DOMESTIC EQUITY MARKET LEADERSHIP: GROWTH OR VALUE?

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Summary and Major Conclusions:

- Growth stocks and growth managers have outperformed value stocks and value managers since 2007, an unprecedented winning streak, but one that is not sustainable. There are credible economic reasons to account for this phenomenon. My thesis is that a reversal in this trend is imminent and that value will outperform growth in coming years.

- There is a general agreement among investment professionals that value stocks tend to outperform growth stocks when measured over very long periods. A landmark study of equity market returns over the past century reveals that large-cap value stocks (+11.9%) easily outperformed large-cap growth stocks (+9.8%).

- But value stocks do not always outperform growth stocks. Rather, stock market history reveals a pendulum effect — a consistent rotation in leadership between growth and value. These rotating periods of leadership have typically been finite, generally lasting less than five years.

- Importantly, the magnitude of outperformance during these periods of rotation in leadership has been enormous. During periods of value stock leadership, excess returns earned over growth stocks have exceeded 5% per year.

- One of the unique characteristics of the current equity bull market is the unusually consistent leadership achieved by growth at the expense of value stocks. Since the end of 2009, the compound annual return on the S&P 500 Growth Index has outperformed the S&P 500 Value Index, 14.2% to 11.4%.

- There are distinct economic, financial, and policy catalysts that determine equity market leadership. History clearly reveals that growth and value stocks each perform best in response to their own unique economic environments.

- Value stocks perform best during the first several years of an economic expansion, whereas growth stocks perform best during the final years of a business expansion, as recession fears become more widespread.

- Value stocks tend to perform best during periods of monetary accommodation, when the Treasury yield curve is in a steep upward-sloping shape. Conversely, growth stocks perform best during monetary tightening cycles, when the yield curve is inverted.

- Value stocks also perform best during periods of rapid growth in corporate earnings. Conversely, growth stocks perform best during periods of sluggish profit growth, when investors are willing to pay a large valuation premium for earnings consistency and predictability.

The primary driver of equity market leadership is investor expectations regarding the next recession. During periods of economic slowdown — when recession fears are elevated — growth stocks invariably outperform value stocks as investors gravitate toward the superior earnings predictability of growth stocks. Conversely, when investors believe that the next recession is well into the future, value stocks perform best. This helps to explain why value stocks always perform best during the early years of an economic expansion, and lag as the cycle matures.

- The overarching driver of equity market leadership involves market expectations regarding recessions. During periods of economic slowdown, when recession fears are elevated, growth stocks invariably outperform value stocks.

- A persistent fear and obsession over recession explains the dominance of growth stock investing over the past decade. Lingering trauma from the Great Recession has resulted in an ingrained bias toward risk aversion, causing investors to embrace high-quality growth stocks over value stocks.

- Economic and policy trends expected to unfold over the next year suggest that a rotation from growth to value stocks is imminent. A long-awaited return to value-stock leadership will be triggered by clear signs of a rebound in world economic growth, accelerating growth in company earnings, and rising bond yields.

- I expect value stocks to outperform growth stocks by five to ten percentage points over the next 12 to 18 months. Industrials, materials, financials, consumer cyclicals, and transports should be the best-performing economic sectors. Small- and mid-cap value stocks should be the best-performing domestic equity categories.

It is important for equity investors to look beyond the direction of the broad market and to develop an understanding of *intra-market or compositional trends*. Examples include performance differentials among the 11 sectors within the S&P 500, between large-cap versus small-cap stocks, and between growth and value stocks. This week's *Economic Perspective* provides an analysis of the issues pertaining to growth versus value stock investing. The report begins with a review of historical performance, followed by an analysis of key economic factors that explain relative investment performance over time.

Investment Thesis: Growth stocks and growth managers have outperformed value stocks and value managers since 2007 — and by a wide margin — an unprecedented winning streak. There are credible economic reasons to account for this phenomenon. *My thesis is that this relative performance trend is not sustainable and that a reversal is imminent, with value outperforming growth in coming years*. I will explain the macroeconomic factors that are likely to trigger this shift in equity market leadership.

Definition of Growth Stocks: The labels "growth" and "value" are self-explanatory. Growth stocks enjoy above-average potential for annual growth in company earnings and dividends. In addition to faster growth, these companies generally achieve a much more consistent and predictable earnings stream. For these reasons, it is not surprising that valuations on growth stocks are in excess of the overall stock market, in some cases by a wide margin. Investors are willing to pay a ***premium*** price for higher quality stocks.

