

US Equities throw down the challenge in 2H18: could multifactor be the answer?

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Market capitalization-weighted benchmark indices—such as the S&P 500—have enjoyed a remarkable run of performance in the US. 2017 was a great year for the S&P 500—a return of more than 20%, as of 31 December 2017, was achieved—but as we look back at the first half of 2018, we are admittedly nowhere close to that pace. Stranger things have certainly happened, but the available evidence could indicate that the second half of 2018 could be a real challenge.

If we step back and think about the transition from 2013 to 2014 with an honest view, at that time, interest rates were headed in a single direction...up. At least, that was the consensus. What we now know is that, although rates did move in one direction, it was actually DOWN.

As we began 2018, there was a great deal of discussion regarding the US 10-Year Treasury note interest rate and the 3.05% level. This was viewed as a critical technical resistance level, and, in theory, once crossed, it would lead to a much higher US 10-Year Treasury note yield.

Now, this level was breached, and after a quick run to an intra-day 3.12% back in mid-May, the US 10-Year treasury hasn't been able to sustain levels above 3.05% or even above 3.00%. Whether we end 2018 at a level of 2.80%, 2.90%, 3.00% or something above 3.05% will have major implications for many asset class returns—US equities and the US Dollar certainly amongst them.

Figure 1: The Fed vs. the 10-Year Treasury Note interest rate

Source: Bloomberg. Data is from 29 December 2017 to 29 June 2018.

You cannot invest directly within an Index. Historical performance is not an indication of future performance and any investments may go down in value.

Now, it is difficult to discuss US asset classes without discussing the US Federal Reserve (Fed), which has raised interest rates twice so far in 2018. What we find very interesting is that the Fed's behaviour has pushed the 2-Year US Treasury yield higher, to the point where it is only about 33 basis points below the current level of the US 10-Year treasury yield, as of 28 June 2018. If this level gets to 0, or even below 0, then it becomes a historic signal that has presaged recessions dating back to the 1970s by approximately 12 to 18 months. If the Fed keeps raising the policy rate, it can now be clearly seen how important the level of the US 10-Year yield becomes.

The late cycle rally continues

We find that one of the toughest things for investors is a longstanding, late cycle bull market rally. It's strange in that historically the performance during these periods can be quite good and last longer than many might initially expect. Even though everyone is waiting for the correction, it can take an awfully long time to arrive. However, if we break down the market by factors, we see some interesting observations.

Figure 2: Momentum has been THE outperforming factor

Source: Bloomberg. 2017 is from 31 December 2016 to 31 December 2017. 1H18 is from 31 December 2017 to 30 June 2018. Momentum refers to the MSCI USA Momentum Index. Quality refers to the MSCI USA Quality Index. Value refers to the MSCI USA Enhanced Value Index. Low Volatility refers to the MSCI USA Minimum Volatility Index. Size refers to the MSCI USA Risk-Weighted Index.

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- As seen on Figure 2, momentum delivered very strong results in 2017 and it is the leading factor once again in the first half of 2018. Many are questioning whether they should choose momentum for new allocations today—betting that the rally continues—or if they should start thinking of the next factor that might outperform during the next phase in the cycle.
- The interest rate discussion we mentioned earlier has implications, as higher interest rates could lead to lower market valuations in the future. At a certain point, valuations may begin to contract if rates do continue to rise, and if that's the case the momentum factor may no longer be the top performer.

Markets have humbled and will continue to humble investors

With the proliferation of new types of indices and exchange traded funds (ETFs), investor choice is probably nearing the highest levels that we've seen in history. There are two edges to this, in that yes, factor strategies that were once only written about in academic papers have been made much more easily accessible, but there is nothing that makes it any easier to predict what might out or underperform in the future. There have been many "certainties" in markets through the years, and investors have often been humbled when real performance has gone the other way.

Multifactor: Take the need to choose your factor out of it

Instead of choosing momentum or trying to choose the next factor set to outperform, multi-factor strategies are designed to diversify exposure across factors at all times. WisdomTree's US Multifactor strategy has outperformed the S&P 500 Index thus far in 2018 (as of 28 June 2018), and it could be at less risk of dramatic underperformance than momentum if in fact the tide turns.

Figure 3: WisdomTree's Multifactor strategy has outperformed in 2018

Source: Bloomberg. 30 June 2017 to 30 June 2018.

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Conclusion

WisdomTree's US Multifactor Index is rebalanced on a quarterly basis in order to continually refresh exposure to the factors that have been shown to drive outperformance over the long-term. This essentially eliminates the need to try to pick and choose the right factor at the right time, recognising that although momentum has worked well, it may not outperform forever.

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