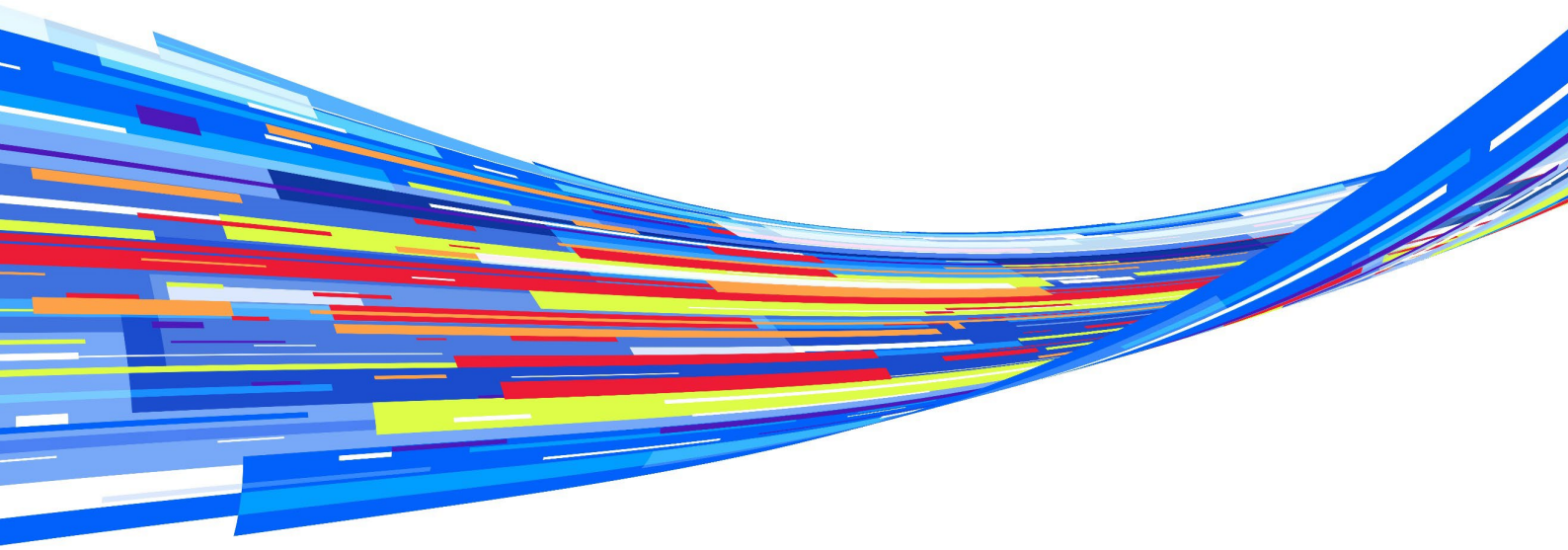
Q2 2022 Equity Manager Report

Russell Investments

Deep recession not expected



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The risks of a recession may be on the rise, but if one does strike the global economy in the next year or two, most equity managers don't expect it to be severe, according to our second-quarter report.

Our report also shows that many managers remain cautious with their positioning as they brace for continued volatility. As they contend with the impact of inflation on businesses and the increasing risks posed by a recession and a decline in the economic growth outlook, equity managers continue to exhibit a preference for businesses with pricing power and strong balance sheets.

The second quarter was dominated by negative market sentiment amid worries over skyrocketing inflation and the risks of a global recession, which helped fuel a further decline in markets—particularly among growth stocks. In the wake of this, our report reveals that managers remain mixed on whether high-growth tech stocks are beginning to bottom out, or still have further to fall. While multiples have compressed and some companies have continued to demonstrate resilience in earnings, managers see the next few months as a barometer for sales and earnings expectations as the economy begins to cool off.

