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In focus

Global Equity Market Equity Themes for 2024: QEP Team

March 2024

Introduction and review of 2023

After a strong end to last year, global equity markets initially struggled to find direction in 2024 but soon resumed their upward momentum, with the S&P500 convincingly breaking through its previous all-time high mid-January, once again predominantly led by the big index stocks. Robust economic data in the US has calmed fears of an imminent recession whilst simultaneously raising doubts about the likelihood of early rate cuts. Nevertheless, surveys suggest that investors are increasingly nervous that the wheels may come off. This shouldn't be a surprise after the stellar gains posted last year, as all the good news already appears to be discounted.

David Philpotts
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A simple interpretation of the unexpectedly strong returns to most equity markets during 2023 is that a global recession was avoided, thanks to a resilient US consumer fuelled by Covid inspired excess savings and China's re-opening, even if the latter was half-baked. Along the way, a mini banking crisis in March was quickly shrugged off and artificial intelligence (AI) hype helped to reinvigorate enthusiasm for the index heavyweights that had sold off in 2022. The re-branded 'Magnificent Seven' (Apple, Microsoft, Amazon, Nvidia, Meta Platforms, Tesla, and Alphabet) single handedly carried the US market higher in the first half of 2023, though their performance also had huge implications for market breadth as two thirds of global stocks (and three in four S&P500 stocks) underperformed last year, almost the lowest level of market participation in decades. On the plus side, this has created a wide dispersion of opportunities which we address further below.

As confidence in the Federal Reserve (Fed) pivot increased, the year concluded with a rather unwelcome 'Santa rally', led by unprofitable stocks, heavily shorted and highly leveraged companies, which proved challenging for quality focused investors. The chart below, which divides the global stock universe into nine intersections of Value and Quality, summarises the key performance drivers of recent market returns. The first three quarters of 2023 (bottom left) represented a barbell between high quality and deep value whilst Q4 (top right) was all about low quality stocks we'd normally avoid which had previously underperformed heavily.

Relative returns to Value and Quality (2021–Jan 2024 global stocks)

Post COVID – Return to normality (2021–2022)

	Cheap	Mkt. like	Expensive
High quality	9.7%	4.3%	-3.9%
Moderate quality	6.0%	2.2%	-11.4%
Low quality	4.5%	-3.3%	-23.1%

Growth and Value barbell (Q1–Q3 2023)

	Cheap	Mkt. like	Expensive
High quality	-1.6%	1.1%	2.9%
Moderate quality	1.1%	-2.3%	-0.6%
Low quality	1.5%	0.5%	-7.4%

'Santa Rally' (Q4 2023) – Distressed stocks rebound

	Cheap	Mkt. like	Expensive
High quality	-2.1%	2.6%	1.4%
Moderate quality	-2.5%	2.1%	1.4%
Low quality	2.6%	2.2%	3.8%

Reversal of junk rally (Jan 2024) – Quality outperforms

	Cheap	Mkt. like	Expensive
High quality	0.3%	1.7%	2.9%
Moderate quality	0.2%	-0.2%	-3.5%
Low quality	-1.6%	-4.4%	-6.2%

Source: Schroders QEP. Data from January 2021 to January 2024. Past performance is not a guide to future performance and may not be repeated. Each month all stocks in QEP's global mega to mid-cap universe, are ranked using QEP's Global Value Rank and Global Quality Rank. Terciles (1/3rds) of the Value rank are used to classify stocks as cheap, market like or expensive, while terciles of the Quality rank are used to classify stocks as high, moderate or low quality. Market capitalisation-weighted portfolios are rebalanced monthly and US$ returns are calculated with transaction costs taken into account. A maximum stock weight of 3% is applied within each cohort. Annualised excess returns are then calculated against a market capitalisation-weighted universe.

Schroders

Whilst junk rallies can be powerful in terms of fostering swift market rotation, it's very unusual for them to persist for an extended period. We attributed Q4's market dynamics to the pricing out of recession risks by investors, rather than the start of a new trend, but also had doubts about whether the market was correct in discounting the risks. A more cautious view seems to have garnered some followers more recently with a notable rotation back into high quality (bottom right in the chart above). Notably, the momentum behind the Magnificent Seven stocks (high quality but not cheap) has also continued into the current year, albeit with some dispersion.

Looking ahead, the key questions for 2024 would appear to be whether a soft landing is in the bag and what this means for rates given the usual 'long and variable' lags. More specifically, will rate cuts be driven by the need to stave off a deeper recession due to disinflation? The Fed has done a good job of reining back enthusiasm for early and swift interest rate cuts, but significant easing is still priced in. We also have the normal uncertainty surrounding geopolitics as well as an unusually high number of national elections to contend with. Further, from a thematic standpoint, secular trends around deglobalization, demographics and decarbonization may have a greater influence on the market regime moving forwards versus the prior decade. High level thoughts from Schroders pertaining to the possibility of a '3D reset' can be found here.

However, the focus on the Fed and politics this year may again be misplaced. Instead, it's better to concentrate more on what we observe today to be the most attractive long-term opportunities, rather than falling into the trap of thinking we can call the economy and translate this into market timing. **Given the wide dispersion of valuation across the market and a less powerful tailwind from beta, we think this year will be more about stock selection**, particularly within the 'Quality at a reasonable price' and 'not-large' Value stocks. We outline below some of the key themes for the year ahead.

Theme 1: Recession avoided, but does it matter?

The likelihood of a US recession has been exhaustively covered elsewhere and further analysis here is unlikely to add meaningfully to this tome of work. That said, given that a 'Goldilocks' scenario now appears to be widely discounted, it's worth exploring the risks around the range of potential outcomes. This feels particularly prudent today because if the last few years have taught us any lessons, it is that forecasts are often misleading.

Unlike the situation this time last year, calling for a recession in early 2024 is a contrarian call. Instead, most economists now regard a soft landing as the most probable end to this cycle. However, soft landings are unusual. On a strict definition (the Fed successfully tightens monetary policy to curb inflation without triggering a recession), the only clear example in recent history is the mid-1990s under Alan Greenspan. If we loosened the definition to cover a mild and short-lived recession, it could be argued that the Fed also pulled it off three more times: mid-1960s, 1984 and early 2000s.

One of the best historical indicators of recession has been the inversion of the yield curve, albeit the correlation is based on a relatively small number of recessions. According to the San Fransico Fed, the average gap between inversion and the onset of a US recession based on data since 1960 is 15 months. However, the range is wide as the shortest gap was six months (1981) while the longest was 24 months (1966). The current yield curve inversion began in July 2022, meaning October 2023 marked the 15-month centre point but the potential impact range still covers most of this year.

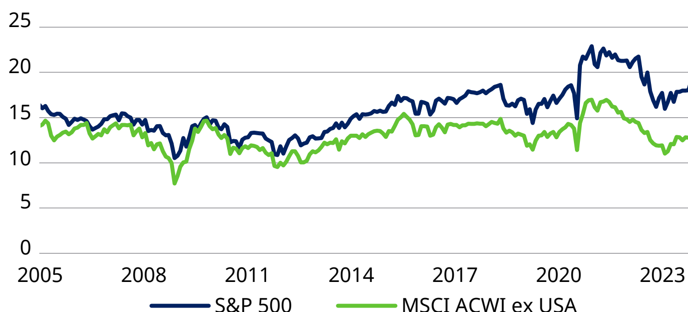
It is well known that the 'lags are long and variable' but if the Fed does keep rates on a plateau for longer than expected, history suggests that after an initial bout of enthusiasm, caution gradually returns even as the timing of the first rate cut approaches. This would advocate risk-off positioning favouring high quality leadership, which is likely to be broader than the usual focus on defensives. The big question is how long the plateau in the Fed funds rate will last. The futures market is looking for a cut as early as May followed by four or five further reductions so that the Fed funds will be below 4% by the end of the year. Whilst it is generally the case that the plateau period is relatively short, it would only take a run of strong US data to dramatically shift market mentality back to 'higher for longer'.

