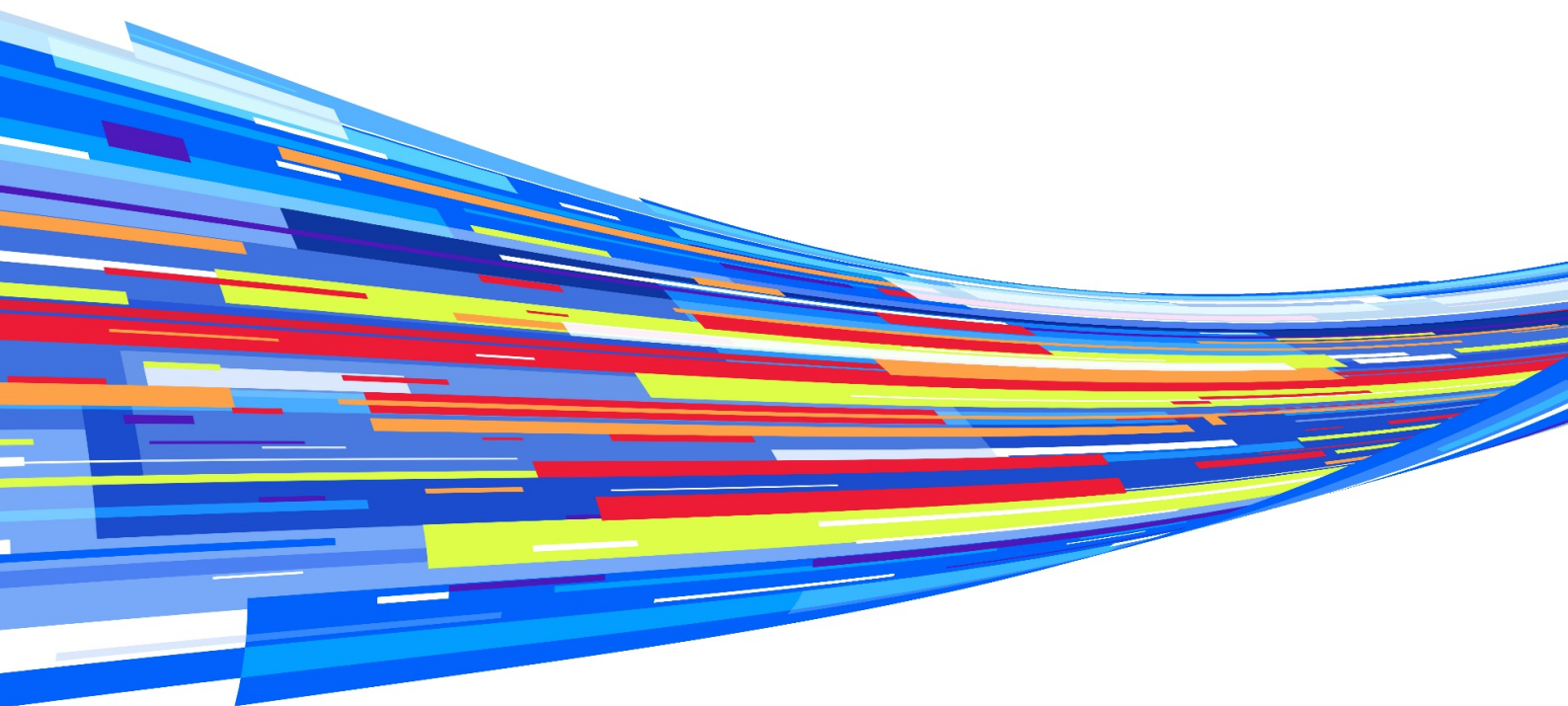




# Equity Manager Report: Emerging markets emerge out front

Report Analysis



As trade tensions cooled last fall, emerging markets sizzled.

