

# LOOKING BACK AT EQUITY FACTORS IN Q1 2023 WITH WISDOMTREE

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Equity markets started 2023 as they closed 2022, with positive performance across regions. However, it was anything but plain sailing for investors as tighter monetary policies started to bite and the most vulnerable banks started to fall. The [M SCI World Index](#) gained 7.7% over the quarter, but Europe performed the best with +8.6%. [Emerging markets](#) trailed other regions with +4%.

This installment of the WisdomTree Quarterly Equity Factor Review aims to shed some light on how equity factors behaved in this complicated quarter and how this may have impacted investors' portfolios.

- As if compensating for 2022, [growth](#) stocks performed the best in Q1.
- [Quality](#) was the second-best factor for the quarter, benefiting from its resilience in uncertain periods.

While [central banks](#) in the U.S., Europe and the UK continued on their [hawkish](#) path, the evolving banking crisis could alter [monetary policies](#) ahead. Chair Powell conceded that tightening financial conditions could have the same impact as another quarter-point rate hike or more from the [Federal Reserve \(the "Fed"\)](#). Markets are now pricing in rate pauses and cuts for later in 2023. However, uncertainty is very high, with [inflation](#) worries warring with [recession](#) fears. Given the rising concerns about the risk of banking industry contagion, shrinking corporate profits and central bank policies ahead, positioning equity exposure toward the quality factor could be prudent.

## Performance in Focus: Growth Rebounds and Quality Outperforms

In the first quarter of 2023, equity markets posted the second positive quarter in a row across regions. In January, markets performed very strongly, anticipating a central bank pivot and easing monetary conditions. February's performance was more muted in reaction to hawkish rhetoric from central bankers. March opened with the bankruptcies of Silicon Valley Bank and Signature Bank, as well as the takeover of Credit Suisse by UBS. While increasing [volatility](#), this "banking crisis" turned rate expectations significantly more dovish, leading to another month of positive performance.

Overall, it was a relatively difficult period for factor investing in developed markets:

- Growth stocks performed the best in Q1 across all geographies, rebounding from a challenging 2022.
- Quality was the second-best factor for the quarter in developed markets, benefiting from its resilience in periods of high volatility and uncertainty.
- In developed markets, other factors like [value](#), high [dividend](#) and [min volatility](#) all suffered from the change in regimes.
- In emerging markets, value and high dividend continued to deliver some outperformance.

**Figure 1: Equity Factor Outperformance in Q1 2023 across Regions**

	World Q1 2023: 7.7%	USA Q1 2023: 7.6%	Europe Q1 2023: 8.6%	Emerging Markets Q1 2023: 4.0%
High Dividend	-6.1%	-8.5%	-3.2%	1.5%
Minimum Volatility	-5.6%	-6.4%	-1.1%	-0.9%
Momentum	-9.1%	-12.0%	-2.9%	-7.5%
Quality	2.8%	2.8%	1.2%	-0.6%
WisdomTree Quality	-1.5%	-3.6%	1.0%	1.7%
Size	-3.4%	-3.8%	-2.7%	-0.1%
Value	-2.2%	-5.3%	-1.1%	2.3%
Growth	7.4%	9.8%	2.9%	12.4%

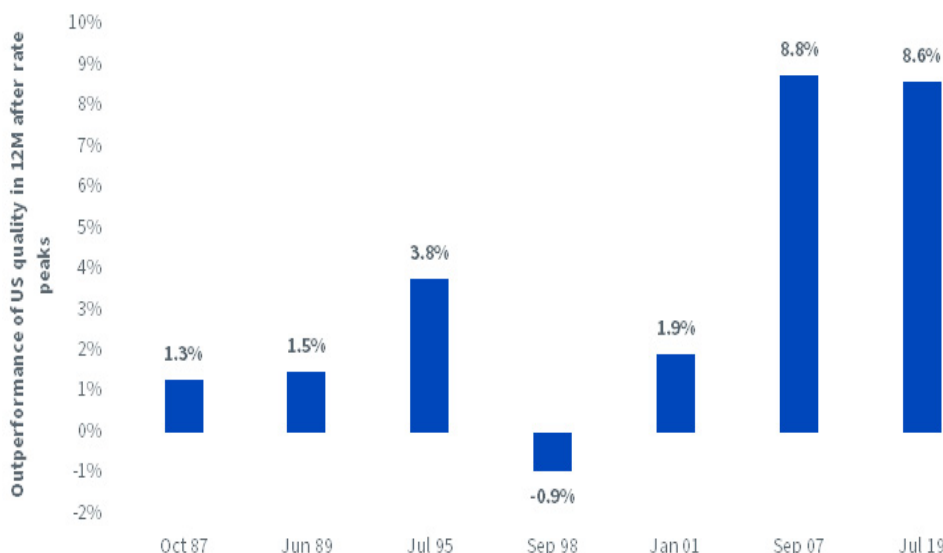
Sources: WisdomTree, Bloomberg, 12/31/22–3/31/23. Calculated in U.S. dollars for all regions except Europe, where calculations are in euros. Past performance is not indicative of future results.

