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The Argument for Value Over Growth Equities Right Now

We came across some research from Bank of America this week (*BofA's Picks for Quality Value stocks, Sept, 29, 2020*) that we thought was particularly interesting because it was 100% based on observations of past cycles, not merely opinions. As always, history does not always repeat precisely, but trends are discernable and anything that can move the odds to the investors favor is appreciated. The topic of the report was the on again, off-again rotation in the stock market from growth and back toward value. Here is a summary of that report.

After growth held the day in a robust August, value again began to see signs of life in September. The conclusion of the report is that this trend toward value is likely to have legs. Briefly, the rationale for that conclusion is based on the following:

1) Value has outperformed growth for at least 3 months coming out of all of the last 14 recessions.
2) B of A's "US Regime Indicator' (a measure of where we are in the economic cycle) has entered into a recovery phase, where value has consistently outperformed.
3) Several valuation models all favor value over growth.

Despite these points, there some compelling arguments for growth dominance to remain, including continued technology disruption and ESG Investing (which favors growth over value). Nonetheless, here is B of A's argument for value.

1) Where We Are in the Economic Cycle Matters

B of A Strategist Savita Subramanian points out that value has outperformed the S&P 500 for at least 3 months measured from the bottom of every U.S. recession since 1929. (See Table at right.)

In addition, the outperformance was not immaterial as it averaged about 12 percentage points during the first 3 months of leadership

Taking a look at the same data from a slightly different perspective, Subramanian then points out how the value factor has outperformed the equal weighted S&P 500 during the recovery phase of the economy with the only 100% hit rate of all the combinations. (See Table below.)

Table 2: Value led following 14 of the last 14 recessions

Relative price performance of the Fama-French Value factor (High Book Value to Market Cap) vs. S&P 500 post recessions, 1929 to 2009

NBER Peak / Trough dates		Value vs SPX performance			
Peak	Trough	Start	End (or 12mth)	# Mth	Rel. Perf. vs SPX
August 1929	March 1933	May-32	Aug-32	3	78.3
May 1937	June 1938	May-40	May-41	>12	27.2
February 1945	October 1945	Aug-45	Nov-45	3	11.1
November 1948	October 1949	Mar-50	Jan-51	10	29.7
July 1953	May 1954	Dec-53	Dec-54	>12	21.5
August 1957	April 1958	Dec-57	Dec-58	>12	26.1
April 1960	February 1961	Jun-60	May-61	11	9.8
December 1969	November 1970	Dec-69	Aug-70	8	9.0
November 1973	March 1975	Nov-74	Nov-75	>12	14.7
January 1980	July 1980	Nov-80	Nov-81	>12	28.3
July 1981	November 1982	Jun-83	Jun-84	>12	16.8
July 1990	March 1991	Dec-91	Jun-92	6	18.1
March 2001	November 2001	Oct-01	Jun-02	8	10.3
December 2007	June 2009	Feb-09	Apr-10	14	25.9

Source: BofA US Equity & Quant Strategy, Dartmouth University data library, Bloomberg

Table 4: Style performance in the four US regime indicator phases (relative to equal-weighted S&P 500)

