MARCH 2022

Thematic investing in the current climate – A more focused approach to sustainable and future-proof investing

Christoph Schon, Senior Principal, Applied Research

Table of Contents

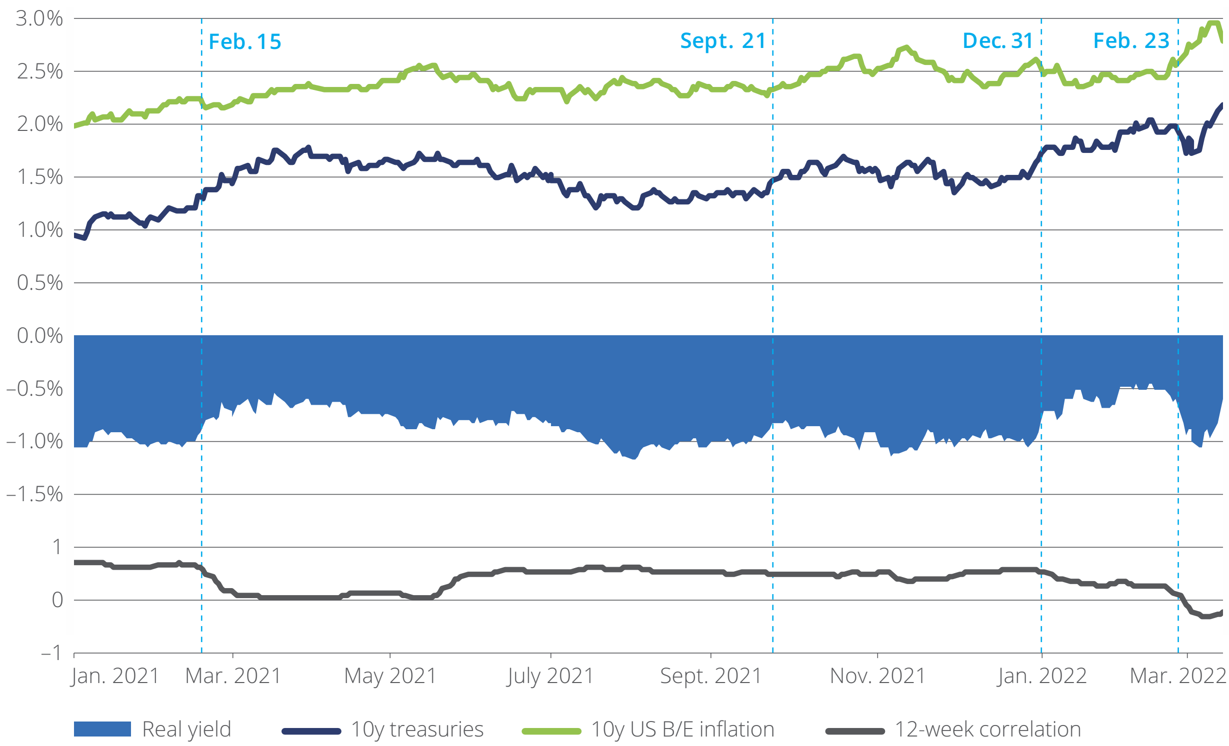
1. Introduction

The Russian invasion of Ukraine spooked equity investors around the world, but losses were not distributed equally across all sectors, with some industries even exhibiting positive returns. This opens up opportunities for more focused strategies such as thematic investing. In particular, the surge in oil and gas prices has not only created additional upward pressure on production costs and consumer prices, but also increased the urgency of a transition to sustainable energy sources. This means that investment vehicles that offer natural protection against inflation and/or focus on sustainability are likely to benefit. The increased threat of cyberattacks should also raise demand for security software and services.

2. The impact of rising inflation, interest rates and inflation on financial markets

Persistently high consumer price growth, fueled by a steady increase in raw material and energy costs, led market participants to revise their inflation expectations upwards over the course of 2021. This was reflected among other things in the 10-year US Treasury break-even rate (represented by the green line in Figure 1), which rose from 2% at the start of 2021 to nearly 2.6% at the end of the year. The move was matched by an almost identical increase in the same-maturity nominal rate (plotted in dark blue in Figure 1), keeping the real yield (the solid, light blue area) fairly constant at around −1% and maintaining a positive correlation between the two time series for most of the year. However, inflation expectations stabilized as central bankers became increasingly forthright about tightening monetary conditions following the Federal Open Market Committee (FOMC) meeting on September 21–22, 2021. As a result, they did not increase when long Treasury yields took off at the start of 2022.

