MERGENCE
INVESTMENT MANAGERS

Macro and Multi-Asset

April 2021

The risk-on mood in global markets has persisted as the vaccine roll out passes 1 billion doses administered. In this report we discuss our view on the Value factor and why we expect the current macro environment to continue to support the recovery of Value. Historically Value has performed well in the recovery stage of the economic cycle and has been challenged by falling yields. With economic growth rebounding, driven by an overstimulated US consumer and strong recovery of inflation, we remain overweight Value within our global asset allocation.

Current Views

Neutral Risk Asset	**Prefer Value over Growth**	**Neutral USDZAR**	**Prefer Emerging Markets over Developed Markets**	**Long Index Volatility**

Asset Allocation Views

Asset Class	Underweight	Neutral	Overweight
SA Equity			Overweight
SA Property			Overweight
SA Fixed Bonds			Overweight
SA Inflation Linked Bonds		Neutral	
Emerging Market Equity	Underweight		
Developed Market Equity	Underweight		
US Large Cap	Underweight		
US Mid Cap Value		Neutral	
UK Equity			Overweight
European Equity	Underweight		
Japan Equity			Overweight
Developed Market Bonds	Underweight		
USD Cash	Underweight		

The Revival of Value

Following a protracted period of relatively weak performance, Value indices outperformed by a considerable margin at the tail end of 2020 and in the first quarter of this year. This recent outperformance of expensive stocks by cheap Value stocks was captured across both developed and emerging markets. The reversal of trends is not surprising, given that Value is a procyclical strategy and typically outperforms in post-recessionary environments. Market pundits are looking at the revival of Value, during a period of stimulus and the reopening of global economies following the roll-out of Covid-19 vaccines. In our research presented here we look back over the last two decades and examine the role cyclicality plays in the performance of Value, how Value behaved in different macroeconomic environments, and why we favour Value as our desired factor tilt in the current macro environment.

The role of cyclicality in the performance of Value

Over the last 15 years, Value has experienced a protracted period of underperformance relative to the global equity market. While research has shown that risk factors go through periods of cyclicality, which can last several years, Value's challenging run has puzzled many academics and practitioners. Many speculate that the Value factor is "broken", and that the macroeconomic environment post the 2008-Global-Financial-Crisis does not favours Value.

The Value factor can be defined as long exposure to cheap assets and a short exposure to expensive assets, using various fundamental measures. Investors can perceive Value as an opportunity, where the economic intuition for the existence of a reward is that exposure to it is undesirable for the average investor because it leads to losses in bad times. The opportunity exists because of the psychological tendency of investors to extrapolate recent events into the future while ignoring evidence to the contrary. While Value lagged for a long time, it is still a valid investment strategy as this behavioural investor bias during bad times still exists.

In 2020 the global economy saw the biggest contraction since the Great Depression. Stocks that performed well over 2020 benefited from the work-from-home economy, Amazon and Zoom being the most prominent examples. The news of Pfizer's vaccine in November last year was the catalyst for Value. Performance shifted to cyclical sectors like financials and industrials and beaten-down sectors like energy that had underperformed during 2020 have now bounced back with the potential for the reopening of the global economy.

