's waning popularity in tandem with his inability to control the Covid outbreak led to his resignation in September. The schedule for the Liberal Democratic Party's (LDP) presidential election is expected to remain the same. Regardless of the LDP election outcome, we expect the current accommodative macro policy framework to be maintained in the near term. There is potential for further fiscal stimulus in the lead-up to the lower house of parliament elections, which could lend an additional tailwind for Japan's equity markets. Japan reported the fifth straight beat of quarterly earnings, with aggregate net income beating consensus expectations by 30.6%[2] over the prior quarter. Japan's earnings revisions trend remains the third-best of the major regions. We believe the long-term prospects for Japan's equity market remain favourable given its attractive valuations amidst a continued structural improvement in corporate governance and return on capital.

The Covid-19 pandemic has led to a bifurcation in performance between **Emerging Markets** (EM) and Developed Markets (DM) primarily due to the slower rollout of vaccinations in EMs. But run rates are improving and, by year-end, the median EM is on track to see the share of fully vaccinated individuals rise from 29.8% to 71%[3]. If this manifests, it would take EMs close to herd immunity. The strong US dollar coupled with concerns of Fed tapering of asset purchases is weighing on sentiment. While we expect the tapering of asset purchases to commence in December 2021, it is unlikely to lead to a repeat of the taper tantrum of 2013 as EM economies are broadly in better shape, evident from their current account positions.

Figure 2: EM taper tantrum risks are low



Source: Haver, CEIC, National Statistics Offices, WisdomTree as of 31 August 2021. GDP is gross domestic product. 2021E stands for 2021 estimates.

The rise in capital investment in developed markets through large scale traditional and green energy infrastructure projects should raise demand for raw materials, which, in turn, should benefit EM companies given the position they hold in global supply chains. EM equity valuations have become more supportive with MSCI's 12-month forward price to earnings (P/E) ratio at 12.9x . EM trades at a meaningful discount to DM in terms of both forward P/E and trailing price to book (P/B) ratios. Relative to MSCI EM, the valuation of real estate, energy and financial sectors looks attractive compared to their long-term historical valuation distribution, while healthcare, consumer discretionary and communication services look stretched.

Growth is back and here to stay

'Sector rotation' was among the buzz terms at the start of this year. And rightly so, given how value was outpacing growth. Energy stocks made gains from rising oil prices while rising yields boosted financials. In Navigating the twists and turns in equities, we posited that it is better to classify this as an oscillation rather than a one-off rotation. We further suggested that this might be a year when growth and value would not only co-exist but complement each other.

Figure 3: Growth caught up with value by the end of August

Source: WisdomTree, Bloomberg. Data as of 09 September 2021. Value and Growth are illustrated using MSCI World Net Total Return Indices in USD.

Historical performance is not an indication of future performance and any investments may go down in value.

We remain subscribed to that assertion, and growth's recent recovery has reinforced our conviction in the view (see figure 3 above). At WisdomTree, we do, however, make a distinction. We prefer the connotation of growth that aligns more closely with long-term themes, i.e., investment opportunities linked to megatrends.

For example, suppose annual passenger electric vehicle sales go from 3 million in 2020 to 66 million by 2040. In that case, a significant amount of investment will be required in the battery solutions value chain as well as the entire ecosystem surrounding the technology in things like charging infrastructure and recycling. This theme is aligned with the energy transition, a megatrend expected to unfold over the coming decades but likely to keep accelerating in the coming months.

Another trend catalysed by the pandemic is that of the digital transition. One key theme that links to this megatrend is that of cloud computing. Cloud technology is not only a necessity for businesses to survive and compete in today's economy but also a meaningful contributor to global economic and employment growth. Over the last 18 months, the total market cap of public cloud companies has increased by $1.3 trillion to a total of $2.3 trillion[5], highlighting the significant growth in this space.

Another theme that goes hand in hand with the digital transition is that of cybersecurity. Mandiant, a cybersecurity firm, reports that one in ten businesses is forced to close once they are victims of a ransomware attack[6]. With engagement with customers happening increasingly online, risking a cyberattack is something all businesses will seek to rule out completely.

The list doesn't end there. The above examples merely illustrate that we expect investors to become increasingly discerning in identifying how to access long term growth. Themes with long shelf lives are likely to remain topical in the coming months (and years).

The key takeaway

The themes discussed allow investors to recognise three distinct dimensions of equity investing. An all-weather core to mitigate the impact of any impending volatility, geographical diversification to benefit from the global cyclical growth opportunities, and thematic investing for long term growth. Diversification also helps guard against complacency, something that can easily creep in given the strong rally in equities since the second quarter of 2020.

This blog was drafted in collaboration with Aneeka Gupta.

Sources

[1] Factset, WisdomTree as of 4 September 2021

[2] Bloomberg, WisdomTree as of 4 September 2021

[3] Pharmaceutical Technology

[4] Bloomberg, WisdomTree as of 31 August 2021

[5] Bessemer Venture Partners August 2021

[6] FireEye 2021 Corporate Presentation

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