Report

Q2 2023
Factor Performance Analysis

Global public equities close Q2 with strong returns

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Prepared by:

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Market Background

June marked the end of a strong Q2 for global public equities as the ACWI is up 6.8% YTD. June's positive equity performance brought up the quarterly average for all regions except the UK, which has lagged behind other regions this year. Canadian and US investors favor volatility (and Growth for the latter), while Emerging Markets continue to favor Value, an ongoing trend since May.

Although the global economy faced significant challenges entering 2023, including geopolitical tensions between the US and China, the war in Ukraine and stubbornly high inflation and elevated interest rates, economic activity has been more resilient than previous economists forecasted.

Many economies, especially in developed markets, saw a rebound in equity markets in the first half of 2023. This trend was largely driven by positive economic surprises such as strong worldwide labor markets, hopes of fleeting inflation, and a peak in interest rates. Although the worst seems to be in the past, economists predict global consumer prices to average just below 4% this year and gradually decrease to central bankers' s long-term targets in 2024 and beyond. Hawkish fed comments indicating elevated rates will need to be held longer than expected flickered hope as the chances of a "goldilocks" soft landing environment increases, where inflation continues moderating while growth remains marginally positive.

Central bankers have faced large amounts of pressure to address inflation and responded with elevated interest rates with further potential increases later this year. Although this caused shocks throughout the economy, the effect of rapid rate increases is yet to be fully realized. However, as with the banking crisis seen in Q1, governments have proven they can effectively leverage other tools at their disposal to contain risks and provide liquidity in such cases.

Globally, inflation has been slow to recede amidst historic interest rate levels partly due to soaring food prices, increased energy prices, and surprisingly high wage growth. Interest rate hikes this year have helped suppress demand to help put downward pressure on prices, which has been seen in the commodities market as crude oil fell as low as $68/barrel In June, and natural gas also halved since December 2022 to $2.65/MMBtu.

Economists predict advanced economies are expected to stay neutral while emerging markets could benefit from the weakness in developed markets. Global GDP growth is predicted to average 2.7% this year, largely driven by fast paced economic growth in China and India, as pent-up demand meets increasing industrial production and capacity.

Factor Summary

- **US Equities:** Growth, Volatility and Size clearly outperformed over Q2 and YTD
- **Europe:** Size, Momentum, Value outperformed both in Q2 and YTD
- **UK:** Size and Momentum outperformed Q2 and YTD, while Value/Growth were mixed
- **Emerging Markets:** Value, Yield and Quality outperformed YTD, with smaller monthly premia
- **Canada:** Slight outperformance in Growth, Volatility, and Quality in the form of low gearing.

US Equities

Although Value subfactors like cash flow yield (+7.3%) outperformed Growth subfactors such as earnings growth 5Y (+6.3%) in June, the quarterly and yearly trend is still strongly favoring volatility as Growth equity outperformed Value equity in the quarter and YTD. Earnings growth beat the market by 4.1% YTD while Yield and EBITDA to enterprise value underperformed by 5.3% and 4.6% respectively.

Investor sentiment remains neutral since there is little excitement outside of the AI boom earlier this quarter, reflected in Value's slight outperformance over Growth this month. While inflation has consistently declined, it is a slow process that economists predict will last well into 2024 and beyond, before the long-term Inflation rate reaches its 2% target.

However, there is reason to believe the US will sustain growth throughout 2023, albeit marginal. The labor market has shown surprising strength as employers fill vacancies at rates much faster than previous recessions. Although COVID-era households' excess savings have been depleted, home values remain stubbornly high and an elevated consumer confidence level, a leading economic indicator, implies growth may not sharply decline.

Although Value outperformed Growth by 100bps in June, Volatility beat out Value by a similar margin as well, led by Tesla (+17%) and Carnival Corporation (+50%).

