What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Dave Hawal

Emerging Markets Trends and Trajectories

Russia dominated the headlines and investor sentiment in emerging markets (EM), during the first quarter of 2022, following their unprovoked invasion of Ukraine. Although prevailing perception holds that Russia is a major country among emerging markets, at the beginning of the year it accounted for only a small percentage of the overall emerging markets opportunity set (3.6% of the MSCI EM Index as of January 1, 2022). While the ongoing war between Russia and Ukraine has been tragic by all accounts, the secondary effects of the war and its influence on the global economy are important considerations.

In the nascent years of EM investing, commodity-centric countries and their State-Owned Enterprises (i.e., Gazprom, the largest Russian natural gas company) dominated the market. That dynamic shifted in the early 2000s towards the EM consumer and rapidly growing Information Technology giants, particularly in China. The quick growth of China and the rise of the emerging consumer have been a boon for growth-oriented investment strategies over the past decade, but that trend seems to be reversing course. Chinese economic growth has slowed, with economic data pointing to a 4.4% GDP expansion in 2022, down from ~7% in the 2010s[1]. The new global inflationary regime caused by the pandemic and resultant supply chain bottlenecks, now exacerbated by the largest war in Europe since 1945, is having an even more pronounced impact on the average consumer in emerging markets. Of particular concern are the price increases in fuel and food, which make up a disproportionate amount of the EM consumers' budgets compared to their developed markets counterparts. Whether EM consumers can continue to drive economic growth in China and elsewhere in the face of commodity price increases remains to be seen.

While asset managers have no option but to wait and see what becomes of their Russian holdings, several we have spoken to are reducing their exposure to China given the elevated geopolitical uncertainty there. Meanwhile, others are adding Chinese exposure, citing more attractive entry points (valuation levels are at multi-year lows) following a months' long exodus of foreign capital from Chinese equity markets. Which approach will prove more fruitful over the long term is anyone's guess, but at the moment the geopolitical and macroeconomic backdrop seems to favor commodity producing countries and value-oriented market sectors.

1 https://www.imf.org/en/Countries/CHN

Suresh Ramasamy

Analysis of Factor Premia During Q1 2022.

The year 2022 has kicked off to a rocky start as both equity and fixed income markets have witnessed declines in the first quarter. The S&P 500 Index and Bloomberg US Aggregate Bond Index returned -4.6% and -5.9% respectively in Q1, and the 10-year Treasury Bond Index returned -7% for the same period. The pattern remains the same with respect to global markets, as the MSCI World Index was down 5.15% for the quarter. Geopolitical tensions, along with higher inflation and tighter monetary policy expectation, drove much of the market performance for the quarter. With respect to factor premia (sources of equity market returns), value and low volatility factors performed well while quality, size, and momentum factors underperformed across the globe.

Factor performance is cyclical and the current performance reflects the prevailing market environment. The recent war between Russia and Ukraine has hugely affected broad market and factor specific returns. Value, which posted a double-digit return in January, has faced headwinds since the tensions began even as the market turned defensive. The quality factor, despite its defensive characteristics, underperformed during this period, too. The higher valuations within "quality" stocks led to a sell-off in the abruptly value-dominated market. As for the size and momentum factors, history repeated itself as high inflation and the expectation of rate increases by the Fed served as headwinds for them. Correlations among factors were unusual over the past 12 months, as value and size, which typically tend to be positively correlated, were less correlated. Correlation of the quality factor versus the size factor dropped significantly to a strong negative, while quality's correlation against the low volatility factor also dropped but remained positive.

Looking forward, even though the war remains a wild card, attention has now moved toward inflation and expected monetary policy tightening by global central banks. History suggests that during times of higher inflation the quality factor tends to shine. During times of Fed rate hikes, value stocks do better. Even though we cannot predict market movements, research shows that long-term returns are a function of valuations. Taking everything into perspective, a multi-factor investment approach, rather than focusing on single factors to drive future returns, is prudent in order to take advantage of diversification. This provides a diversified approach to factor assessment that encompasses not only the macroeconomic environment, but also factor valuations.

Deepankuran K

Biotech Continues to Slide

Following a weak 2021, the Biotechnology sector has continued to be a source of weakness in the small cap growth space. In 2022, the S&P Biotechnology Select Index has fallen 32.1% through April 28, while the Russell 2000 Index has shed a comparatively staid 15.8%. With ongoing geopolitical tensions, high inflation, and the Federal Reserve signaling aggressive rate hikes in its coming meetings, cash-burning sectors like Biotech are seen as less attractive by the market. From the peak in February 2021, the Biotech index has lost more than 50%, making it comparable to the 2015 biotech crash.

The 2020 pandemic was a boon for Biotech, though. Investors poured money into the sector due to vaccine buzz, while easy monetary policy aided the stellar performance. In 2020, Biotech returned 48.1% versus the Russell 2000 Index's 20.0% gain. As the investor frenzy continued, the market also witnessed record numbers of IPOs and M&A activity, with many of these companies in preclinical or stage 1 trials. However, the tides started to change in 2021, when M&A activity started to face more regulatory scrutiny. The Biden administration's increased scrutiny of drug pricing and intellectual property rights further fueled the sell-off, which has entirely erased the gains of 2020.

This crash has been a boon for active managers, who tend to avoid Biotech exposure. Conversely, managers with exposure to the Biotech have struggled, irrespective of the quality of individual stock picks, leading some top performing managers in 2020 to be in the bottom quartile of returns in 2021 and YTD 2022. Despite the headwinds the industry faces, Biotech fund managers are confident about the long-term growth prospects of the industry. They also believe that the relative valuations are attractive compared to the historical averages and that this ongoing crash could be an opportunity for stock picking.

Mike Wedekind

Rising Yields in Q1 Lead to Worst Fixed Income Returns in Decades

Increasingly entrenched inflation, a more hawkish Federal Reserve, and a commodity shock driven by Russia's invasion of Ukraine combined to make the first quarter of 2022 one of the worst for fixed income in decades. The Bloomberg Municipal Index fell 6.23% in Q1, marking its worst quarterly total return since 1981. Global corporate bonds shed over $1 trillion in cumulative value, which Bloomberg notes is the steepest loss for investment grade bonds since Lehman Brothers' collapse and the worst return for high yield debt since the onset of the COVID-19 pandemic.

While total returns on major indices were falling, the policy-sensitive two-year Treasury note yield posted its biggest jump since 1984, and yields at every point along the curve were higher at the end of the quarter than where they started 2022. (Recall that bond prices and yields are inversely related.) However, rate increases were uneven, most clearly evinced by the spread between the 10-year and 2-year US Treasury yields marching towards zero throughout the quarter, indicating an inversion at two key points in the yield curve and a portent of future recession. It took until early April for the inversion to happen, but it raised further alarm bells from an asset class already suffering a sharp drawdown.

Apart from T-bills and bank loans, every segment of the bond market again posted negative total returns in April as Treasury yields continued their ascent. However, amidst the torrent of outflows from bond funds and broadly negative sentiment as the Fed prepares to shrink its balance sheet, the relatively high yields now available have presented buying opportunities that several managers we cover consider to be attractive. Setting aside cyclical retracements of the broader trend towards higher yields, few think interest rates are poised to fall in the near-term. The flip side of the pain bond market investors have felt year-to-date is heightened income that is starting to draw institutional money back into the market.

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