		Value	Growth	Momentum	High Quality	Low Quality	High Risk	Low Risk	Large Cap	Small Cap	Low Beta	High Div. Yield
Phase 1	Avg:	22.9%	-8.5%	-7.7%	-6.2%	7.4%	19.9%	-9.8%	-9.3%	20.2%	-8.4%	4.5%
Recovery	Median:	18.4%	-6.2%	-5.3%	-7.7%	10.0%	13.0%	-12.5%	-7.8%	11.2%	-8.2%	4.3%
	Hit Rate:	100.0%	14.3%	57.1%	28.6%	71.4%	71.4%	28.6%	14.3%	71.4%	14.3%	85.7%
Phase 2	Avg:	2.2%	9.0%	10.1%	1.7%	2.1%	6.3%	-4.2%	0.3%	1.2%	-8.4%	-6.7%
Mid Cycle	Median:	2.2%	1.9%	2.7%	0.0%	2.1%	7.1%	-4.9%	-0.8%	4.3%	-6.2%	-5.7%
	Hit Rate:	62.5%	75.0%	87.5%	50.0%	62.5%	75.0%	25.0%	50.0%	75.0%	0.0%	0.0%
Phase 3	Avg:	-0.1%	-7.6%	-4.7%	4.3%	-8.3%	-14.8%	8.8%	-1.3%	-10.0%	4.0%	4.6%
Late Cycle	Median:	-0.8%	-1.8%	2.3%	5.8%	-8.1%	-15.4%	9.8%	2.3%	-9.1%	-2.6%	1.8%
	Hit Rate:	42.9%	28.6%	57.1%	71.4%	14.3%	0.0%	71.4%	57.1%	0.0%	42.9%	71.4%
Phase 4	Avg:	1.3%	-0.8%	3.5%	4.1%	-5.4%	-4.9%	4.8%	5.4%	-1.1%	-0.3%	-1.7%
Downturn	Median:	-4.9%	-1.9%	1.1%	2.3%	-2.1%	0.0%	3.0%	6.3%	-6.3%	0.1%	-1.6%
(Current)	Hit Rate:	33.3%	50.0%	50.0%	66.7%	33.3%	50.0%	83.3%	83.3%	16.7%	50.0%	33.3%

Note: Performance is calculated as price return relative to equal-weighted S&P 500, for all styles except High Dividend Yield, where total return for the style and the index are used. Hit rate = % of months in phase where style outperformed equal-weighted S&P 500.

Source: BofA US Equity & Quant Strategy, Refinitiv, ICE Data Indices, LLC, Institute for Supply Management, Bureau of Labor Statistics, Federal Reserve

2) The Push/Pull Between Value and Growth is Driven by Profits, Not Interest Rates

Historically, as shown in the table at right, value has outperformed during periods of rising profits no matter the direction of interest rates, suggesting that the profit rebound in an economic recovery is a primary driver for the outperformance of value.

Table 5: Profits, not rates, drive style rotation

Value vs. Growth annualized avg. quarterly performance during different profits and rates regimes (1926 to today)

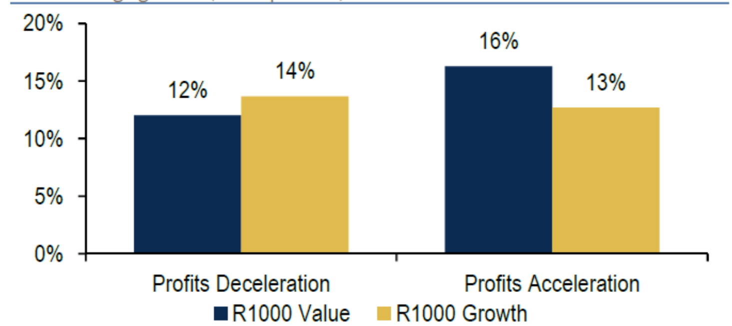
	Rising Rates	Falling Rates
Accelerating Profits	6.2%	8.8%
Decelerating Profits	0.6%	1.7%

Note: Growth and Value indices based on Fama-French measure of Growth and Value
Source: BofA US Equity & Quant Strategy, Fama-French Benchmark Portfolios historical returns, Federal Reserve Board

Confirming this, the chart at right shows the outperformance of the Russell 1000 value index when profits are rising and the underperformance of the value index when profits are declining.