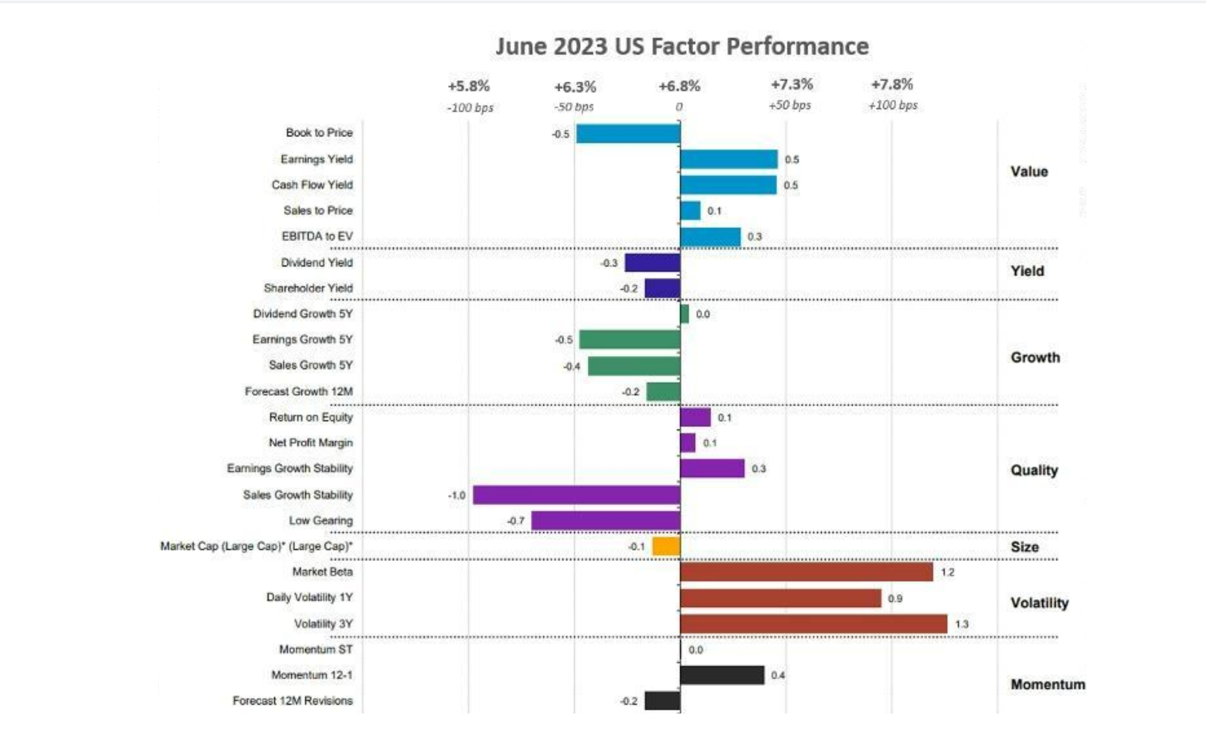

Figure 1: June 2023 US Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

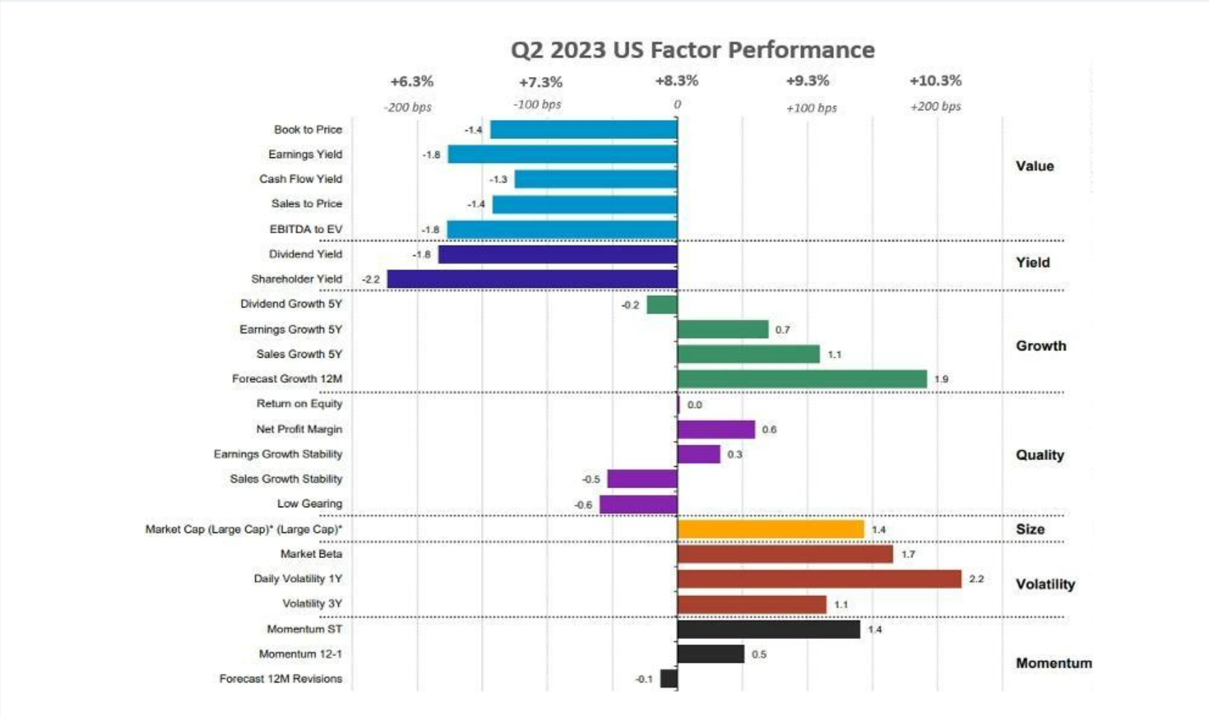

Figure 2: Q2 2023 US Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

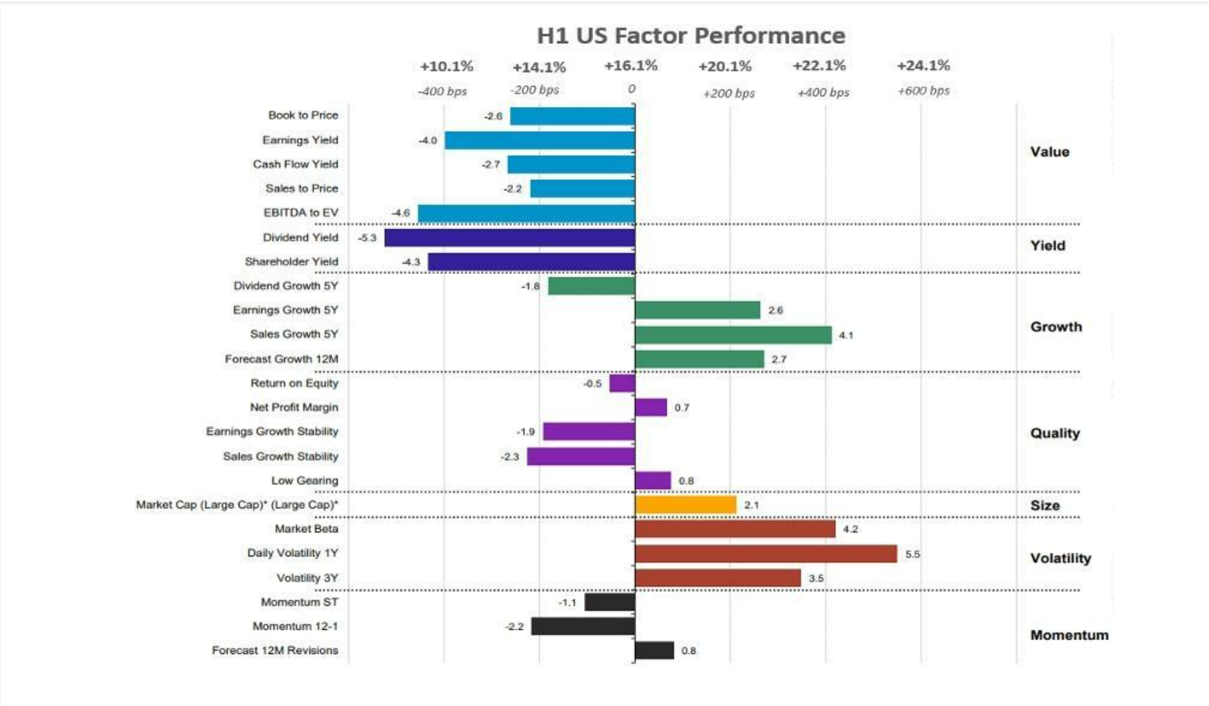

Figure 3: H1 2023 US Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

European Equities

European equities outperformed the UK, realizing a 4.6% return in June that averages out May's poor performance at +2.8% in Q2, and a lofty 13% YTD. Large cap equities have consistently outperformed the region, and for the most part Value subfactors have offered premiums YTD, averaging out to a 50bps premium overall in Q2.