The broad market selloff over the past few months led almost all markets to finish the second quarter with negative returns in U.S. dollars (USD) and local currencies. The exception to this was China, which not only outperformed most other markets, but was the only large economy to end the quarter with positive absolute returns. Investors have adopted an increasingly positive outlook on China, despite the country's ongoing struggles with COVID-19 and the economic impacts of its *zero-tolerance* policy. This is because China's economy is currently *off-cycle*—with the reopening trade yet to play out and government policy increasingly shifting to stimulate growth—in contrast to the tightening cycle occurring across most major economies.

The second quarter did prove to be a more favorable environment for U.S. large cap, U.S. small cap, Japan, Canada and Australia equity managers, while being significantly more challenging for global ex-U.S., emerging markets, Europe, UK and global infrastructure managers. Notably, low-volatility and, to a lesser extent, value were the stand-out factors across most regions, while the growth and quality factors generally underperformed. The exception to this was again China, where growth was the stand-out factor as internet-related names like e-commerce rebounded following a prolonged period of weakness and negative market sentiment. Similar to the first quarter, style was a driver of performance dispersion between strategies during the second quarter, albeit to a lesser extent.

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 second quarter of 2022.

Global equities

Investors bracing for volatility as the new normal

- Recession fears are high and investors see a wide range of outcomes, so many are largely sticking with what they own. Anecdotally, buy/sell activity is lower as managers cautiously await second-quarter earnings season.

Inflation remains top concern, investors seek stable growth

- On the margin, investors are leaning into defensive positions, such as consumer staples and companies with pricing power.
- Growth investors are adding in areas such as productivity-enhancing software and cash-flow-supported tech names, and are wary of hardware providers and other WFH (work-from-home) beneficiaries.

Supply chains issue linger, but value managers hold steady

- Supply disruptions and slowdowns are still pressuring semiconductor makers and their customers, including auto makers and parts suppliers. Value investors are making downward interim earnings adjustments but keeping their expected winners.

Commodity prices still above normal on sustainability play

- Commodities flipped from an inflation hedge to a recession risk in the second quarter, but precious metal prices remain above normal, and investors expect them to play a key role in the growth of sustainable assets.

Energy has seen profit-taking but may extend its run

- Energy was the only sector to finish the first half of the year positive, but the transition to net-zero carbon emissions will be a bumpy road. Investors are short-term bullish on better demand and tight supply, while wary of the longer-term risk as capacity additions collide with greenhouse-gas-reduction efforts.

Japan's favorable monetary conditions offer defense

- Investors expect less impact from high inflation and interest-rate hikes. Signs of improved corporate governance from more pronounced shareholder activism are also attracting interest.

U.S. large cap equities

Energy

- Investors continue to see opportunity in the energy market, as supply/demand has become structurally tighter due to underinvestment and redirected supply flows. Some now favor U.S. natural-gas producers due to withheld Russian supplies to Europe, more difficult regional price arbitrage and less recessionary risk.

Inflation

- Given continued inflation, the rational decision for consumers is to continue to spend now rather than later. On the margin, managers are adding to positions driven by discretionary spending (i.e., travel and leisure).
- Managers note that some inflationary pressures are easing (although not necessarily declining), such as several raw materials and logistics rates. However, most continue to believe that labor inflation will continue to be persistent.
- Value managers note that in periods of higher inflation, investors should look to own shorter-duration (i.e., lower P/E) equity assets. Most are looking to the bond market/yield curve to assess direction and sustainability of inflation as well as the likelihood of a recession.

High-growth technology stocks bottoming?

- Managers believe the *air has been taken out of the tire* in terms of multiple compression for high-growth technology stocks, which may be bottoming out, as they performed better toward the end of the second quarter.
- Growth investors continue to receive positive confirmation on sales and earnings expectations for growth tech stocks and are optimistic that they will begin to have differentiated performance during the third-quarter earnings reporting season.