Chart 3: Russell analysis: Value beats Growth when profits accelerate

Style index performance during periods of decelerating and accelerating S&P 500 earnings growth (1982-present)

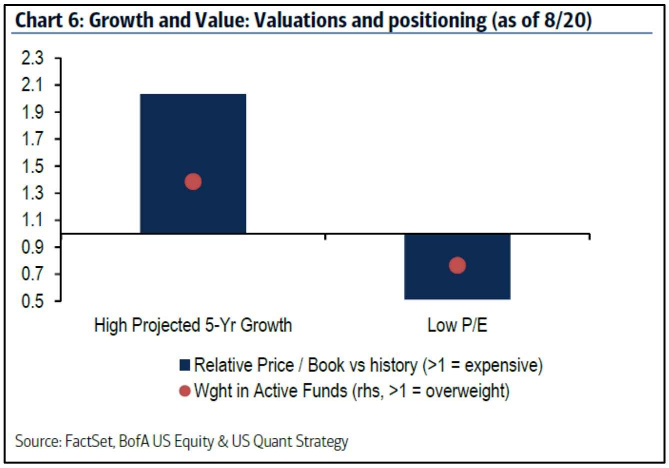


Note: Excludes the Tech Bubble ; source: S&P, Russell, BofA US Equity & Quant Strategy

As Subramanian explains: *"When growth is scarce, investors will pay up for growth. As growth broadens out, investors become more price sensitive and seek out the cheapest growth they can find."*

3) Growth is Massively Overweighted in Long Only Funds

The chart at right is a little confusing, but the blue bars show the relative price-to-book compared with historical norms, where a number above 1 would indicate expensive by historical standards and below 1 would be cheap by historical standards.

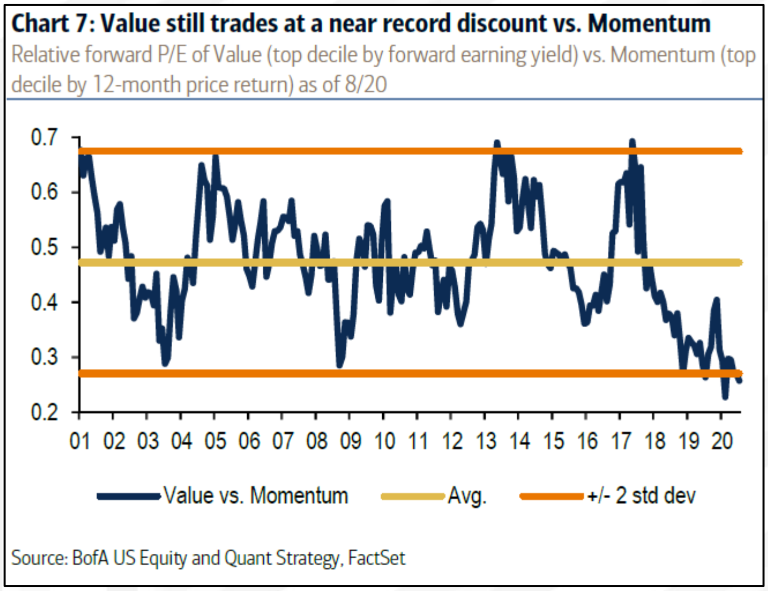


The red dot shows the weight of growth and value stocks in active funds with a value of 1 being the equivalent of a market weight. In other words, active funds are more than 30% overweight growth and materially underweight value.

Again, Subramanian observes: *"Active managers maintain a near-record over weight in growth sectors like TMT (Tech, Media and Telecomm) and a near record underweight in value sectors like Financials. Banks are at a Post–Great Financial Crisis record underweight and FANG carries an overweight of 1.7x by hedge funds, and 1.8x by long only mutual funds. On almost any measure, and among almost every investor group, growth is over-owned and value is neglected."*

4) Value is Undervalued

Again, the chart at right needs some explanation: The tan line is the average valuation of momentum stocks vs. value stocks. The orange lines represent two standard deviations above and below the average, or mean.



Statistics would suggest that this relative valuation should lie within two standard deviations (2 sigma) 95% of the time. And indeed, a 2 sigma move in either direction has typically marked the limit the valuation differential and that is precisely where we sit today.

