Morgan Stanley
INVESTMENT MANAGEMENT

# The New Normal: Higher-for-longer is likely and risk has a cost in a new regime

**WHITEPAPER** | VALUE TEAM | December 2023

## KEY TAKEAWAYS

- The post-global financial crisis period through 2021 was an anomaly; we are now closer to the ~50 years that preceded this 15-year-long anomaly.
- Without the Magnificent Seven, the Russell 1000 Growth Index's returns are far more like those of the Russell 1000 Value Index in 2023.
- We are now in a different rate regime, where there may not be one winner who takes all, and where a balanced equity exposure is essential.

**BOSTON** – In our travels meeting with clients and prospects, we learned that many have been disappointed in this year's growth surge because they believed at the end of 2022 that value would continue to outperform growth for longer. Some consider 2022 an anomaly, and others even claim that value investing is dead, and are allocating only to core or growth U.S. equities.

Moreover, they believe this increase in rates is the anomaly, and that we will see a reversion back to the quantitative easing (QE) period that took place from the global financial crisis (GFC) through 2021. We would argue the opposite, that the post-GFC period through 2021 was the anomaly, and that we are now in a new normal more akin to the 50 or so years that preceded this ~15-year-long anomaly.

One could make the case that the stimulus injected into the U.S. economy following the pandemic should result in a similar period to that of the post-GFC, where extended quantitative easing created a long-term near-zero rate environment. However, this comparison is a challenging one to draw. In reality, QE persisting for such a long period aided the U.S.' debt in running up an additional $23 trillion.[1] Thus, the Federal Reserve has now reached a challenging

[1] Source: Strategas.

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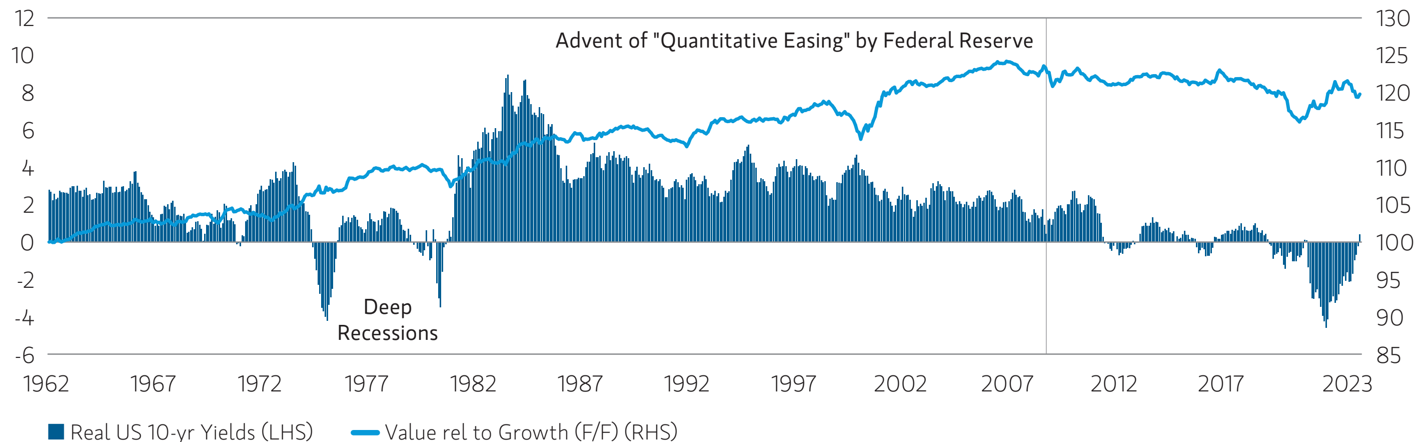
**DISPLAY 1**

**Risk now has a price**




As of 30 September 2023. LHS is the rates %, RHS is cumulative returns %. Source: Fama & French [Kenneth R. French Data Library]; Eaton Vance; Bloomberg. Past performance is no guarantee of future results. Fama French denotes value stocks as those with high book-to-market ratios, and growth stocks as those with low book-to-market ratios.