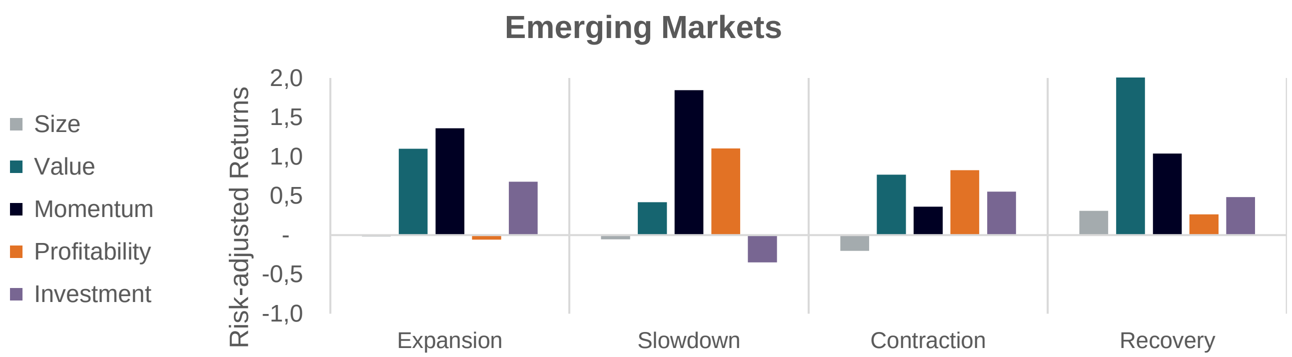
What do macroeconomic factors tell us about factor returns?

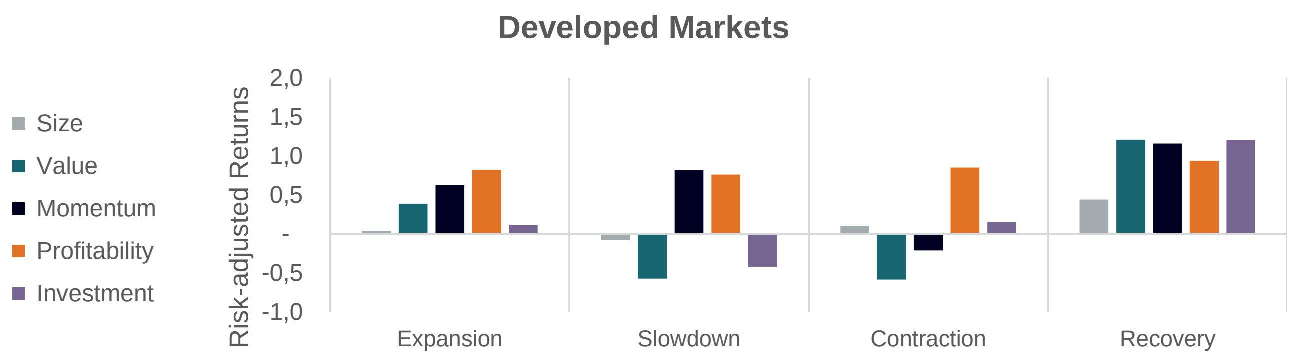
We can learn more by examining the behaviour of Value from a historical perspective. The characteristics of Value from our research findings are:

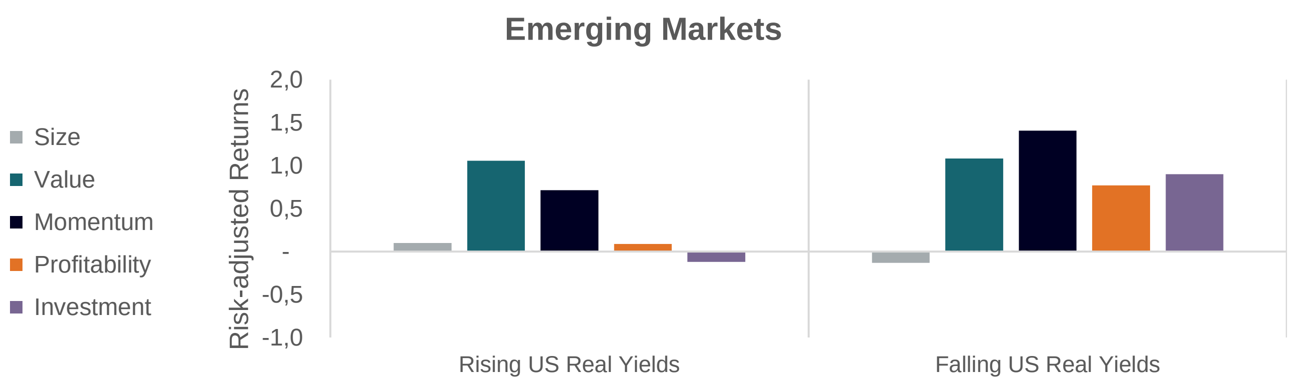
1. Value typically outperforms during periods of market recovery and early-stage expansion in both emerging and developed markets.
2. Value has seen significant risk-adjusted performance during a rising growth and rising inflation regime in both developed and emerging markets.
3. Value has seen improvements in risk-adjusted performance in developed markets over periods of rising US real yields versus falling US real yields.

