Russell US Indexes Spotlight Report

Third Quarter 2021

Large-cap winning streak continues into Q3, buoyed by Growth outperformance

The robust reopening rally in US stocks lost steam in Q3, mired by broad September losses, as investors recalibrated expectations for the US recovery, inflation and Fed policy support. Amid big swings in risk appetite and a late-quarter bond-market selloff, Russell 1000 and large-cap Growth outperformed, trimming small-cap Value's huge YTD lead.

Q3 Highlights

Recovery headwinds spur large-cap Growth rebound

R1000 Growth was the top performer in Q3 as a wall of worry about the US recovery drove a resurgence in high and resilient earnings growth stocks — before the small-cap Value rebound in late September. (page 3)

Growth-heavy industries top the charts

Buoyed by the strong growth rebound, most large-cap industries beat their small-cap peers in Q3, led by Financials, Health Care and Technology. (pages 4-5)

Sector contributions also show tilt to growth

Large-cap Medical Equipment was the best-performing sector in Q3, followed by Technology Software; Telecom Service Providers posted the biggest losses. (page 6)

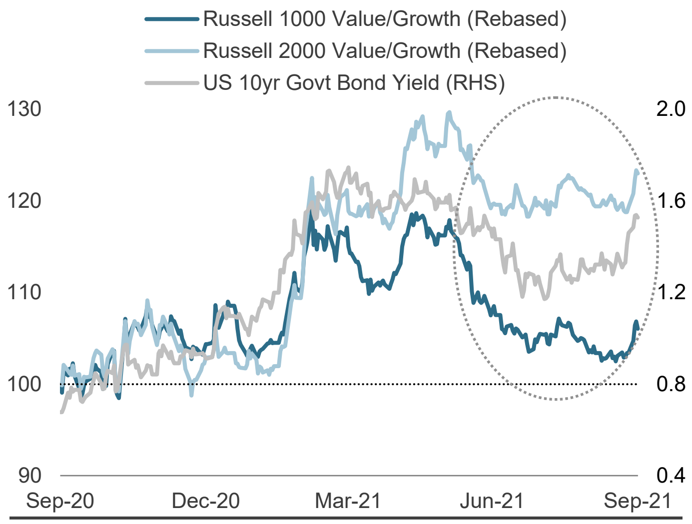
EPS upgrade cycle slows

Forward EPS forecasts hit fresh five-year highs across the Russell indexes in Q3, particularly R1000 Growth. But upward revisions have begun to level off. (page 7-8)

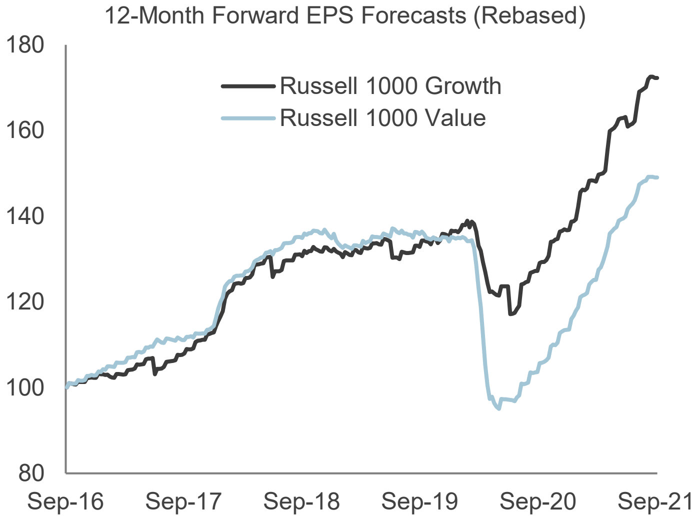
Valuations remain at five-year highs

Forward P/Es have tightened since peaking on pandemic-depressed earnings last year but remain at five-year highs, particularly R1000 Growth after recent outperformance. (page 9)

The R1000 Growth rebound in Q3 outpaced that of its R2000 peer, though both stalled with the late-quarter spike in US bond yields.



Forward EPS estimates for R1000 Growth and Value hit new five-year highs in Q3, even as the uptrend in revisions levels off.



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Russell US Index Performance – 3M & 12M (%)

Key Observations – Third Quarter 2021

Despite a lackluster performance in September, large- and small-cap US stocks have maintained their double-digit gains this year, with the Russell 1000 and Russell 2000 climbing 15.2% and 12.4%, respectively, for the first nine months. Both have trounced the FTSE All-World ex US and FTSE Emerging indexes for the same period (up 6.7% and 1.1%, respectively).

Beneath the surface, however, there has been a dramatic rotation in US market and style leadership. As Chart 2 illustrates, the Russell 1000 has been clawing back ground from the Russell 2000 since mid-March, coinciding with the easing in US bond yields during the early summer months and a strong rebound in the high-growth stocks, notably Technology, which makes up a bigger share of the large-cap index (see page 4). However, both large- and small-cap Value got a second wind in September amid persistently elevated inflation readings and an uptick in bond yields spurred by Fed signaling of an earlier timeline for withdrawing pandemic-era policy support.

The Q3 bounce-back in growth stocks was much more powerful for the tech-heavy Russell 1000 Growth than for small-cap Growth. Despite recent reversals, however, the Russell 2000 Value retains a huge lead over all other style indexes YTD and for the past 12 months.

Chart 1: Despite losing ground to its large-cap counterpart in Q3 and for the YTD, the Russell 2000 remains solidly in the lead for the 12 months. Russell 2000 Value continues to strongly outpace small-cap Growth and both large-cap style peers for the longer-term time frames, even after its Q3 setback.

