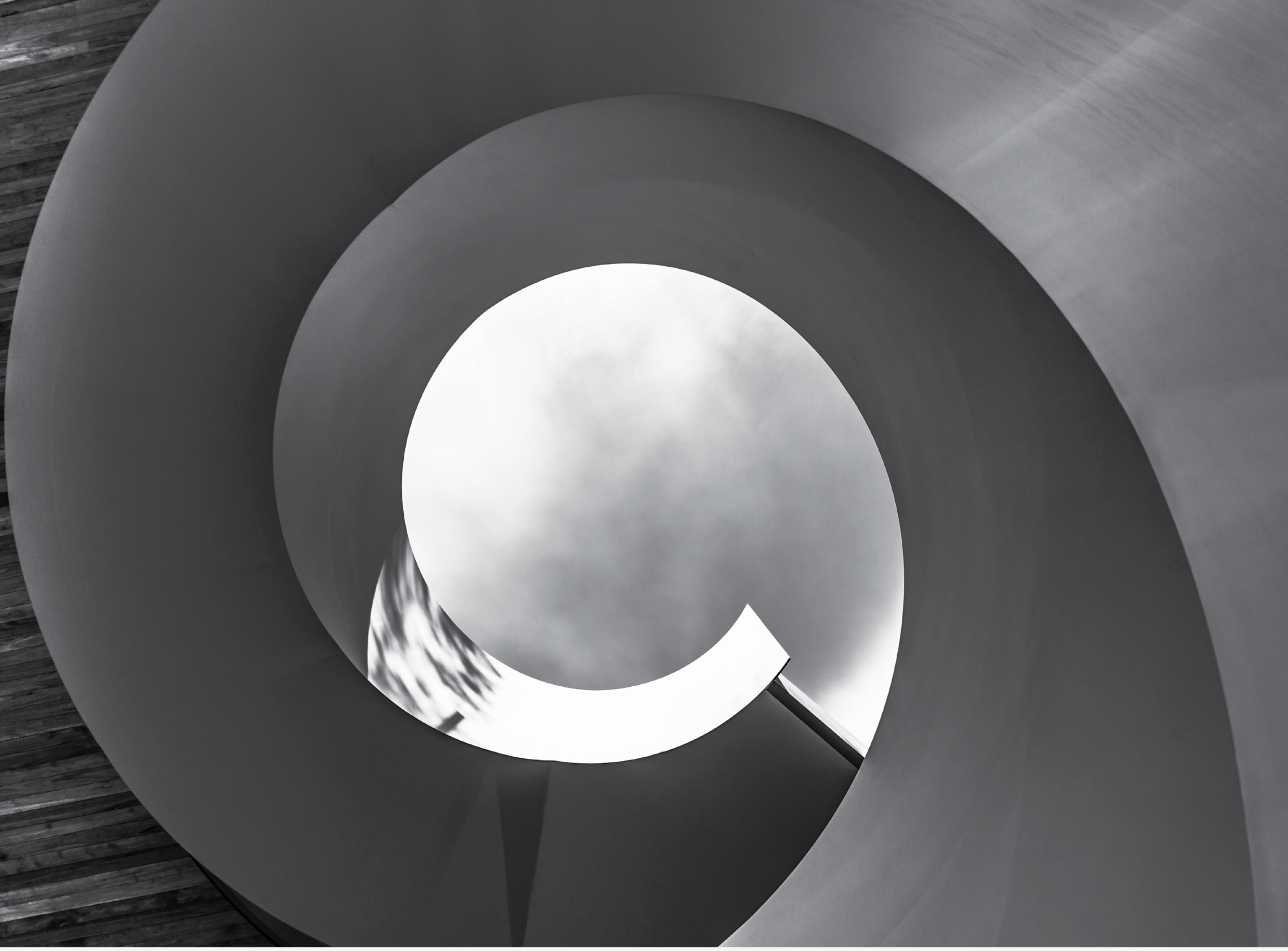


WILSONS

Value Rotation on Pause

Our weekly view on asset allocation.

11 April 2022

Where the Value Rotation is Now

After a period of significant outperformance for value over the past few months, growth has staged a comeback since mid-March.

