Equity Manager Report
Q3 2021

Report Analysis

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Equity Manager Report Q3 2021: How are inflation concerns impacting manager viewpoints?

Do mounting worries over inflation have managers bracing for heightened volatility in the months ahead?

The answer: Yes, according to the results of our third-quarter survey of equity managers in key geographic and equity regions across the globe.

While generally remaining optimistic on the path of the global economic recovery, the latest installment of our quarterly equity manager report shows that managers expect an uptick in volatility during the final months of 2021. This is mainly due to increased uncertainty over the stickiness of inflation as well as ongoing supply-chain disruptions. Persistent inflation has led to a growing expectation of earlier-than-anticipated interest rate increases, which in turn has sparked worries over future growth. Managers are also expressing concerns around the latest developments in China, including the slowdown in growth, contagion from the potential collapse of heavily indebted property-developer Evergrande Group and the recent spate of policy initiatives from Beijing. Ultimately, we believe that managers are becoming increasingly selective as they take into account growth opportunities, valuations and ongoing risks.

Overall, third-quarter performance among equity managers was fairly mixed, with the biggest drivers of differentiation pertaining to regions, rather than factors. The environment was more favorable for emerging markets, U.S. large cap, U.S. small cap, Europe, UK, Australia, Canada and Japan equity managers, while proving to be more challenging for global and global ex-U.S. equity managers. Although there was no standout factor among regions, value, momentum, quality and low-volatility factors generally performed better than the growth factor. There were a few exceptions to this, including in U.S. large cap equities, where both the value and growth factors lagged.

Amid surging energy prices, the energy sector was the highest-performing sector of the third quarter, followed by financials. On the other end of the spectrum, the consumer discretionary, communication services and materials sectors lagged. Our report also shows that some equity managers are continuing to trim some cyclical exposures on strength—and that they've become more selective on where they concentrate their bets.

Drawing on our distinctive 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 third quarter of 2021.

Global and international equities

Macro issues continue to drive expectations

- COVID-19, inflation duration, supply and demand tensions, fiscal policy and regulatory uncertainty remain the prevailing themes.
- Overall, managers are positive on an economic recovery and growth in global markets, but are bracing for increased volatility as the nature of the recovery remains unclear. Some are reducing cyclical exposure following strong returns.

Managers more positive on recovery opportunities

- Continued improvements in the COVID-19 and delta variant situation are expected to drive a cyclical recovery.
- Managers are finding various reasons to be bullish on recovery plays in different regions: Europe's vaccination and savings rates are high, the U.S. may be past the peak of negative delta-related impacts and emerging markets are cheap and pricing in economic recovery fears. Few managers expect major economies to go into lockdown mode again.

Inflationary pressures will continue, for now

- Managers expect inflation to persist mid-term, with interest rates vulnerable to upward pressure and financials poised to benefit.
- Supply and shipping headwinds, rising wages and further demand for goods from higher consumer savings are expected to continue, exacerbated by waning, but still positive, government support. Even managers who predict a reversion of these factors foresee their impact on markets lasting a few more quarters.

Chinese regulation fears are overplayed

- While managers are still wary of the regulatory opacity and uncertainty that has afflicted Chinese markets in recent months, many now consider Chinese stocks oversold and are finding selective, attractive opportunities in the region.
- They cite recovery after historical periods of increased regulatory pressures and confidence in the ability and willingness of policymakers to backstop the system.

U.S. large cap equities

A pause on reopening

- The third-quarter delta variant outbreak put the brakes on consumer stocks that were poised to benefit from a reopening with the economy emerging from the pandemic. The rise of the delta variant pressured both value and growth consumer stocks.
- While many consumer discretionary stocks recovered in the closing weeks of the third quarter, there continue to be attractive prospects across the sector as the economy emerges from the pandemic. Managers are adding to high-conviction consumer positions that are expected to benefit from a continuing recovery.

Supply-chain congestion

- Managers see attractive value and reasonably priced growth opportunities in the producer durables sector. However, industrial companies are struggling to fill demand due to the global supply-chain disruption.
- Supply chain difficulties are expected to continue into early 2022, with any interim price weakness creating opportunities to build positions in high-conviction producer durables stocks.

Continuing inflationary pressures

- U.S. equity managers expect inflationary pressures to persist beyond 2021. Managers think supply-chain-driven materials and goods inflation will be shorter-term in nature and will provide a tailwind to commodities stocks in the near-term. However, they also believe there is a significant risk that wage inflation will be more persistent.
- Quality stocks with pricing power and high profitability are viewed as preferred habitat, due to their ability to pass through higher costs.
- Managers continue to like financials. Companies have improved their profitability during the pandemic, and should also benefit from rising rates that stem from the inflationary environment.

U.S. small cap equities

Good time for active management?

- While the debate on persistent vs. transitory inflation continues, small cap managers believe now is a good time for active management, especially in small caps which tend to lag in inflationary periods.
- Small cap managers are backing their bottom-up fundamental work to actively rotate into companies with strong pricing power.