U.S. small cap equities

Small cap valuations compelling on both absolute and relative basis, but near-term concerns remain

- The Russell 2000 Index forward P/E is 17.7x, vs. 32x in January of 2021 after being down ~30% from the peak. Small caps are now ~25-30% cheaper than large caps, which is well below long-term averages. However, high yield spreads have widened meaningfully by 2.8% to 6%, which is a red flag and reflective of stresses in the market. (Source: Jefferies, BofA)

Managers continue to see headwinds for banks

- Managers believe banks face two key problems:
  1. Based on a regulatory change a couple of years ago, they need to increase loan loss reserves based on a forward estimate of unemployment, even if they don't have problem loans yet
  2. Growth for banks remains a challenge

Market-oriented (MO) managers are now beginning to see opportunities in quality-growth stocks

- MO managers believe the selloff in growth may be overdone, with the Russell 2000 Growth Index recording the worst first half in its history, falling ~30%. At the margin, these managers are now beginning to take profits in value stocks.

More managers are now rotating out of energy

- Both value and growth managers have been taking profits in energy. Some have rotated into defensive areas like healthcare and utilities, while some value managers are finding opportunities in high quality late cyclicals, such as auto suppliers, as well as other discretionary areas like casinos and travel.

Growth managers continue to find opportunities in healthcare

- Conviction remains in the healthcare sector, specifically medical devices, and companies related to increasing procedure volume. They also view managed care as a segment that holds up well during periods of economic weakness.

Europe and UK equities

UK managers divided over financials

- We have seen managers continue to be underweight while allocating more to financials[1], as there is a split in views around the deteriorating macroeconomic backdrop versus the offset of the near-term positive from rising rates.

UK slowdown drives defensive positioning

- Some managers are maintaining slightly higher-than-usual cash balances in order to protect capital through the volatility.
- Within industrials, there is an increasing skew to defensive growth names, as well as a shift to overweighting healthcare and utilities.
- There is reduction and profit-taking in the more cyclical exposures, such as mining, commodity and energy exposures, as these are not immune from the slowing economy.

Prime Minister Boris Johnson's resignation was brushed over

- While British pound sterling may appreciate, the key issues in the UK remain growth, interest rates, the cost-of-living crisis and Ukraine—all of which have not changed with Johnson out of the picture.

More pain for quality in Europe?

- While quality and growth stocks have significantly lagged their value peers, managers have largely shied away from adding to the segment. The quality/growth segments' valuations remain ~30% above 10-year averages[2], and the continued higher real inflation is likely to trigger another series of rate hikes, both in Europe and the U.S.

Cost-of-living crisis

- Within the consumer sectors, managers have become wary of those exposed to lower-income consumers who are most impacted by the cost-of-living crisis, unlike higher-income earners who had built up savings over the COVID-19 lockdowns.

Emerging markets equities

China, China, China

- Regardless of style, managers are rotating back into China after a confluence of market-related and regulatory uncertainties.
- Lockdown easings offer earnings visibility to travel-related themes, e.g., airlines and duty-free, but Macau remains challenged.
- Growth managers see earnings-per-share (EPS) and cashflows normalizing among Chinese consumers.
- The regulatory tone has shifted for Chinese internet names, with approvals for internet deals and online game releases resuming.

[1] Russell Investments manager equity universe
[2] Russell Investments manager discussions, IBES, Factset.

Commodities and tech pause on weaker global outlook

- Some managers have been taking profits in materials as they become increasingly guarded on commodity demand, due to fears of a recession and further interest-rate hikes.
- Rotations have occurred into staples that are inflation hedges, while elsewhere managers are vetting companies on balance sheet and cashflow strength. Some have found quality names on derated valuations, e.g., China/Latin America healthcare and industrials.
- Managers are increasingly weary of the cyclical downturn in semiconductors, following a long runway, due to a softening in global demand and recognition of over-ordering in previous periods.

Brazil will reap rewards over fiscal discipline

- Being earlier to tighten rates given its history with inflation, Brazil is bottoming out compared to other emerging-market economies that are experiencing slowing macroeconomic deterioration. Growth and value managers have been adding to financials given strong loan growth prospects and cheap currency as an export engine.
- Concerns are beginning to abate on political uncertainty, with former President Luiz Inácio Lula da Silva ahead in the polls for October's presidential contest, and a surprising market-friendly centrist campaign.

