Q1 2022 Equity Manager Report

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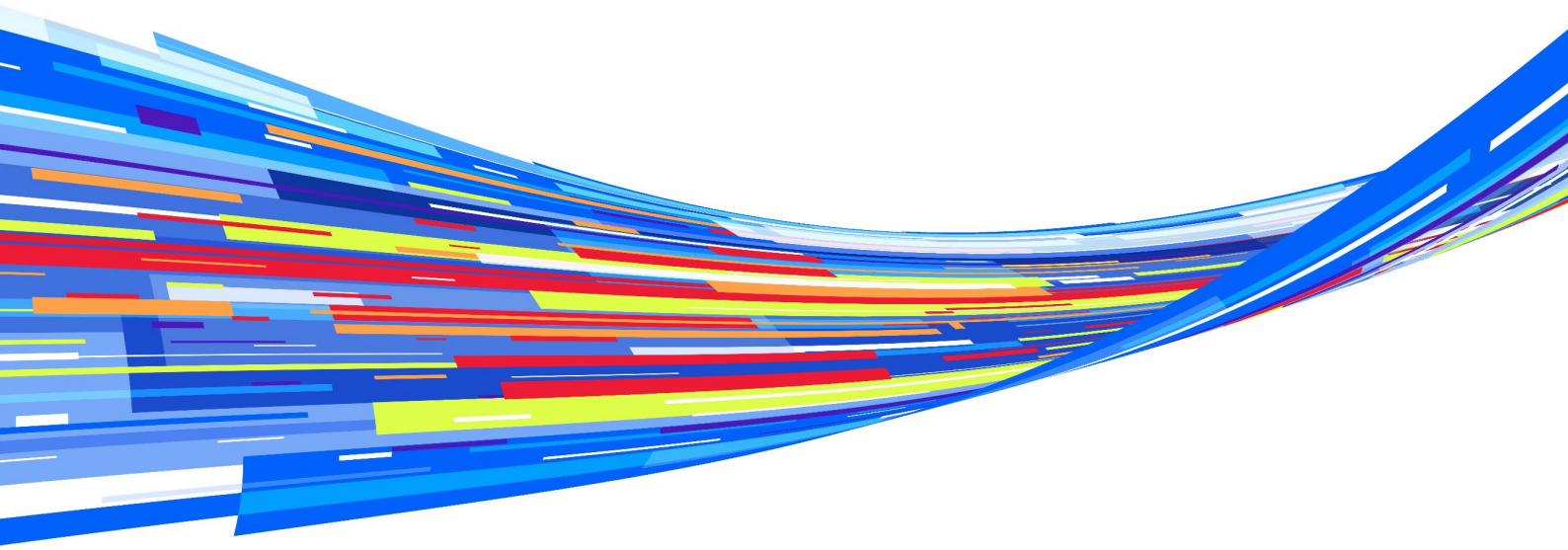
Elevated inflation a key risk for managers



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Q1 2022 Equity Manager Report

Performance highlights from the first quarter of 2022, plus manager expectations on inflation and China's growth slowdown.

Is the daily barrage of inflation-related headlines and data causing equity managers to rethink their positions?

Yes and no.

The results from our first-quarter equity manager report show that most managers generally believe the post-pandemic recovery will continue to support global markets. At the same time, many have become cautious in their positioning, in light of the ongoing uncertainty over skyrocketing inflation. The findings indicate an increased focus on businesses with pricing power that can hedge inflation effects, as well as those with stronger balance sheets and more visible earnings. Some managers have continued to rotate out of highly valued growth stocks as they continue to be impacted by tightening monetary policies and their effects on a slower growth trajectory.

Inflationary worries were further exacerbated by Russia's invasion of Ukraine in late February, which triggered an unprecedented response by governments and corporations alike through severe sanctions and divestments. This heightened inflationary and geopolitical environment triggered a selloff across markets, with most ending in significant negative territory for the quarter (in both U.S. dollars and local currencies).

The first quarter proved to be a more favorable environment for U.S. large cap, U.S. small cap, Japan, Australia and Canada equity managers. The quarter was significantly more challenging for global, global ex-U.S., emerging markets, Europe, UK, global infrastructure and long/short equity managers. Notably, value was a stand-out factor across all regions, with low-volatility also outperforming in most. In contrast, the growth and quality factors underperformed. As a result, style was a meaningful driver of performance dispersion between strategies.

Energy was by far the best-performing sector, dominating index returns across all regions. The exception was in emerging markets, where Russian assets were written down to zero. The materials sector also performed strongly, as did utilities. On the other hand, the information technology and consumer discretionary sectors—key beneficiaries during the pandemic—continued to underperform across all markets.