The market is instead praying for a version of the 1995 style soft landing where the plateau was just five months (Feb 1995 to Jul 1995). However, if rate cuts are just around the corner, it's not clear that policy easing is good for equities, typically because the lagged impact of prior tightening eventually weighs on earnings and equity returns. The bear markets of the early 2000s and 2008 highlighted that much will depend on the inflation/growth mix and why the Fed is easing. If it is in response to staving off a harder economic landing, this is unlikely to be equity friendly. Fiscal policy is also unlikely to come to the rescue as the potential for governments to stimulate (in a busy election year) is limited given high deficits.

Rather than pricing in perfection in late 2023, it may merely be that the market priced out a deep recession and the low-quality rally experienced in the fourth quarter was at least partly justified. A useful starting point as to what is already discounted can be found in survey data. A recent poll of Deutsche Bank's clients[1] revealed that over a third of respondents (37%) see a US hard landing as the biggest risk facing markets in 2024. In second place, 26% expected the US election to be the greatest risk (52% think Trump will win). In third place, 18% of respondents cited an unexpected increase in central bank rates due to sticky inflation. Other risks cited are a commercial real estate slump, an escalation of the Hamas/Israel war, stagflation and a technology sell off. Overall, the respondents were of the view that equities are firmly pricing in a soft landing in the US with an expected modest positive return for the S&P500 this year. 10-year US Treasuries are expected to end 2024 at 3.8% and only 26% forecast yields to be at 4% or above by year end. The January edition of the Bank of America Global Fund Manager Survey and other investor polls paint a similarly benign picture. Such optimism is not being felt by Main Street, which remains firmly in the recession camp, but the last time we saw this type of disconnect, Wall Street called it correctly.

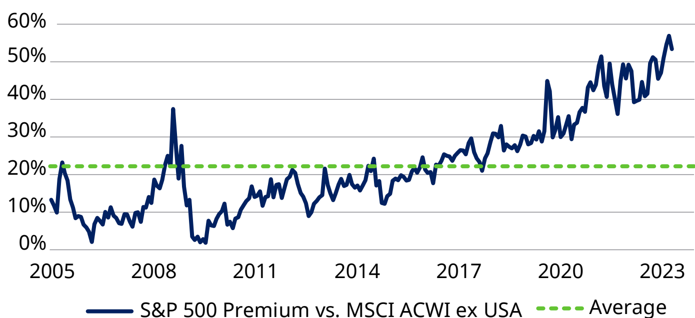
If a harder landing is perceived to be the biggest risk, it's worth exploring what this means for corporate earnings as even a moderate slowdown in global growth would weigh heavily on EPS due to operational leverage. This is a particularly high risk to the US market given its current valuation premium (chart).

Figure 1: Forward price to earnings ratio



1 Source: dbDIG: 540 responses in December 2023.

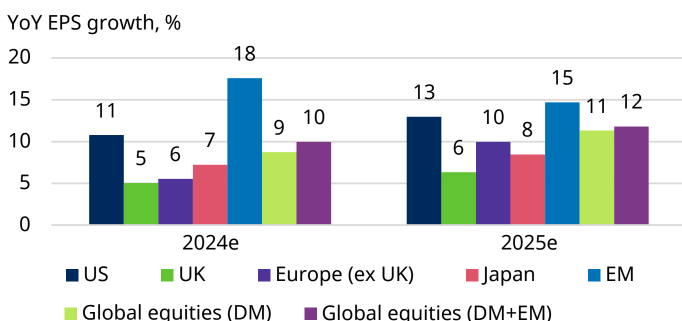
Figure 2: Forward P/E: S&P 500 vs. MSCI ACWI ex-US



Source: LSEG Refinitiv, MSCI, S&P. Showing data from January 2005 to December 2023. Forward price to earnings (P/E) numbers are based on the 12 months forward price to earnings for the respective indices. S&P 500 premium represents the percentage difference between the S&P 500 and MSCI ACWI ex-USA index.

By way of example, US earnings declined by around 20% in the 2002 and 2020 recessions and by as much as -40% in the 2008 global financial crisis. Despite this, bottom-up forecasts for EPS are currently indicating expansion of 11% for 2024 in the US and mid-single digit growth in the UK, Europe and Japan with emerging market earnings expected to rebound by 18% (chart). Forecasts are equally as buoyant for 2025.

Figure 3: Earnings forecasts rebound in 2024–25, especially in the US and emerging markets



Source: LSEG Datastream and Schroders Strategic Research Unit. Data to 31 December 2023. Notes: Japan EPS for 2022 is 4 quarter sum until 31 March of next calendar year, e.g. 2023 = 31/03/2023 – 31/03/2024.

A recovery in earnings of this order may well herald the beginning of the next bull market, but the balance of probabilities suggests that such a robust expansion will be a big ask given the tightening in the system. However, 2023 reminded us of the folly of making assertive top-down calls and given that investors appear to have already discounted the good news, we prefer instead to worry about what could go wrong.

This all suggests that the biggest potential driver of equity weakness this year is likely to come from either a harder-than-expected landing or political uncertainty given widespread national elections around the globe. Other potential sources of volatility are also set to increase as we move through the year. For instance, US core CPI will not have the benefit of flattering base effects and may get stuck at a level deemed unsatisfactory to the Fed, leading to renewed bond market volatility. Earnings will also face tougher base effects, despite the rosy forecasts depicted above. **On balance, we think this year could be rotational and more volatile with less support from broader market returns. If so, it will be more about stock selection but the backdrop favours high quality stocks alongside broader participation, particularly further down the size spectrum** (more on this below).

Theme 2: Longer term: valuations are not compelling for indices, particularly the US

Before we return to shorter term opportunities, it is worth briefly considering the potential for the past ten years to be repeated in the next. Over the past decade, the S&P500 has gained almost 12% on an annualised basis, driven by multiple expansion (57%), earnings growth (26%) and dividend growth (17%). Valuations are the best guide we have when speculating about longer term trends. The S&P500 started this year at around 21 times forward earnings, a near 20% premium to its 15-year median. Other markets are more attractive on this measure, but our preference is always to use the Cyclically Adjusted Price Earnings multiple (CAPE) for longer term analysis which averages earnings over the past decade. Lower CAPEs have historically been strongly associated with higher subsequent 10-year returns (and vice versa).

On this basis, the current CAPE in the US (31x) is 22% higher than its post-1990 average and comparable to the level recorded before the Great Crash of 1929. This clearly suggests that future returns will be lower. For example, if we assumed that real EPS growth matched that achieved over the past decade, which would be no mean feat, and that the current level of the US CAPE is 'correct', this would be consistent with an equity real return around half that observed over the past 10 years (6% vs. 12%). It would still require the AI optimists to be correct in that it will deliver a step change in profitability. Fortunately, the bar is much lower for equities elsewhere, simply because the average CAPE for the Rest of the World (15x) is at a slight discount to its recent history.