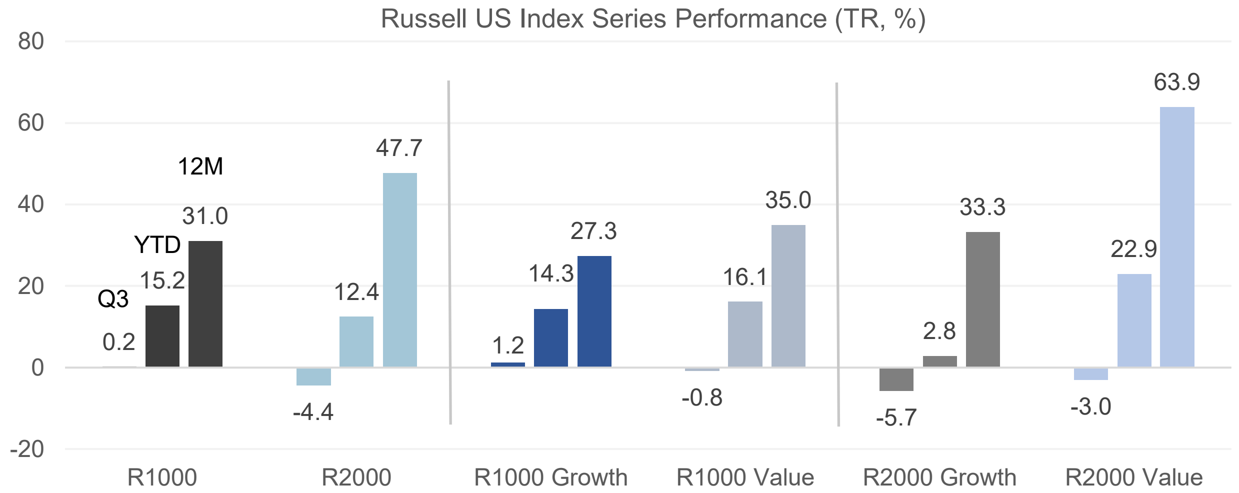
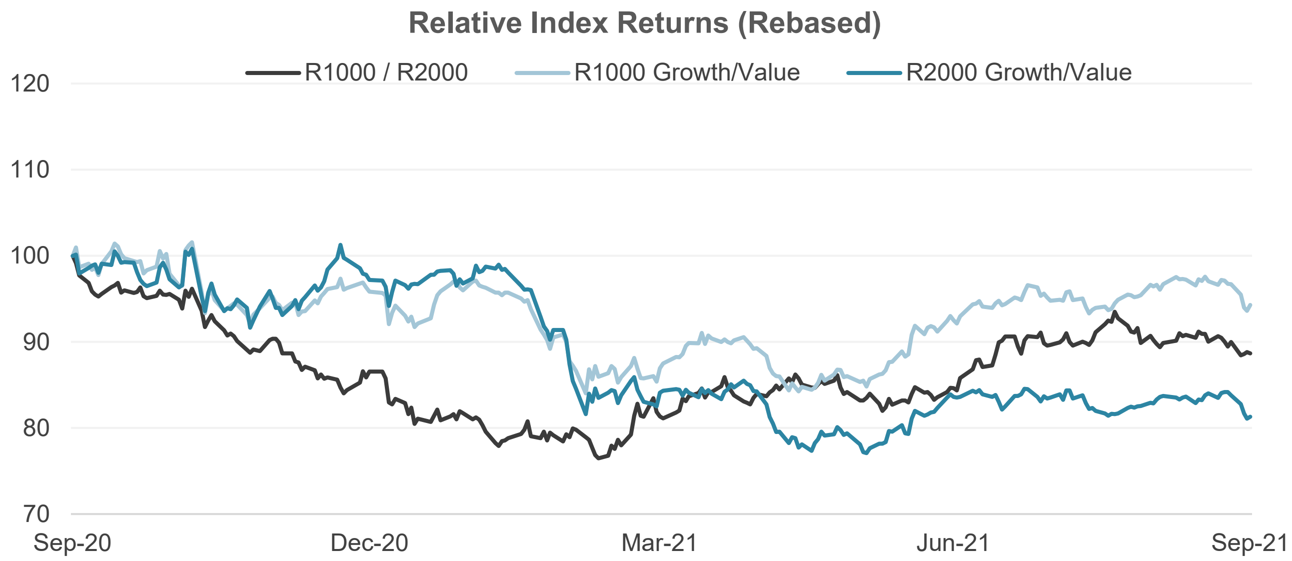


Chart 2: The Russell 1000 built on its Q2 outperformance in the early months of Q3, powered mostly by large-cap growth stocks. But both wavered in September as the spike in bond yields weighed on pricier sectors of the market.



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Macro Backdrop – Q3 2021

A wall of worry has been building over the past several months amid elevated inflation, persistent supply shortages, fading recovery indicators, and a hawkish turn in Fed policy messaging. The China Evergrande debt crisis and the debt-ceiling standoff in Congress further exacerbated growth worries in late September. These shifting economic and inflationary tides have triggered dramatic swings in risk appetite and US style leadership.

The ISM US Manufacturing Index, a reliable proxy for US industrial activity, has rolled over since hitting decade-high expansionary levels in March (Chart 1). Following an above-consensus spike in CPI readings, inflation expectations resumed their uptrend in September after subsiding earlier in Q3 (Chart 2). Bond-market signals followed suit. Since hitting a low of 1.17% in late August, the 10-year Treasury yield has been on an upward climb (Chart 3), surging above 1.5% in the wake of the Fed's FOMC September meeting, when officials confirmed plans (after weeks of speculation) to begin tapering asset-buying as early as November and signalled increased member support for raising rates next year.

After badly lagging in Q1, the Russell 1000 has been on a winning streak – retaking the lead from the small-cap index in July. Both large- and small-cap Growth indexes also have enjoyed strong rebounds for most of Q3 (Charts 3 and 4). However, all three indexes have lost steam with the recent uptick in inflation expectations, US bond yields and growth worries.

Chart 1: US small-caps struggled for most of Q3 amid signs that the robust US recovery was losing momentum.

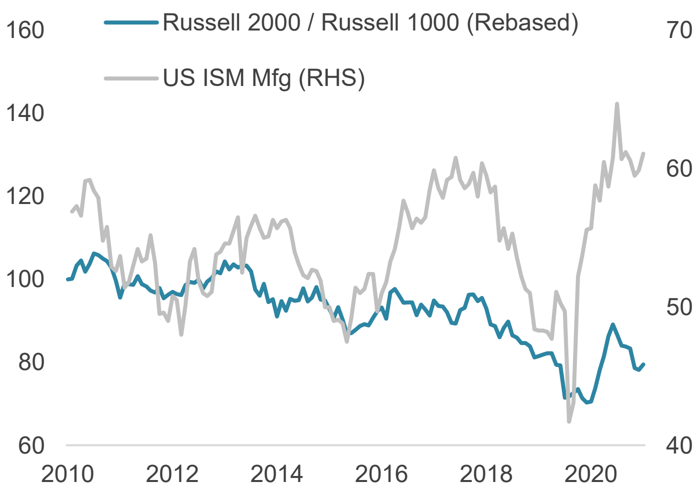


Chart 2: Inflation expectations ticked higher in September amid waning confidence in the 'transitory' narrative.

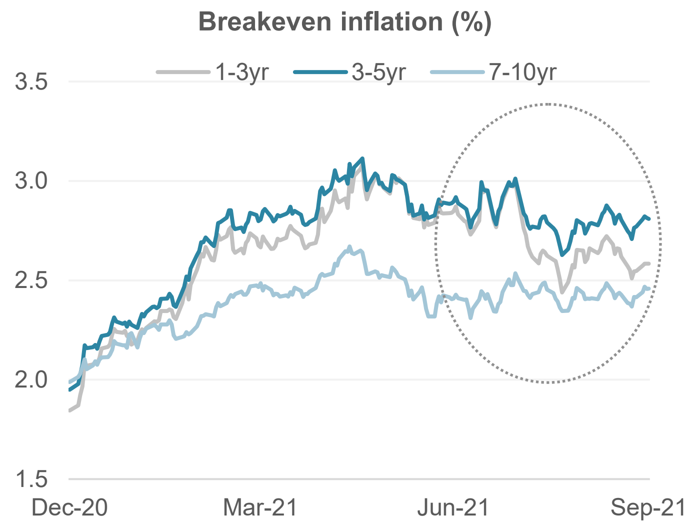


Chart 3: The September spike in US bond yields took some steam out of Russell 1000 revival that began in March.

