Growth versus Value Trade

Equities

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Introduction

Since the bottom in March 2020, market indices around the world have rallied. Monetary and fiscal stimulus have largely fueled investor optimism with markets recording the greatest capital inflow in two decades ($1.1 trillion according to Bank of America). FOMO (fear of missing out) continues to prevail as markets reach all-time highs, and the S&P 500 index is on track to record the third highest year-on-year return since the millennium shift.

However, the past year has been far from smooth for investors. Rapid changes in the economic outlook amidst inflationary concerns and rising interest rates have contributed to "one of the most volatile markets in decades" (Pisani, 2021). As a result, the debate surrounding growth versus value trade has resurrected during the pandemic. With inflation recording a 30-year high in October (Picchi, 2021), the following report aims to contribute to the discussion and ultimately, provide a future outlook.

Risk/On-Risk/Off

Risk-on/risk-off refers to changes in investment activity and market sentiment in response to global economic developments. Theory states when risk is perceived to be low, investors engage in higher-risk investments, and vice versa (Hayes, 2020). The discussion traditionally rendered the allocation of bonds versus equities. However, the prevalence of low interest rates in developed markets over the past decade have centred the debate within equities due to the relatively unattractive return provided by traditional 'risk-off' assets e.g., gold and Treasury bonds. As inflation erodes the purchasing power of money, market participants seek to outpace inflation rates, where traditional risk-off trades have failed in the recent past. Consequently, there is no alternative to equities and the risk-on/risk-off debate has centred within stocks, concerning the allocation of growth versus value stocks (Markowicz, 2021).

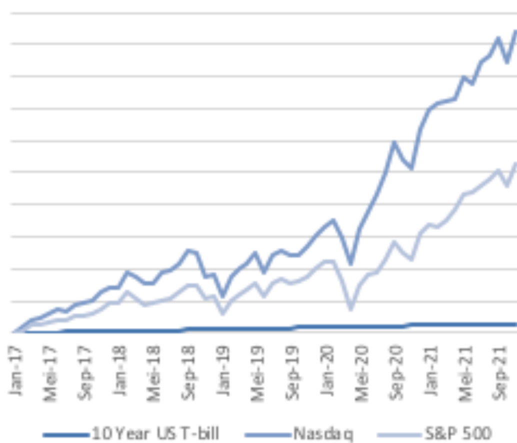
Growth verss Value Trade

Growth stocks commonly refer to highly valued shares (high multiples) in companies that are expected to grow sales and earnings at a significantly faster rate than the market average. Thus, the expectation for future cash flows is greater than the current cash flows. By contrast, value stocks are companies that possess a robust market position, established cash flows, and offer payments of dividends. Consequently, investors face a trade-off between risk and return whereby growth stocks can provide greater exponential capital gains given that the expected growth is fulfilled, and value

stocks provide strong fundamentals at relatively low prices (low multiples) – the opposite of growth stocks (Hayes, 2020).

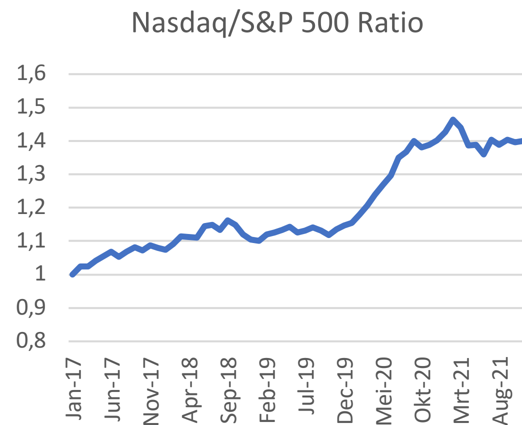
The economic environment in the past years have provided a blessing to growth stocks, characterized by a prospering economy, low interest rates, and a wave of technological innovation. Thus, an investment in the high-growth, tech-dominated Nasdaq has outperformed its cyclical, value-denominated counterpart, the S&P 500 (187.9% vs. 105.6%, respectively) since beginning of 2017 (Figure 1).

Figure 1: Index Performance



However, rising inflation and the corresponding threat of rising interest rates during 2021 has concerned many growth investors. Figure 2 depicts a trend over the past year similar to that of 2018-2019, whereby rising US interest rates was a central theme. The stagnated dominance of the Nasdaq relative to the S&P suggests investors re-allocating to safer cash flows (Stevenson, 2019).

Figure 2: Growth vs. Value Ratio



In recent years, changes in bond yields have provided a strong correlation with the relative performance of growth/value stocks. It is argued that growth stocks largely benefit of falling bond yields as expected cash flows extend further into the future, hence are more sensitive to changes in the discount rate relative to value stocks (Flood, 2021). If low yields are driven by low real interest rates, growth stocks should benefit, all else equal. By contrast, value stocks tend to outperform when yields are rising. Thus, inflation poses a threat to growth investors as interest rates are typically raised in response. Furthermore, it is the speed of rate movements that influence changes in portfolio allocation. Historically, sharp and sudden changes (more than 2 standard deviations i.e. +/-25 bps in today's environment) are associated