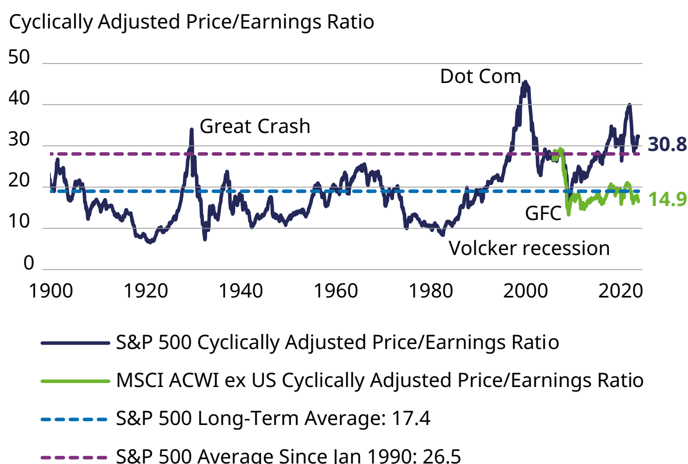


Figure 4: Cyclically adjusted PE ratios for US and Rest of World

Source: Long-term information for the S&P 500 sourced from the website of Robert J. Shiller and Yale department of economics. MSCI ACWI ex US information sourced from MSCI, via LSEG Datastream. Data to October 2023.

In short, the longer-term opportunity from equities is reasonable, but well below what we have enjoyed in the recent past. The hegemony of the US market is also more likely than not to wane going ahead as its superior profitability is already discounted. That said, from a bottom-up perspective there are many high quality opportunities in the US that we favour which is our preferred approach to taking regional positions.

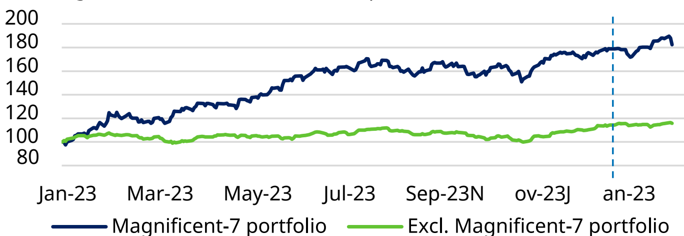
Theme 3: Will the Magnificent Severn continue to dominate performance?

We can't return to the shorter-term outlook without addressing the big index stocks. Market commentators tend to think about the 'Magnificent Seven' as a cohort given significant index representation, underlying technology trends and since they have largely dominated equity performance for the last six years. Rightly or wrongly, the 'Magnificent Seven' are grouped together as an asset class, representing a combination of a high duration play and defensive growth with positive momentum. Whilst their interconnectedness is more nuanced, they do all share a common trait of being leaders in their respective fields and have strong business franchises in fast growing areas. This has resulted in strong profitability and superior cashflow generation for most of the seven, which broadly justifies their robust valuations.

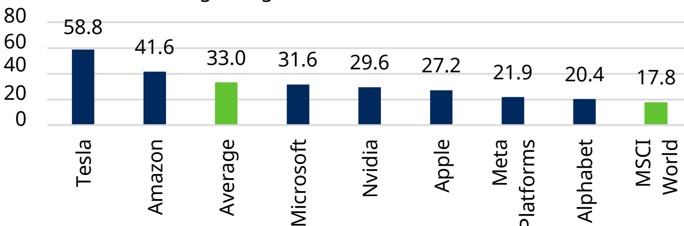
The appeal of robust growth and reasonable valuations at the start of 2023, following the retracement of 2022, set the scene for spectacular gains in the first half of last year. As a group, they rose over 70% in 2023, accounting for the majority of the market's advance. Enthusiasm for AI following the rapid adoption of ChatGPT initially looked overdone but strong earnings growth (e.g. Nvidia) and cost reductions (e.g. Meta/Google) provided further fuel to the rally. They performed particularly well during risk-on periods but provided a high degree of downside protection when market confidence was tested.

Figure 5: The Magnificent 7 rose 76% in 2023, the rest of the world (MSCI ACWI) by 16%

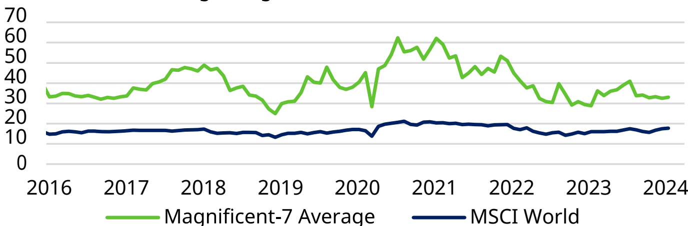
The Magnificent-7 vs. MSCI ACWI ex Super-7



Forward Price Earnings: Magnificent-7 and MSCI World



Forward Price Earnings: Magnificent-7 vs. MSCI World over time



Source: Schroders, LSEG Datastream, MSCI. Past performance is not a guide to future performance and may not be repeated. LHS: Magnicient-7 portfolio is the seven largest companies in MSCI ACWI by free float market capitalisation. These are Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Tesla, Meta (Facebook). Ex Super-7 is a portfolio of the remaining constituents of MSCI ACWI. Data to 31 January 2024 with returns rebased to 1st January 2023. RHS: Forward P/E data is next twelve months as 31 January 2024, from IBES, Tesla not included until January 2019 given negative Earnings expectations skewing data. The Average is the mean of the 7 stocks shown.

The consensus seems to be that the 'Magnificent Seven' stocks will be up again this year. The Deutsche Bank survey referenced earlier indicates that two-thirds of respondents are positive with a sizeable minority even more optimistic forecasting 60%+ returns for the group. Whether these seven stocks can repeat this act in 2024 largely depends on your view of whether they have entered bubble territory. We are not die-hard enthusiasts but are also outside of the bubble camp given the strong Q4 earnings reported during January (Tesla aside). As a result, the valuations of this cohort are rich but not egregious (chart above).

When we rank all global stocks by a range of valuation terms, these seven stocks sit broadly in the middle of the pack with only Tesla cusping close to the bottom 20% of the universe. However, when we look through a quality lens, as captured by their profitability, stability, financial strength and structural growth characteristics, the bulk of them exhibit strong attributes (particularly Nvidia and Microsoft) with Tesla and Amazon less compelling but still better than average.

Given that cloud computing is still in its relative infancy, Amazon (AWS), Microsoft (Azure) and Google (GCP) are well placed to enjoy the transition, alongside their other growth avenues (e.g. enterprise software for Microsoft, e-commerce for Amazon, advertising for Google). On a relative basis, Amazon's superior valuation and lower profitability would suggest it is the least attractive out of the three cloud players. Elsewhere, Meta appears to have made the right moves so far in terms of cost control and product innovation but still has lower barriers to entry in its core social media business (e.g. competition from TikTok). Apple is highly cash generative but is the slowest growing out of the cohort on account of its product maturity, which may warrant more caution given it is valued at a modest discount to Microsoft but at a reasonable premium to Alphabet and Meta. Tesla is the least attractive due to it trading at a higher valuation versus the rest of the Magnificent Seven as well as its vulnerability to competition in electric vehicles and slower EV take-up more broadly.