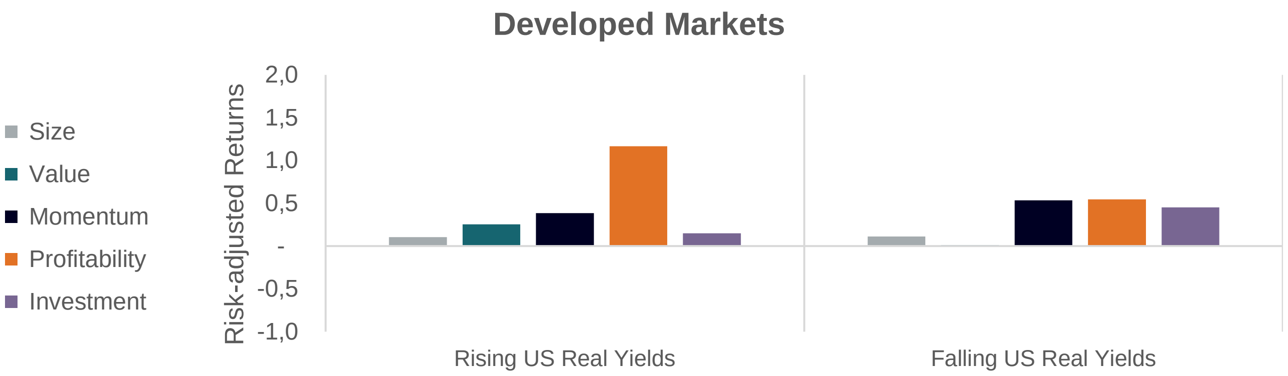
The charts below illustrate what economic indicators tell us about factor returns over subsequent months. We examine five well known risk premia - Size, Value, Momentum, Profitability, and Investment - as drivers of long-term returns. They have been documented extensively in academic research. Monthly risk-adjusted returns measure each strategy's return after adjusting for the degree of risk (volatility) that was taken to achieve it.

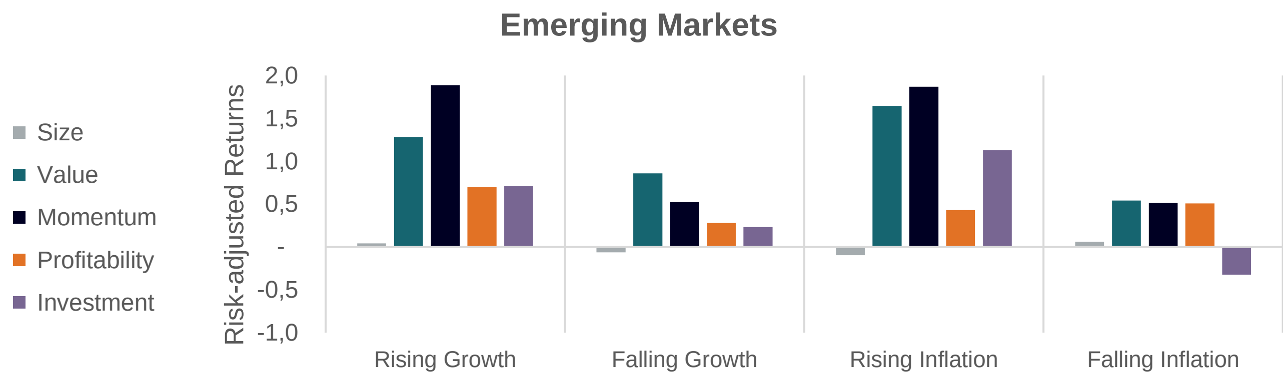
Charts: Monthly risk-adjusted returns of long-short factors over the last 20 years in developed and emerging markets