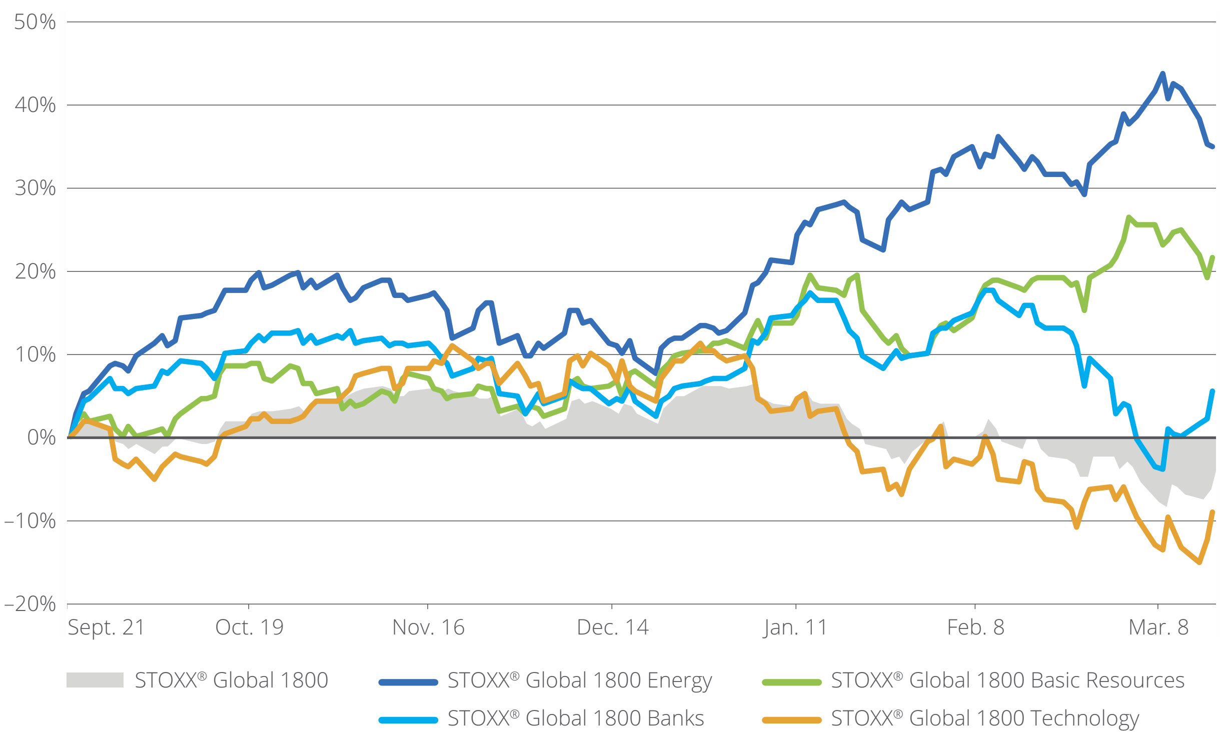
Figure 1: US Treasury yields and break-even inflation rates.



Source: Qontigo.

Equity market reactions to the increases in bond yields and inflation expectations were very mixed. Financial institutions, for example, were among the biggest winners, as higher interest rates were expected to lift their profits from lending and from investing their money. Thus the STOXX® Global Banks 1800 index (shown as the light blue line in Figure 2) returned 17% between the September FOMC meeting and its most recent peak in early February 2022. However, those gains have since been reversed, first by a general downward revision in central bank interest rate expectations, and more recently by asset write-downs relating to the sanctions imposed on Russia.

Figure 2: Global stock-market and selected sector performances since Sept. 21, 2021.



Source: Qontigo.

