2023: Time to dive deep into value

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2023 is off to a cautious start, heralded by the International Monetary Fund (IMF). They have warned that the upcoming recession is likely to leave the global economy fundamentally damaged – with a recession in the US, a deeper slowdown in Europe, and drawn-out recession in the United Kingdom. This is quite possible. However, the current downturn may not look like the downturns of the past - supported by a more resilient labour market. As we transition to 2023, three questions from 2022 still remain unanswered: 1) how sticky will the underlying inflation be 2) how intense will the recession be 3) will we find a solution to Europe's energy crisis.

2022 has been a tough year for equities, evident from the 20% decline in the global stock market capitalisation to USD $96.6 tn1. Expensive growth stocks that had driven markets higher over the past decade began to correct sharply as the interest rate regime changed. In contrast, value stocks, while down for the year, were relative outperformers. The MSCI value index outperformed its growth counterpart by 21% this year1. The rising rate environment had a strong role to play in the higher relative performance.

Source: WisdomTree, Bloomberg as of 30 December 2022. Historical performance is not an indication of future performance and any investments may go down in value.

Central banks turn up the hawkish rhetoric

While inflation has begun showing signs of easing globally, central banks in the US, Europe, and UK continue to remain hawkish. The Federal Open Market Committee's (FOMC) new forecasts for the economy and policy showed few signs that the inflation picture is improving meaningfully. Federal Reserve (Fed) Chair Powell made clear in the December meeting that he wanted to see "substantially" more progress on inflation before the hiking would stop.

The latest European Central Bank (ECB) projections show inflation is unlikely to reach the 2% target until late 2025. At its December meeting, the ECB took a hawkish turn, and we think they are likely to hike by 50bps at least twice more, in February and March 2023. Similarly in the UK, the Monetary Policy Committee (MPC) will need to see core consumer price index (CPI) inflation slow materially before the MPC stops its rate hike cycle. The key question in 2023 remains how sticky inflation will be on the upside (how soon it will approach the central bank's targets), as it will determine the likelihood of central banks maintaining their hawkish stance on monetary policy. Historically the value factor has demonstrated resilience during periods of interest rate volatility.

Source: WisdomTree, Bank of America Securities, Bloomberg, data from 1 Jan 1990 to 31 Jan 2022; annualised relative performance versus equal weighted index.

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De-risking your equity portfolio with the high dividend and value factor

As interest rate volatility is poised to remain high, value-oriented stocks such as financials, energy, utilities, healthcare and industrials may be in better shape to withstand a slowdown. This is because value companies tend to make their money in the near term owing to which earnings for these companies are less discounted than for growth companies whose significant profits and cash flow are expected to occur far in the future. Value stocks also have a better chance of defending and/or growing their operating margins compared to growth stocks.

The high dividend factor is synonymous with an investment strategy that gains exposure to companies that appear undervalued and have demonstrated stable and increasing dividends. The strong performance of the dividend factor in 2022 has been a function of their close relationship with stocks with more stable fundamentals alongside the rising rate environment.

What worked in 2022?

Our approach to blending the high dividend factor alongside the value factor helped the WisdomTree US Equity Income UCITS Index outperform the S&P 500 Index by 24.8% in 2022. As illustrated in the sector attribution (above) the allocation has been positive, contributing to the tracking difference by +21%. The overweight in energy, healthcare and utilities benefitted performance by +12%, 2% and 1% respectively last year.

Source: Factset, WisdomTree as of 31 December 2022.

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The advantage of tilting to higher dividend paying stocks

More importantly, the higher allocation of the WisdomTree US Equity Income UCITS Index to the higher yielding dividend quintiles also contributed to the higher relative performance versus the benchmark.

Source: Factset, WisdomTree as of 31 December 2022.

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1 Source: Bloomberg as of 30 December 2022

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