Value Stocks: The value category includes stocks that sell at a market price below a credible estimate of ***intrinsic value***. The underlying value of a business can be calculated on the basis of either future cash flows or net tangible assets. Stocks are often priced below intrinsic value because of temporary problems or issues, creating a buying opportunity for patient long-term investors.

- **Value Traps**: It is important to point out that a stock might be priced at a very low valuation because of deep-seated, long-term structural problems; poor business prospects; and/or a weak management team. In other words, a depressed valuation may simply mean that a stock is cheap for very good reasons. *Stocks of companies in troubled industries with ineffective business models and poor growth prospects are referred to as value traps and should not be confused with legitimate value stocks*.

Growth Company/Value Stock: Investors should not be dogmatic and should exercise flexibility with definitions and labels. Two rational investors can disagree as to whether stock XYZ is a growth or value stock. Many companies enjoy characteristics of both. It is totally reasonable and not inconsistent to define stock XYZ as a ***growth company but a value stock***. *A legitimate growth company can fall out of favor and become neglected to the point where its market price falls well below the intrinsic value of the business*.

Relative Valuations Quantified: As of the end of October, the valuation gap between growth and value stocks was elevated relative to historical averages. As measured by S&P, the *average price-to-earnings* (P/E) ratio for the S&P 500 Growth Index was 23x, compared with 15x for the value index. The *dividend yield* on value stocks (2.5%) comfortably exceeded the modest 1.5% yield for growth stocks. At 5 times, the *price-to-book ratio* for the growth index was more than double that of the value index.

HISTORICAL RETURNS

Academics and investment professionals agree in principle that value stocks tend to outperform growth stocks when measured over ***very long periods***. This conclusion is supported by numerous academic studies, the most widely cited of which are methodical long-term studies by economists Eugene Fama and Kenneth French.

Based upon the Fama-French study, annualized total returns on large-cap value stocks (+11.9%) have easily exceeded returns on large-cap growth stocks (+9.8%) when measured over the period from 1926 through the middle of 2019. When measured over the past two decades (since 2000), the annualized total return of value stocks of 7.1% compares favorably to the 4.8% return of growth stocks.

Pendulum Effect: However, value stocks do not always outperform growth stocks. An analysis of stock market history reveals a pendulum effect — *a consistent rotation in leadership between growth and value*. These rotating periods of leadership have typically been finite, generally not exceeding five years. The current unprecedented period of growth stock leadership has persisted for 12 years.

- **Massive Outperformance**: It is important to emphasize that the magnitudes of outperformance during these periods of rotation in leadership have been enormous. For example, *during those periods when value stocks have led growth stocks, the excess returns earned by value stocks over growth stocks has exceeded 5% annually*.

Small-Capitalization Stocks: It is interesting to note that the performance advantage for value stocks and value managers is even more pronounced for small-capitalization stocks. Based upon data from Fama and French, small-cap value stocks registered a compound annual total return of 14.5% since 1926, far in excess of the 8.9% total return posted by small-cap growth stocks. There are two primary factors behind this extraordinary performance disparity:

- **The Next Microsoft**: In their determination to discover and own the next great growth stock, small-cap growth managers invariably get carried away with an innovative product or "story" behind a new growth company, and therefore pay an excessive valuation premium, creating the potential for disappointment and a steep market price decline.

- **Inefficient Market**: For the reason discussed above, small-company growth stocks tend to be more widely followed by Wall Street analysts, compared with value stocks, which are often neglected. The result is that small- and mid-cap value stocks are unpopular and less well-known, and therefore have market valuations that tend to be more modest.

In short, the market for small-cap value stocks is less efficient than that of small-cap growth stocks, meaning that less information is incorporated in the stock price, thereby creating greater opportunities for upside surprises. Conversely, the temptation of high expectations toward small growth companies implies a greater opportunity for disappointment.

In conclusion, an analysis of equity market history reveals five crucial takeaways for investors regarding equity style investing:

1. Value stocks and value fund managers have outperformed growth stocks and growth managers over the long term, and by a comfortable margin.

2. However, history also shows a tendency for equity market leadership to temporarily rotate from one style to the next — a pendulum effect — usually persisting for periods of roughly three to five years.

3. Importantly, *the magnitude of outperformance during these discrete interim time periods is sizeable, typically in excess of 5% annually*.

4. The past 12 years have been a glaring departure from history: Growth stocks have consistently outperformed value stocks since 2007 by a margin of 4% annually.

5. History reveals an even larger performance advantage for *small-cap value* versus small-cap growth, *an annual average gap of more than 5.5%*.

