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Durability of value rally may be underestimated

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Many market observers enjoy the growth-versus-value debate — the challenge of calling the “jump ball” between these investment styles. This year has been no exception, especially throughout the summer, as we watched a significant value rally vanish almost as quickly as it began. As evidenced by the past 10 months — or even the past 10 years — attempting to predict the leader of the growth/value race can be a bit of a fool’s errand.

In our view, successful value investors don’t try to play on the twists and turns of sentiment. Positioning a value portfolio goes much deeper than trying to chase trends in investment styles, economic growth, or interest rates. At the same time, we believe the durability of this recent value rally is being underestimated. Based on our analysis, the case for value stocks, particularly in international markets, remains compelling.

The dramatic style rotation of 2020

For many value investors, November 9, 2020, was a big deal — a possible turning point for the style’s decades-long underperformance relative to growth. On that day, we learned of impressive efficacy results in Pfizer-BioNTech Covid-19 vaccine trials. Almost immediately, the market began pricing in a dramatic economic recovery, fueled by the prospects of a return to normal. It was combined with enormous pent-up demand from consumers yearning to spend savings that had reached all-time highs.

This sparked a value rally that gained steam as supply chain issues and sharply stronger demand for goods led to an increase in inflation expectations, interest rates, and bond yields. The 10-year U.S. Treasury yield rose from 0.65% on September 3, 2020, to 1.74% on March 31, 2021. This was good news for value investors, as a rebounding economy, some inflation, and modestly higher interest rates are typically key ingredients for a durable value rally.

Delta arrives and the rally departs

Almost to the day that the 10-year yield peaked in March, we saw growth stocks take the lead once again. What happened? Initial signals came from China. One of the first countries to emerge from the original Covid-19 lockdowns, China has served as a canary in the coal mine for an impending slowdown in global economic growth. New Covid-19 outbreaks in China, combined with declines in exports and services sector activity, halted the notion that global economies were “off to the races.”

The spread of the Delta variant of Covid-19 added to worries about the pace of recovery. It hasn't helped that we have no precedent or a playbook for a global pandemic and investors are reacting to every bit of Covid-19 news.

Interest rates matter for value portfolios

The direction of interest rates almost always impacts the performance of value stocks. We saw the value rally begin to falter when an extraordinarily dovish Federal Reserve, describing inflation as “transitory,” successfully managed inflation expectations down, bringing the 10-year yield down with them. Simple measures of valuation such as price-to-book ratio saw their dramatic outperformance come to a halt — demonstrating the sensitivity between rates and value stocks. We view the current low-rate environment as an unnatural state of affairs, mostly driven by policy, Fed dovishness, and control of inflation expectations.

In our view, value stocks remain inexpensive relative to growth stocks and inexpensive relative to their own fundamentals.

Looking past investors' shifting style preferences

It's important to recognize that growth and value are not mutually exclusive. Regardless of where a stock begins in the style universe, the winners in a value portfolio are typically those that are underappreciated and undervalued. We believe they are companies that are poised to exceed expectations for earnings and revenue growth, that are more disciplined in their capital expenditures, and that will return more capital to shareholders than anticipated.

One strategy is to focus on relative value — the valuation of a company compared with businesses in the same sector. What is the market underappreciating that makes a stock attractive relative to its peer group? This concept may have been lost on many investors in the early months of 2021, when we saw an emphasis on cheapness over quality. This tends to happen with a recovery trade at the start of a new cycle. Enthusiasm over an economic rebound typically leads investors to flock to the cheapest stocks, often with little regard for company fundamentals. Notably, this “cheapness rally” left behind higher-quality companies that became undervalued and presented a few opportune entry points.

In our view, it's also important to define value daily. Once a year, the Russell 1000 Value Index is reconstituted, identifying a value universe of companies with lower price-to-book ratios and low growth rates. However, company fundamentals can change considerably over the course of 12 months; 2020 was a textbook example. In the June 2020 rebalance of the Russell indexes, for example, healthcare stocks shifted to the growth index following their outperformance over the previous 12 months. In the next index rebalance this past June, faltering performance sent healthcare stocks back into the value benchmark. Ongoing analysis of the value universe is necessary to uncover the most compelling stocks, many of which may not currently be part of a value benchmark index.

The potential opportunity in value

We believe we are seeing a compelling valuation gap in today's market. In our view, value stocks remain inexpensive relative to growth stocks and inexpensive relative to their own fundamentals. Also, we believe growth stocks remain expensive by historical measures. Outside the United States, the attractiveness of value stocks — versus their history and versus growth stocks — is even more pronounced, in our opinion.

In our view, investors are overlooking the fact that interest rates, as measured by the 10-year U.S. Treasury yield, are still considerably higher than they were when the value rally began late last year. However, today's generally higher rates — which should be good for value stocks — don't seem to matter to investors distracted by Covid-19 and lower expectations for economic growth. Interest-rate trends in Europe have generally mirrored those of the United States. Germany's 10-year Bund yield, along with those of other European government bonds, has risen recently in response to the hawkish signals from the U.S. Federal Reserve and the Bank of England.

In non-U.S. markets, we are even more optimistic about the rotation into yield-sensitive sectors like banks and commodities. These sectors continue to lag behind their U.S. peers in terms of share price recovery. European bank stocks, which like their U.S. counterparts were the epicenter of earnings uncertainty in 2020, have performed well in 2021. However, their valuations remain at a significant discount to U.S. bank stocks, and we believe they are poised for continued outperformance. European energy stocks, after underperforming for most of the past six months, have recently recovered, likely helped by the rally in oil prices.

Another source of support and growth for yield-sensitive sectors should come with the implementation of the EU recovery and resilience plan. Developed in response to the pandemic, this economic package provides loans and grants to help EU member states recover from the impact of Covid-related recessions. The largest beneficiaries relative to their GDP are likely to be Spain and Italy, as recovery funds are allocated based on the size of the country and the impact of the pandemic on its economy. We believe EU banks will be broad beneficiaries of the EU recovery plan. Loan demand will be generated directly and indirectly by projects funded under the program, which will span energy, transportation, telecom, and residential construction.

On the inflation front, it is worth noting that sharply rising natural gas prices outside the United States may result in higher prices for end goods across the industrials sector. This could raise doubts about the transitory nature of current inflationary trends. If demand holds up in the face of elevated inflation, the associated rise in yields would likely result in a very positive backdrop for value stocks outside the United States, in our view.

As the pendulum continues to swing between style preferences, investors should not lose sight of the compelling valuations and catalysts that we believe are strongly supportive of the value trade across global markets.

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