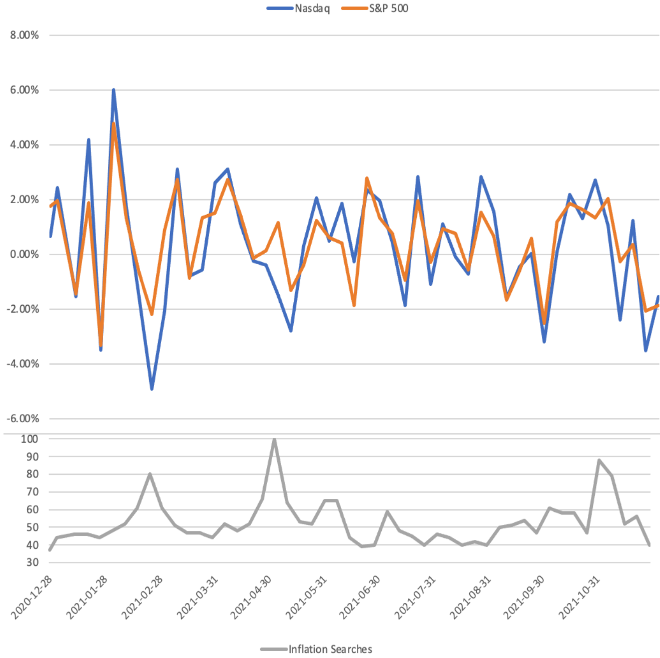
with large impacts on the allocation of value vs. growth. Accelerated interest rates hikes imply immediate short-term cash flows will be discounted at a higher rate whilst forward-looking markets had expected more distant cash flows to suffer, hence growth stocks suffer more due to sensitive valuation calculations (Markowicz, 2021).

The Year 2021

Throughout the year, inflation has been identified as the "top risk" to markets, largely driven by supply chain bottlenecks as a result of pandemic-related restrictions (Leonhardt, 2021). Investors have not been this worried about inflation for decades, as Google trends data depict the highest search interest since 2004 (Authers, 2021). Consequently, investors have shifted between growth and value stocks in anticipation of interest rate hikes.

Figure 3 demonstrates US search interest for "inflation" relative to the indices whereby the Nasdaq has underperformed the S&P 500 the following week after inflation searches have peaked, suggesting capital flowing from growth into value stocks upon interest rate concerns. Thus, it appears that value stocks have re-emerged as an alternative to growth stocks following Federal Reserve announcements of tapering, after being neglected for years (Malik, 2021).

Figure 3: Growth vs. Value Relative to Inflation Interest



The year has presented a volatile market, whereby the spring characterized a strong rotation to value stocks and profit taking on growth stocks amidst uncertainty surrounding inflationary risks. Yet, the market reversed during the summer, and once again favoured growth stocks as Fed reassured investors by defining inflation as "transitory". However, in October 2021, inflation reached a 30-year high and by early December, Fed retired their view of "transitory" as inflation appears to be stickier than predicted (Leonhardt, 2021).

Future Outlook

The market maintains a risk-on approach as fund managers remain overweighting equities relative to bonds due to the outlook of economic growth, according to UBS, Merrill Lynch, GMO, and JPMorgan (2021). It is predicted that 2022 will mark the end of the pandemic and a full global economic recovery is expected. However, a consensus in the forecasts is that inflation will remain high and continue to pose a threat to volatile markets.

The Federal Reserve will raise interest rates starting at the end of next year (2022), although is subject to accelerate if the high inflation rate is persistent. The predicted hikes are 25 basis points in Q4 2022, followed by additional hikes until the expected rate of 1.25-1.5% is reached by end of year 2023 (Sarkar, 2021). The hawkish signal from Fed suggests "selective equity going forward". Hence, another volatile year is expected although prospects suggest the worst is already over (Markowicz, 2021).

The broader value versus growth trade favors value stocks due to higher real rates, although it is the magnitude and pace of the interest rate hikes that will ultimately determine funds' portfolio allocations. Portfolio strategies differ amongst institutions yet suggest overweighting value stocks in the short term. Asset allocation manager at GMO advocates value stocks due going into 2022, as cyclical sectors have the ability to meet a strong customer demand at higher costs (due to inflation). Furthermore, growth stocks will suffer from raised discount rates and "value stocks will grow earnings more quickly than growth stocks will begin to outperform" (Tully, 2021). JP Morgan and UBS depict a similar outlook for overweighting value early in the year but see opportunities in buying technology over the long term. The upward surge of value stocks is expected to pertain until at least the end of Q1 2022. Thereafter, the aforementioned institutions will seek to capitalize on gains and enter growth positions for the coming years. As inflationary and interest rate concerns stabilize through the year, the market will more accurately price growth as an interest rate of 1.25-1.5% remains historically low. Thus, the market is expected to rotate into growth stocks again due to the relative outperformance during economic expansions (Merrill Lynch, 2021).

The markets have blessed equity investors with remarkable returns over the past decade. Low interest rates have shifted the market to "risk-on" as there is no feasible alternative to stocks. Thus, the traditional risk-on/risk-off debate has centered within equities, rendering growth versus value. The economic environment of depressed interest rates, technological innovation, and a prospering economy has fueled the outperformance of growth stocks relative to value over the past few years. However, value stocks have re-emerged during 2021 amidst inflationary concerns and interest rate hikes, presenting the "most volatile market in decades" as investors have shifted between growth and value stocks. The volatility is expected to be persistent through 2022, yet large institutional investors remain risk-on by overweighting equities. The broad growth versus value trade favors value stocks in the short-term, although the structural development of the economy benefits growth stocks for the long-term.

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