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INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Value Stocks: Once In A Decade Opportunity

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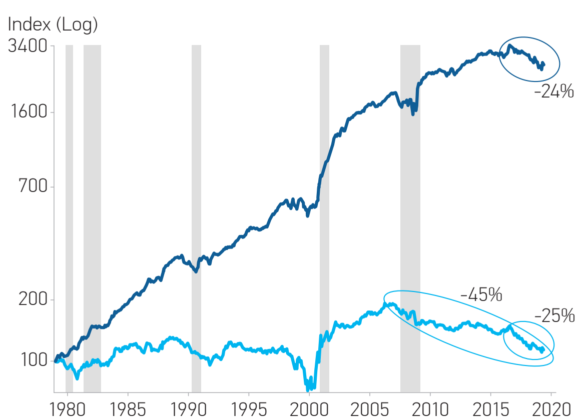
After 12 years of nearly unprecedented underperformance and one of the worst individual months in history (August), value stocks experienced a massive reversal relative to growth and momentum stocks in September 2019. As a result of what looked like interminable dismal performance of value stocks, many investors and pundits appear to have converged to the view that one ought to only own stocks which have exhibited either strong or steady earnings growth. In other words, own growth or quality but stay away from value.

Epitomizing this new conventional wisdom is a recently-published academic paper titled "Explaining the Demise of Value Investing."[1] After positing that value has underperformed not only for the last 12 years, but rather for almost 30 years (using a simplistic definition of value), they explain that economic fundamentals keep "glamour stocks"—as they describe growth stocks—"at the top of their industries for decades… [as] creative destruction seems to have little effect on [them]." They finish by knocking down four potential drivers of "resurrection" for value and concluding with "what's the likelihood of this to happen, and are there many investors who wish this to happen? We doubt it." We beg to differ.

Value, properly-defined, has indeed underperformed, but by much less than what the two professors claim (Display 1). In addition, contrary to their assertion, value stocks are much cheaper and much more ignored today than nearly anytime in the past 50 years. Clearly, the economic environment of low inflation and low rates with only modest growth due to rolling regional crises in the past 12 years has been extremely supportive of growth and

Display 1: **Value Underperformance**

Russell 1000 Value / Growth vs. GMA Value / Growth Factor Return



— Russell 1000 Value / Growth Total Return
— GMA Value / Growth Factor Return*

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Shading represents recessions.
Source: MSIM Global Multi-Asset Team (GMA) Analysis.
Data as of October 10, 2019.
* S&P 1500 adjusted for sector composition.[2]

momentum stocks relative to value stocks (particularly as the high momentum cohort has included an increasing proportion of defensive stocks). The more recent fears of global recession and Japanification have amplified the attractive attributes of growth and momentum stocks. However, any shift in the macroeconomic environment towards greater stability and normalization of inflation or, counterintuitively, towards recession, would likely cause value stocks to look more attractive versus growth and momentum stocks, particularly given recent underperformance and current extreme undervaluation.

Below, we make the case for why we believe that value stocks are poised for outperformance in the medium term.

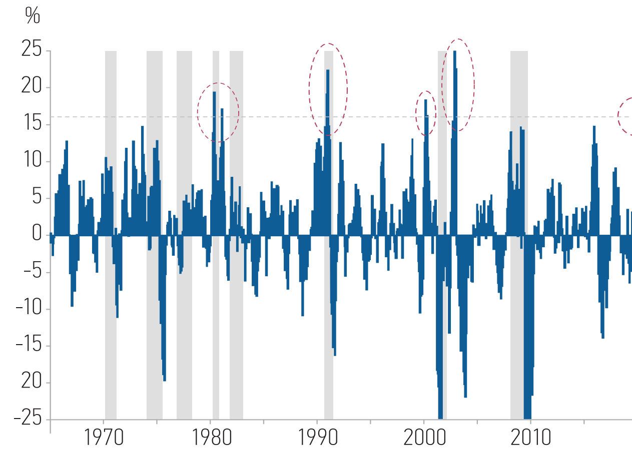
Value stocks have been underperforming for over a decade in the U.S. relative to growth and momentum stocks and in the eurozone relative to quality stocks. Traditional indices such as the Russell 1000 Value and Growth Indices show that value stocks underperformed growth stocks by -41% from July 2006 to August 2019. Value stocks as defined by the Global Multi-Asset (GMA) team are adjusted for sector composition and, as a result, underperformed growth stocks by somewhat less (-24%) and starting later (January 2017), though we note that this underperformance is the worst stretch for value stocks in 55 years of data (Display 1). In the eurozone value stocks (as defined by GMA) have underperformed quality stocks by 34% since 2009.[2]