Energy prices have dramatically declined to below €36/MWh due to increased supply, and despite a resilient labor market, moderating inflation, and rising wages consumption fell below pre-pandemic levels due to increased borrowing costs and persistent inflation. This is due in part to a key European growth contributor, industrial production, lagging other sectors' recovery. Although output is currently robust, new orders declined for eleven consecutive months, negatively impacting inventory levels and employment growth.

Notable outperformers include large firms such as Dutch technology investor group Prosus (+11%); Spanish clothing manufacturer Indsutria de Diseno Textil (+15.9%); and Norwegian energy firm Equinor (+13%).

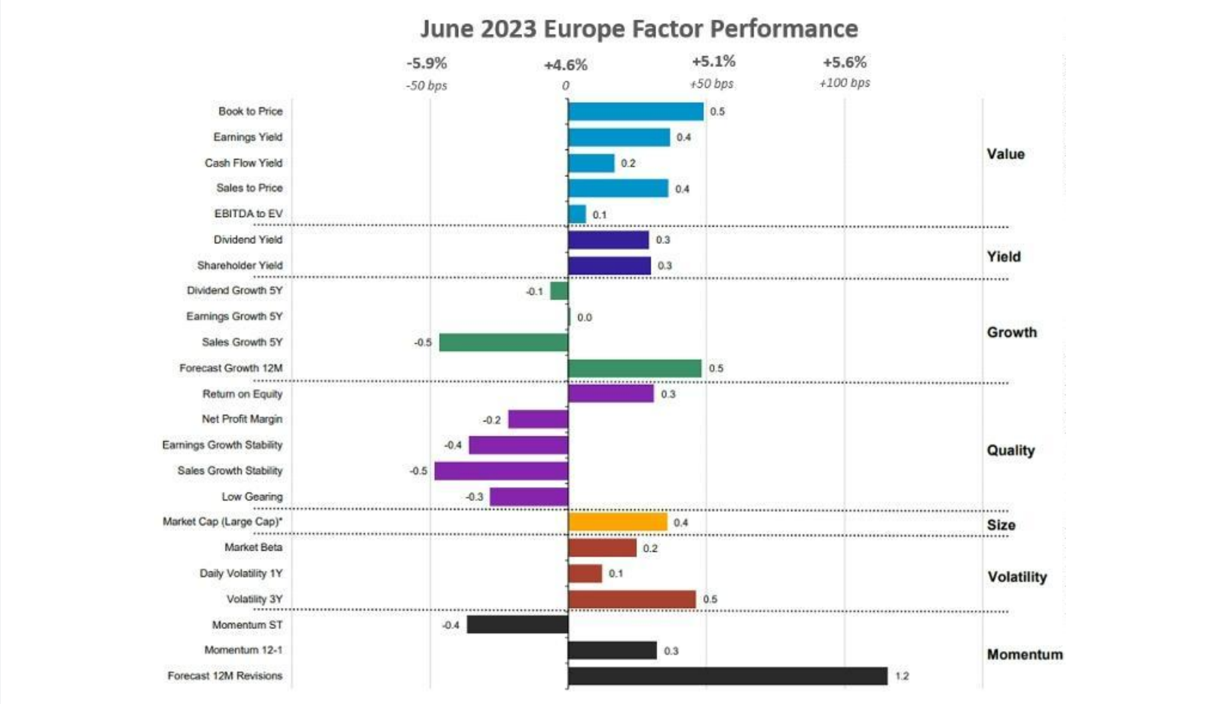

Figure 4: June 2023 Europe Factor Performance (country and sector adjusted)
Source: Investment Metrics, a Confluence company