According to JPM, institutional investors (75% of the Magnificent Seven ownership) are overweight Alphabet and Meta and underweight the rest with a the aggregate underweight to the group circa -3%. This just intensifies the battle between the active and index funds. However, given the high level of uncertainty regarding the challenges facing the group, **it seems wise to monitor their performance on a case-by-case basis like a hawk, particularly from the perspective of ensuring earnings continue to support their recent momentum.**

Longer term, history would strongly suggest mean reversion, but our working assumption is that they will remain dominant in terms of index weight, reflecting their economic and social importance. However, those looking for a repeat of early 2023 when the valuation case was much stronger, are likely to be disappointed unless they can consistently continue to beat earnings expectations, which we would certainly not rule out.

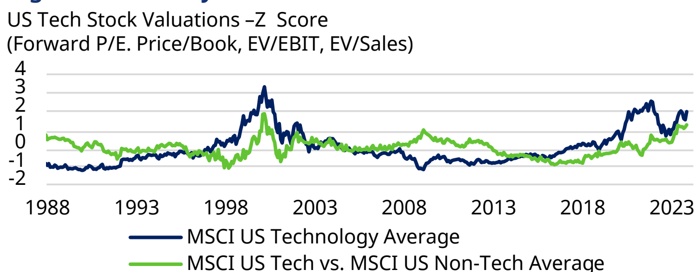
Theme 4: Tech Déjà Vu?

Taking a broader perspective, 2024 began with the US tech sector accounting for as much of the US broad market index as it did at the height of the bubble peak in mid-2000. In other words, tech holds a significant sway, accounting for a sizable chunk of the market (23% of MSCI World and almost 29% of the S&P500). Adding in non-tech 'growth' stocks such as Amazon, Alphabet, Tesla and Meta would add a further 8% to MSCI World and 11% to the S&P weight.

Prior to 2019, US tech stocks traded at valuations broadly in line with the overall market. Fast forward to today, and the picture is starkly different. The 12-month forward P/E for US IT stocks stands at a hefty 27x, compared to the broader market's sub-20x level (a 35% premium). This mark-up is the highest it's been in

four decades, save for the insane heights reached in the dot-com bubble. This raises a critical concern: if the US tech sector stumbles, could it drag the entire market down with it? This time things are different, most notably the sector has much stronger fundamentals compared to 25 years ago, but the outsized influence of US tech on the market is worth watching closely. A tech-driven slump would undoubtedly have ripple effects across various sectors, potentially leading to a significant market correction and loss of confidence.

Figure 6: US Technology valuations not quite back to dot-com highs but still very stretched



Source: MSCI, QEP, Schroders. Data as of November 2023. Past performance is not a guide to future performance and may not be repeated. Using the MSCI World Index, US stocks have been carved out to create a US portfolio. This has then been split again into the Technology sector and non-Technology sector. The relevant holdings have been reweighted to sum to 100%. A Z-Score was calculated on the relevant metrics named above, with the 'Average' showing the simple average of these Z-Scores. For the relative line, we take the Tech Z-Score minus the Non-Tech Z-Score for each underlying component and averaged these differences. Forward P/E data is density weighted, meaning that the weights of future years are taken dependent on analyst dispersion and counts, sourced from QEP systems.

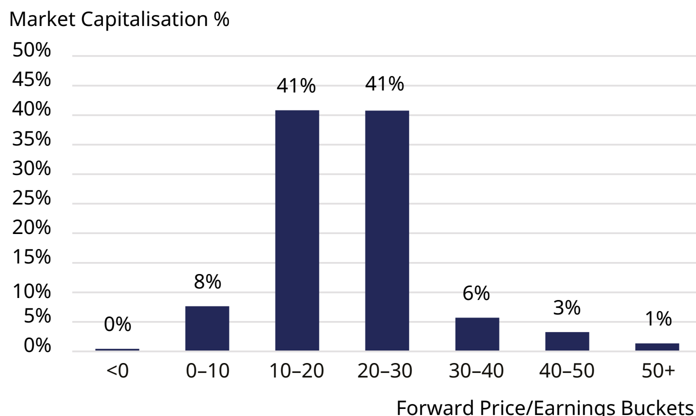
Without the tailwind of zero interest rates, there may be money to be made at some point from timing the tech cycle, but **it is incredibly difficult to separate structural and cyclical forces in the current environment. Instead, we intend to remain selectively positive but do not want to let these positions dominate our risk budget. Instead, there are many compelling prospects with greater confidence in payoffs elsewhere.**

Theme 5: Dispersion of valuation is high indicating an abundance of opportunities

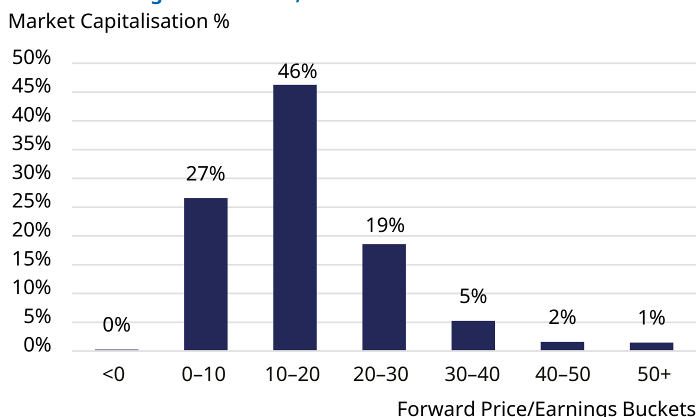
Rather than timing sectors, we believe there is great potential to add value within equities simply because of the current high level of dispersion across the market. A glib way of describing this is that the breadth of valuations outside of the US is indicative of a wide array of distressed opportunities but not necessarily distressed companies which should favour a bottom-up approach (chart).

Figure 7: Forward Price/Earnings compared to history (US and Rest of World)

United States, December 2023



World excluding United States, December 2023



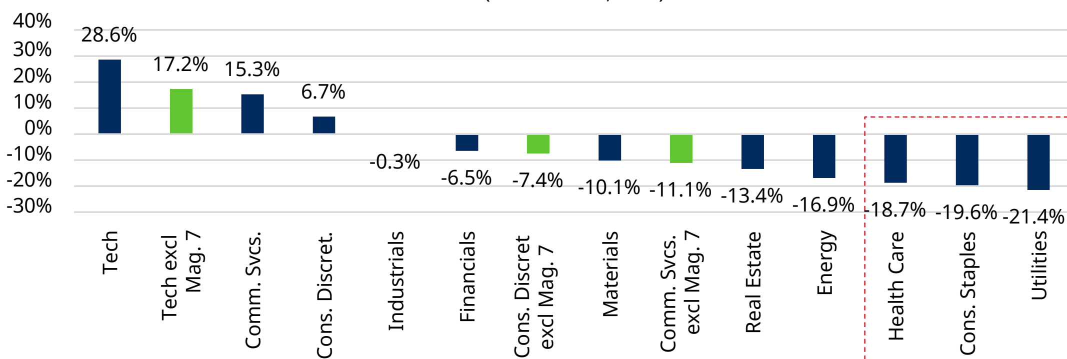
Source: MSCI, QEP in USD as at December 2023. Based on MSCI World Universe. Forward P/E data is density weighted, meaning that the weights of future years are taken dependent on analyst dispersion and counts, sourced from QEP systems, averages based on the monthly data going back to 1986. Buckets show market cap percentages. Past performance is no guarantee of future results.

