Factor Views
Themes from across the factor investing landscape

In brief
- The many market reversals of 1Q 2023 challenged factor investing, though factor performance remained broadly positive over the past 12 months.
- A larger-than-normal “January effect” and significant fluctuations in interest rate expectations impacted equity factors during the quarter, but they remain attractive amid strong medium-term trends.
- We introduce credit factors in this piece, which were positive in aggregate in Q1 and showed their diversifying nature vs. equity factors.
- The merger arbitrage factor sidestepped pockets of equity market volatility.
- The quarter’s volatility, particularly in fixed income markets, disrupted the macro momentum factor’s performance; the carry factor gained modestly.
- We maintain our positive outlook for factors in aggregate. We believe equity factors, value in particular, are well supported by current valuations. Other factors, including merger arbitrage, credit quality and macro carry, also appear attractive.

Overview
Despite a volatile Q1, our outlook remains positive across the majority of factors and none appear expensive—a backdrop that should support returns in the medium to long term.

The first quarter of 2023 felt like it contained several years’ worth of market-moving events. Expectations rose for economic growth early on, precipitating an increase in expectations for future rate hikes. But March brought several high-profile bank...
failures and markets priced in multiple interest rate cuts by year-end, resulting in a swing in rate expectations of 200 basis points (bps) and levels of interest rate volatility last seen in the global financial crisis.

Reversals across and within markets over the quarter challenged a number of the factors that we invest in, such as equity and macro momentum, though others performed better. Macro carry fared well and credit factors—a new addition to this publication—were positive in aggregate (Exhibit 1).

Factors in focus
Equity factors: A strong “January effect” and high factor volatility do not cloud our positive outlook

While 2022 was a banner year for the value, quality and momentum factors, they suffered in 1Q 2023 as equity markets experienced a sharper-than-normal “January effect”: a common rally in which prior year losers turn into January winners (and vice versa), leading to poor performance for the momentum factor.1

All of these features were on display at the start of 2023: Global equity markets rose significantly and our global size factor experienced its 15th strongest month since 1990; at the same time our global momentum factor experienced its 12th worst month since 1990.2 The quality factor also struggled in January to a noteworthy degree as speculative, low-quality names rallied.3

These events occurred before four of the largest bank failures and markets priced in multiple interest rate cuts by year-end, resulting in a swing in rate expectations of 200 basis points (bps) and levels of interest rate volatility last seen in the global financial crisis.

The quarter, as markets tended to favor secular growth names amid expectations of slower economic growth.4 Momentum bounced back slightly in February and March, but ended Q1 significantly lower.

So after all of that volatility, how are factors currently valued and what could that mean for future performance? Global equity factors remain as inexpensive as they have been since the dot-com bubble, though this observation masks regional and factor distinctions. From a regional perspective, U.S. factors stood out for lower valuations than during the dot-com bubble. Factors in other regions remain inexpensive, though not at unprecedented levels.

Value remains universally inexpensive, most notably in the U.S., where it is more than two standard deviations cheaper than its historical average vs. around one standard deviation cheaper in other regions. Quality tells an even more disparate story, with the factor also more than two standard deviations cheaper in the U.S., driven primarily by the smaller cap end of the market, but only neutral in most other regions and even expensive in Japan (Exhibit 2A and 2B).

Credit factors: Similar concept to equity factors, though performing to their own tune

In a new addition to this publication, we introduce credit market factors, focusing on the value, quality and momentum factors within U.S. high yield markets.5 Our approach to credit factors resembles our approach to equity factors. For example, value is defined as a measure of market price relative to a fundamental anchor and quality is based on profitability, among other considerations. Despite philosophical similarities, credit factors tend to be diversifying in nature—and 1Q 2023 was a good example of this feature.

U.S. high yield spreads saw significant Q1 volatility, widening from 389bps to 516bps in March, but ended the quarter little changed. Credit factors performed well in aggregate, in contrast to equity factors. Credit quality extended its upward trend for a fourth quarter, bolstered by a strong March. Credit momentum also rose and did not face the reversals that hurt equity.

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1 Since 1990, our global size factor has generated positive returns of 0.45% on average in the month of January vs. an average of -0.28% over all other months and our global momentum factor has on average seen losses of -0.66% in January vs. gains of 0.38% over all other months. The S&P 500 has, on average, appreciated 1.22% in January using data from 1928-2023 vs. price returns of 0.57% in all other months. However, the effect has reversed since 1990, with average price appreciation in January of 0.29% vs. 0.75% in other months.

2 The worst-performing stocks in the S&P 500 in 2022 were top performers in 1Q 2023, with average returns exceeding 16%, while the top performers in 2022 were negative over the quarter.

3 Momentum and quality have underperformed simultaneously only a handful of times, including noted low-quality reversals in April 2009, November 2002 and, more recently, in November 2020.

4 This stands in contrast to factor performance before and during the onset of COVID-19, when value and quality fell together as markets favored speculative rather than secular growth.

5 J.P. Morgan Asset Management has been explicitly investing in credit factors since 2018, with more information on credit factors available in Schuehle, Niels and Behnood Noei, “Credit Factors: Strong Performance in Turbulent Times.”
Fundamental factors stand out in the U.S., value appears universally inexpensive

EXHIBIT 2A: EQUITY VALUE FACTOR VALUATION SPREADS

EXHIBIT 2B: EQUITY QUALITY FACTOR VALUATION SPREADS


momentum, finishing the quarter with the strongest performance of the credit factors covered in this report. And while credit value was negative during March’s market turbulence, it was offset by slight gains in credit quality and momentum.

