“WHAT’S YOUR TIME-FRAME?”

Given the number of questions we have received about the potential rotation from growth to value and the potential for a market decline in the US, here are our views on these topics.

**Question 1: Is this Rotation from Growth to Value for real?**

My conclusion is:

*It depends on your time frame.*

As part of our investment process, we track how expensive value is relative to the market versus history using Russell indices.¹ By the week of July 23rd, given the magnitude of outperformance of the growth index and the impact of that outperformance on the market overall, that value spread became one standard deviation cheap. In other words, value stocks became unusually cheap. The most recent two times that spread achieved this level of cheapness was in May 2012 and August 2015. *Over the next twelve months, large-cap value did outperform large-cap growth both times.*² So there appears to be some validity here. Cumulative fund flows into value managers by the end of June had trailed flows into growth managers by $15 billion YTD³ which reconfirms:

1. Value was really unloved.
2. The consistency of human behavior, chasing what has already worked.
Two caveats, however:

1. My comparisons were only for the last two times the spread became this cheap. In prior instances, value became 2.5 standard deviations cheap in 2008, and in 2000 it hit over 3. Let’s say you had rotated into value early, when it became one standard deviation cheap in early 2008 or 1999. You would have been crushed, destroyed, thrown to the wolves and probably would have lost all your assets first before ultimately being positively rewarded by the end of 2009 and 2000, given the spread did resolve itself back to “fair value” both times. (As it did in 2013 and 2016 as well). In other words, being right, but way early is no better than being wrong.

2. While Growth underperformed Value in 2012 and 2015 from this point of valuation over the next year, returns were still very strong on an absolute basis.

I do not believe we are in a period like 2000 or 2008, because growth is just not that expensive. While some technology stocks have become pricey, growth stocks are not to the levels of expensiveness they were in 2000, 2008 nor even in 2012. Perhaps the best analogy is 2015, where value modestly outperformed growth over the next 12 months. Given value has already outperformed growth by 287 basis points since July 25th, a lot of outperformance has already occurred.

As a core manager, we have our feet in both growth and value camps but can move a bit more decisively one way or another if warranted. In my opinion, there is a lot of bad news priced into some of the value sectors (and emerging markets as well), and if we get any positive catalysts (such as resolution of trade tensions) these might likely continue to outperform near-term.

**Bottom line:** Tactically, we believe value is set up to outperform growth short term, but longer-term, I do not expect substantial outperformance. *What is your time-frame?*

**Question 2: Is the Market Overall headed for Turbulence?**

My conclusion is: *It depends on your time frame.*

We have seen rolling bear corrections already in various equity markets. From their peaks earlier this year through July 31st, Emerging Markets is down 14%, Europe and Japan are down 9% and China is off 21%, but the S&P 500 is down less than 2%. Could the S&P 500 sail through without any further pain? I doubt it.

1. My experience is that when the market focuses on the micro (corporate earnings, new product announcements, etc.) the market does well, but when it focuses on the macro (geopolitics, Fed, etc.), it struggles more. Unfortunately, we are exiting a great earnings period and entering a period with less micro news. The news flow rotation from the micro to the macro is worrisome. This is exactly why August is generally a tough period for the market.

2. Statistically, the market struggles in the three months leading up to the midterm elections (Aug-Oct). On average, down -1.1%. Of course, the market won’t bleed lower by a tiny percentage every day. So this further supports vulnerabilities.

3. My view since the beginning of the year has been that this will be a year with positive but less stellar returns for the market. But at July 31st levels, the S&P 500 was annualizing 2018 at an 11.3% return which in my opinion is probably a bit high.

All these point to a near-term market pullback or at the very least, justification for near-term more caution for the US.

But I have a problem with getting overly bearish on the market. Here’s why:

1. Bull markets generally end for one of two reasons:
   a. Earnings estimates get way too far ahead of reality and as the economy turns, the numbers have to come down. That is the story of what happened in 2007. *That is not happening now.*
   Companies are reporting *better* than expected results. Estimates have been revised higher, not lower.
   b. P/E multiples get to nosebleed, unsustainable levels, as we saw in March 2000. *That is not happening now.*

At current levels, the market is trading at 15.8 x the current 2019 estimate. A pretty reasonable level. And if we do have some sort of pullback, that would make the market even more attractive on a P/E basis.
2. As I wrote in the May commentary:

*Post the last 18 mid-terms, the market has generated an average return of +16.5% over the next 12 months. And the “hit ratio” is 100%, meaning the market has been positive all 18 times.* So a pretty good outlook later in the year.

**Bottom line:** Tactically, I do expect some sort of near-term weakness, but looking out longer-term, I expect more gains ahead. *What is your time-frame?*

One final point about markets rotating and churning. Personally, a broadening out of performance for the market is a great relief. Narrow breadth is a dangerous indicator. As someone trying to balance delivering performance with good risk management, it becomes problematic when only a couple of very high priced stocks deliver most of the return of the market as they did in Q2 and into early July. Three cheers for more stocks participating, even if the overall market might experience a greater case of the jitters near-term.

Andrew
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1. As measured 100 cheapest stocks on a P/BK, P/E and P/FCF basis relative to the Russell 1000.
2. As measured the performance of the Russell 1000 Value Index as surrogate for large-cap Value and Russell 1000 Growth Index for large-cap growth.
3. Morgan Stanley Research
4. Returns over next 12 months:
   - 2012
     - Russell 1000 Value: 36.9%
     - Russell 1000 Growth: 27.6%
   - 2015
     - Russell 1000 Value: 12.7%
     - Russell 1000 Growth: 12.0%
5. As measured 100 stocks with highest estimated growth rate relative to the Russell 1000.
6. As measured the performance of Russell 1000 Value as surrogate for large-cap Value and Russell 1000 Growth for large-cap growth.
7. As measured emerging markets:EEM, Europe:IEV, Japan:EWJ, China:SHCOMP.
9. The 2018 consensus S&P 500 estimate has risen over the last month from $160.94 to $161.31 and 2019 from $176.94 to $177.61. Factset
10. The forward P/E in March 2000 got to 24.2x. Bloomberg