Value stocks performed well at the end of last year and during the Russian invasion saga. However, growth staged a comeback over the past 3 weeks, as geopolitical tensions eased and global growth expectations moderated. For investors, a key question is whether value outperformance will endure or will the market revert to its decade-long trend of growth dominance.

Over the next 6-12 months we still see the case for value as relatively strong, with the current macro backdrop remaining supportive of this style relative to growth.

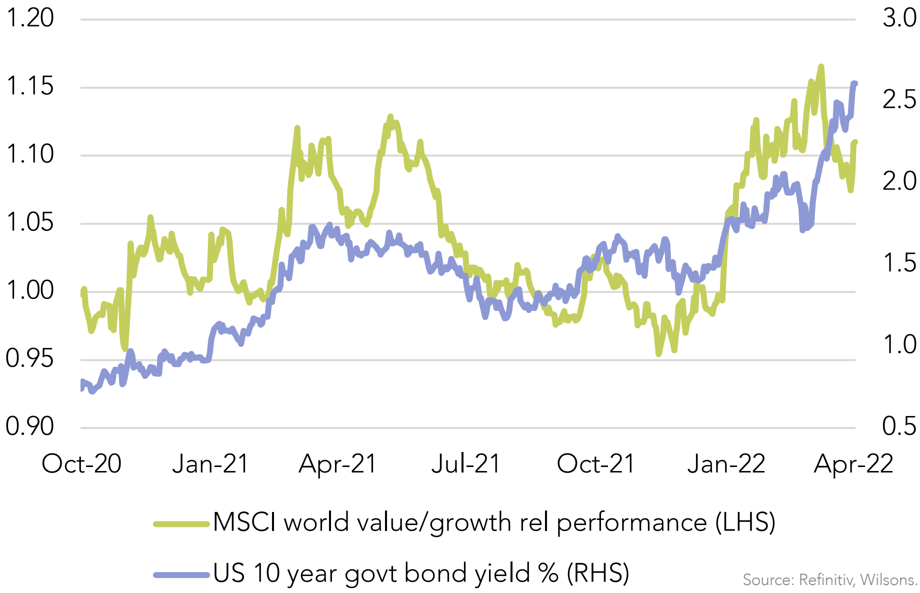
What Factors Impact Value?

We believe the fundamental tailwinds for value (and headwinds for growth) are above-trend global growth, inflation and rising bond yields.

The logic is that as rates rise investors will prefer stocks with current cash flows to those with future ones – the discount rate is rising. Furthermore, strong economic growth should favour value stocks that generally have earnings leveraged to the economic cycle.

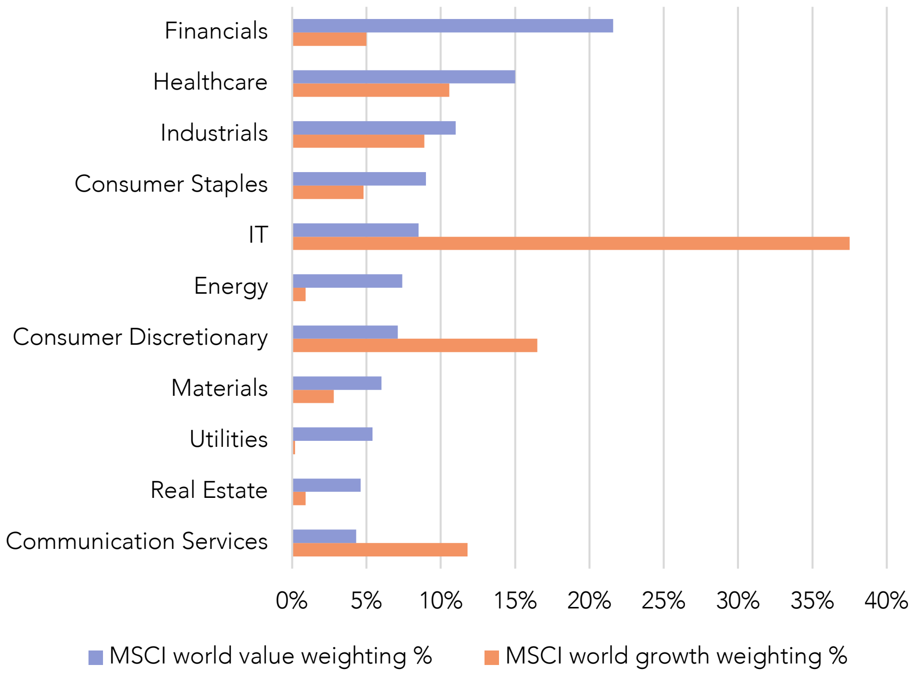
Inflation should also boost commodity prices. Mining and energy companies are a key component of the value investment complex and typically fit the textbook definition of a value company. If we have an economic environment of higher inflation, mining and energy will likely outperform the market.