While investors remain optimistic on China over the longer-term, near-term views have become more mixed, given the impact of the country's *zero-COVID* policies on supply chains and consumption. Our findings reveal that equity managers are looking for more concrete support measures, such as rate cuts and fiscal stimulus.

Drawing on our unique relationship with underlying managers, we've compiled these and other insights from specialists across the manager universe into an easy-to-read report. Listed below are the chief tactical observations from key equity and geographic regions around the globe during the first quarter of 2022.

Global equities

Macroeconomic uncertainty leads to de-risking

- Russia's invasion of Ukraine set off a series of geopolitical effects, including rising energy prices and supply chain shortages. For example, a missed planting season in Ukraine will impact the profit and loss statements of consumer staples companies that rely on sunflower oil.
- Increased uncertainty prompted global managers to de-risk their equity portfolios, taking down tracking error and lowering beta.

Managers look to side-step inflation effects

- In developed markets, rising wages and tight labor markets have exacerbated the pricing of scarce goods.
- Managers continue to look for pricing power to combat inflation effects. Retail and housing stocks have been common sources of funds on demand concerns.

Tightening monetary policy contributes to selloff in growth

- Managers are concerned that rising interest rates will put pressure on global growth and company earnings.
- Managers have rotated out of high-growth, high-valuation stocks into less rate-sensitive names.

Oil and gas: Short-term winners, long-term casualties

- Russia's invasion of Ukraine and ensuing regulatory intervention from the European Union and U.S. led to strong performance from non-Russian energy companies. The invasion contributed to an already out-of-balance oil supply, increasing inflationary pressures globally.
- Many managers expect an expedited energy transition as countries look to decrease reliance on Russian oil and gas.
- However, contrarians and value-driven investors see opportunities based on the view that the transition to clean energy will take longer than stock prices imply. Meanwhile, U.S. oil production forecasts are being revised upward.

U.S. large cap equities

A more measured view on pandemic reopening stocks

- While investors continue to be constructive on industries with emerging business strength from the COVID-19 pandemic, they are being more selective and concerned about how higher inflation might impact consumer spending. As an example, managers continue to be optimistic about medical device companies but less so about travel-and leisure-related industries.

Inflation moderating?

- Many managers are becoming more optimistic that inflation is slowing (although not abating). With supply-chain issues easing in many industries, the rate of change in inflation should slow. For instance, auto production is no longer being held back by semiconductor supply.
- Investors also observe that hiring is slowing in many industries, which should help limit wage inflation. While the Russian invasion of Ukraine caused an unanticipated spike in energy inflation, the momentum of inflation is easing for many other goods and services.

Opportunities for U.S.-centric companies with stable earnings

- With the war in Ukraine and concerns about European growth, managers are emphasizing large cap stocks with more U.S. economic exposure.
- Manages across the growth-value spectrum have shifted to companies with more predictable earnings.

Long-term managers see promise in high-growth technology

- High-growth stocks with expensive current valuations sold off dramatically for the second consecutive quarter. Long-term growth-oriented managers have been incrementally buying into the weakness, as they do not believe future growth prospects have declined significantly for quality secular growers.

U.S. small cap equities

Small cap valuations are increasingly attractive

- Small cap relative valuations are at the lowest level in over 27 years. They are at a 44% discount to mega caps on an EV/EBITDA basis.[1]
- Small caps are also expected to deliver higher earnings growth than large caps in both 2022 and 2023, which suggests favorable valuations relative to future earnings power.

Banks are no longer as favored

- While managers across styles were favoring banks in the last quarter, most managers have now become skeptical of the environment for banks as concerns around yield-curve inversion and its adverse impact on net-interest margins continue to grow.

Market-oriented managers believe rotation from growth to value will continue

- These managers view the overall selloff in small caps to be overdone, but believe the rotation from growth to value is only halfway complete. This is driving their decision to rotate into the relatively cheaper industrials sector, by sourcing capital from defensives like the utilities sector.

Mixed opinions on energy sector

- Some value managers are rotating out of the energy sector into more defensive areas like consumer staples and healthcare.
- Somewhat counterintuitively, growth managers—especially those that include cyclical growth stocks—remain bullish on energy.

Growth managers continue to believe in technology, but remain cognizant of valuations and timing

- Growth managers continue to believe in the secular growth opportunity in technology. Some have started buying the dip, while others acknowledge further multiple compression may occur and it may take until the fourth quarter of 2022 for the sector to rebound.

[1] Source: Bloomberg, WPG Partners.

Europe and UK equities

Reopening trade becomes more nuanced

- In recognition that some of these companies—particularly in the air travel space — have large fuel costs, exposure is shifting to other areas of the reopening trade that are less vulnerable to rising fuel prices. For example, the hospitality segment has minimal energy costs, yet still offers exposure to the reopening theme.

