

Volatility Set to Continue in 2023

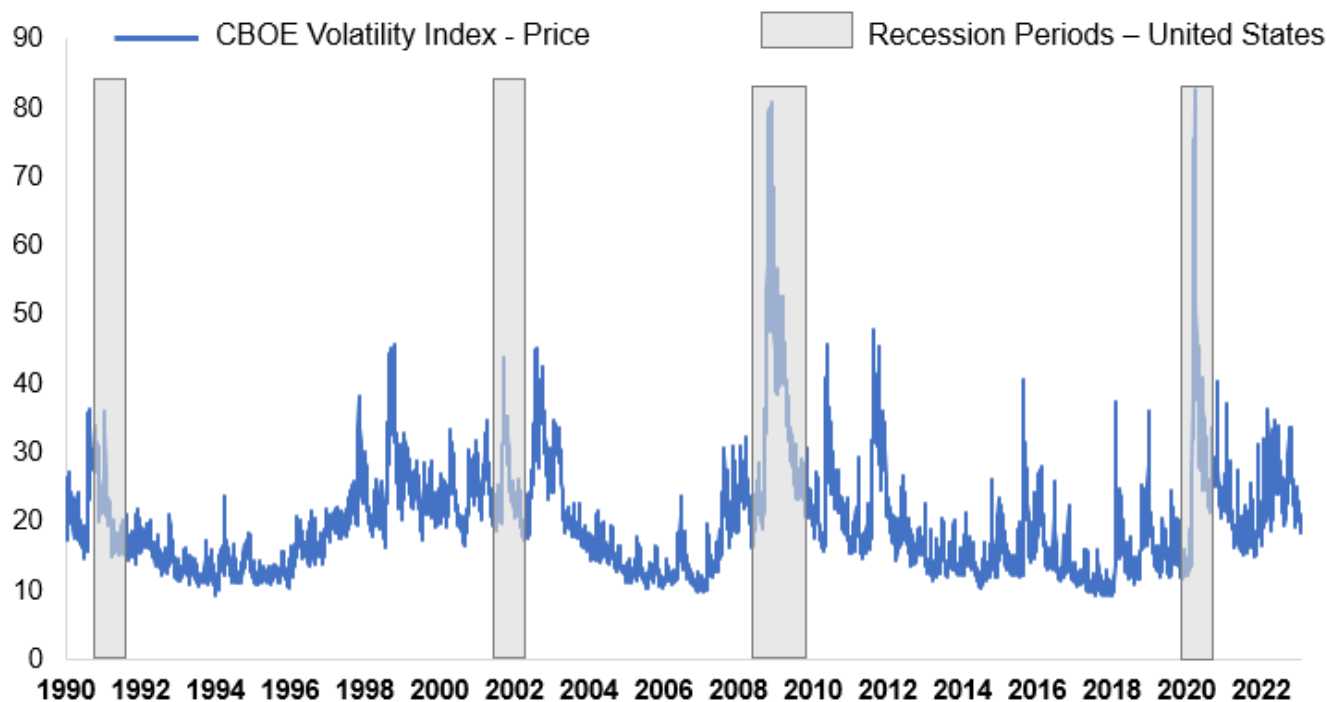
Volatility will remain a key theme in 2023 with continued economic and earnings uncertainty. In February Australian investors favoured lower volatility, better valuations, higher quality and larger capitalization companies.



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The economy is delicately balanced at the moment with larger than normal uncertainty in the future path of company earnings and interest rates. Central banks are walking a fine line with risks of being either too tight or too accommodative. While uncertainty remains for these key elements we should expect more wild swings in equity prices. Figure 1 below shows the CBOE volatility index with the overlay of the US economic recessions. Historically periods of economic slowdown have seen increased economic uncertainty and higher levels of volatility.