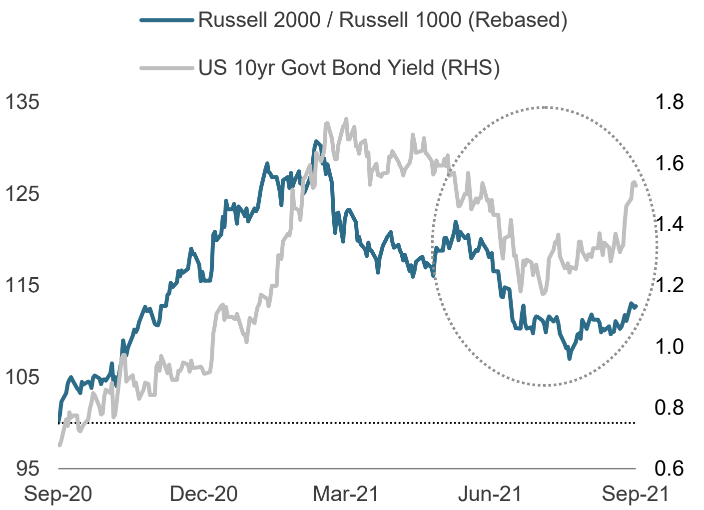
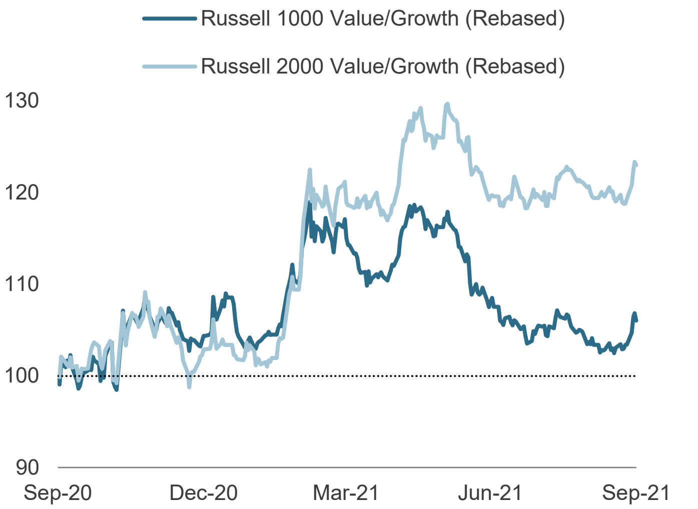


Chart 4: The R1000 Growth rebound in Q3 outpaced that of its R2000 peer, though both stalled as bond yields rose.



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Industry Returns and Exposures – Russell 1000 & Russell 2000

Key observations

There were some striking reversals from longer-term trends in both large- and small-cap industry performances in Q3. We highlight the following key points:

- Amid widespread losses, large-cap industries outperformed their small-cap peers in all but Industrials and Energy.
- R1000 gains were led by Financials, Tech, Utilities and Health Care; Industrials and Materials lost the most.
- For the 12 months, R1000 gains were strongest in Energy and Financials, and weakest in defensive Staples, Utilities and Telecom.
- R2000 Q3 losses were led by Health Care, Staples and Discretionary stocks; only Financials ended higher.
- For the 12 months, R2000 gains were strongest in Energy and Financials, and weakest in defensive Staples, Utilities and Health Care.

Chart 1: Large-cap industries outperformed their small-cap peers in all but Industrials and Energy in Q3.

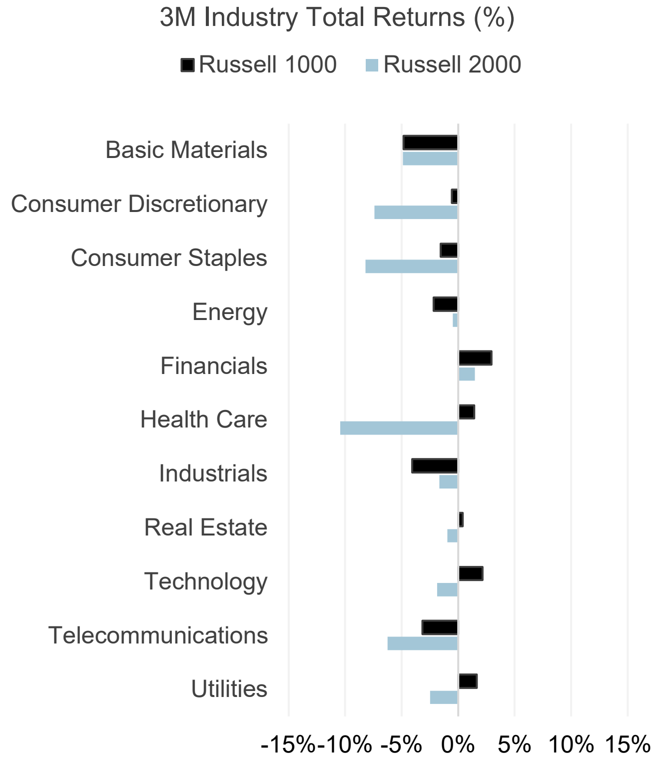
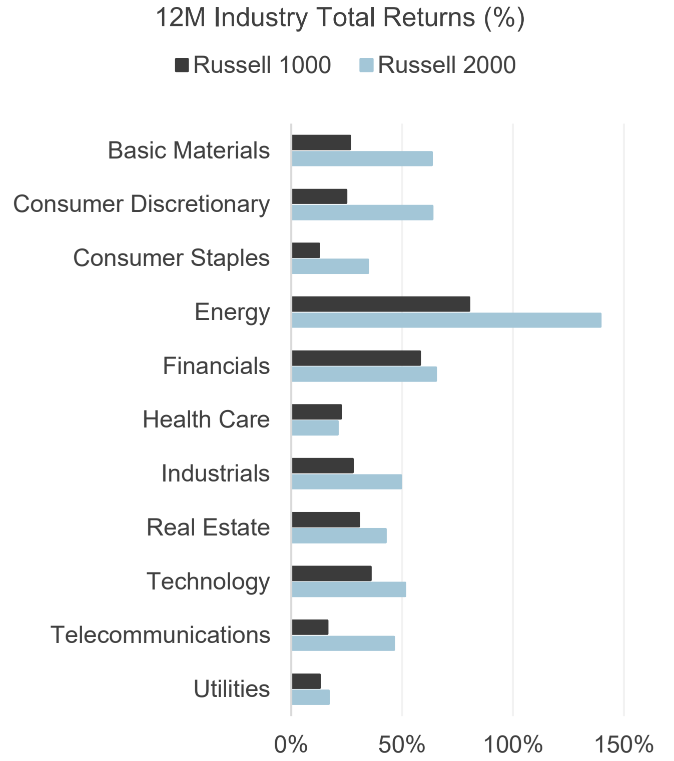
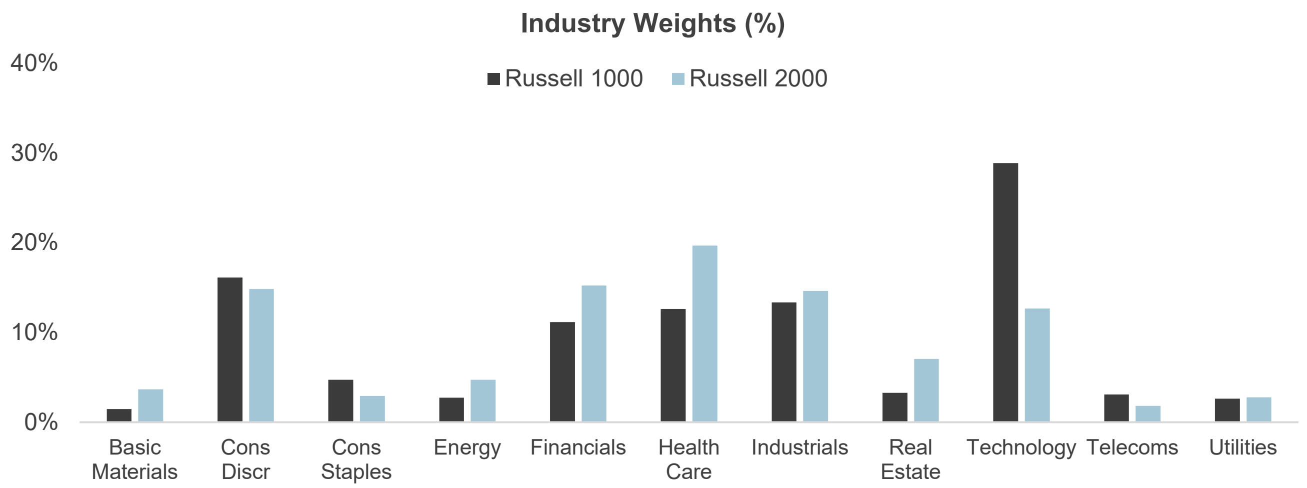