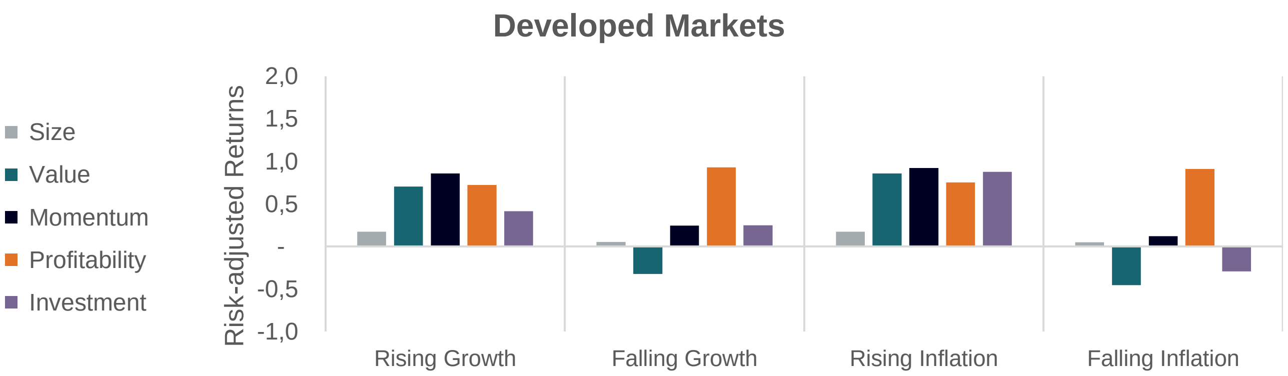












Data Source: AQR Capital. Analysis: Mergence Investment Management

Additional factor observations:

- Momentum (recent winners minus losers) typically underperforms during a market contraction but tends to perform well in most other scenarios. It is also less sensitive to changes in US real yields than other factors.
- Investment (conservative investment minus aggressive) performs relatively better during a rising inflation environment and when real yields are falling.
- Profitability (robust operating profitability minus weak) and Size (small market capitalization minus big) are less sensitive to changes in macroeconomic regimes than other factors.

The macroeconomic environment has aligned favorably for Value assets

The charts below illustrate the current macroeconomic backdrop. Economic indicators have rebounded since the drop last year. US inflation expectations and 10-year US Treasury yields have risen recently.