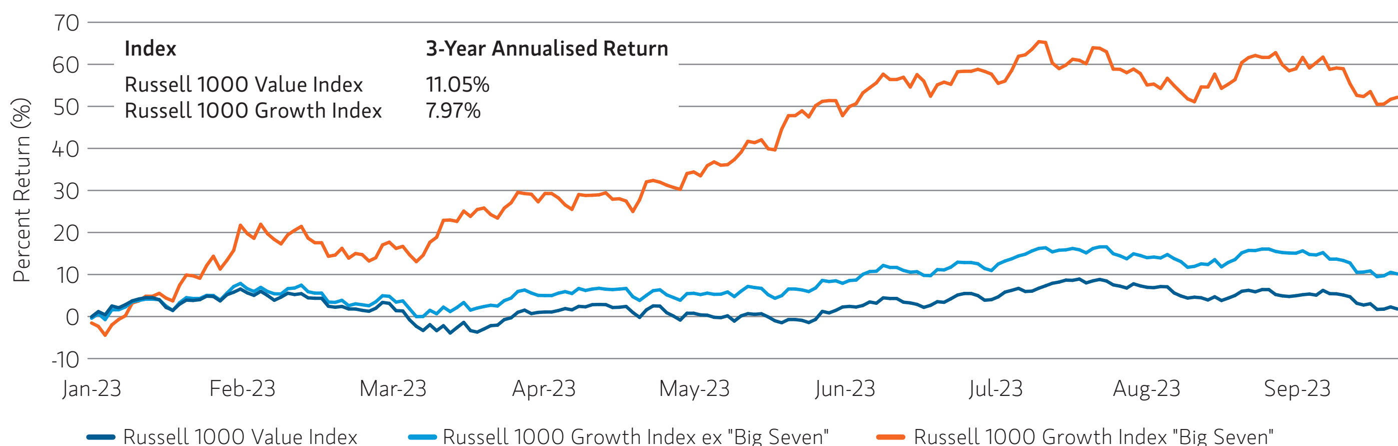
balance: how to control inflation and simultaneously support economic growth. This creates a different rate regime, where there may not be one winner who takes all, and where a balanced equity exposure is essential.

## If we are in a new rate regime, how do we explain 2023 value vs. growth performance?

Looking under the hood, the Magnificent Seven[2] have lived up to their name this year. However, when you look closely at the Russell 1000 Growth Index, ex-the seven heavyweights, the story becomes more surprising. Without the Magnificent Seven, the Growth Index's returns are far more like those of the Russell 1000 Value Index in 2023. Therefore, beyond

**DISPLAY 2**

**Muddled 2023 Year-to-Date Performance Underneath the Magnificent Seven**




Source: FactSet as of September 30, 2023. Magnificent Seven includes Microsoft, Apple, Alphabet, Amazon, Tesla, Meta Platforms, and Nvidia. Past performance is no guarantee of future results. For illustrative purposes only and should not be construed as a recommendation or solicitation to buy or sell any security. It is not possible to directly invest in an index.

[2] The term Magnificent Seven was coined by Bank of America analyst Michael Hartnett in reference to the seven heavyweights in the S&P 500 Index: Microsoft (MSFT), Apple, Alphabet, Amazon, Tesla, Meta Platforms, and Nvidia. It's a nod to the eponymous 1960 film starring Yul Brynner, Steve McQueen, and Charles Bronson.

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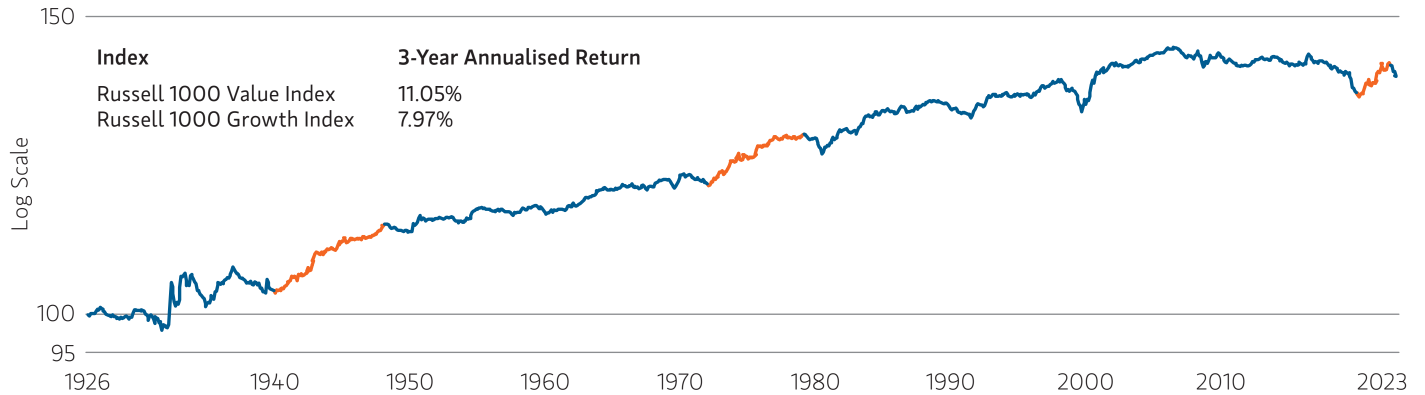
**DISPLAY 3**