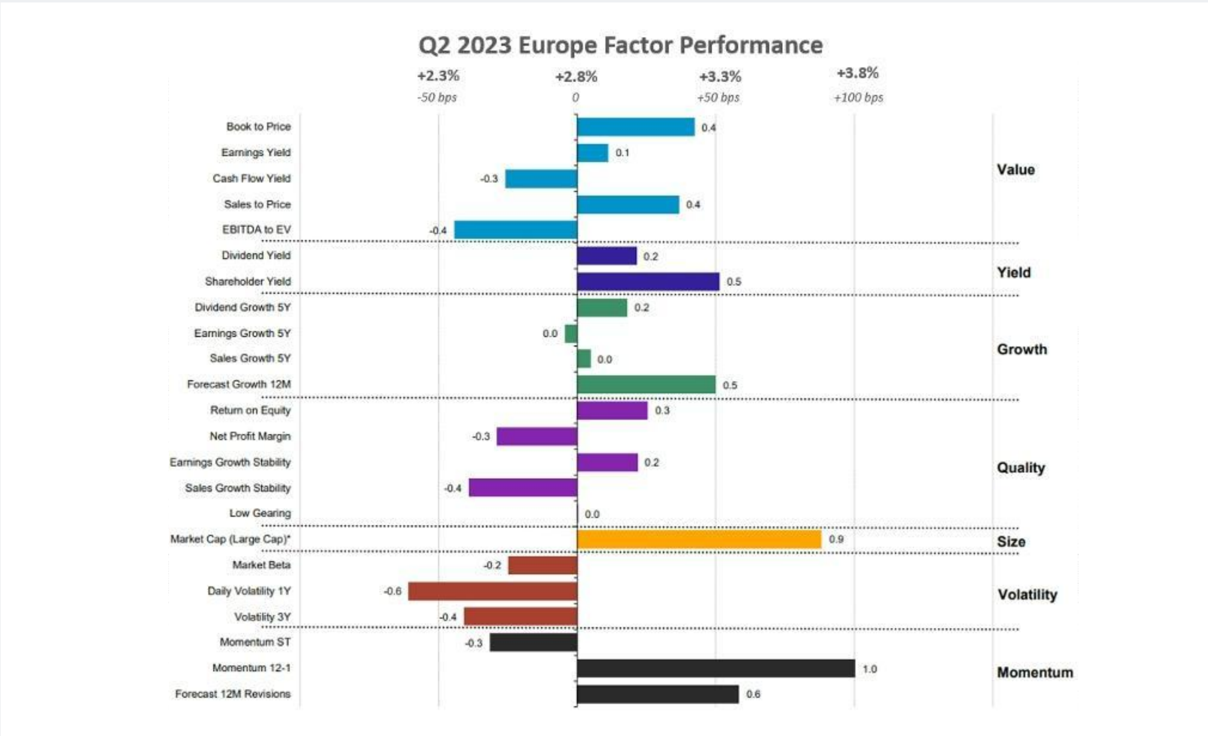

Figure 5: Q2 2023 Europe Factor Performance (country and sector adjusted)
Source: Investment Metrics, a Confluence company

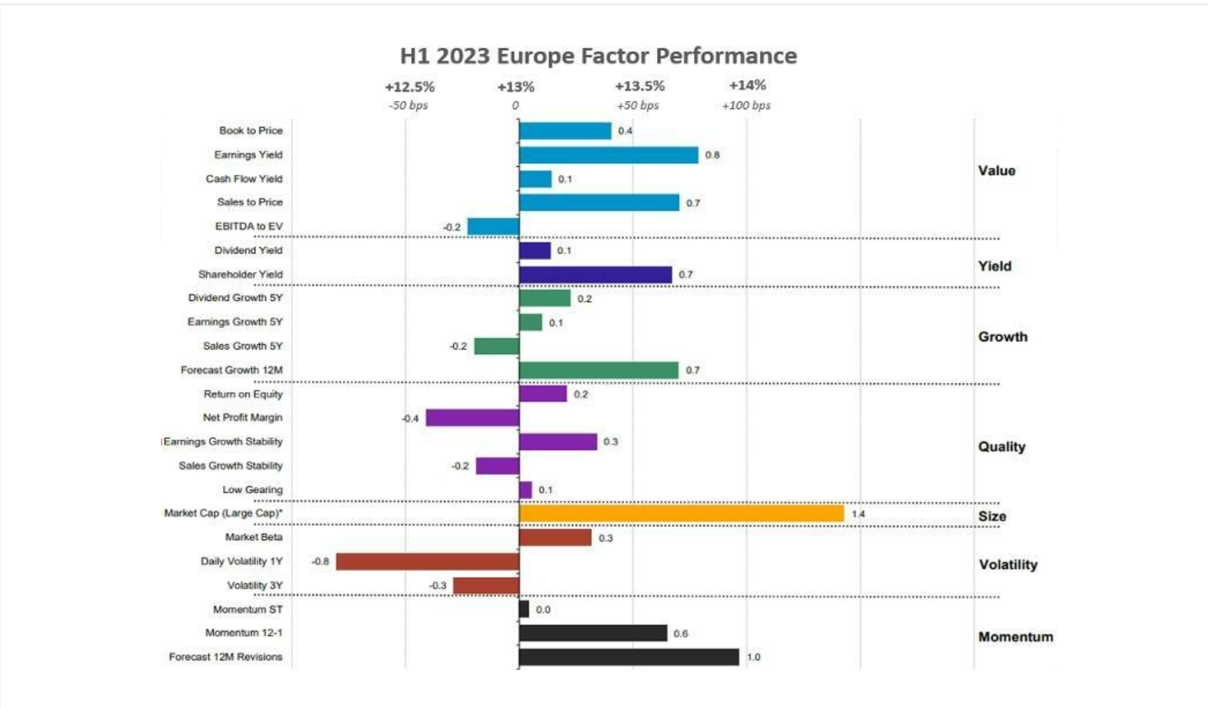

Figure 6: H1 2023 Europe Factor Performance (country and sector adjusted)
Source: Investment Metrics, a Confluence company

UK Equities

UK equities underperformed all other developed markets, losing -1.2% in June, -0.7% in Q2, and returning just 2.6% YTD. However, similar to Europe, neither Value or Growth offered significant premiums across all time periods in the region. Yield overall has underperformed, yet certain Value subfactors including sales-to-price outperformed by the same margin.

Rishi Sunak's new administration has stabilized the region and largely avoided a predicted recession, and the Bank of England now forecasts avoiding a slowdown, predicting a 2.25% GDP increase by mid-2026. However, inflation is still hurting developed markets such as the UK, as elevated prices and borrowing costs hurt consumer spending. Unlike the US, the labor market has begun cooling as unemployment rises, leaving future growth outlooks challenging yet attainable for the new administration.

A notable trend in June and H1 is companies with high forecasted growth over twelve months have outperformed the UK market. This suggests the significant political transition earlier this year has built confidence in the UK economy, as high-volatility and small caps underperform.

Companies with forecasted growth that delivered excess returns include Aston Martin (+25%); Melrose Industries (+49%); and e-commerce retail company THG PLC (+39%).