Chart: Macro regimes based on the Mergence Growth Cycle Indicator

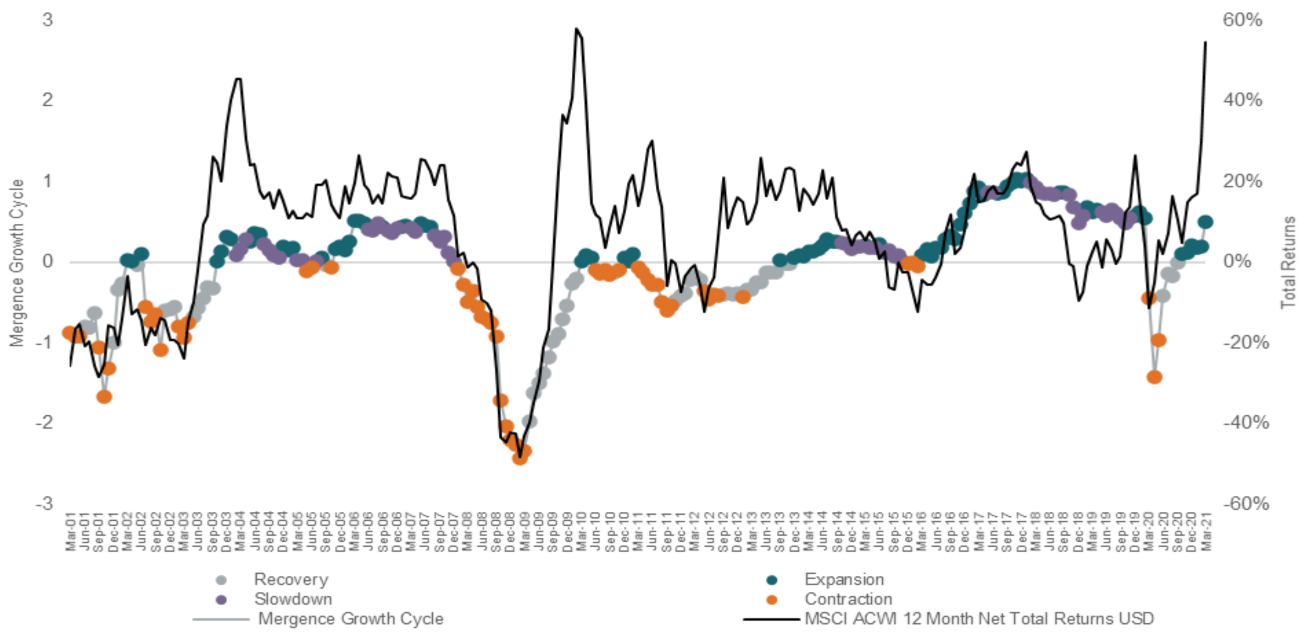
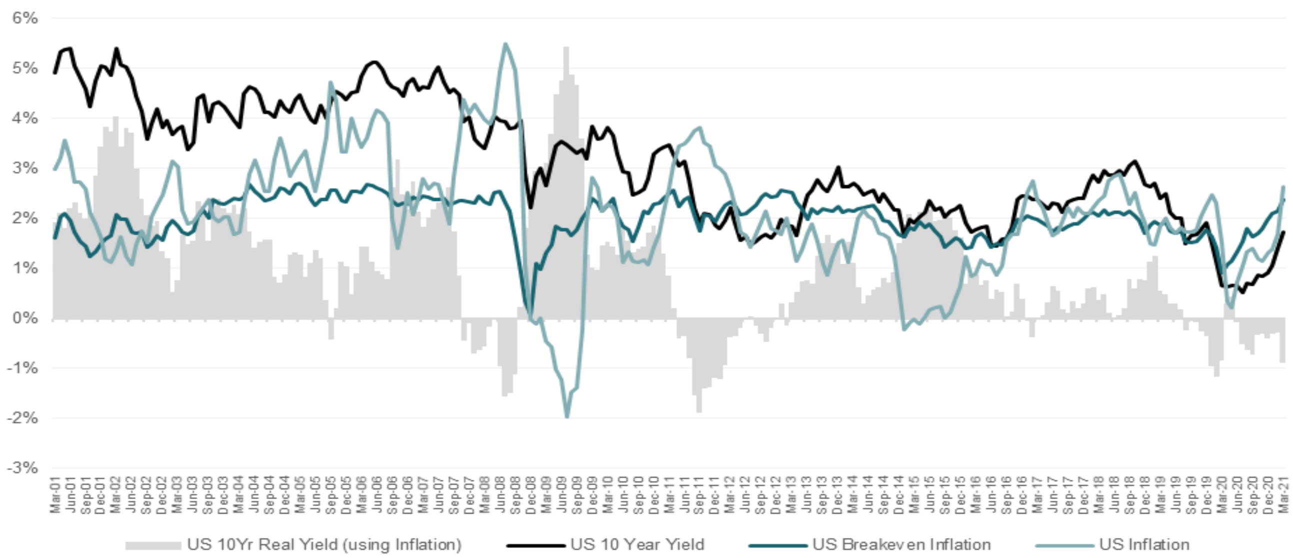