Accelerating the green transition

- Recent developments will accelerate the *green* transition in the medium-term, as the West looks to move away from Russian energy. This should benefit companies that support this transition, i.e., in the industrial sector, which also has strong ESG credentials.

Energy and mining

- Many managers expect commodity prices to remain elevated, given the supply-squeeze and accelerating demand for those commodities required in the transition to green energy. With spare capacity falling, there are short-term opportunities to take advantage of well-positioned energy and mining companies.

Growth expectations remain positive

- GDP growth expectations for the eurozone in 2022 and 2023 have been cut, but remain positive. Low unemployment rates, high consumer savings levels and the continued fiscal spending by European governments is expected to provide continued support for growth in the region.

Slowing globalization

- COVID-19 and the Russia-Ukraine conflict have both highlighted the weakness in European companies' supply chains. As a result, we are observing significant moves toward reshoring. This should benefit industrial European companies with limited global exposure.

Emerging markets equities

Russia strikes out, upstream producers benefit

- Russia was hit with sanctions, removed from MSCI and impacted by capital flight on the political backlash over its invasion of Ukraine.
- As the economic implications sink in, most managers have written off and, where possible, sold down Russian bets.
- Significant knock-on pressure to commodity prices, e.g., natural gas and metals (nickel), have seen managers shift toward alternative suppliers, including Brazil (oil, metals, agriculture), and the energy-heavy Gulf Cooperation Council producers (e.g., Saudi Arabia, the United Arab Emirates, etc.).
- Besides Russian names, some investors also suffered indirect negative exposures through peripheries in Poland and Egypt.

Inflation shapes the opportunity landscape

- Supply chain disruptions initially owing to COVID-19 have been exacerbated by the war in Ukraine. Managers are looking for ideas among exporter countries that will see improved trade balances, e.g., Brazil, Chile, Mexico, Africa and Indonesia.
- Besides an inflation hedge, these overlooked, cheaper markets are attractive in an increasingly valuation-sensitive environment.

- Managers have reduced exposure to net importers, such as India and the Philippines, as corporate margins and headline growth are under pressure due to rising input costs.
- In spite of growth stocks' derating, growth managers are reassessing exposure to recently fallen popular names such as e-commerce, given lower valuation ceilings with rising interest rates.

All eyes on China's policy direction

- Managers are mixed with China, given weaker consumption and the zero-COVID lockdown policies affecting major cities like Shanghai.
- Having initially been more upbeat, investors are uneasy and seek concrete support measures, waiting for signs such as rate cuts and stimulus packages that have yet to formalize.
- Energy price inflation provides further support for policy and investments in the transition to renewables.

Japan equities

Tightening policy leads to further valuation corrections

- U.S. inflation rates remain high and the Russian invasion of Ukraine increased inflationary pressures. The U.S. Federal Reserve (Fed)'s tightening policy continues to negatively impact growth stocks, particularly emerging growth stocks.
- Many growth managers believe the market has largely discounted the impacts of the Fed's monetary tightening. As such, some have been adding to these positions, which are now at more attractive valuations.

Mixed view on global economic outlook

- The rise in commodity prices, U.S. monetary tightening and the renewed spread of COVID-19 in China has the potential to negatively impact the global economy.
- Nevertheless, some managers believe a normalization of economic activities is likely to offset, or even exceed, these concerns toward the end of the year. There is also a renewed expectation for excessive inflationary pressure to begin easing as supply-chain disruptions begin to normalize toward year-end.

Managers avoid making large shifts due to uncertainty

- Growth managers have maintained existing positions with expectations that rate hikes will be put on hold, given weakness in the economic outlook.
- Market-oriented and value managers remain relatively optimistic and have continued to prefer cyclicals such as financials.

More interests in capital goods and autos, less interest in tech

- Due to the tight supply situation, investment demand is expected to be relatively strong. Auto companies are expected to be the beneficiaries of supply-chain normalization and a weaker yen.
- Conversely, more managers have become less positive on semiconductors, as the demand for electronics devices slows down from high levels during the pandemic.

Australian equities

Maintaining energy holdings

- Despite strong performance during the quarter, managers are maintaining their energy overweights, both for company-specific reasons and because Australian energy names still lag their global peers in terms of longer-term performance and price-to-earnings (P/E) valuations. The impact of the Ukraine invasion on gas price and supply provides further support.

ASX expected to outperform developed exchanges

- Managers have a positive view of future relative performance against other developed equity markets, driven by:
  - Factor composition of the Australian Securities Exchange (ASX) leans towards value sectors, e.g., financials and resources. Rising interest and inflation rates are expected to continue to be supportive for these sectors, compared to IT and healthcare.
  - Energy and resources companies are expected to outperform, due to limited supply because of the Ukraine invasion and because few new projects have been approved due to ESG (environmental, social and governance) reasons.
  - Australia is viewed as a well-regulated, reliable market that is geographically distant from geopolitical conflict.
  - China's expected GDP (gross domestic product) growth supports iron ore and lithium prices, with few alternative suppliers.