Figure 1: Value has lost some momentum since mid-March



Source: Refinitiv, Wilsons.

Figure 2: Value indices consist of a higher proportion of cyclical stocks that should benefit from higher rates and robust economic growth



Source: MSCI, Wilsons.

Figure 3: Value has performed well in times of above-trend growth and rising bond yields

Start Date	End Date	MSCI World Value Growth Rel Performance	10 Yr US Bond Yield (Beginning)	10 Yr US Bond Yield (End)	10 Yr US Bond Yield Change (BP)	Average PMI (during period)	10 Yr US Bond Yield Rising	Average PMI above 50
Nov 1980	Mar 1982	17.4%	12.4%	14.1%	172.2	45.8	✓	x
Nov 1982	Feb 1984	8.9%	11.3%	12.0%	74.9	57.2	✓	✓
Apr 1987	Jul 1988	26.3%	8.2%	9.1%	93.3	57.8	✓	✓
Dec 1991	Jul 1994	20.6%	6.7%	7.1%	39.9	53.5	✓	✓
Feb 2000	May 2002	56.5%	6.5%	5.0%	-149.9	47.9	x	x
Mar 2003	Dec 2006	23.5%	3.8%	4.7%	88.5	54.8	✓	✓
Dec 2015	Dec 2016	8.3%	2.3%	2.4%	17.7	51.1	✓	✓
Aug 2020	Mar 2021	11.6%	0.7%	1.7%	106.4	58.9	✓	✓
Nov 2021	Mar 2022	14.1%	1.4%	2.3%	90.0	58.5	✓	✓

Source: Refinitiv, Wilsons

Since 1975, in 7 of the last 9 periods where value has sustainably outperformed growth, we had above-trend economic growth (using the ISM PMI as a proxy) and bond yields were rising.

We have only seen falling bond yields and low economic growth coincide with value outperforming after the tech bubble burst. Although this was due to a significant recalibration of growth stock valuations rather than value-specific factors.

Figure 4: Value has not always been so unloved

Source: Refinitiv, Wilsons.

Economic Outlook Still Supportive of Value

Global economies continue to recover quickly from the pandemic-induced recession in 2020. Our outlook for global growth remains positive despite the risks posed by the sharp rise in energy prices and the current broad inflationary pulse.

With the potential for higher inflation and an acceleration of the shrinkage of the Fed's balance sheet, we believe US bond yields could still rise as the Fed becomes more aggressive to stem the inflationary pressures in the US.

A gradual increase in bond yield rates will act as a relative tailwind for value over growth, in contrast to post GFC/pre-pandemic years when yields trended downwards and supported growth stocks.