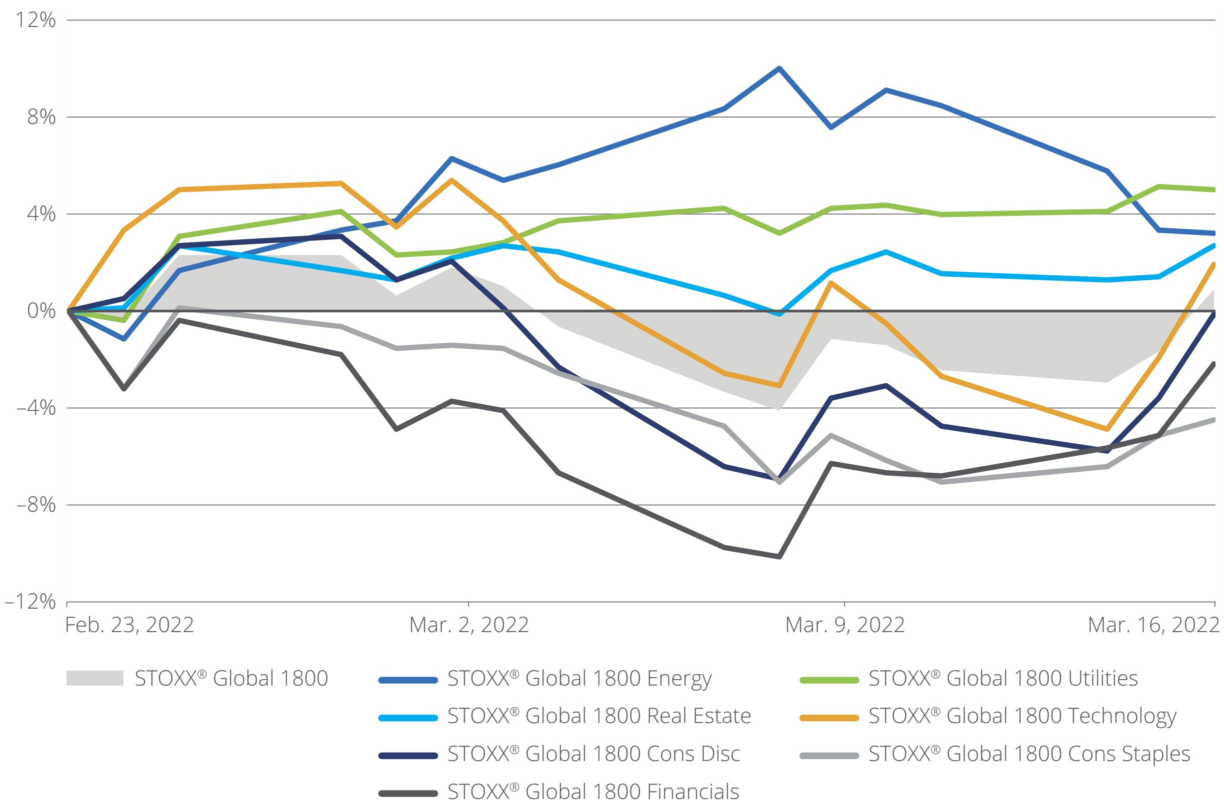
The energy (dark blue line) and basic resources (green line) sectors, on the other hand, have so far been able to hold on to and even extend their gains, thanks to a further boost in commodity prices. Fluctuations in returns were less pronounced for the technology sector – represented by the orange line – as some firms such as semiconductor producers profited from ongoing supply shortages, while manufacturers further down the value chain saw their profits squeezed by the skyrocketing prices for those same input components.

3. The impact of the Russian invasion of Ukraine

The Russian invasion of Ukraine on February 24, 2022, marked a watershed moment for some of these recent trends. Inflation expectations received another boost from soaring commodities prices, with the US 10-year break-even rate approaching 3%. Nominal treasury yields, on the other hand, dropped 25 basis points, as investors fled riskier asset classes for the relative safety of sovereign debt, reversing the tightening of the real yield from the preceding weeks and even turning the correlation between the two rates negative.

These opposing forces translated into a further divergence in equity sector performances. Energy and mining firms extended their steep ascent amid even-faster acceleration of raw material prices, while financial firms suffered additional losses, as geopolitical concerns weighed on sovereign yields and prompted traders to lower their interest rate expectations. Figure 3 shows the cumulative USD gross returns of the STOXX® Global 1800 and some of its industry subindices since February 23, 2022. Three weeks into the conflict, the overall benchmark has just about recovered its initial losses, but the dispersion of the subcomponents highlights the war's diverse effect across different parts of the economy.

Figure 3: STOXX® Global 1800 cumulative total and industry returns since Feb. 23, 2022.