Managers react to rising inflation and interest rates

- Most managers are acknowledging that inflationary pressures are likely to be sticky. Some value managers are betting on energy and financials as likely beneficiaries, while some growth managers are rotating out of consumer discretionary stocks.

Value managers betting on delta variant slowing down

- Value managers are becoming more cyclical in their positioning to bet on the next leg of recovery from the COVID-19 delta variant, such as beneficiaries of business travel and office reopenings.
- Most value managers are finding opportunities in industrials and materials, but some are also excited about the consumer discretionary sector.

Quality growth managers see upside in profitable companies

- Growth managers believe highest return-on-equity (ROE) small cap growth stocks still have room to run, as they lagged last year, and because the valuation spread between top quintile ROE vs. bottom-quintile ROE is very wide, at 1.6x price-to-sales versus 13x.

SPACs getting into market-oriented and value managers' radar

- With SPACs (special purpose acquisition companies) going out of favor in the last two quarters, valuation-conscious core managers and value managers are beginning to research some of the post-deal SPACs, which are now looking similar to special situations opportunities.

Europe and UK equities

Inflation expectations are rising

- There is a lack of consensus among managers if inflation is transitory or more deeply rooted. Regardless, we have seen some inflation protection being adopted by managers increasing exposure to real assets, miners, housebuilders, materials and energy.

Rotation: Growth to value, defensives to cyclicals, tech to the rest

- Value is close to being cheaper than it has ever been, with the polarisation between value stocks still wide. There remains a lot of recovery upside from companies with resilient supply chains, strong balance sheets and responsive business models.

Europe: Earnings-per-share (EPS) expectations for 2022 remain depressed

- The broad market consensus among managers is for the current recovery in company earnings to be short-lived, and for EPS expectations for 2022 to remain below historical averages and not in line with GDP growth expectations.

Europe: Recent outperformance of defensive stocks

- A fall in bond yields has helped bond proxies, but is unlikely to be sustainable as broader growth takes hold throughout Europe-especially in the cheaper parts of the market.

UK: Strong dividends recovery

- The UK market continues to offer the highest dividend yield globally. At the same time, UK equities are relatively and absolutely cheap, which has drawn in investors. We expect increased corporate deal-making in the UK markets to continue.

UK: Financials, mining and oil

- Some managers are increasing exposure to cyclical value, which will benefit from rising bond yields. They are putting capital to work in financials, as well as mining and oil, on a positive outlook for commodity prices.

Emerging markets equities

China risks and opportunities

- Managers are considering Chinese consumer themes on oversold regulatory fears and a visible path to a post-COVID-19 recovery.
- Managers are sanguine over Evergrande Group contagion risks. They are also optimistic over renewed easing if growth-slowdown concerns avoid a hard landing.
- Nascent growth remains attractive in high-end manufacturing and renewable energy, as these industries are seen as key beneficiaries of Chinese policy.

Reassessing the COVID recovery landscape

- Managers are playing an India recovery trade, following recent success in vaccination rates. Autos, discretionary and machinery should benefit as worker mobility returns.
- Positive sentiment exists in markets that are beginning to recover. They are rotating to ASEAN (Association of Southeast Asian Nations) countries on recovery green shoots. Meanwhile, mainland China tourism faces a delayed reopening.
- In Brazil, political volatility, weakening currency and rate rises to curb inflation have resulted in negative market sentiment, delaying the reopening trade as vaccination rates continue to improve.

Innovation continues

- Indian information technology (IT) is benefiting from continued digital transformation, with corporations shifting to cloud-based processing and outsourcing.

- Softening semiconductor data and China's slowdown has led to corrections of Asia hardware tech. SME components and specialist chip makers are benefiting from domestic Chinese policy support as part of the move toward digital infrastructure.

Inflationary expectations are mildly positive

- While broad inflation remains immediately muted, managers are increasingly adding to bank financials.
- Korea sentiment is improving on positive export data, as well as improving house prices and accelerating loan growth.
- Tightening fundamentals and rising prices are improving earnings prospects across copper, cobalt, nickel and oil producers.

Australian equities

Inflation expectations rise

- Managers now expect inflation will persist once supply chain challenges resolve. Some expect inflation will occur earlier and at higher levels than the market expects. They believe that rising interest rates will be the driver of higher inflation, and are of the view that central banks and governments will favor higher inflation to address national debt.

Portfolios unchanged, keeping cyclical tilt

- Despite their increased inflation expectations, equity managers have made few changes to their portfolios over the quarter. The majority of portfolios remain tilted toward companies which benefit from increased economic activity, particularly energy, industrials and materials names. The reopening of Australia after lockdowns is expected to support this pro-cyclical tilt.
- Despite the increase in oil and gas prices, managers are maintaining their holdings in energy-related names, based on their bottom-up view of the companies, supported by the pro-cyclical and higher inflation view.
- Some managers are considering reducing their underweight on iron-ore-exposed names, given the recent correction in the commodity's price.
- Managers are not overly concerned that issues surrounding Evergrande or Chinese policy will impact listed companies, believing the Chinese Communist Party will manage the impacts appropriately.

