

Looking back at equity factors in Q1 2023 with WisdomTree

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Pierre Debru

Head of Research, WisdomTree Europe.

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 MSCI World index gained 7.7% over the quarter, but Europe performed the best with +8.6%. Emerging markets trailed other regions with +4%¹.

This instalment 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, benefitting from its resilience in uncertain periods

While central banks in US, Europe and 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 (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 towards the Quality factor could be prudent.

Performance in focus: Growth rebounds and Quality outperforms

In the first quarter of 2023, equity markets posted a 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 bankruptcy of Silicon Valley Bank and Signature Bank, as well as the takeover of Credit Suisse by UBS. With 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, benefitting 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

Source: WisdomTree, Bloomberg. 31 December 2022 to 31 March 2023. Calculated in US Dollars for all regions except Europe, where calculations are in EUR.

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

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 fears grow, 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 US factors in the 12 months following the end of the last 7 Fed rate hike cycles, we observe that:

- High-Quality companies behaved the best, outperforming in 6 out of 7 periods (as illustrated in Figure 2) and posting an average 3.57% outperformance versus the market
- Growth companies also tend to benefit from easier monetary conditions, leading to outperformance in 5 out of 7 of those periods and an average outperformance of 3.08%
- Small Cap companies and Value companies' performance was mixed, outperforming in 3 and 4 periods respectively (out of seven) but posting double digits underperformance in others

Figure 2: Outperformance of the quality factor in US markets in the 12 months following Fed rates peaking

Source: Kenneth French data library. Data is calculated at a daily frequency and 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 $t-1$.

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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 US, 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 price to earnings ratios of equity factors

Source: WisdomTree, Bloomberg. As of 31 March 2023. World is proxied by MSCI World net TR Index. US is proxied by MSCI USA net TR Index. Europe is proxied by MSCI Europe net TR Index. Emerging Markets is proxied by MSCI Emerging Markets net TR Index. Minimum volatility is proxied by the relevant MSCI Min Volatility net total return index. Quality is proxied by the relevant MSCI Quality net total return index. Momentum is proxied by the relevant MSCI Momentum net total return index. High Dividend is proxied by the relevant MSCI High Dividend net total return index. Size is proxied by the relevant MSCI Small Cap net total return index. Value is proxied by the relevant MSCI Enhanced Value net total return index. WisdomTree Quality is proxied by the relevant WisdomTree Quality Dividend Growth Index.

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Looking forward to 2023, two questions still remain unanswered – (1) how sticky is underlying inflation; (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, and market expectations continue to shift very rapidly. In such an environment, defensive investments such as High-Quality and Low-Volatility companies could benefit and are receiving high interest from investors.

1 Source: WisdomTree, Bloomberg. From 31 December 2022 to 31 March 2023. Europe is proxied by MSCI Europe net TR in EUR and Emerging markets are proxied by MSCI Emerging markets net TR Index in USD. **Historical performance is not an indication of future performance and any investments may go down in value.**

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