Economic ambitions in the Middle East

- Managers are patiently nibble on opportunities in Saudi Arabia given fiscal spending is significant—and are waiting for valuation entry points.

Japan equities

Inflation yet to peak

- While managers still expect inflationary pressures to ease amid improvements in the supply chain and labor-participation rates, many still expect it to be more persistent in the near-term alongside a slower pace of normalization.
- Furthermore, an increasing number of investors believe a combination of underinvestment, deglobalization and/or demographic change will result in structural inflationary pressures.

Economic uncertainty affecting managers' transactions

- Growth managers have become more skeptical about the overall recovery of emerging equities due to tighter monetary policy. Some of them are selectively buying high-growth stocks where valuations have become more attractive due to large price corrections. Digital transformation remains an attractive theme. Others who have more conservative views on the economy have been rotating toward large cap quality stocks.
- Many value managers have shifted to consumers or financials by reducing energy- or commodity-related stocks, which have higher economic sensitivity and had performed well. Since Japan is lagging regarding normalization of economic activities, domestic demand-driven stocks tend to be traded at attractive valuations.

More negative view on tech, positive view on financials

- It has become a more common view that demand for smartphone and PCs (personal computers)—which surged during the pandemic—is likely to see continued correction, and managers are thus avoiding adding these names.

- On the other hand, managers are increasingly adding to their financials exposure on expectations of interest-rate rises. Some expect that the Bank of Japan (BOJ)'s quantitative-easing policy could start to be normalized in the next year when Governor Haruhiko Kuroda's term expires.

Australian equities

Inflation bites

- Companies are feeling the impacts of inflation, with electricity and fuel particularly hitting input costs.
- Managers continue to favor companies which they believe can protect margins in an inflationary environment and/or are exposed to structural growth. Healthcare and consumer staples are the sectors providing the most opportunities.

Definition of screens impacts sustainable opportunity set

- Most Australian sustainable strategies operate screens to exclude companies which are not aligned with their ESG (environmental, social and governance) themes. The definition and level of these screens directly impact the strategies' opportunity set and differ widely.
    - Level and measure used: Most strategies use proportion of revenue from the excluded activity, though net earnings is also used. 10% is the common maximum cap, though 5% is used by some.
    - Inclusion of indirect business: Some also screen for the company's customer activities. E.g., proportion of a packaging company's product sold to alcohol producers.
    - Fossil fuels: All coal or just thermal coal? Some managers allow companies with material metallurgical coal exposure to pass their screens as there is currently no viable alternative for steel smelting. By not excluding metallurgical coal, BHP—which is 10.5% of the ASX 300 Index—is an allowable investment.
    - Gold mining: Some strategies exclude gold miners as they believe gold does not contribute to society. Gold miners are 2.3% of the ASX 300 Index.
- Despite negative screens excluding between 15% to 25% of the index, managers believe they can outperform the ASX 300 due to sustainability tailwinds and stock selection skill.

Canadian equities

Defensive positioning continues as recession fears rise

- With tight monetary policies and decelerating economic growth, managers see high recession risks and expect earnings to be impaired, but generally do not believe a recession will be deep.
- Ongoing market volatility and macroeconomic uncertainty are leading many to wait for further confirmation before accelerating trading activity again. At the margin, managers continue to rotate into defensive stocks, reducing exposures to cyclicals and high-growth.

Views on energy stay bullish long-term despite oil correction

- Managers see energy fundamentals as strong but decoupled from commodity prices, which began to ebb and could continue to fall on recession fears.
- Managers took profits prior to the energy retracement, and many ended the quarter underweight. Within the sector, infrastructure is generally preferred for its defensive qualities, but some managers are beginning to add energy beta through producers.

- Long-term sector views remain unchanged, supported by energy security issues, highlighted by the Russia-Ukraine war. Gas outlooks in particular have been bolstered by energy-transition tailwinds.

Managers eye materials stocks as sector weakens

- Among commodities, managers are particularly interested in copper, following the recent pullback, though they are cautious of timing given its recession exposure. They cite copper's long cycle, energy-transition tailwind and long-term supply shortages.
- Agriculture-related commodities are an attractive area, but face near-term volatility due to the Russia-Ukraine conflict.