ESG comes to the fore

- Managers noted that ESG was a notable theme in the August company reporting season, with companies providing more detail on climate-related issues. They also believe the market is reacting faster to adverse ESG issues than a few years ago, taking a sell first, ask questions later approach. They believe this can provide entry opportunities.

Canadian equities

Supply chain crunch results in short-term pain and opportunity for investment in economically sensitive industries

- Although guidance is likely to be down in the fourth quarter for many companies, growth-biased active managers believe slower growth is a result of supply issues rather than demand issues, presenting selective opportunities in the industrials sector.

Emerging Canadian software boom

- About 70% of the initial public offering (IPO) pipeline are technology companies, increasing breadth beyond mature tech and Shopify.
- However, many Canadian investors, who are conservative in nature and tend to prefer profitable growth over high growth, will not likely participate in the near-term.
- The higher scarcity multiple for larger, more established Canadian tech companies might see some compression as new options enter the market.

Transition from early cycle to mid-cycle results in sector and style rotations

- Deceleration in macro indicators will likely result in increased market volatility, presenting opportunities for active managers to shift portfolio positioning away from cyclicals to more defensive businesses. A focus on quality will likely persist as tapering starts.

Views on commodities are mixed

- Commodity-linked businesses are likely beneficiaries of higher inflation, but upside on commodity prices is limited, according to most. Managers will likely remain underweight the most cyclical businesses.
- Market participants are focused on oil producers with favorable environmental practices and shareholder-friendly cash-flow plans, like dividend growth.

Japan equities

Expectation of stagflation is gradually rising

- Value and market-orientated managers largely maintained or added exposures to financials, expecting inflationary pressures to continue, due to rising commodity prices and/or labor shortages. They're also gradually cutting exposures to cyclical manufacturers that have done well.
- Some growth managers are reducing positions in high valuation stocks due to rate-hike expectations, and believe that corrections could lead to good re-entry opportunities, given long-term fundamentals.
- Managers are generally monitoring whether a normalization of economic activities can ease inflationary pressures.

Reopening theme continues to attract investors

- The decreasing number of COVID-19 cases, alongside an improved vaccination rollout, is expected to positively impact domestic economic activities.
- Both value and growth managers made some shifts to reopening beneficiaries, typically domestic non-manufacturers.
- Supply-chain bottlenecks are expected to gradually ease, improving the negative impact felt by global manufacturers, i.e., autos.

Managers staying calm toward China's regulatory risk

- Managers have been aware of China risk to some extent, and have been applying a discount factor for companies with large exposure to the country.
- Following underperformance of these companies, managers are generally maintaining their exposure, given more attractive valuations.

Tokyo Stock Exchange (TSE) restructuring can lead governance reforms

- The Tokyo Stock Exchange (TSE) will reorganize from five market segments into three early next year. The prime market imposes governance and liquidity criteria, which will be a catalyst for companies that are on the cutoff line to positively change, thereby providing opportunities for investors.

Real assets equities

Real estate secular trends accelerated by pandemic

- Beds - Housing shortage: Rental homes/apartments
  - Strong wage and job growth
  - Housing affordability constraints
- Meds - Aging population: Senior housing/life sciences
  - Fundamentals improving post-vaccine rollout
  - Demographics and needs-based tailwind contributing to a multi-year recovery to/above pre-pandemic levels
- Sheds - E-Commerce: Logistics/select retail
  - Demand for supply-constrained infill logistics
  - Shopper footfall and leasing bounce with easing restrictions
  - Necessity-based and open-air retail stronger vs. malls

Real estate fundamentals improving

- Supportive real estate fundamentals include low vacancy, low/moderate supply, rising replacement cost and the availability of capital.
- Operating fundamentals improve as demand broadens, driving increased earnings visibility.

Infrastructure trends driven by capital, energy and pandemic

- Dry powder in private infrastructure funds over $300 billion-which represents over $500 billion in potential transactions-is creating a valuation floor. Some 20 deals have transpired this year, several of which were take-privates, in different sectors, at premiums ranging from 30% to 50%. The listed infrastructure sector is generally under-valued.
- Cost of energy from renewables continues to decline, while the transition to renewables requires new investments for electrification buildout and grid modernization.
- Demand for natural gas continues, while supplies are constrained. U.S. liquefied natural gas (LNG) infrastructure assets are expected to benefit.

The bottom line

While most managers are generally confident that the economic recovery will remain on track, rising inflation, supply-chain bottlenecks and slumping Chinese growth have led to growing expectations of a bumpier-than-usual conclusion to the year. Amid such an environment, we believe that the views of specialist managers will be critical to exploiting both volatility and opportunity. We look forward to continuing to share these insights with you as the year winds to a close.

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