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ON OUR MINDS

The Great Value Rotation

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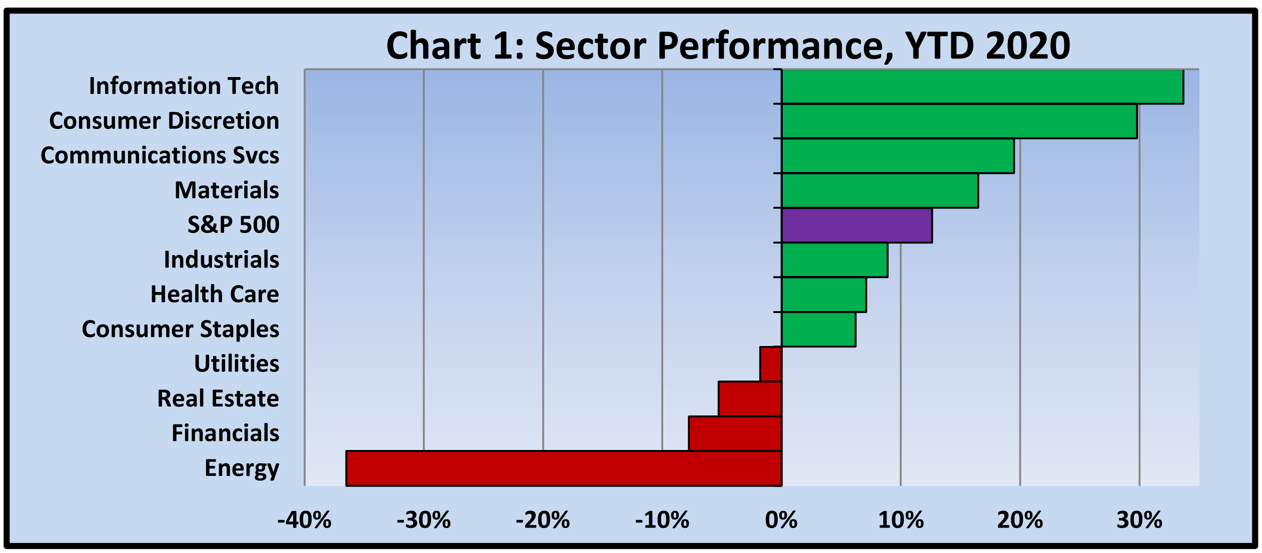
Since late 2016, a small group of stocks has dominated the U.S. and global equity markets, much as the Tyrannosaurus Rex and 1958 tail-finned Cadillac Eldorado cast long shadows in their own days. These market leaders – the FANMAGs[1], software, and a few others – have all benefited from growing market shares, high profit margins, recurring-revenue (subscription) business models, ultra-low interest rates, and favorable long-term demographic trends. All of these factors have contributed to earnings growth that has outstripped that of the broader market.

These "growth" companies have prospered during the Covid-19 pandemic, as individuals and companies pivoted toward work-from-home, online entertainment, and ecommerce. Chart 1 shows that technology (Apple, Microsoft, software), consumer discretionary (Amazon, Netflix), and communications services (Facebook, Alphabet) have outpaced the rest of the market dramatically this year:



Source: FactSet

This phenomenon is not just related to Covid-19, however; the dominance of growth stocks has been driving the markets for half a decade. Nor is this performance surprising: Equity investors crave growth, and these companies have been among the few firms that have shown consistent earnings growth. Most of the rest of the market was mired in the same plodding rut as the broader U.S. economy through the 2010s, and then suffered severely during the pandemic-induced bear market.

