QUALITY, THE FACTOR TO DEAL WITH UNKNOWN-UNKNOWN RISKS

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Global equity markets have enjoyed a stellar run in H1 2021 on the back of the reopening trade. However, cracks are starting to appear as many risks begin to brew on the horizon. Market conditions could very well be in place for this rotation to accelerate. In fact, in Q2, the quality factor (+10.88%) has outperformed cyclical factors like value (3.4%) and small caps (5.4%).[1]

While it's hard to predict the exact timing and the extent of a mid-rally correction or a factor rotation, we believe it would be prudent for investors to consider the quality factor since numerous stars appear to be aligning in favour of that factor since numerous stars are aligning in favour of quality:

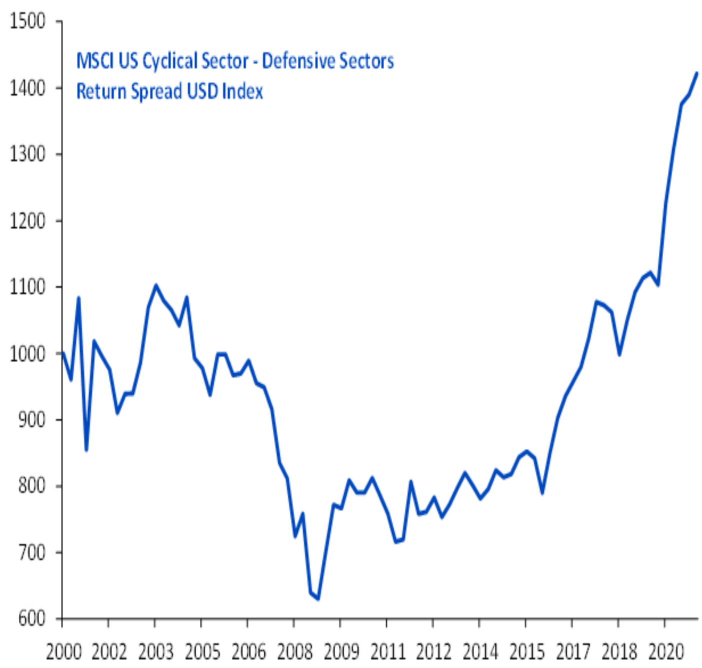
- Unknown-unknown risks are lurking on the horizon, favouring more defensive factors
- Probability of high-quality stocks outperforming improve as market valuation and performance gets stretched
- High-quality equities trade at a discount to the market
- Quality stocks have historically performed better during periods of tapering

The certainty of uncertainty

Looking ahead, it is important to differentiate between those risks as their impact on global markets tends to vary. We divide those risks into two buckets (1) the known-unknowns and the (2) unknown-unknowns.

The known-unknown risks are the traditional risks that the market is aware of but is yet to determine its impact. The spread of the more transmissible Delta variant across many parts of the world is an example of a known-unknown risk that has emerged on the horizon. This risk is hurting the performance of cyclical sectors of the economy as consumer optimism is being challenged. Until now, equity markets were painting a more optimistic outlook on the global economy in terms of higher growth, inflation and consumer confidence, contrary to the narrative on bond markets. However, global equity markets now appear to be conforming to the narrative on global bonds markets. This is evident from the peaking of the ratio of cyclical versus defensive stocks in the US, a key gauge of risk.

Figure 1 – Key risk gauge appears to be reaching a peak



Source: Bloomberg, WisdomTree, quarterly data, from 29th December 2000 to 30th June 2021.