Value's dismal performance relative to growth culminated in the biggest six-month run for momentum stocks since the early 2000s (Display 2). August 2019 was the biggest month for momentum since June 2008, and December 1999 before that. Interestingly, during that stretch, growth stocks made up a historically high share (roughly 50%) of the momentum stock group. A similar phenomenon occurred in the eurozone where quality stocks made up nearly 40% of the momentum stock group, also a historical extreme.[3]

Our studies show that historically, extreme outperformance of momentum has led to subsequent underperformance relative to value of 7% over the following three months and 14% over 12 months with a 100% hit rate since 1965. Much of the first 7% underperformance of U.S. momentum vs. value stocks occurred in the week beginning 9 September. However, our work shows that episodes of sharp momentum underperformance tend to lead to continued value vs. growth outperformance: of the 13 extreme momentum reversals in the U.S. since 1965, value has continued to outperform growth over the next 12 months 77% of the time, with a median additional return vs. growth of 19%. And when the reversal is preceded by extremely high relative valuations (as the recent one was), the subsequent 12-month underperformance of momentum vs. value stocks is even more pronounced (~35-45% over 12 months) and occurs in nearly two in three instances.[4]

Display 2: **Biggest Momentum Run Since 1999 and GFC**

S&P 1500 High vs. Low Price Momentum Stocks: Six Month Total Relative Return



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Source: MSIM Global Multi-Asset Team Analysis. Data as of October 15, 2019.

Valuation and Sentiment:

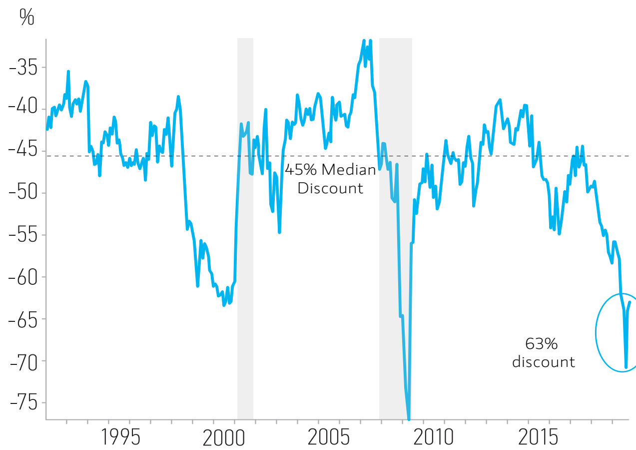
- Valuation: Value stocks (as defined by GMA) are trading at 9.4x 12-month forward price-to-earnings, compared to 19.6x for momentum stocks and 34.2x for growth stocks in the U.S. Value stocks are trading 27% below their historical discount to momentum stocks and 36% below their historical discount to growth stocks (Display 3). Since 1990, value stocks have only been cheaper 4% and 6% of the time, respectively. In Europe, value stocks are trading at 9.0x 12-month forward earnings, 21% below their historical discount to quality stocks.

  From this level of discount in the past, value stocks have subsequently returned 30% over the next 12 months vs. momentum stocks and 15-20% vs. growth and quality stocks, with some periods exceeding 40%.

- Sentiment: Consensus expectations for relative earnings growth over the long term have reached an extreme. U.S. growth and momentum stocks earnings are expected by analysts to outgrow the earnings of value stocks by approximately 8% per annum for the next three to five years. Expectations for such earnings per share (EPS) outperformance have only been higher 2-4% of the time since 1985.

Display 3: **U.S. Value Stocks Trading at Near Record Discount to Growth and Momentum Stocks**

*Forward Price-to-Earnings Discount of U.S. Value Stocks Relative to Growth and Momentum Stocks**



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* S&P 1500 adjusted for sector composition.

