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SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

Andrew Slimmon March 2021 Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | MARCH 2021

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THREE QUESTIONS. THREE CHARTS.

1. US Value

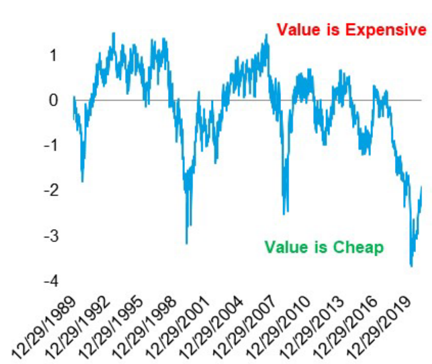
We have received a number of questions regarding whether value's relative outperformance has run its course. *We think there is much more upside*.

Display 1 shows the value spread. The chart on the left is a long-term view and the chart on the right, short-term. Both measure how cheap[1] the 100 cheapest stocks in the Russell 1000 index are relative to the overall index versus history.

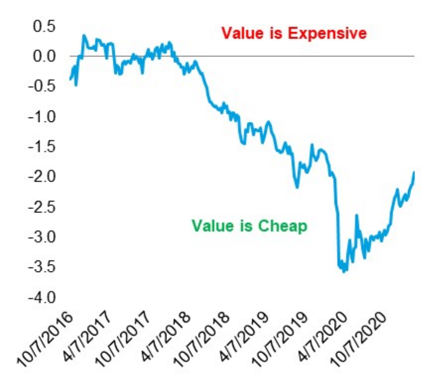
DISPLAY 1

Value Spread[1]

December 31, 1989 – February 26, 2021



October 7, 2016 – February 26, 2021



Source: Bloomberg, Factset.
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[1] Value spread as defined by the valuation differential between the cheapest decile of the Russell 1000 versus that of the market average. Valuation is based upon price-to-book, price-to-earnings, and price-to-free cash in terms of standard deviation.

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As you can see, in recessions, value stocks become unusually cheap. This past recession, value became even cheaper than the previous three recessions! But post-recession, value stocks repriced back to a modest level of expensiveness (above 0 standard deviations). That means they outperformed.

As evident by the Display 1 chart on the right, it's happening again. *We see no reason to believe that value stocks won't reprice back to at least 0 standard deviations*. (We could even make the argument that the Fed's commitment to remain on hold longer suggests value could move well *above* 0.)

The question then becomes, what is in the value bucket today? *61% are financials*. No other sector is above 10%. We are overweight US financials.

Display 1 is not complicated, and we hear a lot about investors "liking financials". If that's the case, why does this fat pitch still exist?

I think the following quote explains it:

> *What surprises me is how reluctant fund managers/institutional investors are to shed exposure to the past leadership when we're at what looks like a breaking point in terms of the economy and political environments. It's the hot stove mentality, because every year since 2008, where anyone has bet on rising interest rates and inflation, they've been smacked down.*
> Savita Subramanian/Bank of America Strategist[2]

2. US Growth

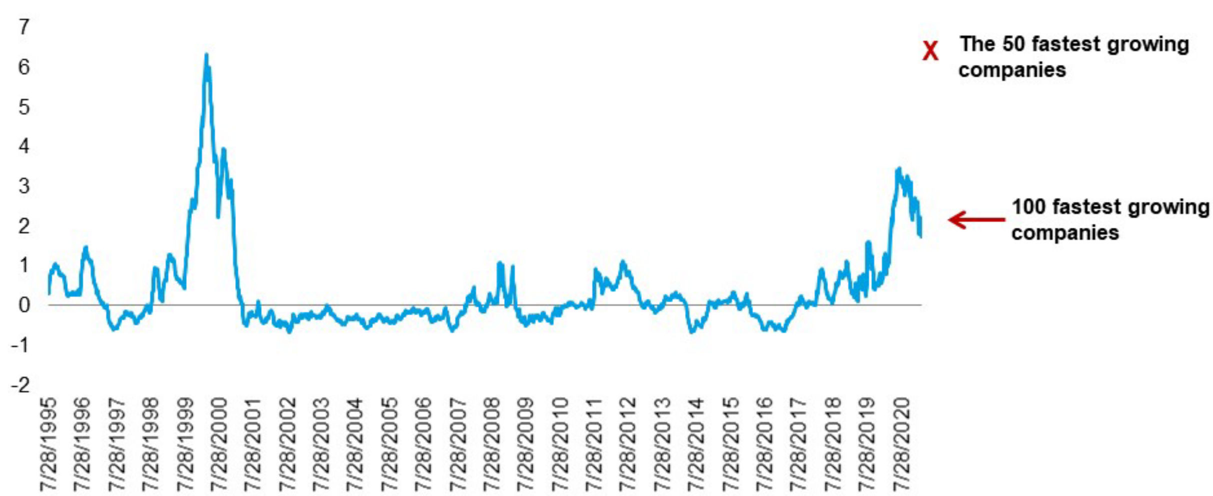
The second most frequently asked question is whether there is a bubble in growth stocks analogous to 1999/2000. *We do not believe growth stocks in aggregate are at risk of a 2000/2001 meltdown, although a subset are*.