Source: Qontigo.

While surging fossil fuel prices favored energy companies, many gas and electricity suppliers faced steep increases in input costs that they were unable to pass on to their retail customers due to government-imposed price caps. Despite this, the utility industry as a whole (represented by the green line) exhibited a positive overall return. The major drivers behind this were firms specializing in recycling and energy production from waste incineration, which are expected to continue to thrive amid the prevailing commodity shortages.

Providers of consumer products – both staples and discretionary alike – are likely to face similar problems of rising input costs and a limited ability to pass these on to their end customers. This is in contrast to the real estate sector, where rents and property prices tend to increase with inflation, resulting in gains for real-estate investment trusts (REITs).

Performance by and within the technology sector was once again mixed. The biggest winners were cyber-security firms, some of which saw their share prices surge more than 15% in the wake of the Russian invasion. Microchip makers also continued to profit from the persistent semiconductor shortage, whereas downstream hardware manufacturers are likely to see their costs rise even more going forward.

The example of the “tech” industry in particular shows that a traditional sector-based investment approach may no longer be suitable in the present situation. How, then can investors adapt and capitalize on the new opportunities arising in this changing world?

4. Thematic investing in the current climate

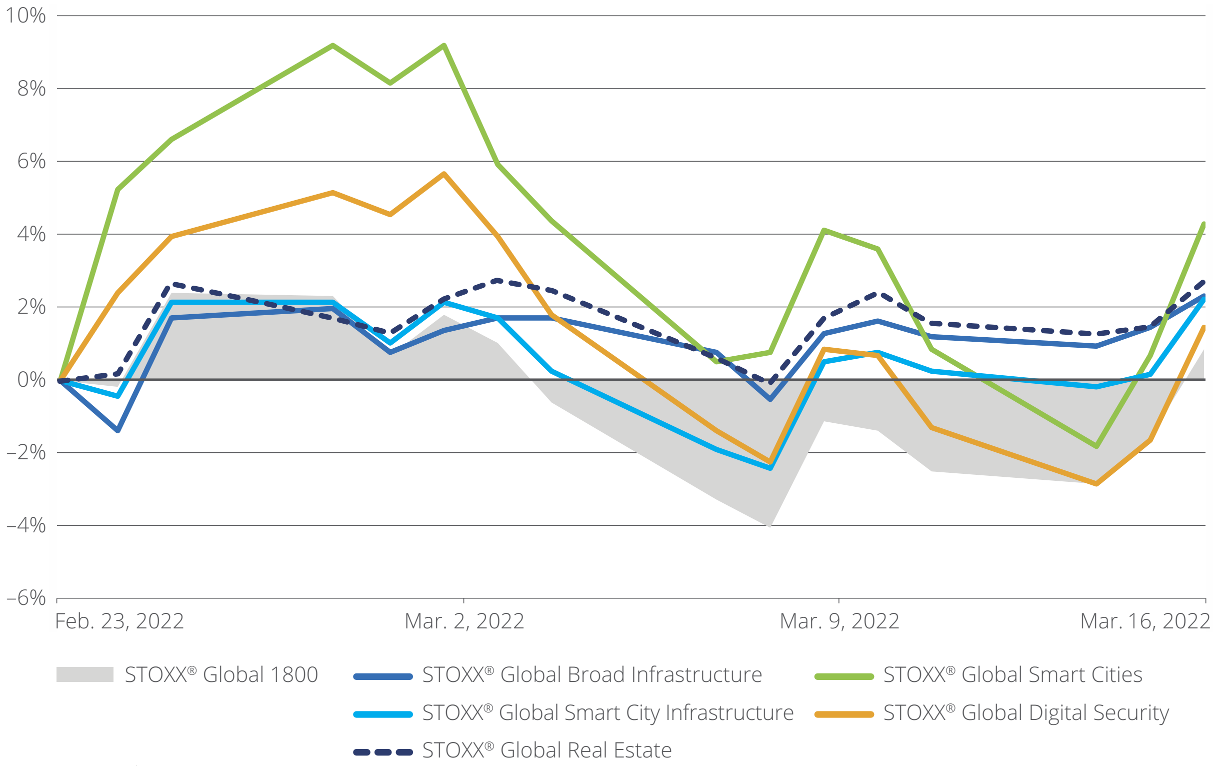
Given this strong dispersion of returns both across and within traditional sectors, investing in themes and megatrends offers a more focused approach plus the added benefits of sustainability and future-proofing.