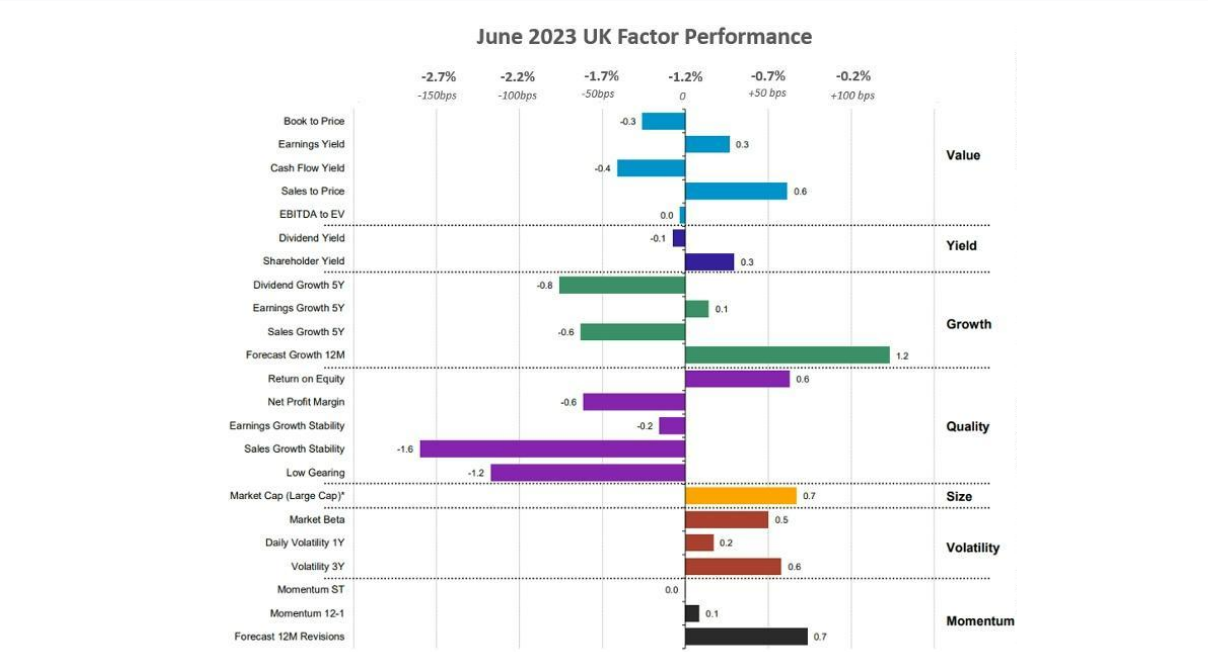

Figure 7: June 2023 UK Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

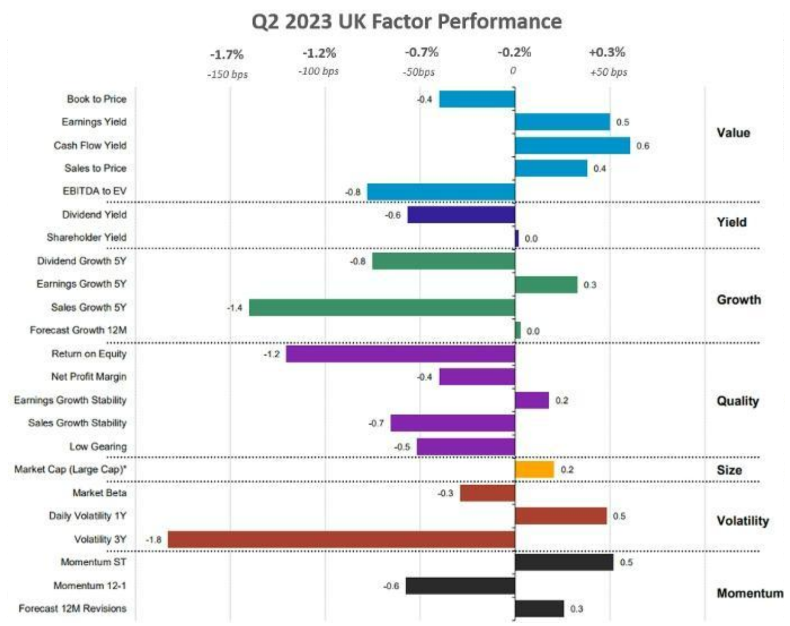

Figure 8: Q2 2023 UK Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

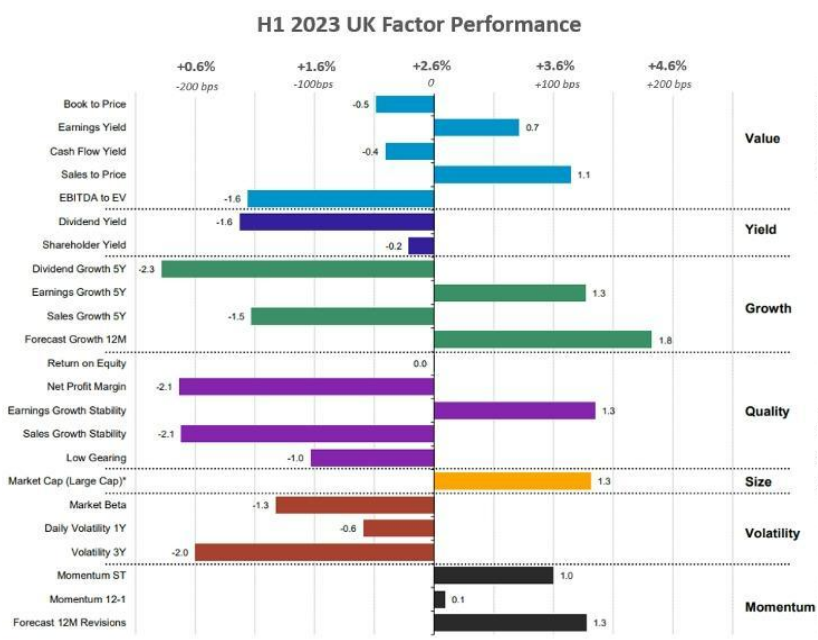

Figure 9: H1 2023 UK Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

Emerging Markets Equities

The factor performance trend in Emerging Markets has been consistent across the three time periods observed below; Value and Yield outperform by over 100bps in Q2 and Quality is later added to the mix in H1 as EM investors favor sales growth stability.

Alongside Value, Yield and dividend growth have notably outperformed the region, suggesting investors are risk averse in the region and prefer safer companies/industries with recession-proof cash flow, as well as high and increasing dividend yields.

Brazilian equities significantly contributed to the region's Value outperformance, mainly across defensive industries such as Financials, Energy, and Utilities. Brazil's largest investment bank, BTG Pactual (+17%) reported a record net income and revenue in Q2, expanding into several areas. Petrobras (+21%), a leading firm in the Brazilian oil, natural gas, and energy industry has significantly outperformed the region and bolstered its dividend, thanks to juiced-up gas prices.