Chart: US Interest rate and inflation expectations



Data Source: Bloomberg. Analysis: Mergence Investment Management

We have seen a search for Value in various regions, and in Covid-19 recovery sectors and have tilted our global tactical style positioning to reflect a change in market sentiment. We believe there is room for the performance of this factor to persist over the short term. Regionally we favour the UK and Japan, which have lower valuations relative to others. These regions appear likely to recover earlier and will benefit from fiscal support and meaningful increases in earnings growth. Value, globally, has gone through a lengthy period of being at a large discount to other factors, potentially offering a tailwind going forward.

Our baseline scenarios are however not without risks. These risks include the tapering of stimulus that can dent expectations of global growth, and slower than expected containment of the Covid-19 virus. It also remains to be proven whether the current revival of Value is a short-term trend or a longer-term structural shift. While we have taken tactical tilts to Value, we are closely monitoring the pandemic's ongoing impact on sectors and regions and remain diversified in the core strategic asset allocation of our multi-asset funds.

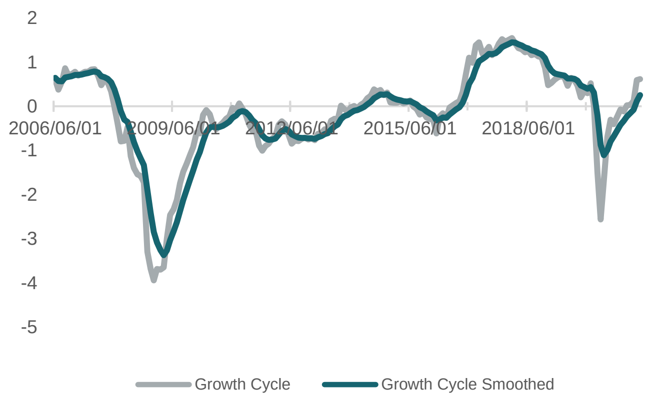
References

AQR Capital Management. (n.d.). *AQR Datasets*. Retrieved from https://www.aqr.com/Insights/Datasets

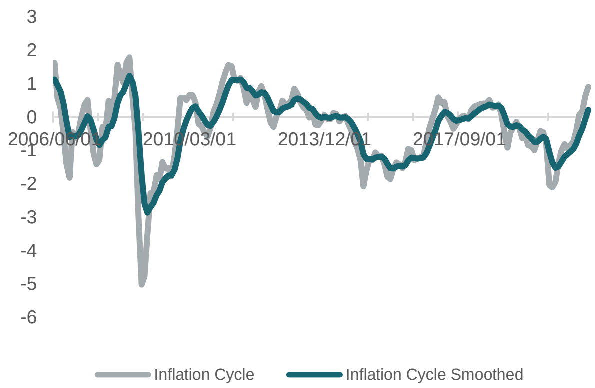
Fama, E. F., & French, K. R. (2015, April). A five-factor asset pricing model. *Journal of Financial Economics, 116*(1), 1-22.