We reviewed a range of thematic indices and found that the following stand out:

– STOXX® Global Broad Infrastructure
– STOXX® Global Digital Security
– STOXX® Global Smart Cities
– STOXX® Global Smart City Infrastructure

Figure 4 shows the performance of these indices in the wake of the Russian invasion of Ukraine on February 24, 2022. Once again, the light grey area represents the cumulative return of the STOXX® Global 1800. Russia’s military aggression and the (anticipated) sanctions by Western nations sparked fears of virtual attacks from Russian hackers, which in turn boosted the share prices of some cybersecurity firms by more than 20%. This was reflected in the strong performance of the STOXX® Global Digital Security and STOXX® Global Smart Cities indices, both of which have significant exposures to security software and equipment providers. What is more, the Smart Cities theme profited from also being invested in manufacturers of microchips and renewable energy equipment, which accounted for 26% and 7% of its holdings respectively.

Figure 4: Thematic index performance since Feb. 23, 2022.



Source: Qontigo.

With inflation expected to stay at elevated levels for the foreseeable future, real estate and infrastructure investments are bound to attract investor interest as a way of protecting against the adverse effects of rising consumer prices. Consequently, related themes are also likely to benefit from this reallocation of capital. The STOXX® Global Broad Infrastructure index, for example, has outperformed the STOXX® Global 1800 by almost 1.4% since February 23, closely tracking the STOXX® Global Real Estate index (which is represented by the dark blue dashed line).

4.1 Smart City Infrastructure: benefiting from exposure to multiple subthemes

The STOXX® Global Smart City Infrastructure index has also benefited from its large exposure to real estate investments, which represent around 25% of its market capitalization and accounted for nearly half its outperformance relative to the global benchmark in the first three weeks after the Russian invasion. However, the index also covers many of the other subthemes that are likely to prosper going forward, such as waste management and recycling, cybersecurity and semiconductors.

Figure 5 shows the results of a return attribution of the STOXX® Global Smart City Infrastructure index against the STOXX® Global 1800 for the period from February 23 to March 16, 2022, broken down by industry. The total active return was 1.4%, with 0.9% coming from sector over- and underweights and 0.5% from differences in the securities chosen and in weightings.

Figure 5: Performance attribution of STOXX® Global Smart City Infrastructure vs. STOXX® Global 1800.

Industry	Active weight	Category allocation	Security selection	Total
Real Estate	22.6%	0.4%	0.2%	0.6%
Utilities	7.4%	0.3%	0.3%	0.6%
Financials	–10.9%	0.3%	0.2%	0.5%
Consumer Staples	–6.4%	0.4%	0.0%	0.4%
Industrials	14.6%	0.1%	0.2%	0.3%
Basic Materials	–1.8%	0.0%	0.1%	0.1%
Consumer Discretionary	–10.8%	0.1%	–0.1%	0.0%
Energy	–4.4%	–0.1%	0.0%	–0.1%
Technology	–6.4%	–0.1%	–0.1%	–0.2%
Health Care	–12.1%	–0.3%	0.0%	–0.3%
Telecommunications	8.4%	–0.1%	–0.2%	–0.4%
Total		0.9%	0.5%	1.4%

Source: Qontigo, Axioma Risk™.

The biggest contribution to outperformance (0.4%) came from overweighting the real estate industry by almost 23%, thus benefitting from higher inflation expectations. The significant underweight in the financials sector also paid off, as bond yields remained depressed by flight-to-safety flows.

The utilities industry makes up around 10% of the STOXX® Global Smart City Infrastructure index, compared with less than 3% in the global benchmark. Most of the utility companies in the STOXX® Global Smart City Infrastructure index are waste and disposal services providers, with an 8% market value weight in the index versus just 0.2% in the benchmark. This also happened to be the best-performing segment in the industry. Overweighting these firms therefore had two advantages: The superior performance of the index holdings generated a security selection gain of 0.3%, while the general industry overweight accounted for another 0.3% of the total active return.