Chart 2: R2000 industries were well ahead of R1000 peers for the 12 months, particularly in Energy and Materials.





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Industry Returns & Exposures – Russell 1000 & 2000 Growth & Value

Key observations

There were some striking reversals from earlier trends in industry performances across the Growth and Value style indexes in Q3. We highlight the following key points:

- Large-cap Growth industries outperformed those of all other style indexes in Q3, led by Financials, Health Care, Utilities and Tech. Telecom, Energy, Basic Materials and Industrials were notable underperformers.
- Small-cap Growth was the biggest style laggard in Q3, hurt mostly by losses in Health Care, Staples and Energy.
- Small-cap Value outpaced all other style indexes for the 12 months, led by Energy, Materials, Consumer Discretionary and Financials.
- Large-cap Growth was the worst style performer for the 12 months, with most industries posting losses for the period, particularly Telecom and Energy.

Chart 1: Large-cap Growth outperformed style peers in Q3, buoyed mostly by gains in Financials, Health Care & Tech.

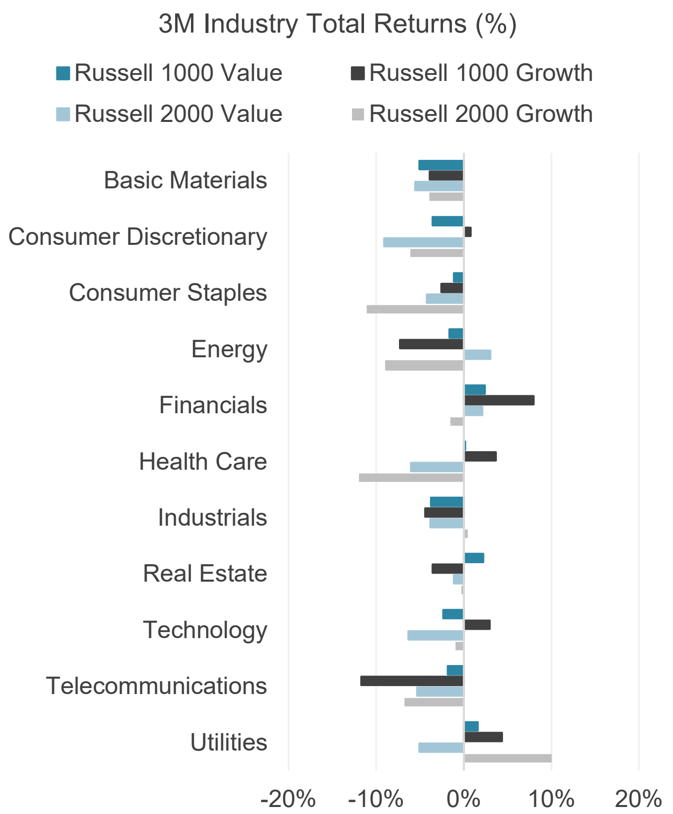
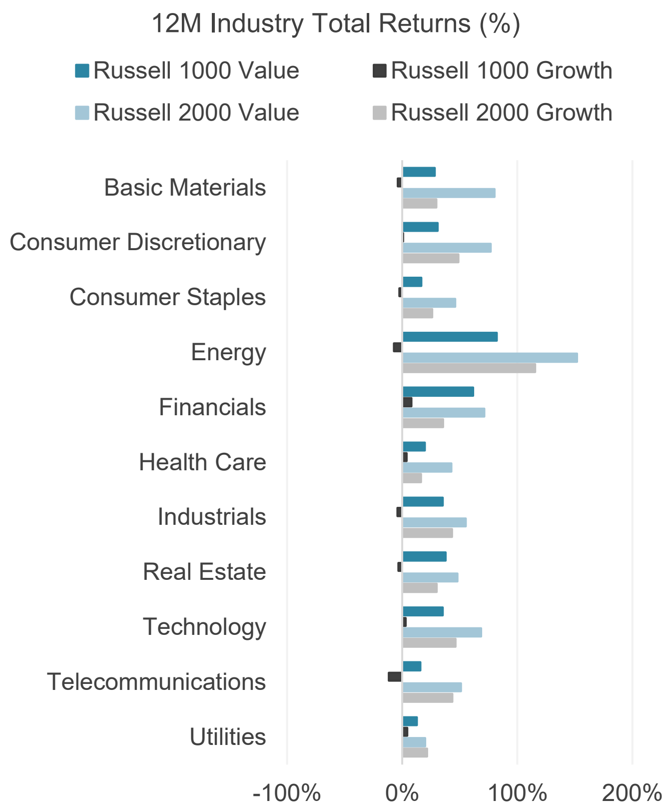
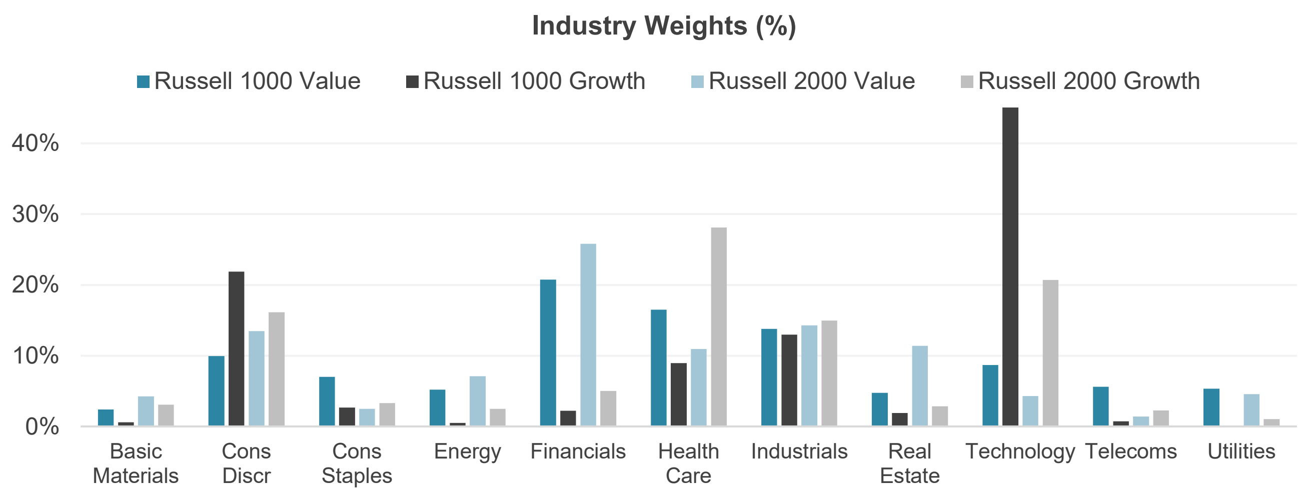


Chart 2: R2000 Value outperformed all style indexes for the 12 months, led by reflation winners such as Energy.