Given the breadth of opportunity, a few trades that we would highlight include:

Quality (and defensives) to make a comeback

Against the backdrop of a broadly risk-on market, the powerful rebound in the 'Magnificent Seven' stocks last year left the boring old defensive sectors (healthcare, utilities, staples) well behind. Alongside energy, these sectors were the worst performing in 2023 (chart).

Figure 8: Defensives were left behind last year

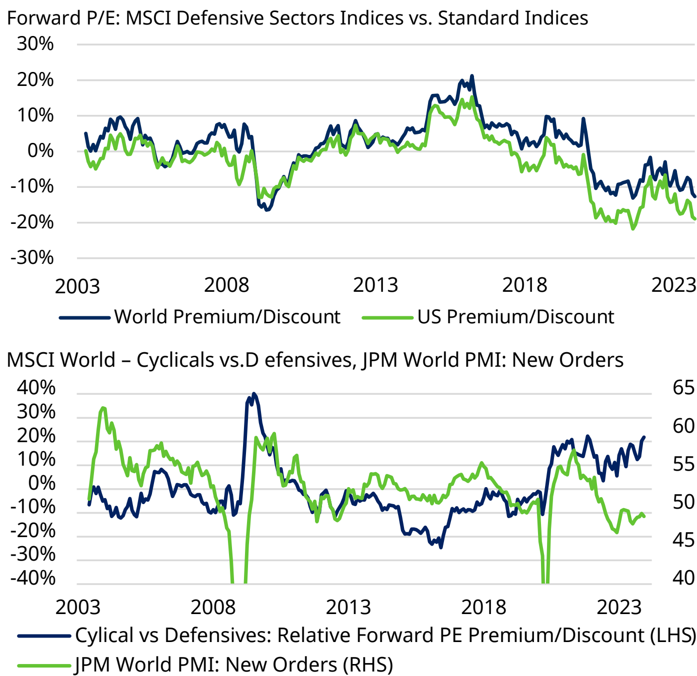


Company	Sector
Tesla	Consumer Discretionary
Amazon	Consumer Discretionary
Microsoft	Technology
Apple	Technology
Nvidia	Technology
Alphabet	Communication Services
Meta Platforms	Communication Services

Source: MSCI, LSEG Datastream, QEP, Schroders. Data as of December 2023. Past performance is not a guide to future performance and may not be repeated. MSCI AC World sector performance shown for relevant Total Return indices in USD. The 'excluded' versions of the sectors assume the relevant stocks have been removed for that sector, and the other remaining holdings have been reweighted to 100%. The exclusions would be performed when looking at that sector in isolation (for example removing Apple would not reweight stocks across the entire universe).

We would highlight the attractive valuation of defensives (see chart below) and, on the other side, also flag that cyclicals appear richly priced for a world where growth is likely to be challenged, even without a hard landing (see charts). In particular, cyclical stocks in Europe appear to be pricing in a strong recovery. More broadly, this cohort tend to move in line with earnings revisions which may soon roll over. The valuation gap is even wider on normalised earnings because the earnings of cyclical companies are inflated at this point in the economic cycle.

Figure 9: Defensives have lagged whilst cyclical performance seems out of line with economic momentum



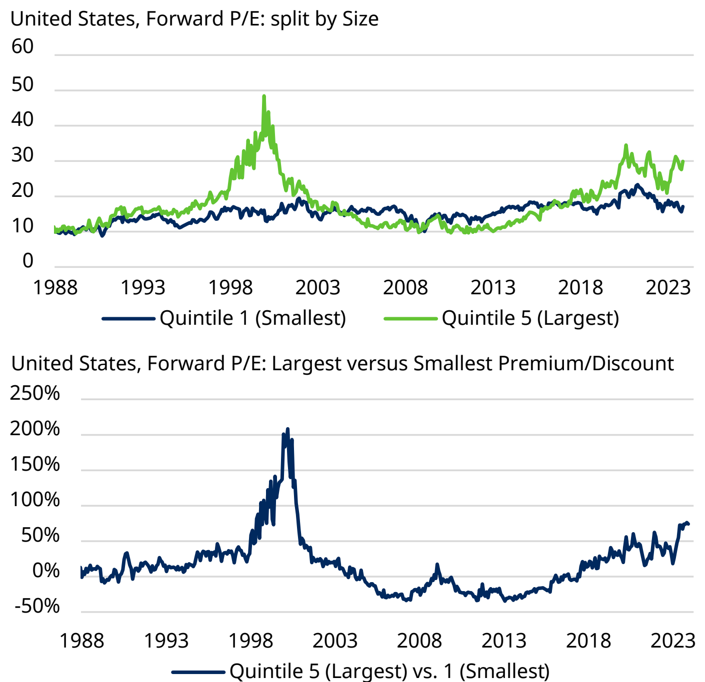
Source: MSCI, LSEG Datastream, JPM, QEP, Schroders. Data as of December 2023. LHS: MSCI World Defensive Sectors Index vs World, and same for MSCI USA. RHS: MSCI World Defensive Sectors Index and MSCI World Cyclical Sectors Index. JPMorgan Purchasing Managers Index, World, Manufacturing Sector, New Orders, SA. Premium or Discount calculated using the Forward P/E (NTM) sourced via LSEG Datastream.

Our base assumption is also for an uptick in volatility, which would be consistent with affordable quality returning to favour, particularly if bond yields continue to decline. As noted above, prior Fed plateaus have typically favoured defensive areas. **Our preference is for playing old school defence through pharma and staples (home products, drink), but the overarching trade will be Quality.** Based on equity market performance in January, this trade seems to have legs. A hedged approach would be to favour quality and structural growth within the US, complimented by holdings in more cyclically exposed value stocks in the rest of the world and further down the cap spectrum (see next point). The latter cohort are more operationally leveraged if growth does positively surprise.

Small caps look attractive (but beware the traps)

Continuing the theme of relative value opportunities, if we look at the flipside of big tech, there are many opportunities in small caps, which have also been left behind in recent years. With the largest stocks trading close to their all-time highs, small cap valuations are now at levels typically observed during recessionary times. In other words, the valuation spread is extended at present, albeit not to the same extent as 2000 which was just prior to their last great bull run. Further support for 'not large' stocks comes from the observation that the quality of this group is on average superior to that period, although this masks high diversity and careful stock selection is critical. Fortunately, the breadth of opportunity means that this is not a constraint.

Figure 10: US small cap discount elevated but not back to 2000 levels



Source: MSCI, QEP, Schroders. Data as of November 2023. Using the MSCI World Index, US stocks have been carved out to create a US portfolio. From there, using the Market Capitalisation of all stocks in USD we have split the universe into 5 groups to create quintiles. Forward P/E (NTM) sourced from IBES via QEP systems.