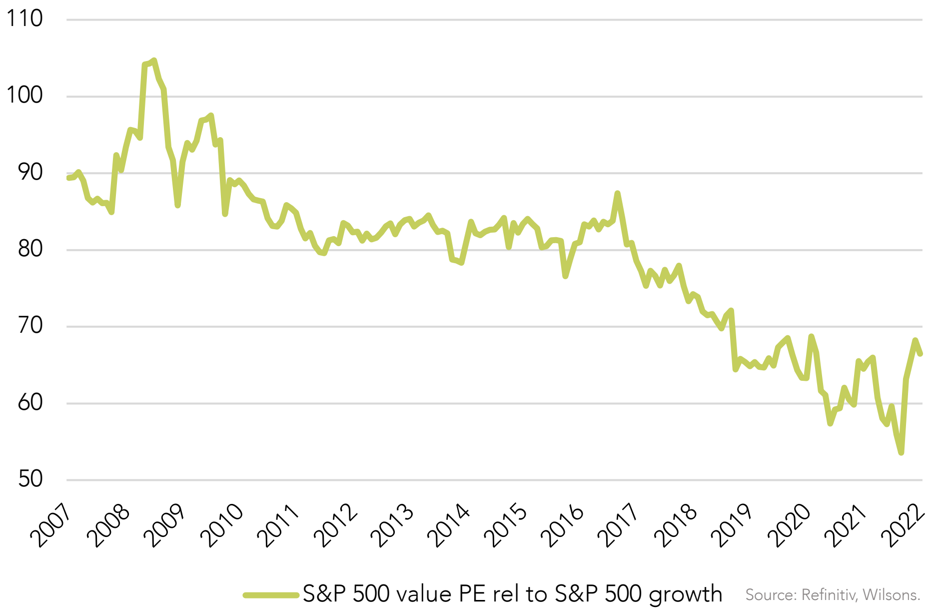
While the macro landscape has been muddied recently, we still think that, on balance, the environment of robust economic growth and rising bond yields still favours value over growth.

Valuation Dispersion Still Wide

The valuation dispersion between growth and value has widened over the past decade due to the extended outperformance of the growth style. The steady decline in interest rates has been an important driver in expanding the rating of long duration growth stocks.

Despite the rotation towards value over the past 18 months, valuations are still relatively low compared to the 2007-2010 period. It seems difficult to refute that many long-suffering value stocks still offer attractive relative valuations, especially in the face of robust economic growth and rising interest rates.

Figure 5: Value still looks cheap on a relative PE basis



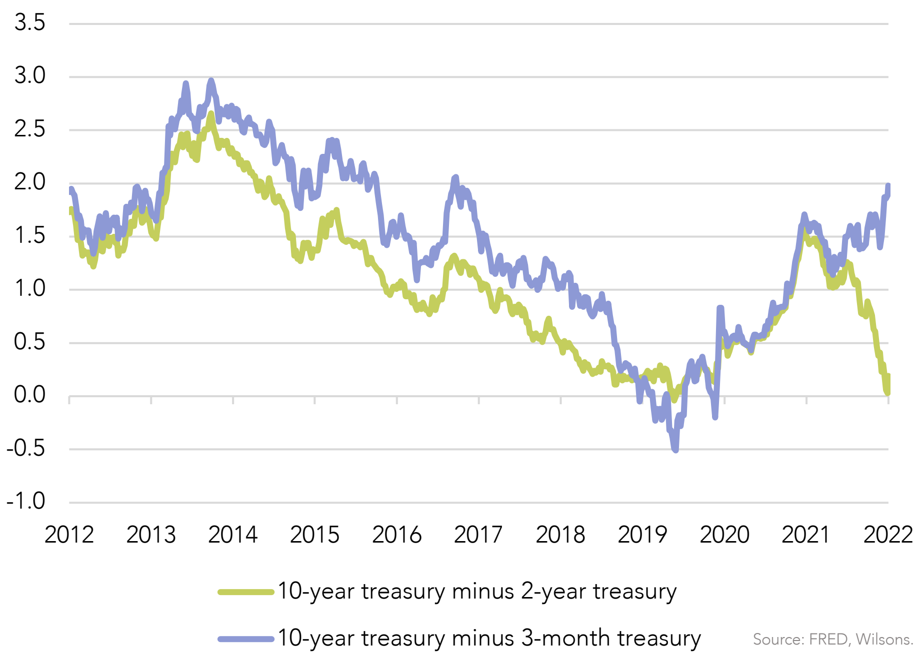
Source: Refinitiv, Wilsons.

Risks to Value

Recession risk

A recession would be a significant risk to the value argument. Value stocks are more leveraged to the economy than growth stocks. Therefore, a recession would likely negatively impact earnings prospects for value stocks, leading to a period of underperformance vs growth.