Key Charts

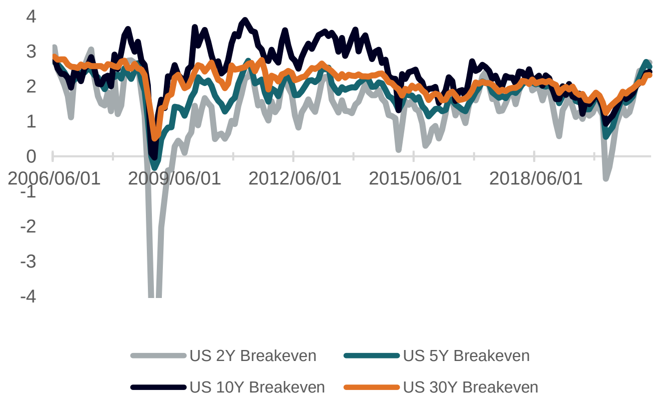
Mergence Growth Cycle



Mergence Inflation Cycle

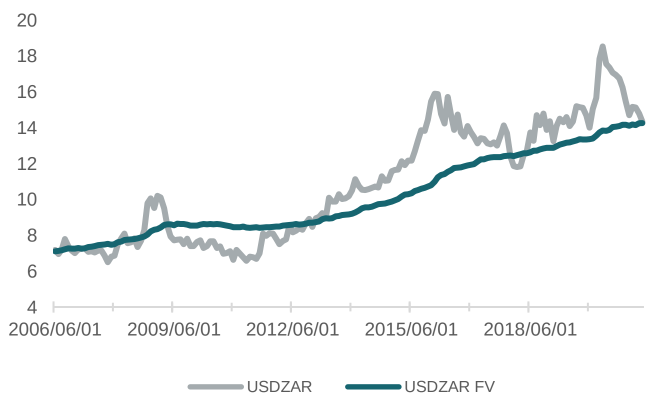


US Breakeven Rates

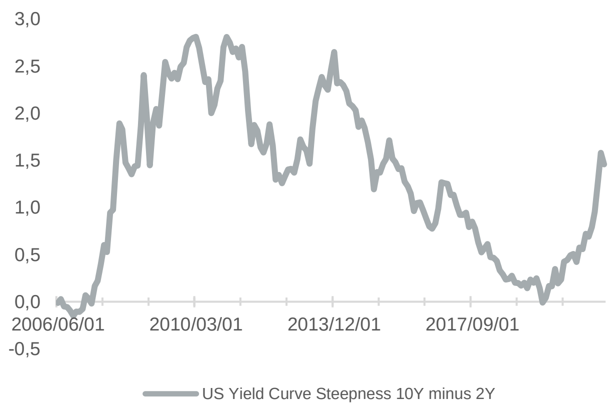


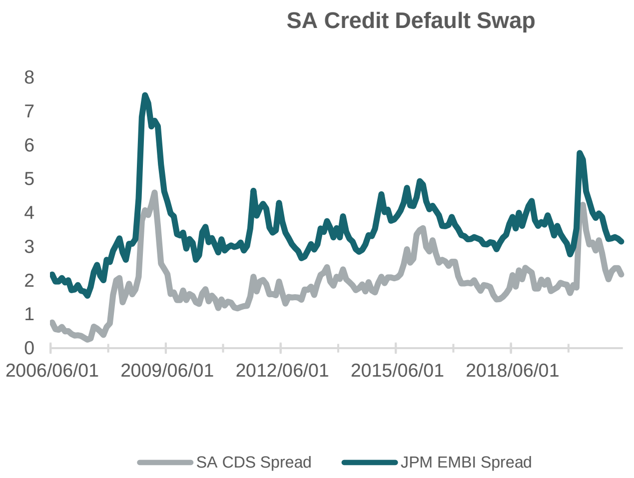
US Bond Yields

