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Investment Institute Asset Class Views

Global factor views:

Improved stock-picking conditions and ‘Quality’ appears in favour

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Key points

- Global growth looks set to slow, but this should help ease inflationary pressure while interest rates appear close to peak levels
- We are positive on high Quality stocks, neutral on Value, Low Volatility and negative on Momentum
- We expect improved conditions for stock pickers because the conditions that drove the large value-growth rotation last year are behind us

Following the extraordinary macroeconomic and market pressures of 2022, we expect there will be some respite for investors over the coming year. However, it won’t be plain sailing as global economic growth will likely slow – from an expected 3.2% in 2022, to 2.3%.[i]

But while we see some potential risk of recession in Europe and the US, the easing of growth should mean the inflationary pressure of the past year recedes, although we do not anticipate inflation will return to central bank targets until 2024. Of course, any deterioration in geopolitics remains a source of risk to inflation and growth.

More positively, we believe the shock of rapidly tightening monetary policy is now behind us and we see less risk of adverse interest rate surprises in 2023, with rates likely peaking around spring. In addition, the fourth quarter’s equity rally has spilled over into the new year, while China’s reopening should significantly bolster both domestic and international trade.

Given current macro conditions we outline our outlook for equity market factors below.

Quality: Positive

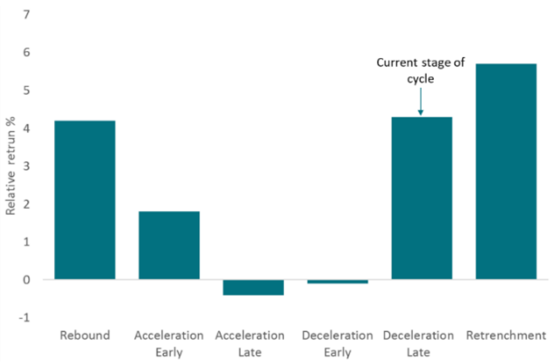
Quality stocks – equities with more consistent earnings and typically less share price volatility – did not deliver their normal level of defensiveness in 2022 for two reasons, namely a lack of exposure to energy stocks and because Quality Growth de-rated when interest rates rose - see Chart 1.[ii]

Chart 1: Global factor performance in 2022

However, as we move into early 2023, we have a more positive outlook because Quality tends to outperform when macro momentum is weak or slowing (as it is now) but also fares well in recovery phases - **see Chart 2.**

In addition, interest rates are close to peak, meaning the de-rating headwind experienced by Quality Growth is likely to be behind us. Finally, a weak macro backdrop combined with optimistic earnings expectations increase the risk of negative earnings surprises, but high-quality companies should be less exposed to this risk. While macroeconomic and earnings views underpin our positive outlook for this factor, we would note that Quality remains relatively expensive, which argues in favour of an active approach to avoid expensive stocks.

Chart 2: Quality performance through the economic cycle[iii]



Value: Neutral

Rising interest rates drove a market wide de-rating in 2022, where higher duration - i.e., Growth stocks -suffered most, but Value stocks - those which appear to be trading for less than their underlying value - outperformed. The rotation towards Value and away from Growth in 2022 was the largest one-year rotation since the 2000 technology bubble burst. Value's strong performance last year was driven by a wide valuation gap between Value and Growth stocks - **see Chart 3** - and the dominant performance of the energy sector.

As we go into 2023, we are neutral on Value because the valuation spread with Growth is now closer to its long-term average and with interest rates now close to peak levels, we do not expect the same de-rating headwinds for Growth stocks. However, we remain neutral on Value because while we may be close to peak rates, we also don't expect rates to fall quickly. A more benign Value-Growth style environment should lead to improved conditions for stock selection.

Chart 3: Valuation gap between Value and Growth stocks

Momentum: Negative

With Momentum, the aim is to capture stocks which have had a positive price change relative to the market over the last 12 months. This factor endured a volatile 2022, initially suffering from a reversal in fortune for growth sectors such as technology but it was subsequently buoyed as it became increasingly exposed to the energy sector. As we start 2023, we have a negative outlook for price Momentum because it has become a crowded trade and highly exposed to the energy sector. But in the absence of a serious deterioration in geopolitics, the recent significant excess performance of the sector is unlikely to persist, and this may weigh on the performance of Momentum. With market-wide earnings forecasts looking optimistic, our preferred measure of investor sentiment is earnings revisions.

Low Volatility: Neutral

The Ukraine war damaged global growth expectations, sent inflation soaring and dampened investors' risk appetite in 2022. Against that backdrop, it should come as no surprise that Low Volatility (or low beta) stocks outperformed the market in 2022. But in 2023 expectations of slowing economic growth continues to argue in favour of the defensive attributes of the style. However, we remain neutral because Low Volatility is not cheap and the style is relatively crowded, which creates downside risk under a market recovery scenario.

[i] Outlook 2023-2024, AXA IM

[ii] Source for all charts: AXA IM Equity QI, 2023

[iii] Stage of economic cycle: Based on six-month rolling average of ISM New Orders: Rebound (increasing, below 46), Early Acceleration (increasing, 46-55), Late Acceleration (increasing, above 55), Early Deceleration (decreasing, above 55), Late Deceleration (decreasing, 55-46), Retrenchment (decreasing, below 46)

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