The fourth quarter of 2019 brought significant positive absolute returns to the asset class, with emerging markets returning 11.9% as positive news surrounding a phase-one resolution between the U.S. and China began surfacing. Emerging markets led the pack during the September-through-December period, rebounding sharply from third-quarter losses caused in large part by trade uncertainty. According to our latest **Equity Manager Report**, this helped create a modestly favourable environment for emerging market equity managers during the fourth quarter.<sup>1</sup>

The quarter proved to be favourable for active management outside of North America on the whole, with UK, Europe, Australia and Japan equity managers faring well. In the UK, the outcome of the 13 December general election provided greater clarity surrounding Brexit, spurring a year-end rally. However, within North America, U.S. large-cap, U.S. small-cap and Canada equity managers faced a more challenging environment.

On balance, the fourth quarter saw a reduction in risk perception - at least temporarily - leading to a *risk-on* environment. Overall, this resulted in a very positive year for all equity markets, in both local currencies and U.S. dollars. Value and growth stocks performed strongly across most regions on the back of this *risk-on* environment, which in turn resulted in the low-volatility factor underperforming. The environment was particularly favourable for the **information technology** and **healthcare** sectors, which finished the quarter as stand-out performers. Meanwhile, more defensive sectors, such as **consumer staples** and **utilities**, struggled during this period.

As was the case in the third quarter, growth managers continued to express concerns around valuations of companies in the **information technology** and **consumer** sectors, where valuations marched steadily higher. While taking profits in certain areas, growth managers also still see a positive runway in other sectors - such as the **semiconductor** sector, which is a beneficiary of the tailwinds associated with the rollout of 5G networks. Conversely, value managers see opportunities in **energy**, **tech hardware** and **industrials**.

At Russell Investments, our distinctive relationship with underlying managers allows us access to unique, forward-looking views like these - from a wide range of specialists across the manager universe. With this in mind, here are our *chief tactical observations* from key geographic and equity regions, in alphabetical order, for the fourth quarter of 2019.

## Australian equities

### Preference for cyclicals over defensives

- Managers are preferring companies who are likely to benefit from economic growth, rather than those less reliant on economic activity. Underweights in utilities, REITs and other interest-rate sensitive stocks are common.

### Increased conviction in active management

- After a difficult 2019 for active management, managers are expecting an improvement in relative returns in 2020. They're confident in their stock theses and have maintained or increased active money.

### Maintaining underweight to banks

- Despite the fall in share prices over the quarter, managers are maintaining their underweight to the big four banks. They believe that the headwinds of low rates, increased regulation and a weak consumer mean other sectors provide better opportunities.

*Despite the fall in share prices over the quarter, managers are maintaining their underweight to the big four banks.*

<sup>1</sup> Source: Russell Investments equity manager research, Q4 2019. From analysis of manager returns and factor returns.

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## Canadian equities

### Runway for active management

- Modest expected earnings growth, continued monetary easing and limited evidence of clear sector leadership for 2020, combined with caution-driven volatility, indicate potential tailwinds for active management.

### Patience paying off for value managers

- Although Canadian equities posted exceptionally strong returns in 2019, this was driven primarily by a few sectors (and stocks) leaving lots of potential on the table - particularly in appropriately capitalised businesses trading at compelling valuations.

### Continued opportunities in energy, ex-pipelines

- Value managers in particular have continued to reduce their underweight to energy overall, citing the sector as ripe for outperformance, provided the current fragile calm market environment persists.

## Emerging markets equities

### High-growth managers see momentum continuing

- Domestic consumer brands are going from strength to strength amid top-line growth. Semiconductor manufacturers see positive catalysts including device upgrades, 5G rollout and DRAM (dynamic random access memory) inventory tightening/consolidation.

### Value managers remain disciplined

- As semiconductors continue to rerate, managers seek cheaper 5G alternatives. Attractive cyclicals include older generation tech hardware, along with continual conviction in heavy industrials and energy.

### Macro-oriented managers largely remain constructive

- Top-down managers see low interest rates as a positive for emerging markets when it comes to valuation and growth outlooks. The focus is on larger country markets that absorb liquidity. Conversely, quant managers are more negative, as recent abnormal factor behaviour possibly indicates the final stretch in this rally.

## Europe and UK equities

### UK value managers overweight domestic companies

- Value managers continue to see opportunities in the UK energy sector, given how poorly it's performed.
- Over the near-term, we expect domestic stocks to continue to lead the current outperformance - in anticipation of fiscal stimulus.