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

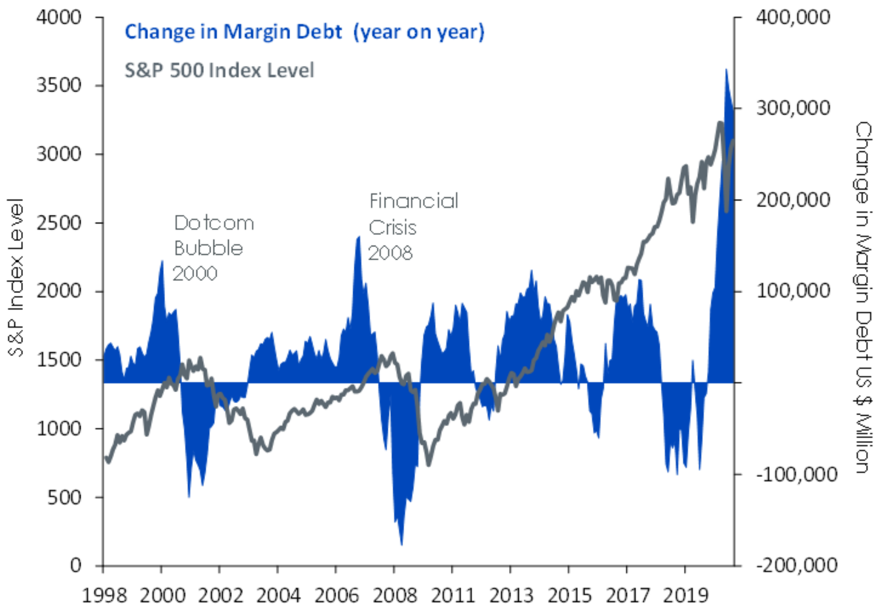
Countries such as the US, Euro-Area and UK that have achieved higher vaccination rates and should be able to withstand the rise in cases without having to impose renewed lockdowns. However, for economies lagging in the pace of vaccinations, such as Asia, we expect to see a lag in domestic consumption for a short duration while external demand and capex should continue to bolster their economies. In that vein, fiscal and monetary policy support is unlikely to be withdrawn in the near term, contrary to market expectations. In our view, the current uncertainty is a reflection of the ongoing transition of global markets from the early phase of the cyclical recovery to the mid-cycle phase of the recovery. And so, we remain less worried about the known-unknown risks but caution investors to be vigilant of the unknown unknown risks.

Stay vigilant of unknown-unknowns risks

Risks that have yet to be identified are associated with unknown-unknown risks. We have been paying close attention to stock market leverage. Margin debt, known as the amount that individuals and institutions borrow against their stock holdings, has been a good representation of stock market leverage. The change in margin debt levels over the prior year as measured by Financial Industry Regulatory Authority (FINRA) appears to have attained a peak last month. Comparing the annual change in margin debt levels versus the S&P 500 Index, we observed that peaks in margin debt levels have been an important precursor of corrections on the US stock market, as seen in 2000 and 2008 during the dotcom bubble and great financial crisis. While it's hard to predict the exact timing of a correction, we believe it would be prudent for investors to consider and potentially look towards a higher allocation to the quality factor, given the presence of unknown-

unknown risks lurking on the horizon."

Figure 2 – Annual change in margin debt versus the performance of S&P 500 Index



Source: FINRA, Bloomberg, WisdomTree, data available as of close 30th June 2021.

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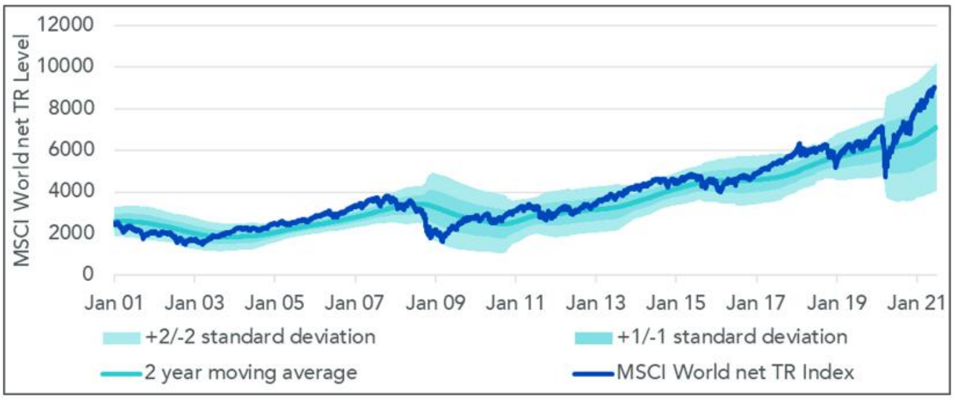
Quality, a factor for post-recovery markets

Looking at the market quantitatively, we observe below that at a certain point in the cycle, the early recovery has run its course, undervalued stocks have rebounded, and easy investments have been exploited. Investors then expect a rotation among the best-performing stocks. This rotation usually goes from value and small caps to other factors such as quality. But is it systematically the case?