Figure 6: US 2-year 10-year yield curve flashing amber for a recession risk but not the 3-month 10-year



Source: FRED, Wilsons.

In recent weeks the yield curve measured by the 2-year to 10-year has flattened considerably, with occasional inversions during US trading sessions. This has potentially worried investors that value may start to underperform, as historically an inverted yield curve has been a fairly reliable indicator of a looming recession.

However, it is not until the 3-month to 10-year inverts that a recession appears to be "confirmed", and even then, there is a significant lag. Over the past quarter the 3-month to 10-year curve has actually steepened. We expect continued fascination with the possible inversion of the 2-year to 10-year but do not anticipate a US recession is around the corner.

Interestingly, the 2-year to 10-year US yield curve has re-steepened this past week as 10-year yields have pushed higher again. This has put renewed pressure on growth stocks. The yield curve may steepen further when the Fed starts to actively reduce its balance sheet, potentially pushing 10-year yields higher and providing further relative impetus for value stocks.

Read The Flattening Us Yield Curve - Are recession Risks Rising?

From reflation back to a low growth world

In our view, the most pertinent medium to long-term risk to value is a reversion to a pre-pandemic world/regime of slow growth and low inflation from the current backdrop of high inflation and above-trend growth.

In a low growth world it is likely only a few outstanding growth businesses will prosper, while the majority will struggle to generate significant earnings growth.

This would likely be a supportive environment for growth stocks.

An ageing population and the overhang of large debt burdens in many developed countries are likely to exert headwinds on economic growth and interest rates in the medium-term, which means a return to a low growth/low inflation world.

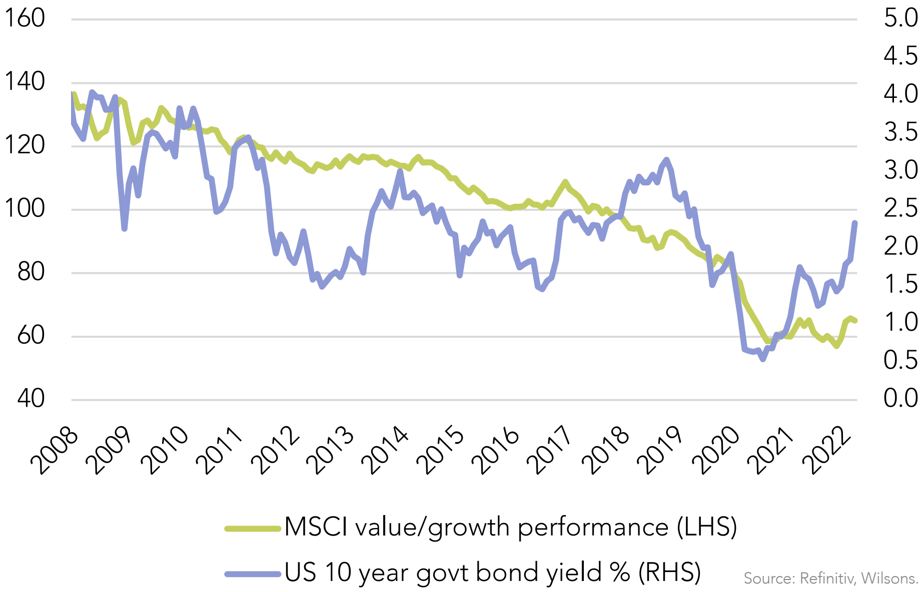
We believe this is not an imminent risk in a world still recovering from the pandemic, with low unemployment, higher wages and households sitting on elevated cash reserves. However, as the transitory effects of the pandemic and the global recovery normalise, the structural forces supporting a low growth world/regime should start to reemerge.

Low growth a medium-term story

We think there is a decent probability that once the global recovery and inflation anomalies from COVID have subsided, global interest rates will stabilise or ease back somewhat, as they did pre-COVID.

Although we believe that a low growth world is more likely in the medium-term, we still think value should outperform growth over the next 6-12 months as we enter a sustained period of rising interest rates for the first time since 2018.

Figure 7: A low inflation, low rate world has been supportive of growth, but we do not see this backdrop as imminent



Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

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