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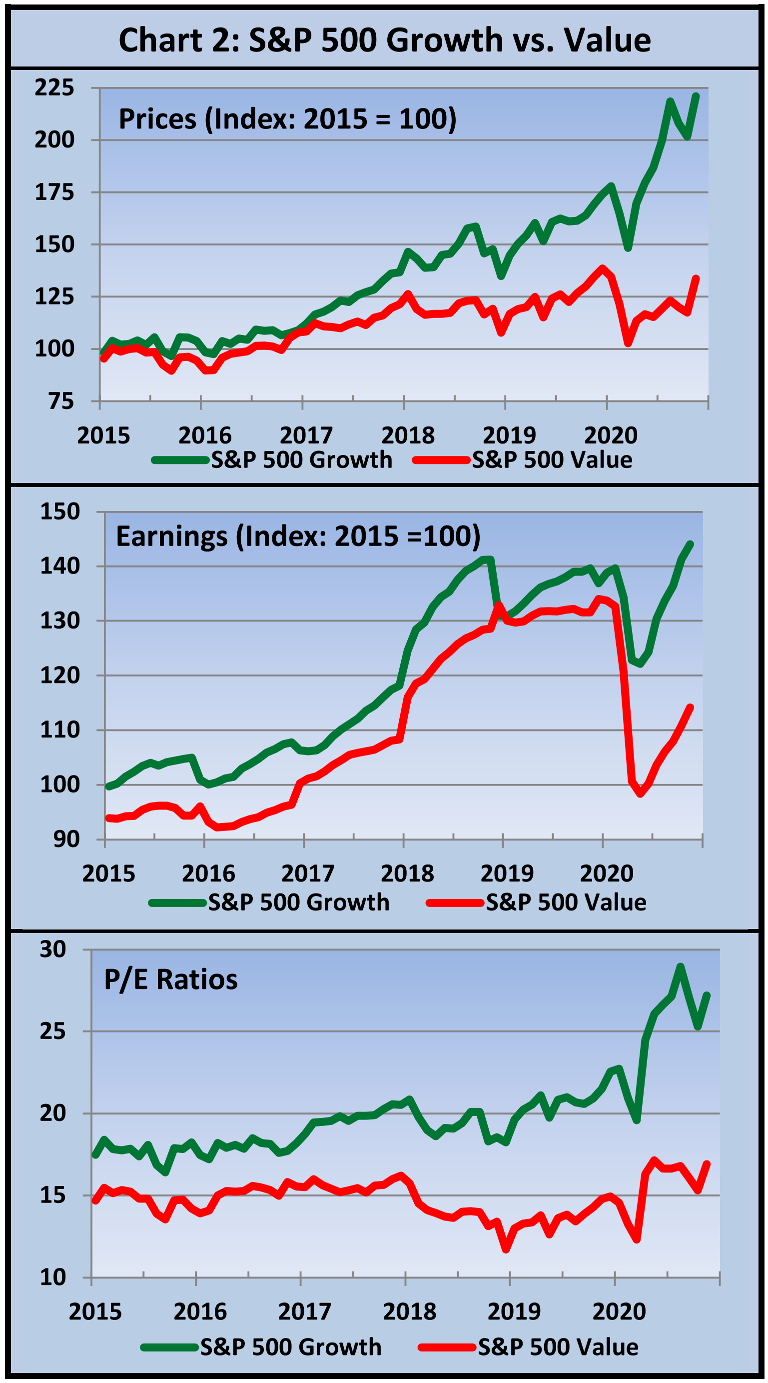
[1] Facebook, Amazon, Netflix, Microsoft, Apple, and Alphabet (Google).

Investors crowded into the few true growth stocks because there wasn't much alternative. In Chart 2, the S&P 500 is split into "growth" and "value" stocks, based primarily on the pace of earnings growth. The top two panels show share prices and earnings per share for these two buckets of stocks, indexed so that prices and earnings are set to 100 at January 1, 2015.

The top panel shows that prices of growth stocks have left those of value stocks eating dust – the same result that might have occurred had that 1958 Caddy Eldorado been drag racing an old Ford Del Rio station wagon. From a standing start, growth stocks have more than doubled in roughly six years, while value stocks have risen just 33%.

The middle panel explains why. Growth stocks have had more horsepower under the hood, in the form of sharply faster earnings growth; that's been especially true this year, as the FANMAGs thrived in work-from-home and shelter-in-place environments while many other sectors struggled. Since January 2015, growth stock earnings are up 44%, while value stock earnings have inched up only 14%. Growth stock profits are at record levels, while value stock profits are still well below recent highs.

But perhaps the most interesting aspect of Chart 2 is the bottom panel, showing price/earnings ratios for these two groups of stocks over the past six years. It's not surprising that growth stocks typically trade at higher multiples of year-ahead earnings; they grow faster, after all, so the present value of their future earnings is likely to be higher than for slower-growing value stocks. The differential between growth and value P/Es held fairly steady through 2019, but widened sharply this year in response to the growing divergence in earnings growth rates.



Source: FactSet

Two factors were at work here, both related to the pandemic: First, the Federal Reserve slashed interest rates, which boosted the relative attractiveness of future earnings and hence of growth stocks over value stocks; with interest rates so low, investors could also justify ever-higher P/E ratios (and other valuation metrics) for these growth stocks. Second, the steep recession devastated earnings prospects for almost all companies – all, that is, except for the FANMAGs and related stocks. Since these few dynamos constitute nearly 40% of the overall stock market's value,[2] their rising fortunes pulled the entire growth sector's P/E ratios higher.

