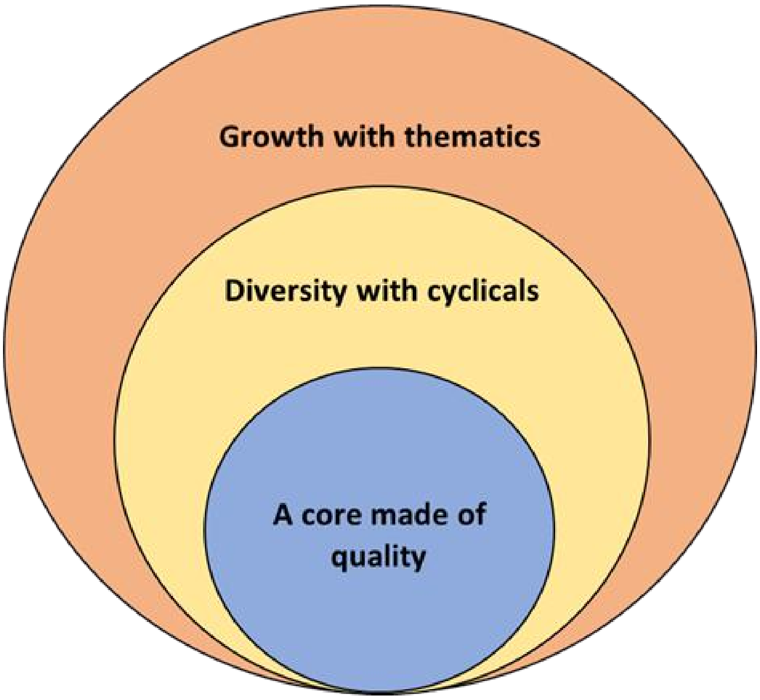
A MOMENT IN MARKETS – NAVIGATING THE TWISTS AND TURNS IN EQUITIES

Mobeen Tahir – Director, Research
11 May 2021

It is turning out to be another eventful year in equity markets. Sector rotation, policy largesse, the everything rally – investors have much to contend with. In January, we introduced a framework for navigating equity markets this year. The underlying principle at the heart of the proposed strategy was that of diversity. Despite a largely conducive macro backdrop for equities this year, our conviction in the need to diversify has been reinforced.



Source: WisdomTree. **For illustrative purposes only.**

The framework revisited

The proposed illustration was introduced as one possible way investors may achieve diversification across factors and geographies (see figure above). It was framed as a strategic asset allocation that gives due consideration to current market conditions. There were essentially three key pillars within the framework.

The first pillar is that of quality which features as a core exposure in the portfolio. Quality is a factor that tends to be endorsed by both academics as well as industry practitioners. In 2014, Fama and French adapted their 3-factor model to include two new factors – one of which was profitability, i.e., companies with higher profitability tend to outperform over the long term. At WisdomTree, we subscribe to the notion of profitability as a useful measure for defining quality. In theory, all equity factors are designed to outperform the broader market over the long term as they offer some unique risk premium. Quality's merit lies in its balance between downside protection and upside participation. Since the turn of the millennium, global quality stocks have outperformed the market by an annualised rate of 2%[1]. We, therefore, favour quality as an all-weather core exposure in the portfolio.

The second layer recognises that now is a promising time to gain exposure to assets that benefit from a cyclical upswing. The reignition of economic engines worldwide, with the support of vaccines in the battle against the pandemic, has inspired a relief rally in many parts of the equity spectrum. In Time to capitalize on value in Europe, we discuss why value is bouncing back and how Europe is making the case as a market for accessing the factor. Europe's export reliant economy, its sector mix with a cyclical bias, and coordinated policy support from the European Union are the key forces fueling the resurgence in the market.

We also proposed considering geographical diversity through emerging markets and factor diversity through small caps within this layer. So far, emerging markets have been held back by pandemic woes in many countries, including India, Brazil, and Russia. But with vaccine distribution improving by the day, hope remains that all countries will emerge from the crisis. That, along with ongoing weakness in the US dollar and steady strength in the Chinese economy, bodes well for emerging markets. Small caps have delivered on their promise so far this year[2], an expected outcome given their strong relationship with the improving global economy.