In the following analysis, we try to assess the behaviour of different equity factors in periods following a sharp rise in equity prices. In a recovery, equity markets usually surpass their long term moving averages and trend much higher (i.e. one standard deviation above the moving average, then two, and so on). As illustrated in Figure 3, we currently stand slightly above the one standard deviation mark.

Figure 3: MSCI World, its 2-year moving average and Bollinger bands



Source: WisdomTree, Bloomberg. Date from 31st December 1998 to 30th June 2021, daily in USD. The standard deviation is also calculated on a 2-years look back basis.

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On analysing the data since 1998, we observed that if the MSCI World was 0.5 standard deviation above its two year moving average, its average performance in the subsequent six months would been +4%. However when it was above two standard deviations, it was 2.8%, and when it was above 2.5 standard deviations, it was -0.4%. So, as equity markets rise and stretch, the probability of a market reversal increases.

In Figure 4, we look at the same analysis but for different factors. We observe that as soon as the MSCI World is above the 0.5 standard deviation line, Small Caps have had a higher tendency to underperform than to outperform. Small Caps do very well in the recovery run-up, so it is the first factor to turn or reverse, so to speak. Value, while more robust, exhibits the same behaviour if equity markets get high enough. Looking at quality, on the contrary, its performance expectations are very robust when equity markets start to rise. The higher the performance of equity markets, the higher the magnitude of the reversal, the higher the expected outperformance. Historically, quality was the best factor for the following six months as soon as the market rose above the 0.5 standard deviation mark.

Figure 4: Average 6-months outperformance of equity factors (vs MSCI World net TR Index) when equity markets are above given thresholds

Source: WisdomTree, Bloomberg. Date from 31st December 1998 to 30th June 2021, daily in USD. The standard deviation is also calculated on a 2-years look back basis.

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This supports our qualitative analysis. When markets have recovered from the crisis and investors start to look forward to the next thing, cyclical investments look riskier, and investors tend to circle back to all-weather investments. Investments that can grow in lockstep with the market but also withstand unexpected events, such as Quality equities. You can find our analysis of the all-weather characteristics of quality and the WisdomTree Quality Dividend Growth approach here and here.

The time for quality is here

In addition to the robustness of the quality factor during different phases of the economic cycle, there are other stars aligning for quality:

- High-quality equities not only trade at a discount to the market but also versus low-quality equities

Quality equities are, by definition, are meant to be safer, have better business models, generate more cash flows than other factor-driven equities. Finance 101 tells us that we should pay more for safety and quality. AAA bonds are more expensive and yield less than BBB bonds. And yet, quality stocks have been trading at a discount. At the end of June, the MSCI World Quality exhibited a trailing 12-month price to earnings ratio of 29.1 versus 30.1 for the MSCI World. At the same time, WisdomTree Global Developed Quality Dividend Growth Index had a price to earnings ratio (PE) of 22.[2]

- Quality stocks have historically performed better in periods of tapering

While markets have shown some signs of nervousness since tapering has come back in the Fed’s vocabulary, investors geared to the quality factor should feel more secure. As illustrated in Figure 5, quality stocks have historically done well in similar periods of tightening monetary policy.

Figure 5: Outperformance of Quality indices (vs MSCI World) in periods following tapering events

		MSCI World Quality		WisdomTree Global Developed Quality Dividend Growth	
Event	Date	Next 3M	Next 6M	Next 3M	Next 6M
QE1 Ends	31/03/2010	1.2%	0.4%	2.0%	2.2%
QE2 Ends	30/06/2011	5.9%	7.3%	3.8%	4.6%
QE3 Ends	29/10/2014	1.4%	-0.4%	2.2%	1.9%
Balance Sheets normalization starts	20/09/2017	1.9%	2.9%	1.1%	0.4%
Tapering of balance sheet normalisation announced	20/03/2019	1.2%	1.2%	0.6%	1.0%

Source: WisdomTree, Bloomberg. Date from 31st March 2010 to 30th June 2021, daily in USD. Dates are extracted from FOMC reports.

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Global equities are proxied by the MSCI World net TR Index. Min Vol is proxied by MSCI World Min Volatility net total return index. is proxied by MSCI World Quality net total return index. Value is proxied by MSCI World Enhanced Value net total return index. Small-Cap is proxied by MSCI World Small Cap net total return index.

Sources

[1] Factset, Bloomberg, WisdomTree as of 21st July 2021

[2] Bloomberg, WisdomTree as of 21st July 2021

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