Figure 11: Valuation vs. 15-year median (% above/below)

Equity market	Forward P/E	Trailing P/E	P/B	Dividend Yield
US large caps	20 (20%)	25 (21%)	4.5 (57%)	1.4 (37%)
US small caps	19 (-6%)	26 (-12%)	2.2 (0%)	1.6 (-5%)
World ex-US large caps	13 (-3%)	15 (-8%)	1.8 (8%)	3.1 (2%)
World ex-US small caps	13 (-15%)	17 (-22%)	1.3 (-8%)	3.0 (-17%)

Key:	<-25%	-25% to -15%	-15% to -5%	-5% to 0%	0% to 5%	5% to 15%	15% to 25%	>25%
	Cheap			Neutral			Expensive	

Source: LSEG Datastream, MSCI and Schroders. Data to 31 December 2023. Figures are shown on a rounded basis. Assessment of cheap/expensive is relative to 15-year median. Cyclically-adjusted price/earnings multiple (CAPE) not shown due to insufficient history for small caps.

It's true that small cap earnings momentum has lagged relative to larger stocks but, other than sheer neglect, the fact they have fallen from favour is largely attributed to concerns about their leverage when yields were rising sharply. **It may seem unlikely that economically sensitive small caps could outperform in a downturn, but they did exactly that in the initial stages of both the early 2000s and 2008 recession as well as the subsequent recoveries.** The justification at the time was that small caps had priced in recession risks earlier and to a greater extent. This argument seems less powerful than 24 years ago but is still valid today.

It could also be reasoned that concerns related to their ability to finance debt will ease as interest rates decline but historically MSCI's ACWI SMID index has outperformed in 60% of months since 1997 when short term or longer-term rates were rising, presumably indicative of expected economic momentum. The fact that small and mid-cap lagged so much in 2023 against the backdrop of rising rates and yields suggests again that we should be wary of applying simple rules. The usual rules probably don't apply when factoring in the legacy of the first bout of cost push inflation we have observed in decades.

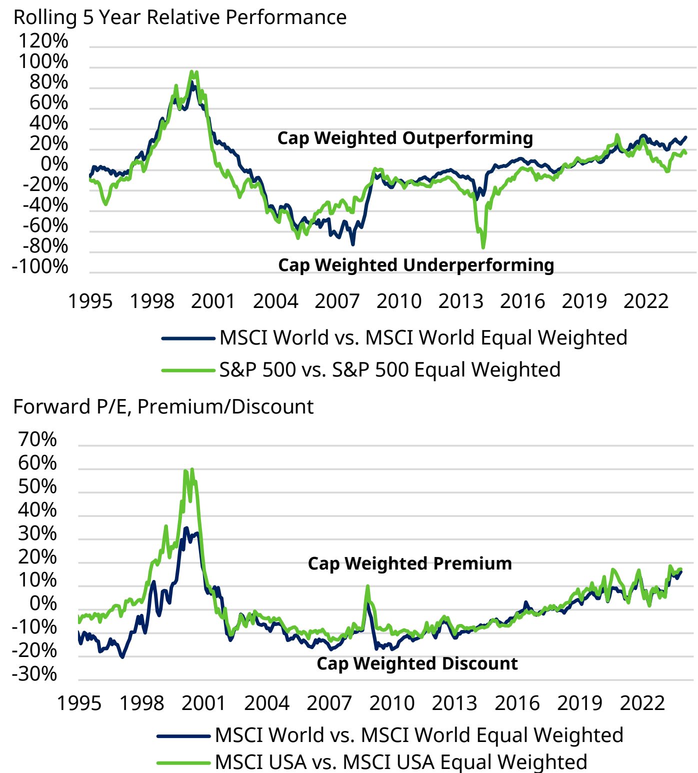
One caveat worth making is we don't typically like the arbitrary distinction between small, mid and large cap stocks in terms of making investment allocations. **It would be lazy to label all small caps as domestic cyclicals.** Instead, it is a very heterogeneous group which offers an array of characteristics. The opportunity set is also huge. Out of the QEP's stock universe of over global 13,000 companies, 3,200 could be regarded as mid-cap (market cap between $2.5bn–$10bn) with a further 4,500 labelled as small-cap (market cap between $500mn and $2.5bn). This permits the benefit of being able to diversify in the SMID space given this broad opportunity set, while also meaning we can afford to be very selective, and our preference is firmly on identifying the most compelling valuation opportunities after discarding the many value traps. In other words, the bar can be set very high when looking through a quality lens. Within this area, we currently favour technology (Asia and US) as well as industrials (e.g. Japan) and SMID in the UK.

It's less about small and more about the 'average' stock

We'd also extend our dislike of categorising stocks by their size to make a broader comment that the 'average' stock is very compelling. **The dominance of the index heavyweights between 2017–2021 and again during the narrow market of 2023 has meant that the median stock has been neglected.** One way to measure this is to focus on equally weighted indices. In 2023, the equally weighted MSCI World benchmark gained 'just' 17.3%, which was 7.1% behind its capitalisation weighted equivalent whilst, unsurprisingly, the same comparison for the MSCI US highlights an even larger performance drag of 9.5% (17.6% vs 27.1%). It also explains why the average active manager performed so poorly last year. Moreover, the cap weighted US index continued to trounce its equal weighted version in January.

Over the past decade, the equally weighted MSCI World index has lagged by more than 50% in cumulative terms but in the decade following the collapse of the tech bubble, where the valuation gap was similar, it outperformed by almost 75%.

Figure 12: Cap-weighted vs. equally weighted benchmarks



Source: MSCI, Standard & Poors, LSEG Datastream, QEP, Schroders. Data as at December 2023. Past performance is not a guide to future performance and may not be repeated. LHS: Data based on Total Return indices in USD, rolling period performance. RHS: Data from QEP. MSCI World data used to create carved out United States portfolio. Forward P/E (NTM) sourced from IBES via QEP systems.

This does not seem healthy as the concentration in the S&P500 has not been this high since the early 1970s during the nifty-fifties bubble. However, the debate is more about whether the typical forces of creative destruction, which has historically always displaced the big index stocks, is still in play in this world of technological innovation and higher barriers to entry due to network effects. If things are not different this time, the current level of concentration in the US would be consistent with strong outperformance of the average stock. However, as noted earlier, **it may be preferable for risk reasons to take a more hedged view on the largest stocks (where possible) whilst still tapping into the potential upside elsewhere**. It is very difficult to quantify the potential for persistence in market concentration, but we have sympathy with the narrative that the world has changed, although it's still important to keep an eye on the price paid for future growth prospects.

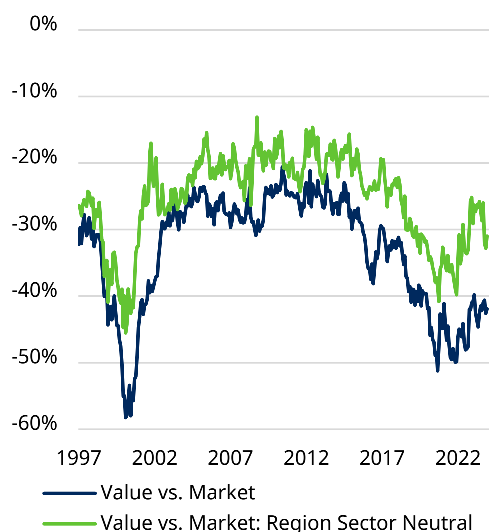
The Value opportunity is broad based – Quality at a reasonable price is the sweet spot

The rule of thumb is that Value outperforms when interest rates are rising and vice versa, due to their shorter duration. For the past three decades at least, this rule has worked regardless of whether we look at short or long term interest rates, although the relationship is far weaker prior to the Global Financial Crisis. Highlighting the tight fit between the underperformance of Value post-2010 alongside falling bond yields does not necessarily mean that correlation is causation. For example, using the performance of the MSCI ACWI style indices from 1997 as our guide, the Value index actually outperformed Growth in 10% more months during periods when short-term rates were falling and market valuations were relatively expensive. This potentially reflects animal spirits and enthusiasm for chasing momentum which pushed Growth valuations too high. At the very least, it again suggests we should avoid overly simplistic rules of thumb.