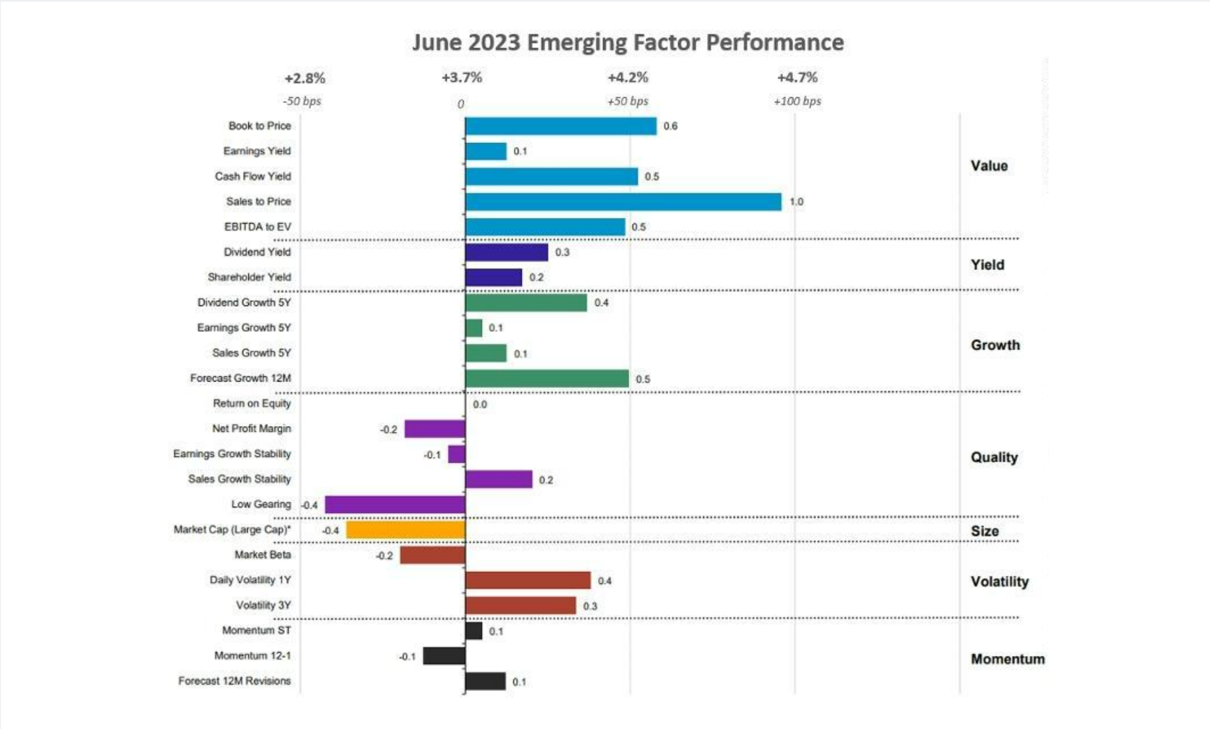

Figure 10: June 2023 Emerging Factor Performance (country and sector adjusted)
Source: Investment Metrics, a Confluence company

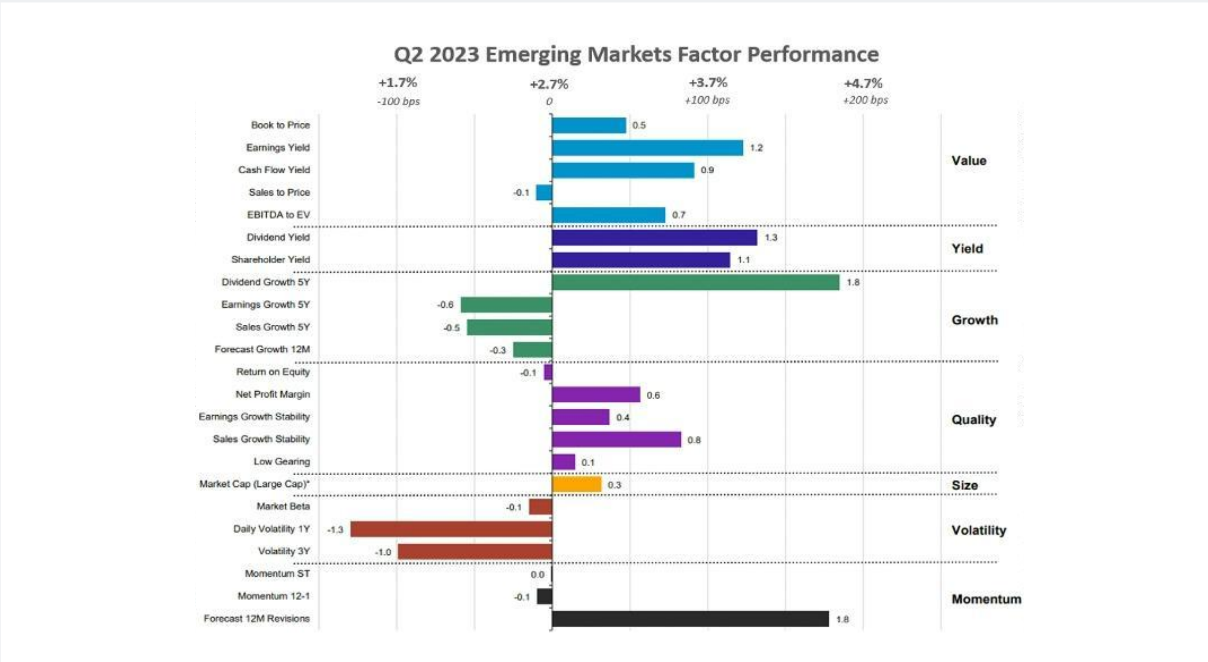

Figure 11: Q2 2023 Emerging Factor Performance (country and sector adjusted)
Source: Investment Metrics, a Confluence company