### European growth and market-orientated managers not adding to UK

- Most continental European managers, with the exception of those that are more valuation-driven, still believe there is too much uncertainty around Brexit, policy-making and the long-term growth trajectory of the country to warrant a significant reallocation of capital.
- As a result, they are currently underweight the market in aggregate.

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## Global and international equities

### Outlook

- The consensus has shifted toward easing, benign economic conditions and fading trade, Brexit and Middle East threats. However, managers see higher risk in markets that have risen on multiple expansion and deteriorating earnings growth.

### Where managers see opportunities

- 5G wireless technology offers opportunities across the value chain. While semiconductor stocks rose nearly two times the standard indices in 2019, some see 5G and consolidation as continued tailwinds. UK stocks rerated, but valuation spreads remain wide. Tobacco stocks have seen new buyers recently, due to October lows on valuation and falling concerns.

### Crowding an issue for quants

- Quant managers are seeing low/no alpha from value, due to crowding in low volatility. They continue to seek non-traditional alpha sources, including anti-crowding models.

## Japan equities

### Growth managers weary of valuations

- Many growth managers continued to trim stocks with stretched valuations, while making shifts to smaller cap stocks that had lagged due to expanded risk premium.

### Value managers shifting to lagging sectors

- Value managers reduced positions within technology and shifted exposure into different sectors that have lagged. Some made shifts to deeper cyclicals and/or autos, while others increased exposure to utilities while paying attention to diversifying risks.

### Market-oriented managers becoming more optimistic

- Many market-oriented managers maintained, but reduced, cyclical exposures and technology positions on the back of strong performance. Expectations of a recovery in the global economy remain on the back of a favourable inventory cycle and calming U.S.-China trade tensions.

## Real asset equities

### Global property managers

- On price-to-net asset value (NAV) basis, Hong Kong and Australia are trading at significant discounts to historical levels, while Singapore and large-cap UK look expensive.<sup>2</sup>
- Managers are tilting toward opportunities in the UK (student housing, industrial and storage), U.S. residential sector (single and multi-family) and niche segments including data centers and towers. They're avoiding U.S. malls and offices due to ongoing weakness as well as higher capital expenditures needed to keep tenants.

### Global infrastructure managers

- With infrastructure companies continually needing to earn their licenses to operate, responsible investment - particularly with respect to sustainability - will increasingly be a driver of returns, especially so in an environment with increased partisan politics.

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<sup>2</sup> Source: UBS Global Research, Russell Investments

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## U.S. large-cap equities

### Continuing healthcare opportunity

- Across the style spectrum, managers are expecting volatility in healthcare due to the 2020 election year, but forward-looking fundamentals are favourable. While healthcare stocks rallied in the fourth quarter as the regulatory overhang took a breather, equity investors expect more opportunities to add to the sector.

### Value opportunity in energy

- Many value managers are viewing energy as the most attractive segment for returns going forward, as the sector has continued to lag and yields are very appealing.
- Within the different categories of value, managers are finding idiosyncratic opportunities within defensive value stocks, and less conviction in *traditional value* (where more cyclical companies are underappreciated by the market and trade at lower multiples).

## U.S. small-cap equities

### Core managers with style flexibility lean into value

- Core managers believe there is a developing opportunity in value stocks. On a sector basis, opportunistic managers are rotating to banks and the consumer discretionary sector.

### Value managers add to energy and materials

- While many long-only managers have abandoned small-cap energy, contrarian value managers continue to add to the sector as valuations became increasingly attractive. They have also been adding to materials.

### Growth managers trim healthcare but add to technology

- Despite a strong quarter for biotechnology, managers continue to underweight the industry - but they have added to technology stocks. Within technology, there is a preference for recurring revenue businesses, such as software, over cyclical industries, such as semiconductors.

## The bottom line

As expectations and valuations continue to rise in the wake of a strong 2019, the risk of earnings disappointing in certain *hot* sectors remains. This makes it all the more critical to pay close attention to the views of specialist managers as 2020 gets underway. We'll continue to keep you apprised of the latest observations throughout the manager universe as the year unfolds.

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## For more information

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