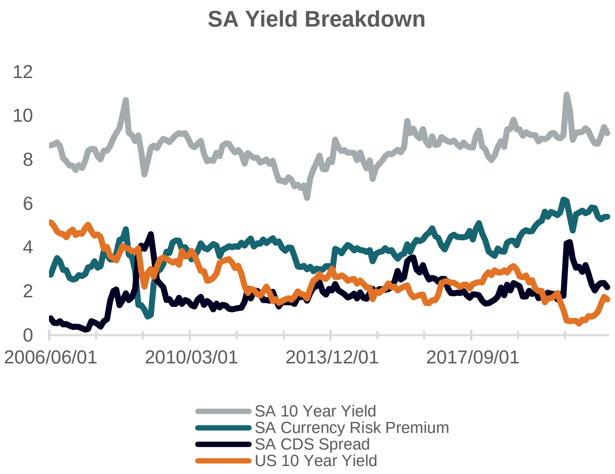
USDZAR

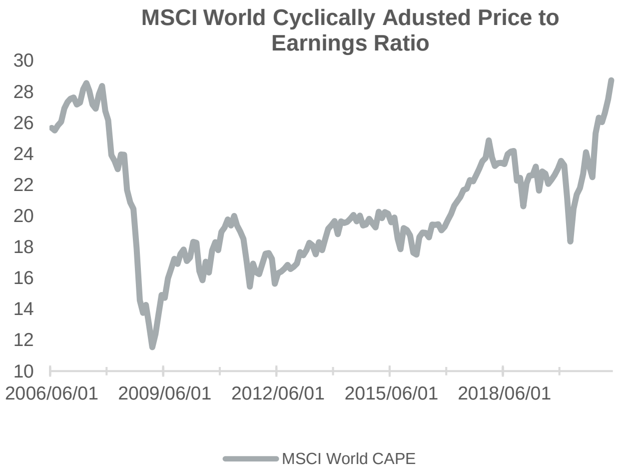


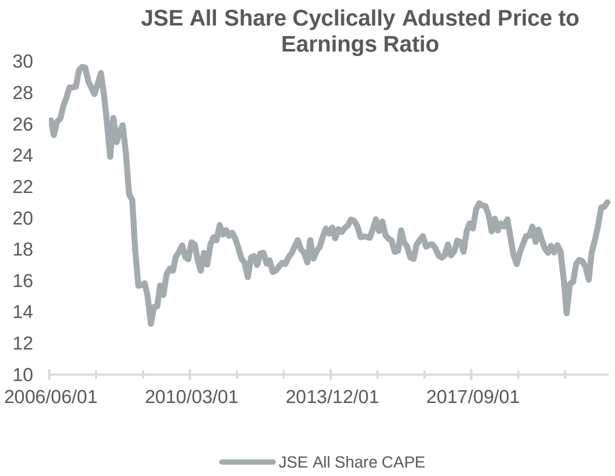
US Yield Curve

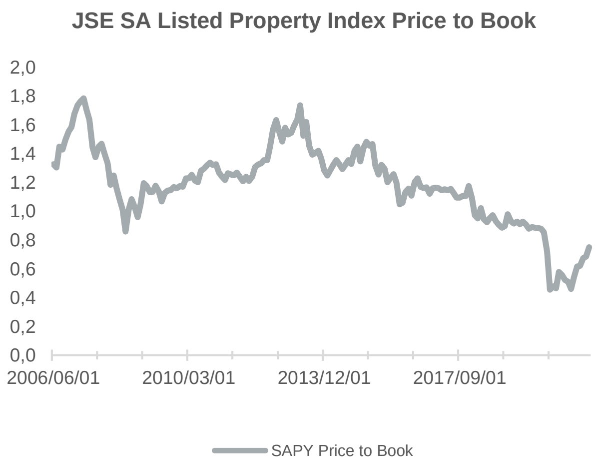


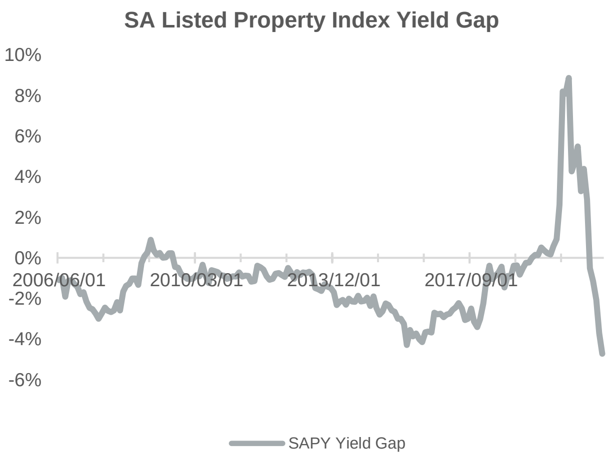












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