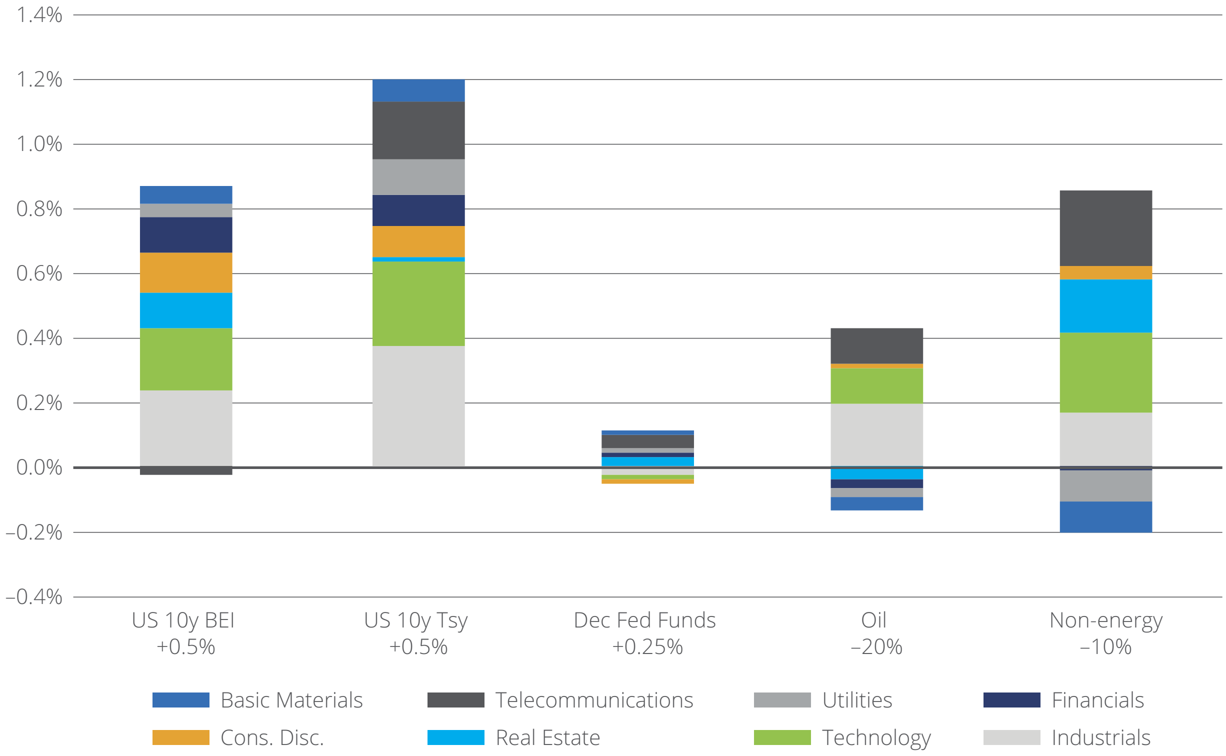
While surging oil and gas prices hurt many of the electricity suppliers in the STOXX® Global 1800, they provided an initial windfall for the companies that extract these sources of energy from the ground. However, with crude prices once more receding from their recent highs, not being invested in the energy sector at all had only a minor detrimental effect (–0.1%) on the effective return.

4.2 Resilience to near-term macroeconomic risks

So far, the STOXX® Smart City Infrastructure seems to have benefited from the rise in inflation expectations. Is this likely to continue, though? What if bond yields start to rise again, or central bankers feel the need to hit the monetary policy brakes even harder to combat mounting pressures on consumer prices? And what will happen once European countries have shifted to alternative sources for their raw materials and energy needs, and commodity prices start to normalize once more?

We created a range of stress tests simulating these scenarios. Figure 6 shows the results for upward shocks of 0.50% in the 10-year US Treasury nominal yield (Tsy) and break-even inflation rate (BEI), an additional 25-basis point hike in the Fed Funds target rate beyond what is priced in for the end of 2022, plus a 20% drop in the oil price and a decline of 10% in the costs of non-energy commodities. The betas and covariances for the analysis were calibrated using the daily returns since September 21, 2021.

Figure 6: Simulated returns of STOXX® Global Smart City Infrastructure for selected macro shocks.



Source: Qontigo, Axioma Risk™.

The analysis indicates that further rises in both inflation expectations and long-term sovereign yields are likely have a positive impact on the thematic index. Adjustments to monetary policy, on the other hand, appear to have no notable effect on any of its sectors or securities. A reduction in commodity prices can also be expected to benefit the companies in the index. This applies especially to firms in the industrials and technology sectors, which would see their input costs reduced.