The third layer includes growth through thematics. One key feature of this layered approach is that it allows growth and value to not only coexist but complement each other, given that each factor adds a unique dimension to the asset allocation. While value focuses on the cyclical recovery, growth recognises the notable expansion in the thematics universe. In President Biden's $2 trillion infrastructure plan, around $174bn has been pledged for electric vehicles (EV) initiatives including the building of 500,000 EV charging points by 2030[3]. Electric vehicles are one important theme within the energy transition megatrend and will require an entire ecosystem of battery solutions to really accelerate. For investors seeking differentiated opportunities with long shelf lives, thematics continue to offer a promising frontier.

Put together, the three layers combine an all-weather element with both cyclical and long-term elements to add diversity across multiple dimensions. But what about the macro backdrop for equities for the rest of the year and what are the key risks facing markets?

The macro backdrop

While there was nervousness in equity markets during the first quarter of the year when US Treasury yields were on a steep ascent, plateauing yields and strong first quarter earnings have calmed nerves. According to FactSet, for the second quarter of the year, analysts are foreseeing the second highest quarterly increase in earnings per share for S&P 500 Index companies since 2002. Pent up demand is beginning to become apparent in economic data. US retail sales were up 9.8% month on month in March beating market forecasts of a 5.9% increase[4]. US consumer confidence is on the rise and has significant headroom for improvement before it reaches pre-pandemic levels[5]. Monetary and fiscal accommodation can be expected to lend additional support.

But performance has not been steady across the spectrum. The notion of sector and factor rotation has been voiced widely this year, but what has happened in markets so far this year can easily be classified as oscillation rather than a one-off rotation. Value clearly outperformed growth in the first quarter given the gains in financials, but growth bounced back strongly in April as strong technology sector earnings revived the sector. This trend may persist throughout the year before reaching some sort of an equilibrium.

In the meanwhile, policy risk is emerging as another thing for investors to consider. On Tuesday 04 May, the tech-heavy NASDAQ Composite Index dropped nearly 2%[6] when the US Treasury Secretary (and ex-Federal Reserve Chair) Janet Yellen asserted that the central bank ought to consider tightening the screws on its monetary policy to keep the economy from overheating. While there was nothing controversial about what she said, the reaction from markets is a stark reminder of how sensitive and reliant markets have become to monetary policy. And while the Federal Reserve's policy is not, and should not, be influenced by market moves, the central bank would probably not want to create tectonic shifts in markets when it begins to withdraw liquidity. Managing expectations through forward guidance could be key to avoid an outcome where necessary policy measures induce market volatility. This risk seems to be growing given that, for now, the narrative from the central bank seems to be that of indefinite accommodation. Having said that, policy risk itself is not enough to warrant reducing equity exposure. It does, however, reinforce the case for diversity.

Thus 2021 could be another good year for equity markets but, under the hood, may look very different compared to 2020. While tactical investors may find opportunities in the twists and turns within the equity spectrum, strategic investors may benefit from adopting a balanced approach.

Sources

[1] Bloomberg, data as of 06 May 2021 based on the comparison between MSCI World Quality Net Total Return USD Index and MSCI World Net Total Return USD Index.

[2] Bloomberg, data as of 06 May 2021 based on the outperformance of the MSCI World Small Cap Index to the MSCI World Index.

[3] https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/

[4] US Census Bureau

[5] University of Michigan

[6] Bloomberg

Related blogs

+ A moment in markets – Navigating equity markets in the year ahead

+ Time to capitalise on value in Europe
+ How to organise the thematic universe? Introducing The WisdomTree thematic classification

Related products

+ GGRA/GGRG - WisdomTree Global Quality Dividend Growth UCITS ETF - USD Acc
+ DFEE/DFE - WisdomTree Europe SmallCap Dividend UCITS ETF
+ EEIE/EEI - WisdomTree Europe Equity Income UCITS ETF
+ VOLT - WisdomTree Battery Solutions UCITS ETF
+ WCLD/KLWD - WisdomTree Cloud Computing UCITS ETF
+ WisdomTree Artificial Intelligence UCITS ETF - USD Acc
+ WCBR - WisdomTree Cybersecurity UCITS ETF – USD Acc

View the online version of this article here.

Important Information

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.