Looking back at equity factors in Q3 with WisdomTree

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Recession risks have risen significantly since last quarter. Energy price shocks are simultaneously destroying supply and demand for goods and services. However, most central banks are more concerned with taming inflation than dealing with economic slowdowns. Hopes of a Federal Reserve pivot appear misplaced, and the US dollar (USD) may rally for longer if the Federal Reserve (Fed) continues to raise rates faster than its peers.

Against this difficult backdrop, markets suffered in Q3 2022, with developed equities shedding -6% and emerging markets dropping more than -11% in USD terms.

This instalment of the WisdomTree Quarterly Equity Factor Review aims to shed some light on how equity factors behaved in these changing market conditions and how this may have impacted investors' portfolios.

- Value and High Dividends took a breather for a quarter after six months of outperforming at neck-breaking speed.
- Size and Momentum posted outperformance for the first time this year.
- Quality performed strongly in Europe. Quality with a Value tilt continued to resist well.
- Most factors outperformed in emerging markets.

While we do not expect the global economy to suffer a full-blown downturn, we expect to see a series of individual country recessions taking shape at different times. Overall, 'building resilience' continues to be the name of the game in equities. Across factors, we continue to tilt to Dividend and Quality factors, given the expectations for weak economic growth, higher rates and elevated inflation.

Performance in focus: High Dividend and Value take a breather

In the third quarter of 2022, equity markets enjoyed a rollercoaster ride. In the first half of the quarter, following good inflation numbers and weak economic data, markets priced in a Fed pivot leading to a sharp rebound. However, hopes of such a pivot were dashed quickly, leading the MSCI World to lose -6.2% over the quarter. Recent US inflation prints came in higher than expected, putting additional pressure on the Central Bank to hike rates aggressively.

Faced with those two very different periods, equity factors performed quite differently:

- High Dividend and Value suffered in the first six weeks of the quarter in most developed regions and, despite a sharp rebound around the end of the quarter, both factors closed the quarter with an underperformance.
- Momentum and Size benefitted from the Fed pivot narrative early in the quarter, driving them to outperformance in Global and US equities.
- Quality delivered a strong performance in Europe but continued to suffer in global and US equities. However, like in Q1 & Q2, the definition of Quality and the criteria used would have hugely impacted the result. Quality, left unattended, tends to tilt toward growth (investors pay for Quality, after all) and would have suffered from that tilt, as illustrated with MSCI Quality ("Quality" in Figures 1 and 2). Highly profitable companies and dividend growers have fared better this quarter, as illustrated by WisdomTree Quality below.
- In emerging markets, all factors but Value outperformed, with Momentum delivering a strong + 9.6%.

Figure 1: Equity factor outperformance in Q3 2022 across regions

Source: WisdomTree, Bloomberg. 30 June 2022 to 30 September 2022. 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.

Looking at the outperformance of factors over the first nine months of the year, we notice that:

- High Dividend continues to dominate, despite the small turbulences in July. The trend since the end of August looks strong again.
- Despite a very strong Q1, Value is now looking a bit worse and has left the second place to Minimum Volatility, which appears to benefit strongly from the heightened uncertainty in the market. Value is a mostly cyclical factor, and an inflationary environment with aggressive rate hikes is very supportive; fears of recession and increased volatility are not.
- Despite a strong Q3, Size and Momentum remain in underperformance territory. Investors continue to keep an eye on implied duration, pushing all growth stocks on the back burner.
- Finally, Quality remains the worst performer of the year when its growth tilt remains unchecked. WisdomTree Quality, a Quality Value version of the factor, delivered some outperformance. With the market turning even more defensive, as highlighted by the performance of Minimum Volatility, Quality is showing signs of life again

Figure 2: Year to date outperformance of equity factors in developed markets

Source: WisdomTree, Bloomberg. 31 December 2021 to 30 September 2022.

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

In September, markets really took stock of the ever-increasing risk of recessions. Unsurprisingly, the most defensive factors, High Dividend, Minimum Volatility and WisdomTree Quality, delivered the strongest outperformance for the month. If inflation remains stubbornly high and central banks continue on their hawkish path, those factors could continue to benefit.

Valuations continue to come down across the board

In Q3 2022, valuations continued to compress across the board for factors. The only exception is small cap in emerging markets, which became marginally more expensive.

European stocks' valuations dropped the fastest, with this market showing the largest discount to long-term averages. Factor-wise, Minimum Volatility and Momentum saw the largest drops, with price-earnings ratio (P/E ratio) losing around 1 point across geographies.

Figure 3: Historical evolution of price to earnings ratios of equity factors

Source: WisdomTree, Bloomberg. As of 30 September 2022.

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

Recession risks have risen. While, in our view, the global economy should avoid a full-blown downturn, we expect to see a series of individual country recessions take shape at different points in time. Evident from recent data, the downturn in the US is expected in the second half of 2023, whilst the Eurozone and United Kingdom should enter a recession by Q4 this year. Across factors, we continue to favour resilience and tilt to Dividend and Quality factors, given the expectations for weak economic growth, higher rates and elevated inflation.

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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