### The Impact of Central Banks' Pivots on Factor Performance

Looking forward to the rest of 2023, the timing of the Fed pivot will be one of the main factors driving equity performance. As economies decelerate, recession fear grows and inflation decelerates, central banks will need to start planning for some landing (soft or not). Such periods of monetary policy changes are always quite difficult for equity investors, and it is always good to look back at similar periods in the past to inform our current positioning. Using the performance of U.S. factors in the 12 months following the end of the last seven Fed rate hike cycles, we observe that:

- High-quality companies behaved the best, outperforming in six out of seven periods (as illustrated in figure 2) and posting an average 3.57% outperformance versus the market.<sup>1</sup>
- Growth companies also tend to benefit from easier monetary conditions, leading to outperformance in five out of seven of those periods and an average outperformance of 3.08%.
- Small-cap companies and value companies' performance was mixed, outperforming in three and four periods respectively (out of seven) but posting double-digit underperformance in others.

**Figure 2: Outperformance of the Quality Factor in U.S. Markets in the 12 Months following Fed Rates Peaking**



Source: Kenneth French data library. Data is calculated at a daily frequency as of February 2023. Stocks are selected to be above the median market cap, with "High Quality" representing the top 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. The market represents the portfolio of all available publicly listed stocks in the United States. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general and administrative expenses divided by book equity for the last fiscal year end in t-1. Past performance is not indicative of future results.

### Valuations Continued to Increase in Q1

In Q1 2023, market [valuations](#) continued to increase across regions on the back of the positive performance. However, in developed markets, while quality and value got more expensive faster than the markets, [small caps](#) and min volatility got cheaper. In the U.S., the value factors got even cheaper, with a current [P/E](#) of only 7.2. In emerging markets, [momentum](#) also got significantly cheaper. Overall, the most defensive factors, min volatility and quality, are currently the most expensive on a relative basis.

**Figure 3: Historical Evolution of the Price-to-Earnings Ratios of Equity Factors**

	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months
Market	16.8	↑ 1.0	18.8	↑ 1.2	13.2	↑ 1.3	12.4	↑ 1.0
High Dividend	13.5	↑ 0.7	14.6	↑ 0.5	10.3	↑ 1.7	7.7	↑ 1.0
Minimum Volatility	17.6	↓ 0.0	18.6	↓ -0.2	16.6	↑ 1.1	12.9	↓ -0.2
Momentum	12.8	↑ 0.6	14.4	↑ 0.4	11.9	↑ 1.2	11.6	↓ -1.2
Quality	20.8	↑ 2.8	21.7	↑ 2.5	17.8	↑ 3.0	15.3	↑ 2.0
Size	16.3	↓ -0.2	19.0	↓ -0.1	13.6	↓ -0.1	12.2	↓ -0.2
Value	9.4	↑ 1.4	7.2	↓ -2.2	8.4	↑ 1.0	6.3	↑ 1.4

Sources: WisdomTree, Bloomberg, as of 3/31/23. Past performance is not indicative of future results.

"World" = MSCI World Index, "U.S." = MSCI USA Index, "Europe" = MSCI Europe Index, "Emerging Markets" = MSCI Emerging Markets Index, "Minimum Volatility" = the relevant MSCI Min Volatility Index, "Quality" = the relevant MSCI Quality Index, "Momentum" = the relevant MSCI Momentum Index, "High Dividend" = the relevant MSCI High Dividend Index, "Size" = the relevant MSCI Small Cap Index, "Value" = the relevant MSCI Enhanced Value Index and "WisdomTree Quality" = the relevant WisdomTree Quality Dividend Growth Index.

For definitions of terms and indexes in the table, please visit our [glossary](#).

Looking forward to 2023, two questions remain unanswered: (1) How sticky is underlying inflation, and (2) How intense will the recession be? However, the balance of risk is slowly shifting from inflation to recession across developed economies.

Our Senior Investment Strategy Advisor, Jeremy Siegel, suggested the Fed pause and pivot should happen sooner than anticipated, and markets are starting to price that in. But uncertainty remains very high, and interest rate volatility is very elevated.

We see rising risks from banks tightening lending standards, shrinking corporate profits and central bank policies ahead,

with market expectations continuing to shift very rapidly. In such an environment, defensive investments such as high-quality and low-volatility companies benefit and receive high interest from investors.

*Pierre Debru is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company, WisdomTree, Inc.*

<sup>1</sup> Source: Kenneth French data library. Data is calculated at a daily frequency, as of February 2023. Stocks are selected to be above the median market cap, with "High Quality" representing the top 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. The market represents the portfolio of all available publicly listed stocks in the United States. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general and administrative expenses divided by book equity for the last fiscal year end in t-1. Past performance is not indicative of future results.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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## DEFINITIONS

**MSCI World Index** : Captures large and mid-cap representation across 23 Developed Markets (DM) countries.

**Emerging market** : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Central bank** : Refers to the the monetary authority of any country.

**Hawkish** : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Inflation** : Characterized by rising price levels.

**Recession** : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**Dividend** : A portion of corporate profits paid out to shareholders.

**Minimum Volatility** : Funds that use an optimization that will consider the correlation of companies to each other in order to get a lower volatility index overall.

**Valuation** : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Small caps** : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

**Price-to-earnings (P/E) ratio** : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.