Figure 1: Volatility and Economic Uncertainty are Linked

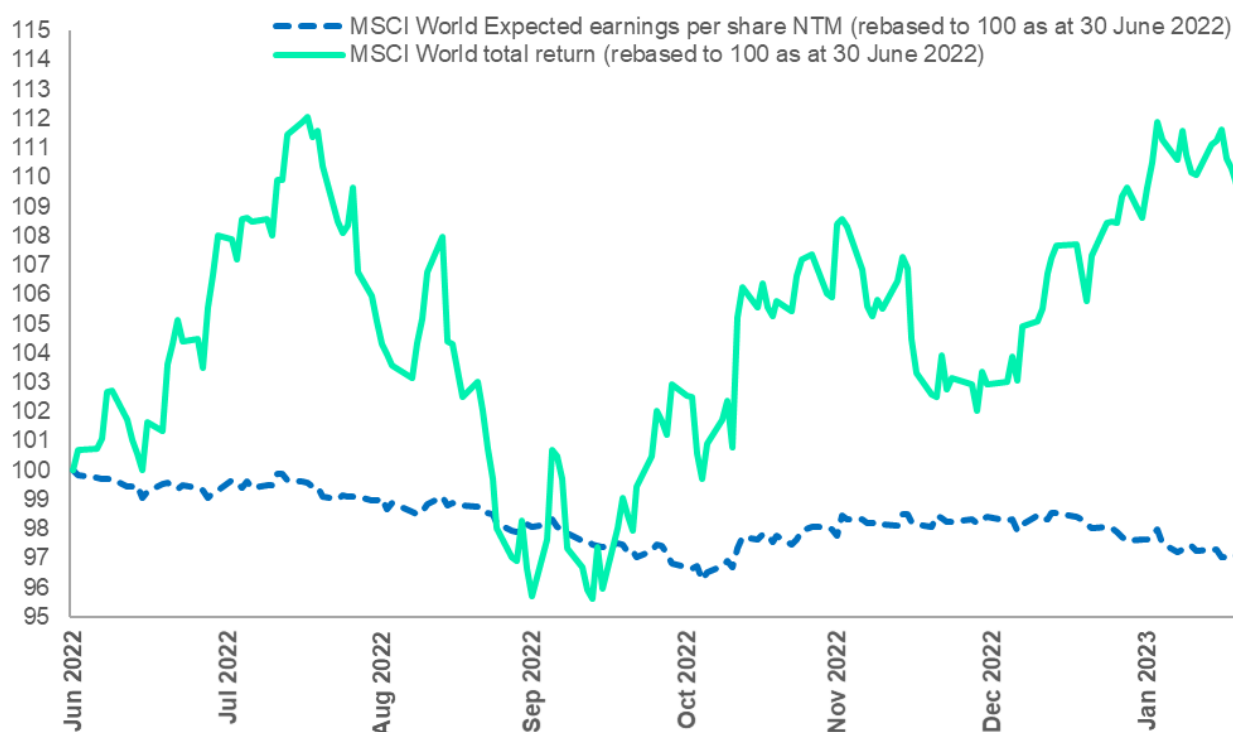


Source: Factset, VIX Based on daily closing VIX since Jan 1990.

The more uncertain the calculation of fair value the greater the role for investors’ animal spirits¹ of fear and greed to influence price determination and further exaggerate volatility.

As investors digest recent earnings trends and global macro risks we have seen investors turn more bearish in February. Figure 2 below highlights both the wild swings in returns for the MSCI World Index since 30th June 2022 as well as the persistent down trend in earnings. Equity investors are trying to look through the current earnings slowdown but the longer the trend remains negative and the more uncertain the economic outlook the harder it becomes.

Figure 2: Will Earnings Catch up With the Recent Rally?



Source: State Street Global Advisors, Factset. From 30 June 30 2022 to 21 February 2023. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. NTM = Next Twelve Months.

Investors Favour Fundamentals in February

The S&P/ASX 300 Index has also given up ground in February. We have seen Australian investors favour companies with lower volatility, better valuations, higher quality and larger capitalization. Figure 3 below reports the quintile spread returns for several standard company characteristics for the S&P ASX 300 universe of stocks in February so far.

Figure 3: Investors Refocus on Quality, Value and Lower Risk in February

Company Characteristic	Quintile Spread Return*
Lower Risk - Volatility (200 day)	+12.42%
Better Value – Dividend Yield	+8.2%
Higher Quality – ROE (NTM)	+5.8%
Larger Market Cap	+8.9%

Source: State Street Global Advisors, Factset. *The quintile spread returns are calculated by the difference in average returns between the top and bottom quintiles of the stocks from the S&P/ASX 300 Index for the February reporting period from 31 Jan 2023 to 22 February 2023. Notes: ROE = Return on Equity. Lower volatility outperformed higher volatility. Higher dividend yield outperformed lower dividend yield. Higher expected ROE outperformed lower Expected ROE. Larger companies outperform Smaller companies. Past performance is not an indication of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

The Bottom Line – Continued Volatility Favours Quality, Value and Lower Risk

The economic environment is especially delicate at the moment. Investors are trying to look through the current earnings slow down but it is getting more difficult. With the increased economic uncertainty we should expect continued volatility. The preference for value, quality and less volatile securities is likely to remain an investor preference whilst these concerns persist.

Footnotes

¹ Animal Spirits = A term to describe how people arrive at financial decisions in times of economic stress or uncertainty.

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