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Russell 1000 Industries – Sector Weights & Contributions to Return*

Key observations

Drilling deeper into the sector performances of the 11 Russell 1000 industries in Q3, we highlight the following key points:

- As the best-performing industry in Q3, Financials' strength came predominantly from Banks (contributing more than a third of the industry's gain), on the back of rising interest rates and the US steepening yield curve.
- Most of Q3 gains of the second-best performing industry, Technology, came from large exposure to the Software and Computer Services sector.
- Returns of all four sectors within the badly lagging Basic Materials industry were negative, with Chemicals making up more than half of the industry's weight.
- Returns of all seven sectors within poorly performing Industrials were negative.
- Medical equipment and Services (nearly 40% of the Health Care industry) was the best-performing sector of all.
- Telecommunications Service Providers (more than half of the Telecom industry) was the worst-performing sector of all.

Table 1: Medical Equipment was the top-performing sector within the Russell 1000 in Q3; the Telecom Service Providers ranked at the bottom. Banks led outperforming Financials returns amid the late-September rise in bond yields.

Sector	Avg. Weight	Q3 Contrib.
Basic Material		
Chemicals	57.5%	-1.94%
Industrial Materials	7.4%	-0.38%
Industrial Metals and Mining	26.9%	-1.06%
Precious Metals and Mining	8.2%	-1.18%
Consumer Discretionary		
Automobiles and Parts	12.3%	0.84%
Consumer Services	4.0%	-0.19%
Household Goods & Home Construction	2.3%	-0.15%
Leisure Goods	3.9%	-0.39%
Media	12.0%	0.19%
Personal Goods	7.2%	-0.37%
Retailers	41.0%	-0.27%
Travel and Leisure	17.5%	0.11%
Consumer Staples		
Beverages	26.6%	-0.74%
Food Producers	23.3%	-1.20%
Personal Care Drug & Grocery Stores	38.6%	0.46%
Tobacco	11.6%	-0.34%
Energy		
Alternative Energy	4.9%	-1.01%
Oil Gas and Coal	95.1%	-1.15%
Financials		
Banks	36.4%	1.67%
Finance and Credit Services	6.8%	0.36%
Investment Banking and Brokerage Svcs	36.1%	0.33%
Life Insurance	4.2%	0.08%
Mortgage Real Estate Investment Trusts	0.8%	-0.02%
Non-life Insurance	15.8%	0.69%

Sector	Avg. Weight	Q3 Contrib.
Health Care		
Health Care Providers	17.0%	-0.76%
Medical Equipment and Services	36.9%	2.29%
Pharmaceuticals and Biotechnology	46.1%	0.09%
Industrials		
Aerospace and Defense	10.6%	-0.37%
Construction and Materials	5.8%	-0.14%
Electronic and Electrical Equipment	8.7%	-0.08%
General Industrials	15.9%	-0.70%
Industrial Engineering	8.0%	-0.50%
Industrial Support Services	38.7%	-1.06%
Industrial Transportation	12.2%	-1.16%
Real Estate		
Real Estate Investment & Services Dev.	8.0%	0.07%
Real Estate Investment Trusts	92.0%	0.34%
Technology		
Software and Computer Services	60.8%	1.95%
Technology Hardware and Equipment	39.2%	0.21%
Telecomunications		
Telecommunications Equipment	39.3%	-0.53%
Telecommunications Service Providers	60.7%	-3.94%
Utilities		
Electricity	67.1%	1.04%
Gas Water and Multi-utilities	23.8%	0.11%
Waste and Disposal Services	9.1%	0.62%

Source: FTSE Russell. *Indexes data shown here are from the Russell Capped Index Series, except for the Real Estate Industry. Data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures. For professional investors only.

EPS Growth Outlook and Revision Cycle – Russell 1000 & Russell 2000

The US earnings outlook has improved considerably from the depths of the pandemic in mid-2020 with the gradual reopening of the US economy this year. Consensus 12-month forward EPS forecasts for both the Russell 1000 and Russell 2000 remain at five-year highs (Chart 1). In recent months, however, expectations for future growth have levelled off as persistent supply-chain bottlenecks, rising wage growth and rocketing energy costs suggest increased pressure on profit margins ahead.

Early in the recovery, the Russell 2000 had been the EPS upcycle pacesetter, having suffered a far steeper earnings collapse than its large-cap counterpart last year. However, after surging off its 2020 lows amid reopening/vaccine euphoria earlier this year, upward revisions to the Russell 2000's 12-month forward EPS forecasts have diminished this year and reversed course in Q3 (Chart 2). Forward EPS estimates have held up far better for the Russell 1000.

Analysts' revision ratios tell a similar story (Chart 3). The ratio of upgrades and downgrades narrowed significantly in Q3, more so for the Russell 1000 than the Russell 2000. Upgrades for both indexes were only modestly ahead of downgrades by quarter-end.

Chart 1: Forward EPS forecasts for both R1000 and R2000 continued to edge higher in Q3, hitting new five-year highs.

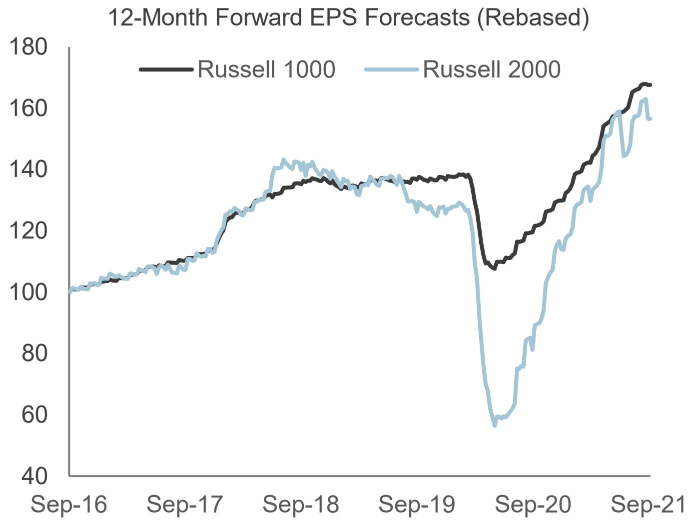


Chart 2: The upgrade cycle for R2000 reversed course in Q3, while that of R1000 has been relatively steady.