Display 2 shows a chart that looks at how expensive the highest growth companies are relative to the market relative to history.[3]

DISPLAY 2

High Growth Valuation

July 1995 through February 2021



Source: Factset.

High growth as defined by the valuation differential in terms of standard deviation between the highest growth decile of the Russell 1000 based on low beta, high growth, high volatility, and high momentum versus that of the market median.

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[2] Barrons/ February 2021.

[3] As measured on a price to book value basis.

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While the 100 fastest growing companies nearly achieved four standard deviations expensive last summer, that was nowhere near the level where they traded in late 1999. In addition, the most recent valuation level has already come down from its peak. Keep in mind, the Large-cap Growth index (RLG) has underperformed the S&P 500 by over 700 basis points since last August[4].

However, a subset of this group, the 50 fastest growing companies (marked by the X), are trading at bubble territory levels. While perusing this group of stocks, another quote comes to mind:

> *In every stock market cycle, there is a dominant investor who captures the market's zeitgeist by incorporating and reflecting the ideals and beliefs of the times. And there is no price too high to pay for these concepts……in this case disruptive technologies.* Doug Kass[5]

As a result, while we are underweight US growth stocks in our strategies, we certainly own some. Just not any of the 50 most expensive growth stocks!

3. A Correction

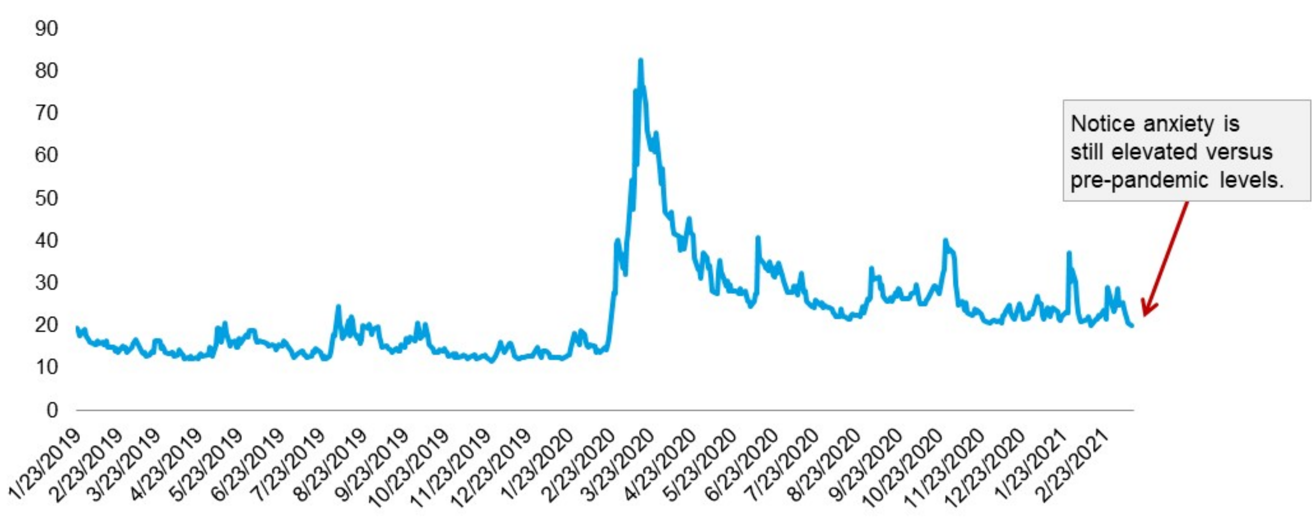
The market continues to refuse to offer opportunities to invest, other than at all-time highs. That leads to the third question we regularly receive. When is a fatter pitch coming, and what will be a good barometer to use as a signal? In our opinion, *watch the VIX*.[6]

As you can see in Display 3, the VIX has dropped significantly from pandemic levels, sitting at just over 20, but remains elevated versus pre-pandemic levels. That suggests anxiety levels remain high, a bullish sign in our opinion. It's a relatively safer time to invest when the traffic light (the VIX) is flashing caution than when it's flashing the "all-clear" green light. To us, green means complacency and too much bullishness.

DISPLAY 3

VIX

January 2019 – February 2021



Source: Bloomberg.

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[4] Bloomberg as of March 15, 2021.

[5] Barrons, February 2021.

[6] The VIX measures the estimate of the expected volatility of the S&P 500.

A VIX above 20 is still flashing caution mode, but we think at some point this year, the VIX should drop to pre-pandemic levels…the 'green light'.

Historically, when the VIX remains elevated above 20 for an extremely long time (as it has since last year) and then finally sustainably breaks below 20, the returns for the market over the next 3 months have historically been uninspiring.[7]

Watch the VIX. We suspect as we get to post-pandemic times, a burst of enthusiasm (life back to some level of normalcy) could finally push the VIX back to mid-teens levels. Historically, times of complacency are when markets have become more vulnerable.

Andrew

[7] Bespoke, January 2021.

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