KEY ECONOMIC CATALYSTS

Can the relative performance of growth versus value stocks be linked to discrete macroeconomic factors? ***History clearly reveals that growth and value stocks each perform best in response to their own unique economic environments***. The primary economic factors driving relative investment performance between growth and value can be summarized as follows:

1. **Stage of the Business Cycle**: An analysis of previous market cycles reveals a very clear pattern, namely that value stocks perform best during the early and middle stages of an economic expansion, whereas growth stocks perform best during the final years of a business expansion, as recession fears become more widespread.

2. **Mid-Cycle Slowdowns**: Mid-cycle slowdowns are periods of economic weakness that do not end in recession. Growth stocks perform best during the early phase of the slowdown, as economic confidence weakens, but value stocks begin to outperform once the market perceives an imminent rebound in economic activity and company earnings.

   - **The Current Cycle**: There have been two mid-cycle slowdowns during the current business expansion cycle: One in 2012 and the other in 2015. *Each of these slowdowns raised market fears of an outright recession, which never occurred*. Instead, GDP growth accelerated in the aftermath of these two temporary economic slumps. *In both cases, value stocks massively outperformed growth stocks over the subsequent one-to-two-year periods*.

- **Current Economy**: While many investors continue to fear an end-of-cycle recession, I continue to believe that the current economic weakness is a classic mid-cycle slowdown. A bottoming in quarterly US GDP growth — expected within the next several quarters — will be the signal for a large-scale rotation from growth stocks into value stocks.

3. **Corporate Earnings Growth**: Value stocks perform best during periods of rapid growth in corporate earnings, while growth stocks perform best during periods of sluggish profit growth. The explanation involves the economic principle of ***opportunity cost***. When overall corporate earnings exceed 15%, the steady and predictable 10% average trendline increases of growth stocks are less appealing. Conversely, when earnings growth falls to 5% or less, the stability and predictability of growth companies is more appealing to investors.

4. **Interest Rates and Inflation**: Growth stocks perform best in an environment of low interest rates and inflation, while value stocks perform best when interest rates and inflation are elevated. Value stocks generally offer investors higher dividend yields, whereas growth stocks offer sustained earnings growth well into the future. Higher interest rates mean that the present value of future cash flows to investors is *more heavily discounted* for growth stocks, thereby reducing current values.

5. **Federal Reserve Policy**: Value stocks tend to perform best during periods of monetary accommodation, while growth stocks perform best during monetary tightening cycles. In a related matter, value stocks perform best when the yield curve has a steep upward slope, while growth stocks perform best during periods of yield-curve inversions.

Expectations for Recession: In my judgment, *the overarching driver of equity market leadership involves market expectations regarding recessions*. During periods of economic slowdown — when recession fears are elevated — growth stocks invariably outperform value stocks as investors gravitate toward the higher earnings predictability and financial security that growth stocks offer. Conversely, when investors believe that the next recession is well into the future, value stocks perform best. This helps explain why value stocks always perform best during the early years of an economic expansion, and lag as the cycle matures.

- **Explaining the Past Decade**: How can the extraordinary dominance of growth stocks during the past decade be explained? In three words: ***Retrenched recession fears***. The severity of the Great Recession and its lingering trauma has left an ingrained bias toward risk aversion and defensive investing among a large segment of the investor universe, who live constantly in fear of the next recession.

- **Playing Defense**: Persistent fears of recession — amplified during the mid-cycle slowdowns in 2012, 2015, and 2019 — caused equity investors to embrace a highly defensive, safety-first portfolio strategy. This resulted in a distinct preference for traditional high-quality growth stocks beginning in 2007, and an aversion to economically sensitive value stocks.

INVESTMENT OUTLOOK

Economic and policy trends expected to unfold over the next year suggest that a rotation from growth to value stocks is imminent. Specifically, a shift in equity market leadership is predicated upon the following economic and policy trends: A resumption of world economic growth; accelerating growth in corporate earnings; highly accommodative central bank policies worldwide; a gradual rise in government bond yields; and a steepening Treasury yield curve.

Pulling it all together, I expect value stocks to outperform growth stocks by five to ten percentage points over the next 12 to 18 months. In terms of economic sector leadership, industrials, materials, financials, consumer cyclicals, and transports should perform best, while consumer staples, utilities, and real estate should lag. Small- and mid-cap stocks should outperform large-cap stocks in 2020. I expect small- and mid-cap value stocks to be the best-performing domestic equity categories.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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