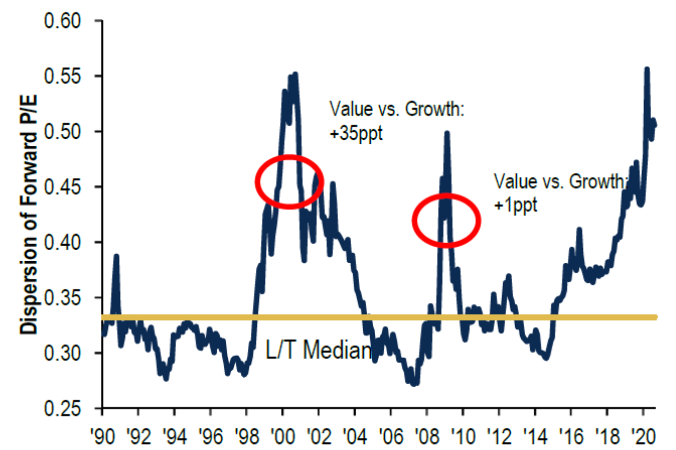
Subramanian points out *"The only other instances during which value traded at such a steep discount were 2003 and 2008, after which value outperformed momentum by 22ppt and 69ppt, respectively, over the subsequent 12 months."*

5) Reversion to the Mean

As growth grows pricier forward P/Es rise and the dispersion of forward P/Es for growth stocks vs. value stocks rises and at times reaches extremes, as shown in the chart at right. (Tan line is average dispersion over time.)

Chart 9: Valuation dispersion peaks usually precede Value cycles

S&P 500 valuation dispersion on forward P/E, 1990-8/20



Note: dispersion is measured as the coefficient of variation of forward P/E

Source: FactSet, BofA US Equity & Quant Strategy

Subramanian points out that when valuation dispersion has been this high or higher, Value stocks have outperformed Growth 95% of the time over the subsequent 12 months, by 24 percentage points on average.

As we said earlier, none of the above is a guarantee of anything. This may be a time when growth outperforms value to extremes we have not seen before, but this report presents a strong body evidence that the start-stop rotation away from growth stocks that we have seen all summer long gives us good reason to believe that the trend is ultimately real and more important, that after a very long winning streak for growth, Wall St. is probably not well prepared for this rotation.

Our portfolios have benefited from growth stocks, but under our discipline, we have never abandoned value in our effort to keep portfolio risks balanced.

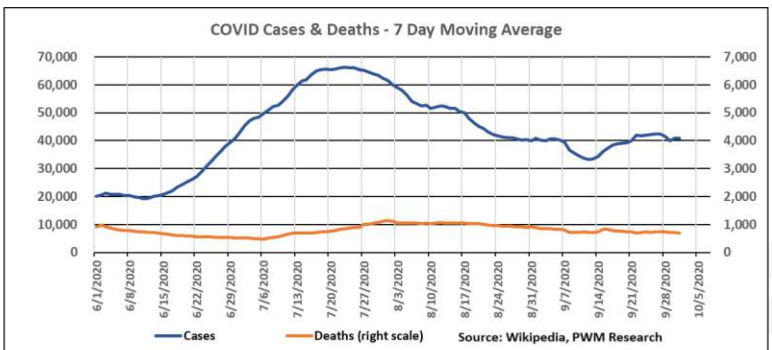
Is a Second Wave Coming?

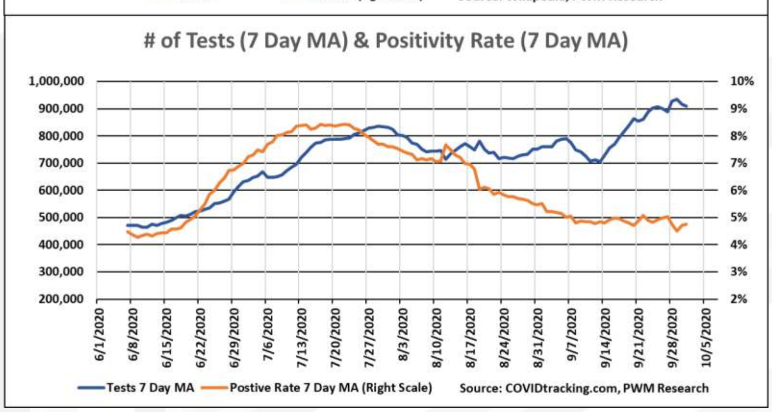
As we move into Autumn, we are increasingly bombarded with speculation about whether a second wave is coming, how it will interact with the seasonal flu and whether we may have to close down again. As little of what wee see in the media is based on fact, we'd thought we'd take a look at the current facts.