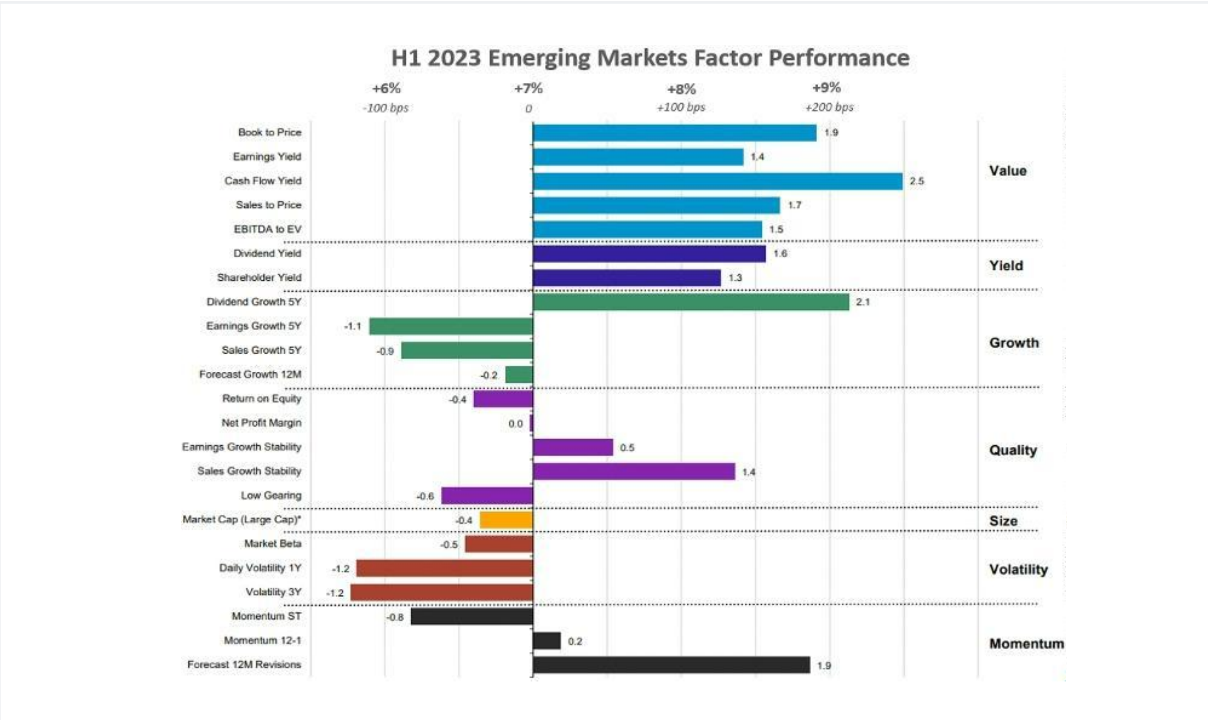

Figure 12: H1 2023 Emerging Factor Performance (country and sector adjusted)
Source: Investment Metrics, a Confluence company

Canadian Equities

In Canada, the factor performance trend realized in June tilted the scale in Value's favor, yet not enough to outperform Growth in Q2 as subfactors such as sales growth outperformed the market by 80 bps, and its value counterparts cash flow yield and sales to price by over 100bps.

A large focus in Canada lies on companies with high sales and low levels of debt amidst a high-interest rate environment, as well as short- and long-term volatility over Q2, but more notably in the first half of 2023. Volatile stocks have largely outperformed the Canadian market, especially those with a high market beta and volatility over three years.