Bank exposures come down as real estate risks loom

- The risk of real estate impairment is a growing concern. Managers believe banks can absorb the credit risks but are being patient for now.

Long/short equity

Acceleration of Q1 themes

- Many managers are still managing record low exposures, and U.S. equity long/short net leverage reached its lowest level since the global financial crisis (35%) in early June[3].
- Overall positioning suggests most hedge funds remain relatively concerned about the potential for further downside. However, managers are also aware of the risk of missing out on a market rally.

Shift in regional allocations

- Some managers are starting to add risk to underperforming areas of the market, such as Chinese equities, tech, biotech and other parts of healthcare.
- Buying in Asia has increased, while investors reduce exposures to North America and EMEA.

Long/short alpha turns positive, increase in short opportunities

- Long alpha turned positive in June, the first month since September[4], while shorts continue to produce alpha.
- Many hedge funds have continued to find short opportunities despite the significant market decline.

Forced selling for tech funds

- Well-known managers in the TMT (tech, media and telecom) space have been rumored to be forced sellers due to poor performance and redemptions.

Hedge funds with private exposure are finally feeling the pain

- Hedge funds are starting to mark down privates, contributing to underperformance in the space. We expect the markdowns to continue.

[3] Morgan Stanley Prime Brokerage Research
[4] Data from Morgan Stanley Prime Brokerage

New hedge fund launches despite market decline

- New hedge fund launches reached the highest level since the first quarter of 2021, making for the second-highest quarter since the fourth quarter of 2017.[5]
- Launches may be more prevalent for non-equity hedge funds.

Real assets equities

Global property sector backdrop

- In the second quarter, global property performed in-line with broader equities but continued to under-perform over longer periods (down over 850 basis points, annualized, for trailing 3 years). Global property also traded at a significant (about 20%) discount to private market values[6]
- The office sector continues to experience weak demand as tenants right-size space needs. As leases expire, managers are expecting vacancies to increase and income to fall. Even with a 37% discount to net asset value[7], managers continue to underweight the U.S. office sector, which is now just 5.5% of the global index.
- U.S. industrials, now nearly 10% of the global index, were weak (-22% return), mainly due to Amazon's announcement of reducing industrial space. Managers view the decline in share price as a buying opportunity on the expectation that other e-commerce companies will continue to lease space and occupancies will only decline nationally from 97% to 95%. Further, as leases roll over, the new leases should provide an opportunity to raise rents 15% to 20% to get to market rent levels. Our managers in the private markets that own industrials confirm these expectations.

Infrastructure

- Infrastructure significantly outperformed global property and broader equities in Q2, pushing the year-to-date outperformance to over 19%[8]. The massive outperformance is viewed as possibly an opportunity to rotate out of infrastructure and into property.
- Airports were negatively impacted from poor execution by airlines/ground staff. The crisis in Ukraine also weakened operating conditions in Europe. As a result, sentiment is distinctly negative for the airport sector.
- Toll roads are benefiting from overall traffic volumes near 100% and the ability to pass through higher inflation. The take-private of Atlantia ($18 billion market cap) by the Benneton family and Blackstone illustrates the buying power of private capital, estimated to be over $330 billion[9] , that is on the sidelines ready to acquire listed infrastructure assets. This is an important consideration when evaluating rotating out of infrastructure.

The bottom line

Equity managers remain cautious in their positioning amid a backdrop of persistently elevated inflation, aggressive central bank tightening and rising recessionary risks. In such an environment, we believe that the views of specialist managers will be crucial to exploiting both volatility and opportunity. We look forward to continuing to share these insights with you as the second half of the year gets underway.

[5] Data from HFR Market Research
[6] Source: UBS
[7] Source: Green Street
[8] S&P Global Infrastructure; MSCI ACWI
[9] Source: Cohen & Steers

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For more information

Call Russell Investments at **+82 2 6137 6900** or visit **russellinvestments.com/kr**

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