**A Century of Value: Cumulative Returns to Value from 1926-2022**




As of 30 September 2023. Source: Fama & French [Kenneth R. French Data Library]; Eaton Vance. Graph represents Fama & French's HML Factor model cumulative monthly returns. Past performance is no guarantee of future results.

those seven behemoths, the market story has been far murkier this year.

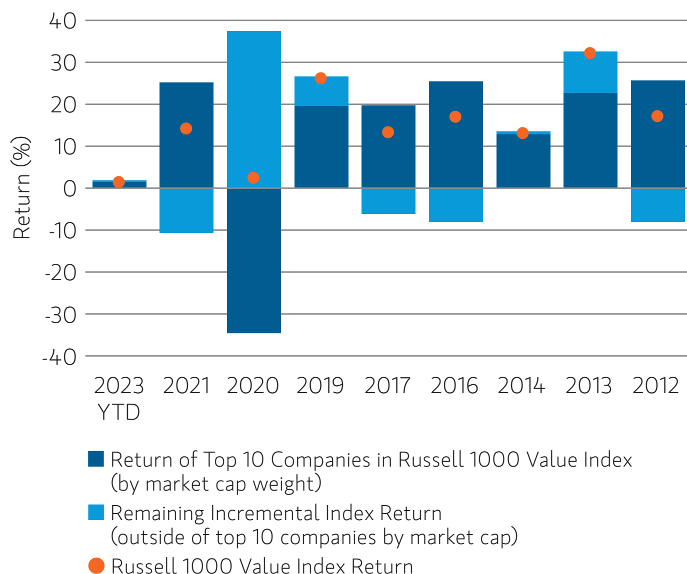
It may surprise many that, on a three-year annualized basis, value is outperforming growth by over 3% by comparing Russell 1000 Value Index to Russell 1000 Growth Index returns over three years, as of 30 September 2023. Looking back further at the past century, seeking out undervalued securities has continuously paid off (*Display 3* below). The last decade of zero-to-negative real rates (in which growth thrived) was the anomaly.

We believe all investors have behavioral biases. We have written about the library of portfolio exercises we perform as a team to combat these biases and promote longer-term idea generation.

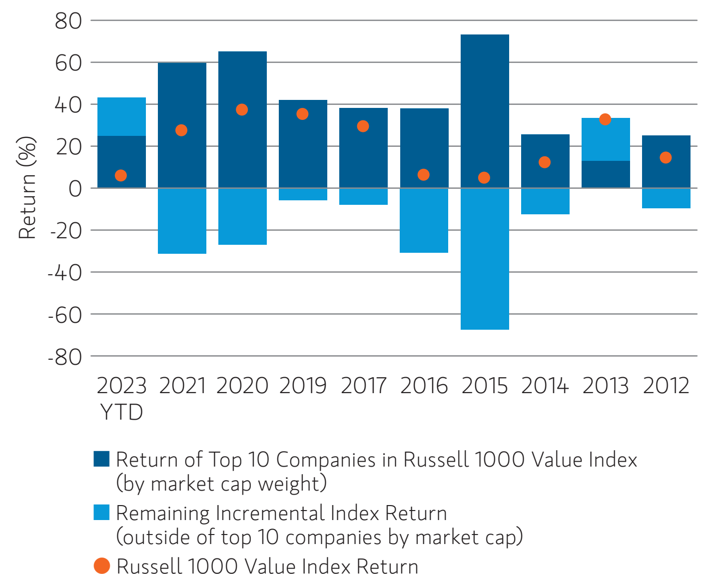
Amongst other investor behavioral biases, we seek to guard against recency bias. Studies have shown that people are prone to make decisions based on recent events, which in markets

**DISPLAY 4**

**Annual Russell 1000 Value Index Return Contribution (During Positive Index Performance Years)**




**Annual Russell 1000 Growth Index Return Contribution (During Positive Index Performance Years)**




Source: FactSet as of 30 September 2023.