Source: MSIM Global Multi-Asset Team Analysis. Data as of October 10, 2019.

Fundamental/Macro Drivers: The environment of the past few years has been a 'perfect storm' for value stocks:

- The yield curve began a 200 basis point flattening in December 2016 as the Fed executed its second rate hike in a two-year, 200 basis point tightening cycle.
- U.S. economic growth, juiced by the 2018 tax cuts, began to slow from very strong levels in the second half of 2018 and was further impacted by the implementation of tariffs on Chinese imports by the U.S.
- Inflation continued to miss forecasts and reached a recent low of 1.5%, driven by slowing economic growth, a stronger dollar and a steady flow of 'one-off' negatives.

Each of these conditions created headwinds for value stocks, which typically have less duration and more economic growth sensitivity than growth stocks, and were starting from expensive relative valuations in the first quarter of 2017.

At the nadir in August, value stocks were facing the possibility of 125 basis points of rate cuts, the lowest 30-year yield in history (and the lowest bond yields in 5,000 years of recorded history),[5] and fears of a global recession driven by a potential trade war with China and deteriorating economic data, as global manufacturing PMIs reached near-recession levels. But as we look forward over the next one to two years, it appears that the U.S. economy will avoid a recession: housing activity has rebounded to cycle highs and the insured unemployment rate hit a new low of 1.1% in September.[6] In addition, inflation is likely to rebound to 2% as one-off deflationary factors fade. As a result, the Fed is likely to pause after one last rate cut and bond yields are likely to stabilize and even rebound. 'Japanification' is pushed off for another year.

While value stocks typically perform best in accelerating growth and inflation environments with steepening yield curves, stabilization of these macro drivers should, in our view, be sufficient to drive a cyclical rebound in value stocks over the next year (+15-20% relative outperformance), given recent underperformance and current extreme undervaluation. A more durable regime shift in favor of value stocks—supported by an extension of the current economic expansion for another one to three years and/or the revival of inflation and thus higher interest rates—could lead to even more significant outperformance. In prior value cycles, value stocks have outperformed growth stocks by 100% or more over five to ten years. This is not our base case, though starting valuations indicate that this scenario has a not insignificant probability of occurring.

The biggest macro risks to our case are: 1) Those that would lead to a deeper slowdown/ recession. Some potential catalysts for this would include Chinese growth continuing to slip, slowing U.S. profits hurting corporate sentiment, and the trade war with China re-escalating. 2) A Japanification scenario. Some potential catalysts for this include ineffective monetary policy being unable to prevent weaker growth and lower inflation, and new lows in U.S. bond yields. These could lead to a further potentially parabolic rally in growth and momentum stocks (similar to this year— culminating in August 2019-like performance). The biggest micro risk is continued gains by 'disrupters'—funded by easy money and the allure of owning the next Amazon (or Google or Facebook), at the expense of disrupted companies—could lead to further outperformance of growth stocks over value.

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FOOTNOTES

[1] Lev, Baruch; Srivastava, Anup. "Explaining the Demise of Value Investing" (August 25, 2019). SSRN: https://ssrn.com/abstract=3442539 or http://dx.doi.org/10.2139/ssrn.3442539

[2] Value vs. growth stocks are defined by the GMA team simply as the cheapest stocks, using five value factors, relative to the most expensive stocks on a sector-neutral basis (i.e. the same percentage of names in tech and financials as the overall market, but within each sector, the cheapest stocks are bought and the most expensive ones are sold; in the U.S. each stock in the cohort is given equal weight, in Europe, market capitalization weights are used). Eurozone Quality stocks are defined similarly, using Return on Equity as the criteria for quality.

[3] Ibid.

[4] MSIM Global Multi-Asset Team analysis; Haver, Bloomberg.

[5] Homer, Sidney; Sylla, Richard. A History of Interest Rates. 2005. Hoboken, NJ: John Wiley & Sons, Inc.

[6] The insured unemployment rate is the number of people currently receiving unemployment insurance as a percentage of the labor force. (Source: Federal Reserve Bank of St. Louis. "Labor Market Slack and the Insured Unemployment Rate." Last modified November 3, 2015. https://www.stlouisfed.org/on-the-economy/2015/november/labor-market-slack-insured-unemployment-rate)

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