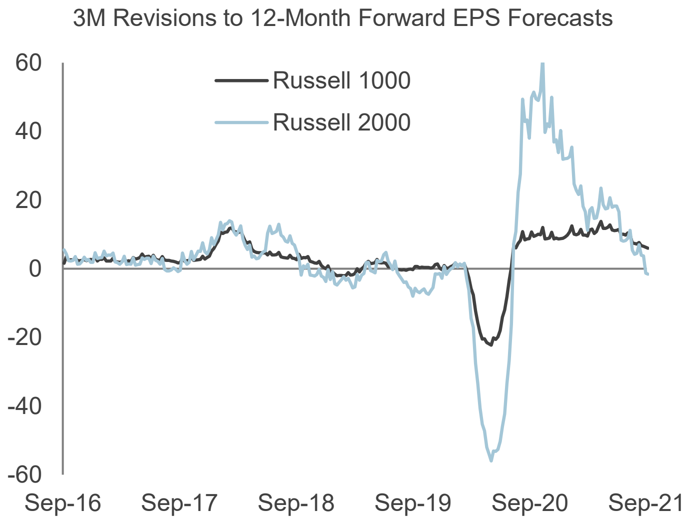
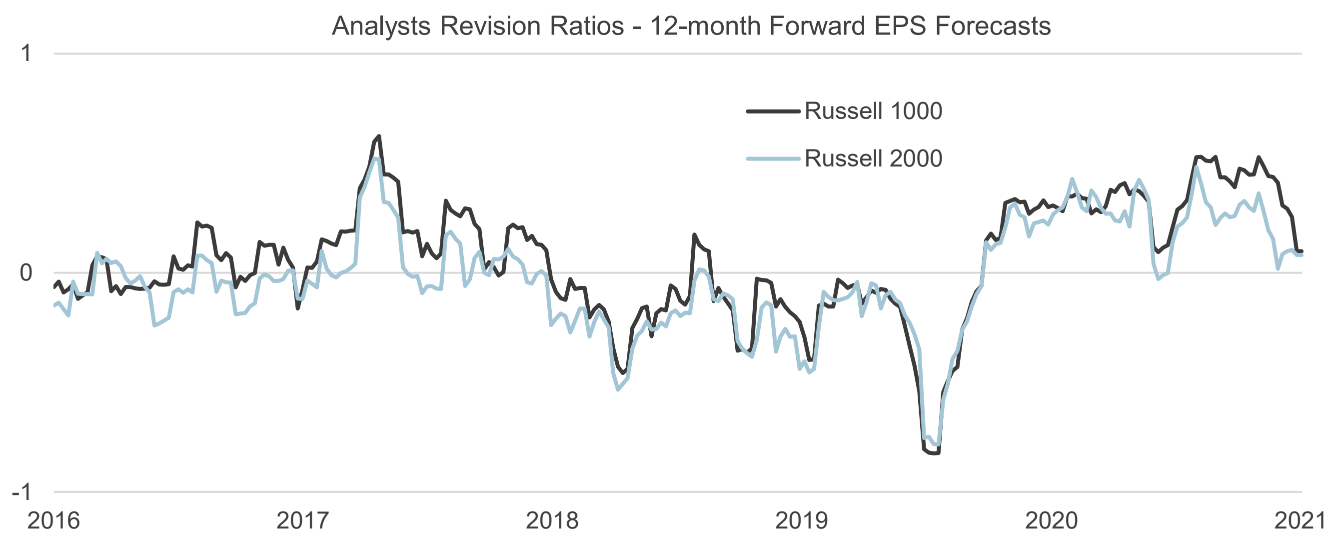


Chart 3: While still outnumbering downgrades, upgrades to forward EPS forecasts for both the large and small-cap indexes have plunged since August, with ratios hovering at or near pandemic lows.



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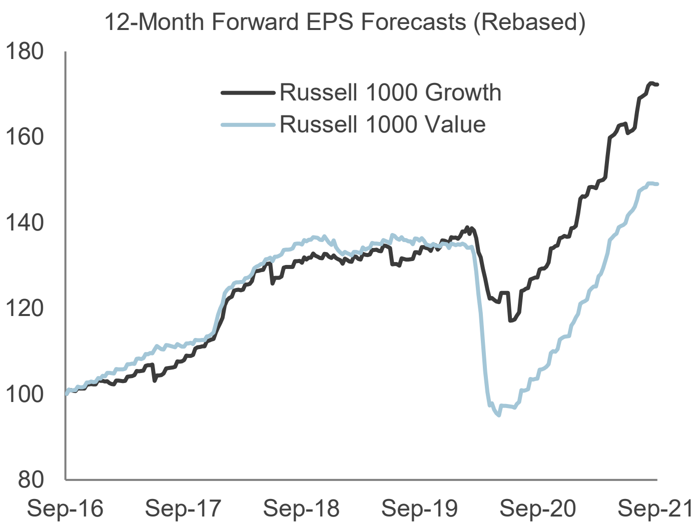
EPS Growth Outlook and Revision Cycle – R1000 & R2000 Growth & Value

As in the case for the large- and small-cap benchmarks, the forward forecast upgrade cycle has moderated across style indexes in recent months, with revisions turning negative for small-cap Value in Q3. Even so, consensus 12-month forward EPS forecasts for both large-cap style indexes hit fresh five-year highs in Q3, and remain at five-year highs for small-cap Value (Charts 1 and 2, left). Small-cap Growth has yet to achieve that milestone.

Upward EPS forecast revisions for both Russell 1000 Growth and Value have wavered since peaking in June (Chart 1, right), with the growth trajectory for the former projected to far outpace that of the latter.

Of the four style indexes, Russell 2000 Value has been the post-crisis EPS upcycle pacesetter, having suffered a far steeper collapse in consensus forecasts than the other style indexes last year. However, since peaking in late 2020, upgrades to forward EPS forecasts the small-cap Value index have been trending lower, and turned negative in Q3 (Chart 2, right). While the revision cycle has been more erratic for R2000 Growth than for its Value counterpart this year, it remains positive after enjoying a sharp upswing in June/July.

Chart 1: Forward EPS estimates for both R1000 Growth and Value climbed to new five-year highs in Q3, far more so for the former, despite the downtrend in forward EPS forecast upgrades for both indexes since June.