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sometimes hold more weight than a longer-term view. We believe many investors focused on recency this year, as the Magnificent Seven is up 52.2% year-to-date, but these stocks are now expensively trading at an average of 53.6x P/E (as of 30 September 2023). Artificial reality (AI) could be game-changing, but we believe these stocks must prove their benefits for the user and technology providers.

**DISPLAY 5**
**Correlations**

| | AS OF 30 SEPTEMBER 2021 | AS OF 30 SEPTEMBER 2023 |
|---|---|---|
| | BLOOMBERG US AGGREGATE BOND INDEX | |
| Russell 1000 Growth Index | 92% | 58% |
| S&P 500 Index | 89% | 49% |
| Russell 1000 Value Index | 79% | 35% |

Seven-year correlations calculated using daily total returns.
Source: Bloomberg, as of 30 September 2023.

## What is active management's role in this new regime?

The success of the Magnificent Seven stocks has caused large concentration within top companies in a number of major indexes (Russell 1000 Growth Index has 51.25% of its weight in the top 10 companies by market capitalization and S&P 500 Index has 30.71% as of 30 September 2023). In contrast, only 17.86% of Russell 1000 Value Index companies are in the top 10 by market capitalization. Further, in *Display* 4 below, we display the percentage of each index return's contribution to return from the top 10 companies by market capitalization weight, as well as from the remainder of the index, below the top 10 companies. We believe that for value stocks in particular, there is still a great deal of potential to add value for clients beyond those top 10 companies, offering significant opportunity for an active manager to select companies and generate alpha for clients through the cycle.

## The Benefit of a Balanced Equity Allocation

As 2023 progressed, the markets have slowly been pulled into our view of the world from late 2022 that inflation would not be transitory and that we are in a higher-for-longer regime. In such a regime, having a diverse asset allocation across value and growth is important. We have long spoken about the correlation among various equity indexes and fixed income (represented by the Bloomberg US Aggregate Bond Index). Heading into 2022, based on correlations between broad indices, we warned investors that a typical 60/40 portfolio lacked a diverse asset mix. While the numbers have shifted over the last two years, it remains clear to us that maintaining value in your portfolio offers more diversification than simply indexing for U.S. exposure by solely holding a core U.S. equity position.

Still, harping back to our views on recency bias, it can be tempting to allocate to core, and not think about balancing between value and growth. However, looking back at bull and bear S&P 500 markets since the new millennium shows the additional benefit that can be captured through a more nuanced approach. Looking at *Display 6* below, in only one S&P bull market going back to 2000 did a S&P 500 Index allocation serve an investor better (and only by ~1%) than a value or growth allocations.

**DISPLAY 6**

| | 24/03/00 – 09/10/02 | 09/10/02 – 09/10/07 | 09/10/07 – 09/03/09 | 09/03/09 – 19/02/20 | 19/02/20 – 23/03/20* | 23/03/20 – 03/01/21 | 03/01/22 – 12/10/22 |
|---|---|---|---|---|---|---|---|
| Russell 1000 Value Index | -11.83% | 20.54% | -47.61% | 16.54% | -38.16% | 50.16% | -17.47% |
| Russell 1000 Growth Index | -32.84% | 15.14% | -39.60% | 20.21% | -31.46% | 62.57% | -31.79% |
| S&P 500 Index | -21.97% | 18.08% | -55.37% | 15.65% | -33.78% | 55.78% | -24.47% |

Past performance is no guarantee of future results. Returns are calculated in U.S. dollars and include the reinvestment of distributions. Sources: Morgan Stanley, Russell Investment Company, S&P Global, FactSet. Data dating back to 24/03/00. Data does not date back to earlier in 2000, due to cycle prior to 24/03/00-09/10/02 bull cycle dating from 04/12/87 to 24/03/00. Bear markets are declines of 20% or more in the S&P 500 Index (bear markets shown in tan in table above). Bull markets are the gains between bear markets defined as declines of 20% or more in the S&P 500 Index (bull markets are shown in blue in table above). Returns in table are annualized.

* Time periods during the Global Pandemic.

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## Conclusion

We are in a new regime where higher-for-longer is likely and risk has a cost. We believe a diversified allocation is essential in this increasingly unpredictable environment. Our Opportunistic Value investment philosophy focuses on quality, leading companies that are mispriced or misunderstood by the market and are trading at a discount to their intrinsic value.

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**Risk Considerations**

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Diversification does not eliminate the risk of loss. Active management attempts to outperform a passive benchmark through proactive security selection and assumes considerable risk should managers incorrectly anticipate changing conditions.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass.

Correlation is a statistical measure of how two securities move in relation to each other.

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