The top chart (below) shows a 7-day moving average of COVID cases and deaths since June 1. We us a moving average because the daily data gets very choppy based on on how the data is delivered each day. Over the course of a week, that choppiness gets filtered out and trends become easier to see. As shown around mid-September, daily COVID cases began to rise again after being in a decline since late July. That rise has leveled off very recently and stands at roughly 4000 new cases per day nationwide. The especially good news on the top chart is that the rise in cases does not appear to have led to a rising number of deaths. This is something we have discussed previously, noting that COVID treatments are improving and that new cases have tended to be clustered among the young, who do not appear to be as susceptible to the disease. In fact, the CDC recently revised its [estimate of the infection mortality ratio] by age that demonstrates that effect. Of course, this is still an estimate but the estimated mortality rate has been consistently declining.

Age	Est. Mortality Rate
0-19 years:	0.003%
20-49 years:	0.02%
50-69 years:	0.5%
70+ years:	5.4%

The real question then becomes the reason for the recent rise in the number of cases and at least so far, the reason appears to be more testing. We say that because the positivity rate of COVID testing has stayed roughly flat (see bottom chart at right).





The number of tests has risen substantially, which makes sense as schools opened and testing in that group ramped up. So even with a flat positivity rate, we are seeing more cases. However, if this were a second wave, we'd expect the positivity rate to be increasing.

None of this means that a second wave won't come, but it does appear to indicate that if it is coming, it has not yet started.

Seasonal flu will be another complicating factor as the symptoms can be very similar. However, we do have some experience with a COVID/seasonal flu combination. Back in the Spring, the southern hemisphere was in the middle of flu season as COVID broke out. Their experience was not what was originally expected. The actions to prevent COVID (distancing, masks, etc.) also had the effect of reducing the seasonal flu to very low levels. If we can maintain our discipline, the COVID flu combination does not have to be a massive problem.

Trump has COVID-19, What are the implications?

Running the Country: As long as he is not incapacitated, Trump will continue to lead the US as other world leaders have done. If incapacitated, VP Pence will take command. This makes watching the VP's COIVD tests all the more important. Thus far, he is negative, but he has likely had close contact with Trump, so that can easily change over coming days. If both are incapacitated, Nancy Pelosi would take control.

The Election: The election process will continue no matter what happens. The campaign, however, will obviously change. Presidential debates are likely off-the-table, unless there can be some agreement for a Zoom debate. (This might actually be better, as the moderator could turn off one mic when the other is speaking.) The VP debate is likely still on, and of greater importance, but subject to the VP remaining clear of COVID. It will be interesting to watch the election betting odds to gauge sentiment.

Effect on Markets: The kneejerk reaction is a lower stock market, but with more muted responses on fixed income and gold markets. What matters more is how the market acts over the next several weeks. We would not expect any big reaction in either direction. We are already hearing numerous comments citing 'increased uncertainty' and that market don't like uncertainty. This is a concept that we dislike. The world is always uncertain. We don't see the election as any more uncertain today than it was before this announcement. The process of replacing a President that is incapacitated is well known and has successfully transitioned numerous administrations. We would expect a similar transition if Trump's illness becomes serious.

COIVD Stimulus Legislation: We perceive the odds of a stimulus to be very low and nothing here changes that. A deal before the election would be a substantial positive for the stock market.