Our outlook for credit factors is positive. Quality is inexpensive relative to its long-term valuation. While value and momentum are closer to fair value, spread dispersion within the high yield market tends to be a tailwind, especially for the value factor. At the end of March, 76% of issuers were trading plus or minus 100bps from the average market spread—seven percentage points wider than the long-term average of 69%. Historically, when spread dispersion has traded at or above its current levels, the average forward 12-month return for the value factor has been 2.7%, with the factor performing positively 93% of the time.

Merger arbitrage factor: Sidestepped pockets of volatility within equity markets

The merger arbitrage factor was flat over the quarter and remains generally insensitive to broader equity market conditions, exhibiting steady, below-average volatility over the past couple of years. Rolling 12-month volatility is in the 20th percentile and rolling 24-month volatility is in the 10th percentile.
Like last quarter, merger activity remains below its long-term average (by roughly one standard deviation) as macro uncertainty and structural changes in rates and financing conditions are keeping companies from pursuing new transactions. If anything, tighter financial conditions following last month’s bank failures may continue to keep a lid on M&A activity. Spread levels, however, remain attractive in the 90th percentile relative to their longer-term history, likely benefiting in part from a higher nominal rate environment and reflecting some of the uncertainties noted earlier.

Macro factors: Carry steered through a volatile quarter while momentum was upended

Market reversals in fixed income, as well as equity and commodities, disrupted momentum factors—trend in particular. However, carry gained, buoyed by strength in currency (FX) carry and, to a lesser extent, fixed income carry.

The carry factor’s recent outperformance over momentum is likely to continue, and carry is our preferred macro factor. Carry spreads remain attractive across fixed income markets, particularly in terms of real yield differentials, which are around a 30-year high, with spreads between countries above 300bps (94th percentile). Commodity carry spreads have improved recently. While the data series is much more volatile than for other carry factors, commodity carry spreads are in the 96th percentile relative to their long-term history. Currency carry spreads are generally inexpensive relative to their short-term history, though fairly valued on a longer-term basis. For example, FX G10 carry spreads of roughly 350bps are the highest since 2008, but well below the 1990s and early 2000s prevailing range of 400bps–600bps (and are in the 46th percentile vs. their long-term history).

Momentum factors are more squarely neutral, in terms of attractiveness vs. their long-term average. Dispersion is limited in relative value momentum within FX G10 markets and about average in commodity markets. From a time-series or trend perspective, 1Q 2023 washed out many recent trends as equities and bonds rose while the dollar and commodities fell, reversing 2022 performance. And while momentum factors tend to be less predictable than other factors, a lack of significant trends makes it hard to argue for an above- or below-average outlook.

Concluding remarks

We continue to see generally attractive prospects for a wide range of factors: equity value, especially, across the globe; equity quality in the U.S. market; the newly introduced credit factor of quality and, to a lesser extent, value; and we maintain our positive outlook on merger arbitrage and macro carry. We expect the environment for traditional asset classes to remain uncertain and believe that factors can play an important complementary role in a broader portfolio context.
Factor opportunity set

The table below summarizes our outlook for each of the factors accessed by the Quantitative Solutions platform. It does not constitute a recommendation but, rather, indicates our estimate of the attractiveness of factors in the current market environment.

FACTOR VIEWS VS. LAST QUARTER:

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<th>Rationale</th>
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<th>Neutral on valuation, attractive on dispersion</th>
<th>Attractive on valuation, driven by U.S. markets, attractive on dispersion</th>
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<th>Neutral on deal premia, attractive on % of friendly deals, negative on activity level</th>
<th>Neutral on FX spreads, positive on fixed income spread, positive on commodity spread</th>
<th>Neutral on FX price dispersion, neutral on commodity price dispersion, neutral on significant price trends</th>
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Source: J.P. Morgan Asset Management; for illustrative purposes only.

Our framework for evaluating factor outlooks is centered on the concepts of dispersion and valuation, as well as the opportunity for diversification. For equity factors, we measure dispersion and valuation spreads between top-quartile and bottom-quartile stocks on a market, region and sector-neutral basis. For event-driven factors, we measure implied carry and the level of corporate activity as indicative of the ability to minimize idiosyncratic stock risk. For credit factors, we measure dispersion and valuation spreads between top-quartile and bottom-quartile issuers. For macro factors, we measure the dispersion or spread between top-ranked and bottom-ranked markets, as well as the number of significantly trending markets.

Glossary

- **Credit value**: Long/short U.S. high yield corporate bonds based on default-adjusted spread and spread to long-term sustainable debt ratio; sector and market neutral
- **Credit quality**: Long/short U.S. high yield corporate bonds based on profitability, coverage ratios and market leverage; sector and market neutral
- **Credit momentum**: Long/short U.S. high yield corporate bonds based on equity and bond price changes; sector and market neutral
- **Equity momentum**: Long/short global developed stocks based on price change and earnings revisions; sector and region neutral
- **Equity value**: Long/short global developed stocks based on book-to-price, earnings yield, dividend yield, cash flow yield; sector and region neutral
- **Equity quality**: Long/short global developed stocks based on financial risk, profitability and earnings quality; sector and region neutral
- **Equity size**: Long/short global developed stocks based on market capitalization; sector and region neutral
- **Merger arb**: Long target company and short acquirer (when offer involves stock component) in announced merger deals across global developed markets
- **Event-driven (other)**: Conglomerate discount arbitrage, share repurchases, equity index arbitrage, post-reorganization equities and shareholder activism
- **Macro carry**: FX G10 carry, FX emerging market carry, fixed income term premium, fixed income real yield, commodity carry
- **Macro momentum**: FX cross-sectional momentum, commodity cross-sectional momentum and time-series momentum across equity, fixed income and commodity markets
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