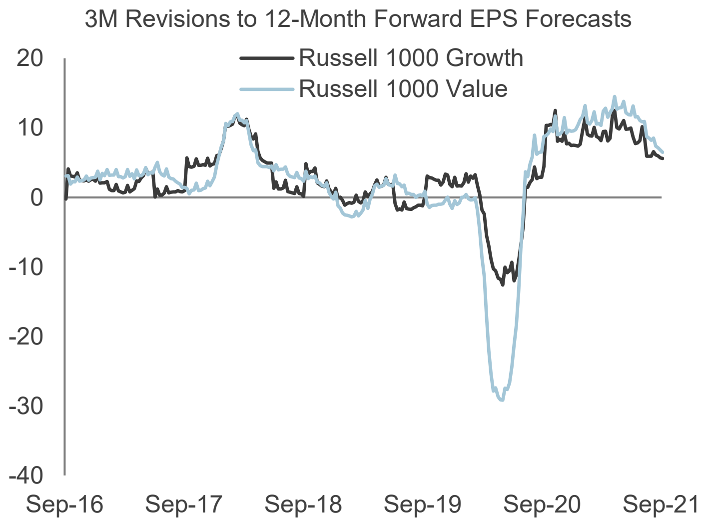
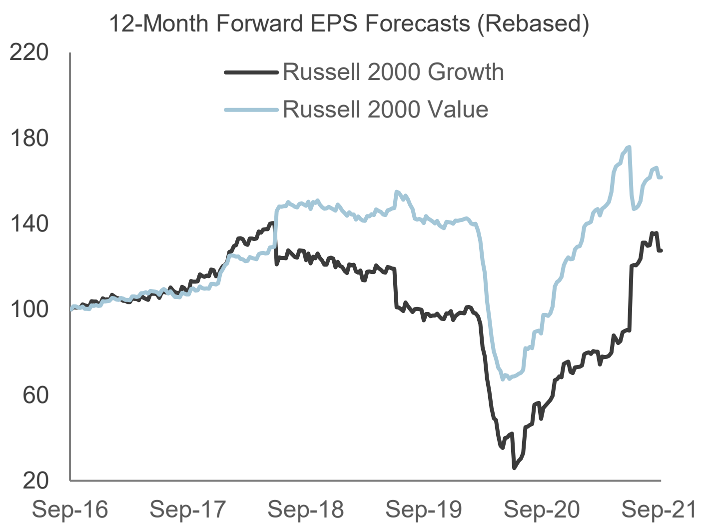
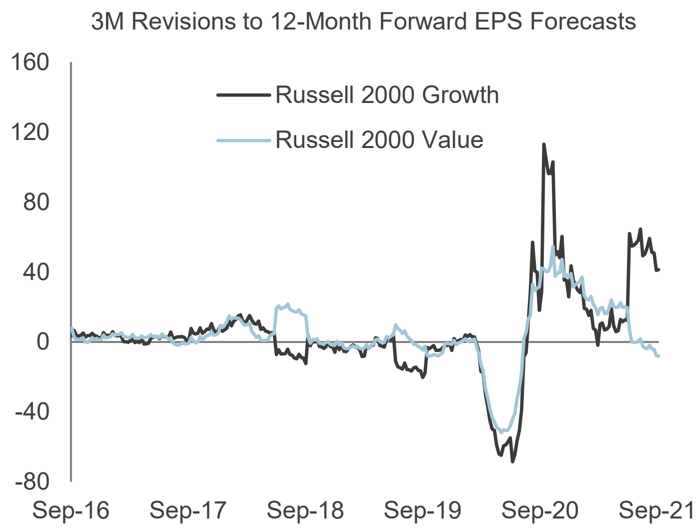


Chart 2: Upgrades to forward EPS forecasts have also diminished for the R2000 style indexes. Despite the recent negative turn in the revision cycle, EPS forecasts for small-cap Value remain at five-year highs; Growth still has catching up to do.





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Valuation Comparisons – 12-Month Forward P/Es

Forward P/Es continued to tighten across the Russell US indexes in Q3 since peaking on depressed earnings last year, as earnings growth (and expectations) have normalized. However, all remain at five-years highs, most significantly those of the Growth indexes.

The Russell 2000 forward P/E has pulled back to around 27 times forward EPS estimates currently, while that of the Russell 1000 has held relatively steadily at around 21 times (Chart 1). The valuation gap between the two indexes has narrowed significantly since peaking in June 2020, and are now more in line with historical norms.

Though Growth typically trades at a premium to Value, the gap remains unusually wide between the Russell Growth and Value indexes (Charts 2 and 3). This is largely the result of the far stronger re-ratings of both the large- and small-cap Growth indexes off of their Covid lows this year. The current premium is particularly pronounced for the large-cap Growth index, which not only enjoyed a much stronger re-rating from its crisis depths, but has also maintained those post-pandemic levels this year.

This year's rally has kept forward P/Es for both Value indexes relatively steady, despite downward EPS forecast revisions.

Chart 1: Forward P/Es for both the R1000 and R2000 have contracted since last September, though significantly more so for the small-cap index. The gap between the two has returned to historical norms.

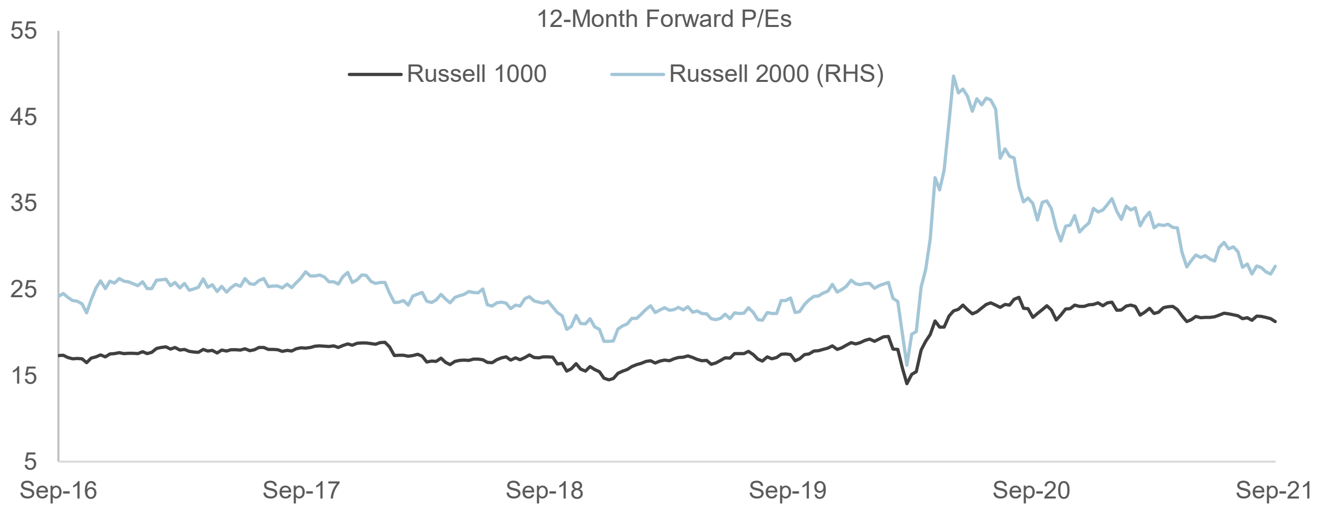


Chart 2: R1 Growth still holds at a huge premium its Value peer, an upshot of its stronger re-rating from Covid lows.