We prefer to gauge the quantum of opportunity by instead assuming that valuations will ultimately revert back to their long run average after taking into account the analyst forecast differential in earnings growth. This does not provide any insight into timing the market or potential catalysts but, on this basis, the prospects for Value are still very compelling with 3.3% annualised expected outperformance over the next three years. This rises to 4.7% if we further condition for affordable high quality stocks (the top left part of the matrix presented at the start of this paper). which is our favoured stamping ground. On a sector-neutral return, the expected return would be 3.1% p.a., reflecting the concentration of value in certain sectors today (see table).

Figure 13: The intersection of Value and Quality is the sweet spot

Forward P/E of Value vs. MSCI ACWI IMI



MSCI AC World IMI –Expected return over 3 years (assuming reversion)

	Value	Quality	Top Third of QEP Value and Quality	Top Third of QEP Value and Quality (Sector neutral)
Long Run Forward P/E Premium/ Discount to Market	-32%	10%	-19%	-19%
Current Forward PE	11.7	23.9	13.8	14.7
Current Forward PE of Market	20.2	20.2	20.2	20.2
Market Forward PE Adjusted to Long Term Premium/Discount	13.4	22.1	16.3	16.4
Multiple Change Current to Long Term average	14.8%	-7.3%	18.1%	11.3%
3 year growth in EPS (relative to ACWI IMI)	-4.0%	0.8%	-2.9%	-1.6%
Expected 3 year Return Relative to the Market	**10.2%**	**-6.6%**	**14.7%**	**9.6%**
Annualized 3 year relative return	**3.3%**	**-2.2%**	**4.7%**	**3.1%**

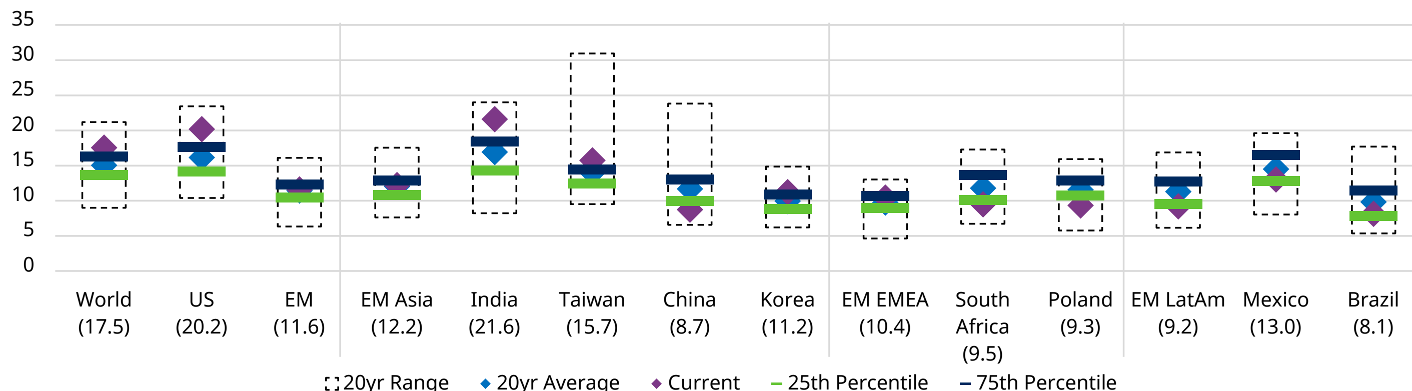
Source: QEP, IBES, data from January 1997 to December 2023. LHS: Value basket is formed from a cap weighted cheapest tercile (top 30%) of global stocks based on a MSCI AC World IMI universe ranked by QEP Composite Value rank. Forward P/E multiple is based on next twelve months. RHS: Value/Quality basket is formed of the stocks in both the top third of the QEP Global Value rank, and the Global Quality rank. Expected return assumes normalisation of Forward Price/Earnings over the next 3 years. The Forward Price/ Earnings numbers are based on QEP constructed portfolios, the growth in EPS numbers are based on the constructed QEP portfolios.

EM could be a diversifier

Going long emerging markets was every strategist's favourite place to be at the start of 2023. They were disappointed, albeit almost all of this was due to the poor performance of China, which has continued into 2024. It may pay to be sceptical again, but the value story is still there, especially for China and Latin America/Non-Asia EM (see chart).

Figure 14: EM valuations are in line with their own history (20 years) but cheaper than DM

Forward P/E; Current, Average, Range, Percentiles



Source: MSCI, LSEG Datastream, QEP, Schroders. Data as of December 2023. Countries and Regions based on MSCI index holdings and Forward P/E (NTM) data from IBES via LSEG Datastream. 20-year range, average and percentile information based on monthly datapoints.

We noted earlier that for developed markets to deliver even average performance over the next ten years requires both strong earnings growth and even higher valuations. However, the situation in emerging markets is almost the opposite. The shorter-term buy case for EM is as follows:

- **EM growth premium:** EM is expected to be more resilient against the backdrop of a weaker global economic environment. The EM-DM GDP growth differential is forecast to widen to a five-year high with earnings growth almost double that anticipated in developed markets. Solid EM macro fundamentals should provide a buffer in the event of a less benign 2024 US scenario
- **EM disinflation:** Rate cuts are also coming to emerging markets and probably more quickly than in DM as EM central banks started the tightening process earlier
- **China stimulus:** China's equity market had a torrid time in 2023 as investors shied away from China amid economic uncertainty and real estate market turmoil. The start of this year has seen more evidence of a lack of appetite for bottom-fishing. However, there seems to be an increasing consensus that China will soon turn on the pumps in earnest. China's approach will most likely prioritise stimulating production rather than consumption, although deflation is still likely to end this year. The government will need to delicately manage a reduction in construction and housing development to align with collapsing demand. Still, many of the risks are now well flagged and we may be close to the point of "peak pessimism". A combination of a mild cyclical recovery and positive EPS growth, cheap valuations and underweight positioning could set up a tactical rally in Chinese equities which may gain momentum. However, we are always cautious of market timing and see a better bottom-up case, favouring Asian technology more broadly
- **Indian equities** have been a standout performer in recent years. The economic outlook remains robust with c.7% multi-year GDP growth likely and Nifty 50 earnings growth should remain well into double figures this year and next. With foreign investor positioning still light, any corrections will likely be met with new flows, particularly since India is regarded as a safe-haven relative to China

Despite the relatively upbeat overview presented above, **we would still step carefully and argue that stock selection should drive regional allocations rather than top-down views**. The key risks to EM are geopolitical with significant elections (Mexico, South Africa, India, Brazil) and the ongoing threat that China will follow through with its stated intentions towards Taiwan. The outcome of Taiwanese national elections in mid-January (i.e. the re-election of President Lai Ching-te, head of the pro-sovereignty Democratic Progressive Party, or DPP) was not unexpected but was also not the result China would have preferred. It does nothing to de-escalate the current tensions between China and Taiwan. We are not military strategists but it's easy to fall into the trap of down weighting low probability but extremely high impact scenarios. That said, there are no obvious hedges, but we would expect increasing investor interest in separate allocations to China as a result.