The main exception to this are the basic materials and utility companies in the non-energy commodity scenario. While losses for the former are probably no surprise, it is worth recalling the index's strong exposure to waste management recycling firms. As raw materials get cheaper again, there will be less demand for the latter.

5. Thematic investing going forward: focused, sustainable and future-proof

The recent divergence of stock returns, both across the equity market as a whole and within specific subsegments, has highlighted the benefits of a more targeted investment approach. Thematic strategies offer the advantage of focusing on longer-horizon, structural changes – sometimes referred to as "megatrends" – that cross the established boundaries of more conventional region-, country- or sector-based offerings. In some cases they may also come with the added bonus of screening for environmental, social and governance (ESG) factors and of being aligned with many of the United Nations Sustainable Development Goals (SDGs).

Admittedly, the current environment is extreme and abnormal, and it would not be appropriate to simply extrapolate recent gains and losses into the future. In fact, many recent market distortions are likely to revert to their historical means and equilibriums. Fossil fuel prices remain elevated for the time being, but are likely to come down again eventually. In the short term, other oil- and gas-producing countries will increase their output to plug the gap caused by boycotting Russian commodities, while in the long term companies and consumers will adapt their demand for, and sources of, raw materials.

However, this is not the only point that needs to be borne in mind: Soaring energy costs may have been one of the largest contributors to the recent surge in inflation, but even if they come down again substantially, other distortions are likely to persist for longer. The global economy is still working its way through the backlogs in the global supply chain caused by the numerous COVID-19 restrictions over the past two years. At the same time, labor shortages in some industries look set to become chronic, as many workers seem to have decided not to return to their old jobs when lockdown restrictions and furlough schemes ended.

These ongoing shortages in physical and human resources will inevitably keep consumer price growth at elevated levels for the foreseeable future. One way of hedging against this is by investing in real estate and infrastructure, where payouts and returns are more likely to rise with inflation. Thematic strategies, such as Smart Cities and Smart City Infrastructure, allow investors to combine this approach with the ability to profit from structural changes taking place over long periods. Chief among these is the transition to a circular economy based on renewable power generation and sustainable waste management through recycling. Investors are also likely to benefit from the ongoing automation of production processes, intensified by tightening labor markets, and accelerating digitalization in all ways of life, plus the increasing need for cybersecurity that comes with it.

6. Contacts & Information

Learn more about how Qontigo can help you better manage risk and enhance your investment process.
Qontigo.com

Europe

Frankfurt
Mergenthalerallee 61
65760 Eschborn, Germany
+49 69 2 11 0

London
8 Old Jewry
4th Floor
London EC2R 8DN, United Kingdom
+44 20 7862 7680

Paris
19 Boulevard Malesherbes
75008, Paris, France
+33 1 55 27 38 38

Prague
Futurama Business Park Building F
Sokolovska 662/136b
186 00 Prague 8, Czech Republic

Zug
Theilerstrasse 1A
6300 Zug, Switzerland
+41 43 430 71 60

Americas

Atlanta
400 Northridge Road, Suite 550
Atlanta, GA 30350
+1 678 672 5400

Buenos Aires
Corrientes Avenue 800, 33rd Floor
Office 101
Buenos Aires C1043AAU, Argentina
+54 11 5983 0320

Chicago
20 N. Upper Wacker Drive, Suite 1144
Chicago, IL 60606
+1 224 324 4279

New York
17 State Street, Suite 2700
New York, NY 10004 USA
+1 212 991 4500

San Francisco
201 Mission Street, Suite #2150
San Francisco, CA 94105
+1 415 614 4170

Asia Pacific

Hong Kong
28/F LHT Tower
31 Queen's Road Central
Hong Kong
+852 8203 2790

Singapore
80 Robinson Road, #02-00
Singapore 068898, Singapore
+852 8203 2790

Sydney
9 Castlereagh Street, Level 17
Sydney, NSW 2000, Australia
+852 8203 2790

Tokyo
27F Marunouchi Kitaguchi Building,
1-6-5 Marunouchi Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 4578 6688

QONTIGO
AXIOMA | DAX | STOXX

Part of DEUTSCHE BÖRSE GROUP