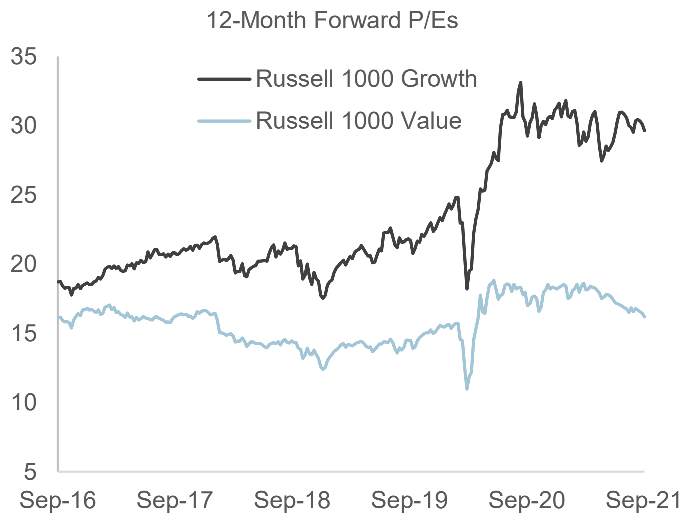
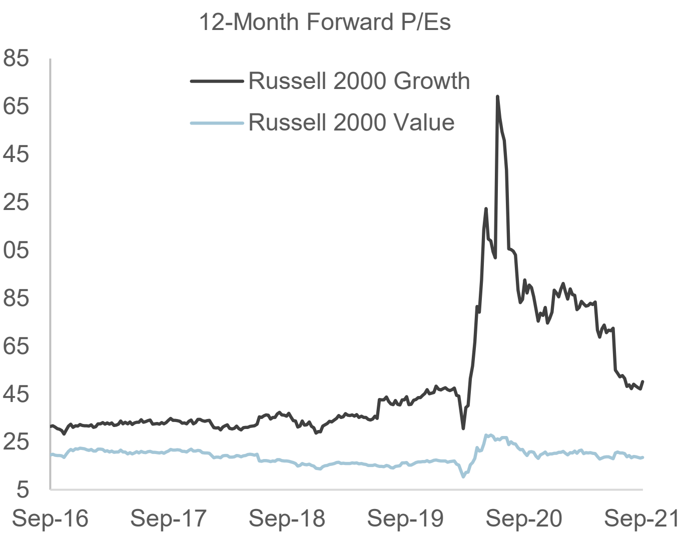


Chart 3: R2000 Growth also retains a hefty premium to small-cap Value, despite its much steeper de-rating.



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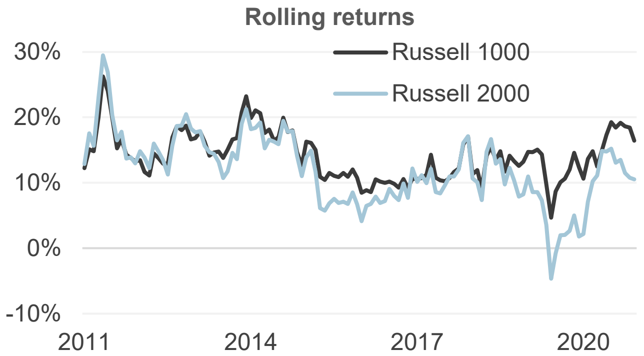
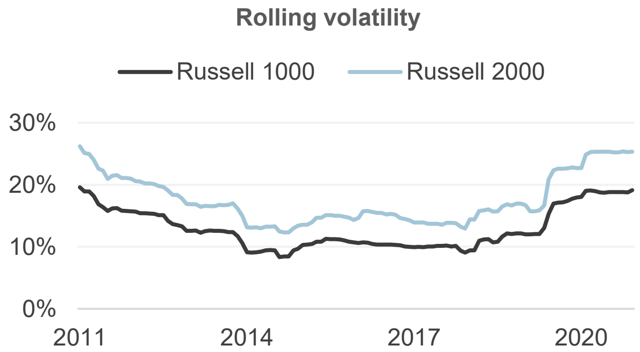
Return & Risk – Rolling Three-Year Patterns

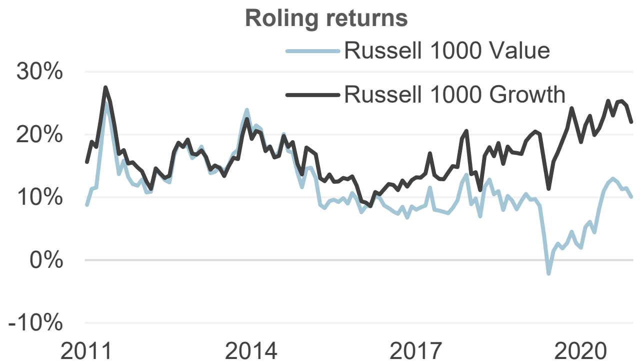
In the most recent three-year period, the Russell 1000 has outpaced the Russell 2000 with much less volatility, as have the large- and small-cap Growth indexes. The rolling 3-yr charts below show return and volatility patterns over time.

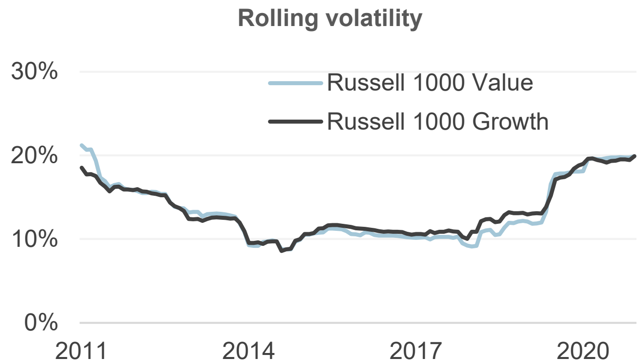
The R1000 has outperformed the R2000 recently, while volatility has risen for both since the pandemic outbreak last year.



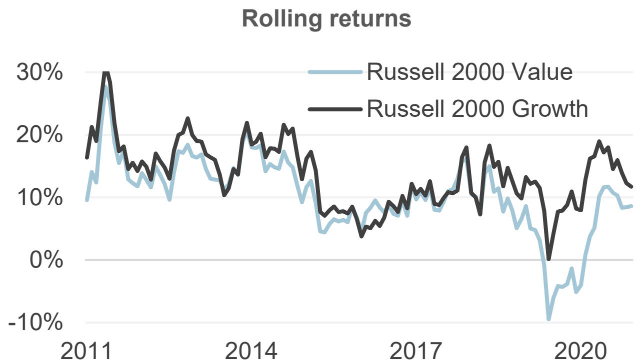


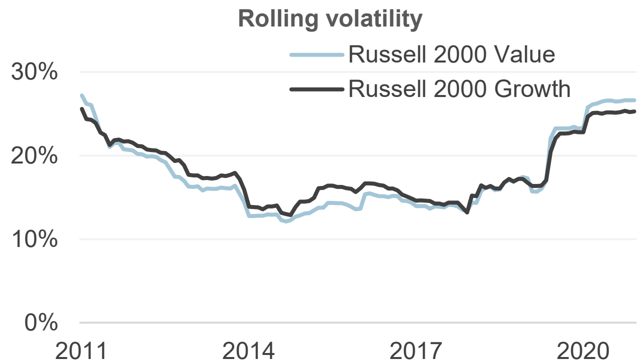
The R1000 Growth significantly expanded its outperformance versus the R1000 Value in 2020, with similar volatility.





R2000 Growth held up better than R2000 Value in the pandemic sell-off and rebound, finishing with slightly less volatility.





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Source: Equity markets data is based on the following: FTSE All-World® (World), FTSE All-Share® (UK), FTSE 100(UK large caps) FTSE 250 (UK mid caps), Russell 2000® (US small caps), Russell 1000® (US large caps), FTSE World ex UK, FTSE Europe ex UK (Eurozone), FTSE World ex US, FTSE Japan, FTSE Asia Pacific ex Japan and FTSE Emerging (emerging markets) Indexes.