The summary would be that **emerging markets offer a range of good candidates for diversification from developed markets but this should be driven by careful bottom-up stock picking.**

USD peaked? Probably but not much downside either

Another point of consensus among strategists at the start of the year was for a weaker dollar. However, the surprising strength of the greenback in early 2024 suggests that its 'king dollar' moniker remains firmly in place for now. The key headwind is clearly the downward trend in US rates whilst on the flip side other western nations seem less enthusiastic to ease policy and Japan will be looking to raise rates at some point. Sustained USD weakness will require not just the Fed following through on rate cuts but stronger relative growth elsewhere which is by no means assured outside of emerging markets. Taking all of this together, **we would not be surprised to see a range bound dollar led by bond market volatility.**

Theme 6: Geopolitics – a year of national elections

Equity markets have proved remarkably resilient to geopolitical tensions over the past two years. There remains no near-term resolution to the Russia/Ukraine conflict, which will soon enter its third year, whilst the Israel-Hamas conflict has so far been regarded as a local issue. Elsewhere, China continues to march in an authoritarian direction and the recent election of Javier Milei, the new 'anarcho-capitalist' as president of Argentina highlights the ongoing appeal of populist leaders.

A large potential source of volatility will most likely come from the US Presidential election in November. As at the time of writing, Trump appears to have a slight lead over Biden but with a high margin of uncertainty. How this develops will depend again on resilience of the US economy but the potential for a final term Trump government taking the US out of NATO in a second term is another clear source of potential risk. The experience of 2016 provides only a partial guide but the final weeks leading up to and immediately following the 2016 election were marked by high volatility, although attributing specific causes is clearly complex. As a general background fact, based on data since 1928, the S&P500 has risen 11% in election years with 19 out of the 23 years generating positive performance (83%). When a Democrat was in office and a Republican was elected, performance was 12.9% compared to 11% when a Democrat was re-elected[2].

Outside of the US, this year is unusual in hosting what must be the highest number of elections in living memory. No less than 40 countries will go to the polls in national elections, covering 3.2 billion people, including the UK, South Africa, India, Iran and Russia. Elections seem like a big deal at the time but have historically had less impact on global markets than their news coverage would suggest is warranted. The stakes are probably higher now though, particularly given the ongoing wars in Ukraine and the Middle East and the rush to control the supply of critical minerals could lead to further trade restrictions in the interests of national security.

We would be careful in extrapolating the sanguine response of the equity market in recent years to geopolitical shocks, particularly against a potentially less supportive economic backdrop. Once again, the risks would appear to be skewed to the downside.

2 Source: https://advisor.morganstanley.com/the-ernie-garcia-group/documents/field/e/er/ernie-garcia-group/S%26P%20500%20in%20Presidential%20Election%20years.pdf)

Theme 7: Short term ESG fatigue should not overshadow the longer term trend

After a difficult year for sustainability focused investors in 2022, last year was less hostile thanks to the weaker performance of energy stocks, but a general fatigue with ESG investing is increasingly evident in the slower pace of investor flows and growing regulatory burdens. There are also signs that the froth has come out of some of the valuations of sustainability champions, such as renewable energy stocks, which peaked in 2020 (chart).

Figure 15: Some froth has come out of the ESG market – renewables

Valuations: Renewable Energy Equipment Sector

Source: MSCI, LSEG Datastream, QEP, Schroders. Monthly data as of December 2023. Index used was the World-Datastream Renewable Energy Equipment, and the Forward P/E (NTM) and Price/Book data was sourced via LSEG Datastream.

According to Morningstar, the median sustainable large-blend equity fund in the US universe broadly matched the returns of conventional large-blend equity funds in 2023 despite the tailwind from avoiding high carbon emitters in a year when oil prices were volatile but weakened. Concerns about the performance impact of sustainability are clearly valid as much of the academic work in this area has focused on the relationship between relative performance and sustainability credentials with mixed conclusions. However, these studies often fail to address causality and, more importantly, lack adjustments for the short-term performance of different business models.

A stronger case for sustainability focused investment can be made if stocks are in a state of transition, leading to a one-off uplift in relative valuation during the adjustment phase, although we still don't have sufficient data to prove this convincingly. There does appear to be a growing interest in what could be termed a more 'honest' approach to sustainability investing, which focuses more on transition stocks, particularly those in 'brown' industries. Excluding these areas from ESG portfolios overlooks their potential for green advancements and the resources they possess for impactful innovation. We expect the trend towards more engagement led strategies to continue as well as a broadening out of the focus on decarbonisation to wider environmental issues such as biodiversity. The fact that biodiversity impact is currently much harder to measure than greenhouse gas emissions creates a challenge for investors but once again highlights the important role of engagement given that one size will certainly not fit all. With climate resilience emerging as a new investment theme within the low carbon transition, it also brings with it increased demand for solutions that help economies prepare for, adapt to and withstand climate hazards.

The increased preference for 'impact' also has implications for passive approaches which are currently more focused on exclusions. We have noted a growing interest from our client base for sustainability-focused low active risk strategies, where the normal discussion around the potential trade-offs between expected return and sustainability is less important than having a positive 'impact'. Clearly, **ESG is an evolving area but we remain firmly committed to providing clients with a range of potential solutions in what we have always regarded as a client led discussion.**

Summary and final thoughts

At the time of writing, there are several known unknowns, and few strategists, after being humbled by their poor forecasting abilities during 2023, are willing to stick their necks out again. Bloomberg's recent annual summary of Wall Street expectations described this as a middle-of-the-road scenario (i.e. a benign economic slowdown and easier monetary policies, setting the stage for positive yet underwhelming equity gains). So far, market dynamics in early 2024 suggest a rotation back into higher quality stocks, particularly those that lagged late last year (e.g. health care), alongside the ongoing dominance of the technology growth themes. Out of these, Tesla has had a bumpier ride year to date, even as the broader market hit new highs.

The Q4 earnings season kicked off in mid-January with the banks first to report. In general, they painted a relatively stable picture of the consumer and the economy. While growth has slowed, the consumer is still spending and, depending on the definition, probably still has excess savings. There were certainly no red flags cited with JPMorgan Chase's CEO succinctly summarising 'the way we see it, the consumer is fine'. Yet according to the latest S&P Global survey, investor confidence collapsed in January, with geopolitics and the US presidential election cited as the key drivers. So far at least, the solid earnings of the big stocks outside of Tesla are supporting their performance but the big picture still seems to be one of market priced for good news, which does increase the potential for tail risks to have an outsized impact.

From our perspective, **the risks would seem modestly skewed to disappointment, but our key observation is that the wide dispersion of valuations across the market at present, caused by extremely narrow breadth during 2023, has set the stage for bottom-up rather than top-down calls. It seems less likely that beta will drive returns, meaning that alpha generation will be even more important going ahead which should benefit active managers.** Given our diversified approach, this suits us well and our focus will primarily be on high quality stocks that are well suited to navigate economic uncertainty, particularly since the wide range of valuation opportunities does not require us to pay a premium. For our Value focused strategies, the prospects look equally compelling, but the road will most likely be bumpier.

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