Canadian equities

Active managers take advantage of wide sector dispersions

- Higher commodity prices and rising rates dictated market leadership in the first quarter. Energy and materials posted strong gains, leading to a ~65% performance gap between the top and bottom sectors.
- Dispersion and breadth are generally good for active managers. For example, some capitalized on market volatility by cutting strong cyclicals and adding to weaker sectors that fell into an attractive range (e.g., technology and industrials), while others opportunistically bought oversold quality cyclicals.

Defensive positioning likely to persist

- Managers reduced cyclicality in response to the uncertainty and lack of visibility around macroeconomic conditions.
- Consumer spending concerns are elevated as uncertainty persists, gas prices remain high and rates continue to rise.
- Defensive positioning is supported by lower growth expectations. Even within cyclical sectors, managers have leaned into defensive industries, e.g., pipelines and diversified financials.

Commodities lead, but managers are leery of future outlooks

- Managers reduced commodities exposures, citing a hawkish Fed, inverting yield curves and maturing commodity cycles.
- Concerns include elevated future oil prices baked into energy valuations, and downward pressure on gold from rising rates.
- However, managers also anticipate an increased demand for North American energy, driven by the Russia-Ukraine crisis.

Supply-chain woes stay top-of-mind

- Unstable costs are creating margin pressure, which is impacting investor sentiment in the shorter-term. Chip shortages continue to be a headwind for auto suppliers, but managers are also eyeing opportunities for a rebound to normal.
- Congested U.S. west coast ports suggest potential alternate route opportunities for rail and transport companies.

Long/short equity

Increasing use of private positions in equity hedge funds

- Over the last several years, the use of private equity exposure in hedge fund long/short portfolios has been increasing.
- Most hedge funds separate privates equities from public equities. However, the managers that commingle privates with publics could face liquidity issues, especially as marks come down in a manager's private book.
- Due to the increase in redemptions, some managers have already decided to side-pocket privates to help alleviate liquidity issues.

Massive selloff in China-specific equities

- Equity long/short managers entered the first quarter of 2022 with historically low exposure to China equities.
- While exposure to China remains low due to the continued selloff in China-specific equities, select managers are starting to add on risk.

Managers continue deleveraging

- March ended as the largest month of selling across global equities since June 2013.[2]
- General positioning/flows: Hedge funds continue to sell tech (tech exposure is at 10-year low) and L/S managers were the largest net buyers of energy.[3]

Managers continue wait-and-see approach, remain risk-off

- Gross and net exposures remain low, as there is a lack of conviction in investment opportunities, resulting in managers maintaining a wait-and-see approach as they seek greater clarity.
- We expect managers to continue to protect capital well on down markets. A risk would be a strong market rally, as current risk-off positioning would be a headwind.

Real assets equities

REITs (real estate investment trusts) on offense: Mergers & acquisitions (M&A) activity increasing

- Global direct transactions levels are elevated.
- Public-to-public REIT M&A activity is at all-time highs.
- REIT managers report that significant amounts of private equity capital is expected to be deployed.

[2] Data from Morgan Stanley Prime Brokerage.
[3] Data from Morgan Stanley Prime Brokerage.

Beds, meds and sheds: Economy-relevant real estate

- Managers note that there are significant shortages in rental homes/apartments and manufactured housing. Residential affordability is a global challenge. However, there is a possibility of increasing regulatory risks.
- The aging population appears to be impacting sectors such as senior housing, life science, and medical office.
- Managers are seeing needs-based demand, with occupancy rates bouncing back and pricing power evident. In addition, the strong housing market enables recycling into senior housing facilities.
- In the e-commerce space, logistics, data centers, storage, and U.S. coastal markets and infill locations are highly sought after and supply-constrained. Supply bottlenecks and inventory management are moving from *just in time* to *just in case*. Rising oil prices, slowing consumption are both risks that managers are concerned about.

Infrastructure-significant subsector dispersion offers opportunities

- Real assets typically outperform stocks and bonds during periods of lower than-expected growth and higher than expected inflation, due to the ability to pass through higher costs to users. Airports and toll roads have CPI+ (consumer price index) fee increases in concession agreements. Midstream, freight rails and ports have revenue escalators to inflation. Regulated utilities have periodic rate cases to address inflation impact.

The bottom line

Unrelenting pricing pressures, coupled with slumping Chinese growth and uncertainty surrounding the war in Ukraine and its impacts on commodity sourcing and pricing, have led to heightened investor caution, as the second quarter gets underway. In such an environment, we believe the views of specialist managers will be critical to identifying and exploiting future risks and opportunities. We look forward to continuing to share these insights with you as 2022 further hits its stride.

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