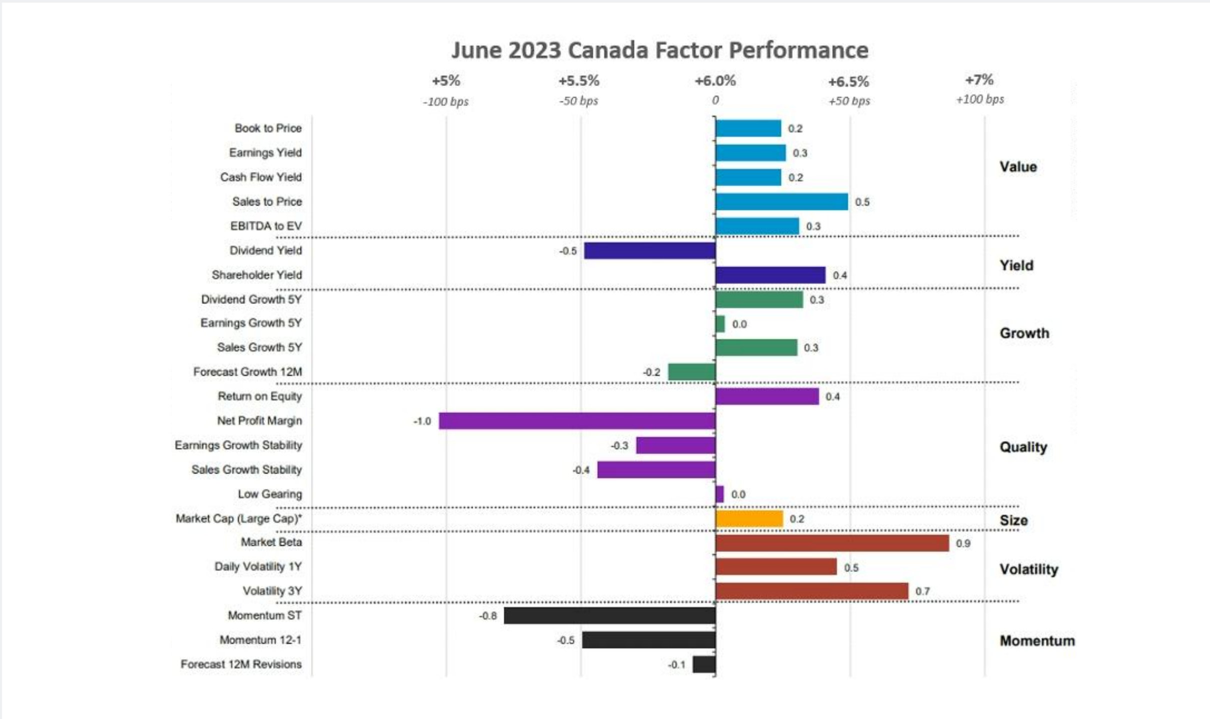

Figure 13: June 2023 Canada Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

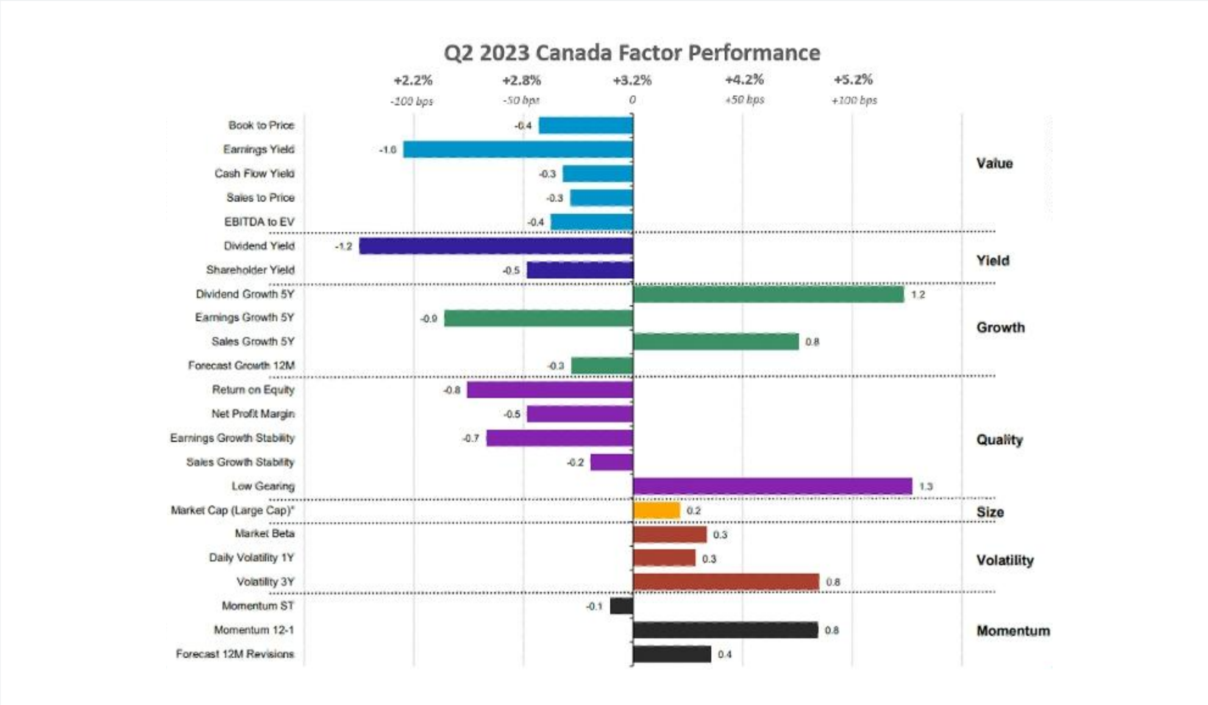

Figure 14: Q2 2023 Canada Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

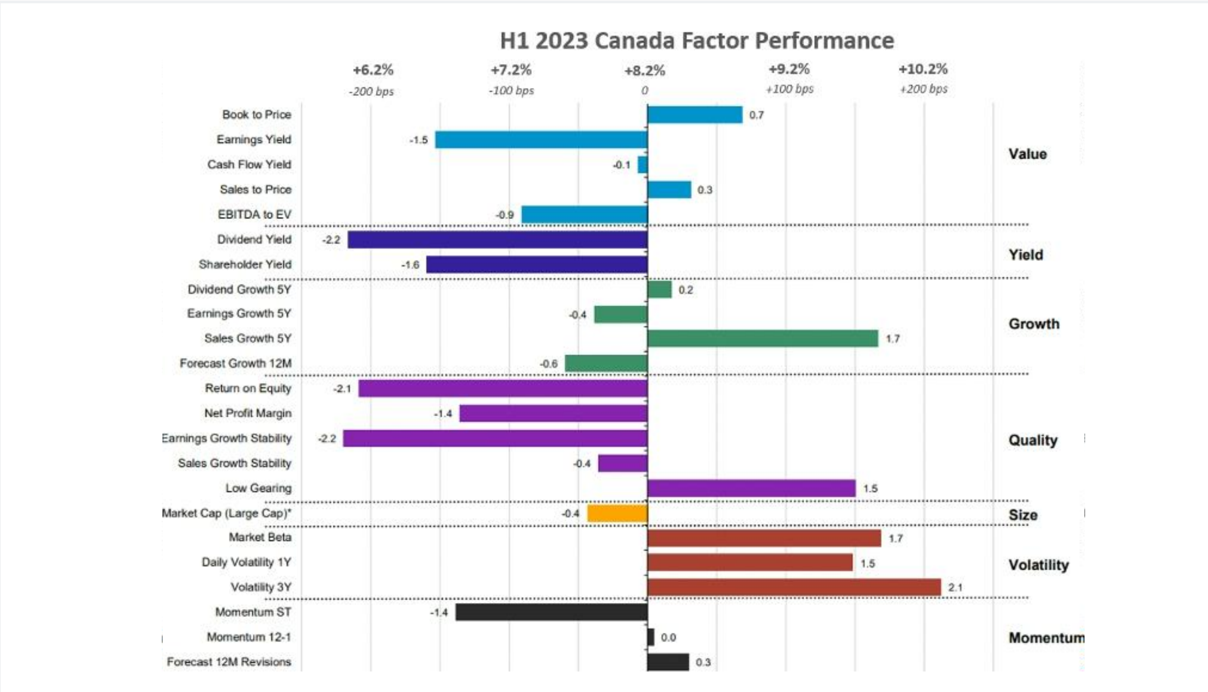

Figure 15: H1 2023 Canada Factor Performance (sector adjusted)
Source: Investment Metrics, a Confluence company

Appendix: How to read the charts

Each factor's performance is based on the relative performance of its top 50% of stocks by market cap, compared to the overall market. The Size factor uses the top 70% of stocks, as the only exception.

For example, for the book-to-price factor, we determine the period's performance of the basket of stocks with the highest book-to-price values, relative to the total market. Each factor is analyzed independently, market and fundamental data are adjusted to enable sector-average (within each country) relative data to be used, and the performance measurement isolates the factor's contribution to return.

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