SCOTUS: Look for Supreme Court nominee, Amy Coney Barrett, to be pushed through the Senate with greater speed an urgency as they will be unwilling to risk a sudden change in administration affecting this appointment.

What We’re Reading

Wall Street Versus Main Street: Are Stocks in a Bubble?

Why demand for seaweed is about to boom (15 min. Video)

White House, Democrats remain far apart on fresh round of COVID aid

The night American democracy hit rock bottom

Jobless claims edge lower as slow recovery continues

A Democratic sweep may not be so bad if it leads to a bigger stimulus

One Day, Thousands of Job Cuts: Economic Pain Is Deepening

American, United move ahead with furloughs; will recall with aid deal

The Stock Trading Revolution

Pain Is Beginning to Creep Into Markets, Says BlackRock’s Barry

The above headlines are from multiple sources, including, Reuters, The Wall Street Journal, The NY Times, Bloomberg, Barron’s, and CNBC.

Markets This Week

The back and forth between growth and value continued this week with Value one again taking the lead. A strong week in the stock market was led by REITs, Homebuilders and small and mid-cap indexes, while Information Tech and communication services lagged and energy continued to be the weakest link. Strength in stocks was offset by some weakness in the fixed income sector with long term treasuries down almost 1.5% for the week. At the other end of the quality spectrum high yield debt was strong as yield spreads narrowed.

US Equities	1 week	YTD	Fixed Income	1 week	YTD	Sector Breakdown	1 week	YTD
S&P 500 (SPY)	1.55%	4.79%	20+ Yr. Treasuries (TLT)	-1.43%	21.13%	Consumer Disc. (XLY)	2.98%	19.07%
Dow (DIA)	1.89%	-1.70%	Barclays US Aggregate (AGG)	-0.19%	6.20%	Info. Technology (XLK)	0.90%	26.39%
NASDAQ (QQQ)	0.98%	29.52%	Intermediate Municipal (MUB)	-0.22%	2.73%	Financials (XLF)	3.36%	-19.88%
Russell 1000 Growth (IWF)	1.39%	22.94%	US Corporate Bonds (LQD)	0.42%	6.94%	Health Care (XLV)	1.07%	3.19%
Russell 1000 Value (IWD)	2.19%	-11.70%	Barclays US High Yield (HYG)	1.07%	-2.12%	Utilities (XLU)	3.33%	-4.35%
Vanguard Mid-Cap (VO)	3.04%	0.89%				Industrials (XLI)	1.44%	-3.58%
Vanguard Small-Cap (VB)	3.98%	-4.80%				Energy (XLE)	-2.87%	-49.45%
						Materials (XLB)	1.34%	4.32%
International Equities	1 week	YTD	Commodities	1 week	YTD	Consumer Staples (XLP)	1.67%	3.15%
MSCI EAFE (EFA)	1.29%	-6.69%	Commodities (PDBC)	-2.10%	-19.69%	Comm. Services (XLC)	0.87%	10.66%
MSCI Emerging (EEM)	2.50%	-1.39%	Gold (GLD)	2.03%	24.94%	REITS (VNQ)	5.46%	-10.13%
						Homebuilders (XHB)	5.87%	21.88%

The table above is an analysis of the weekly and year to date returns of various markets/sectors that we follow (More RED = worse performing markets/sectors; More GREEN = best performing markets/sectors). Source: PWM Research

Retirement Planning:

[A Departure Checklist for Your Unexpected Retirement.]

Here is a simple checklist you can use to properly plan for an unexpected turn toward retirement.

Tax Planning:

How Taxpayers Can Take Advantage Of Trump's Tax Planning.

Studying how Donald Trump goes about tax planning can actually help you improve your own plans as well.

Estate Planning:

Why Estate Planning Is Worth Every Cent.

The value of an estate plan is in the planning. Without planning, the documents are worse than useless.

Health:

'Provocative results' boost hopes of antibody treatment for COVID-19.

New research and testing has been conducted that has furthered the benefits of using antibody treatments to defeat coronavirus cells within the body.