As the U.S. and global economies begin to emerge from the pandemic, however, these dynamics may change – and that prospect has fueled a surge in value stocks. Since the beginning of November, three major catalysts propelled a rotation of investor money from growth into value. First, the presidential election was resolved without devolving into chaos, and with an outcome that was especially pleasing to investors: Donald Trump will be leaving Washington, but the Democrats won't have anything close to a mandate to raise taxes.

Second, a trio of favorable Covid-19 vaccine trial results boosted hopes that widespread inoculation can begin early next year, meaning that the economy can fully reopen sometime later next year. This will be especially good news to companies that have suffered the most during the pandemic, so their share prices have rallied the most; this includes "pro-cyclical" recreation and hospitality stocks, as well as the energy sector (benefiting from expected higher demand and lower output).

Finally, investors have begun to consider the possibility that long-term interest rates may start to rise, driven by a combination of more Treasury issuance and some inflationary pressures as the economy regains its mojo. The 10-year Treasury note is already close to yielding 1% again, and some Wall Street strategists see it hitting 1.5% or 2% over the coming months. If that would happen, it would have two effects favoring pro-cyclical value stocks: It would diminish the value of future earnings of growth companies, and it would boost short-term profits for the banks (which constitute a large portion of the value bucket of stocks).[3]

Thanks to these three catalysts, most value stocks transformed themselves seemingly overnight in November. No longer could they be compared to that dowdy Ford Del Rio; suddenly the better metaphor might be a perky Nash Rambler, itching to compete with those overbearing FANMAG Caddies. Looking down the road, the value stocks start December from cheaper valuations, will benefit more from the possibility of higher long-term interest rates, and have far more operating leverage as a vaccine-boosted economy revives.

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[2] The entire technology sector plus the FANMAGs are included in this figure. Just the six FANMAG companies constitute nearly one-quarter (23%) of the S&P 500 market value all by themselves.

[3] It's worth noting that some value stocks, such as utilities and real estate, have largely been left out of the "value rotation" because their prospects won't improve much as the economy shifts into a post-Covid mindset. What's more, higher interest rates won't help them as they might help other value stocks; shares of utilities and real estate tend to sag when rates rise.

That’s not to say that the time has come for a wholesale switch from growth to value; we have a potentially difficult winter ahead of us, with many potential pitfalls before the economy can recover fully. Nor would it be wise to discount the earnings power of the giant FANMAG companies; even after the pandemic has run its course, they will still be riding a powerful long-term demographic and technological wave that will support continued success for years into the future. Even as value stocks have reawakened, the FANMAGs have sustained their momentum.

Still, value stocks demand some attention. That little Nash Rambler is persistently in the Cadillac’s rear-view mirror, honking its horn and demanding a chance to fly. Investors would be wise to listen to the Playmates’ 1958 novelty hit, “Beep Beep,” to see why they might want to give value stocks a chance:

> *While riding in my Cadillac, what to my surprise,*
> *A little Nash Rambler was following me, about one-third my size.*
> *The guy must have wanted it to pass me up, as he kept on tooting his horn. Beep! Beep!*
> *I'll show him that a Cadillac is not a car to scorn.*
> *Beep, beep. Beep, beep. His horn went beep, beep, beep.*
> *I pushed my foot down to the floor to give the guy the shake,*
> *But the little Nash Rambler stayed right behind; he still had on his brake.*
> *He must have thought his car had more guts, as he kept on tooting his horn. Beep! Beep!*
> *I'll show him that a Cadillac is not a car to scorn.*
> *Beep, beep. Beep, beep. His horn went beep, beep, beep.*
> *My car went into passing gear and we took off with gust.*
> *And soon we were doing ninety, must have left him in the dust.*
> *When I peeked in the mirror of my car, I couldn't believe my eyes.*
> *The little Nash Rambler was right behind, you'd think that guy could fly.*
> *Beep, beep. Beep, beep. His horn went beep, beep, beep.*
> *Now we're doing a hundred and ten, it certainly was a race.*
> *For a Rambler to pass a Caddy would be a big disgrace.*
> *For the guy who wanted to pass me, he kept on tooting his horn. Beep! Beep!*
> *I'll show him that a Cadillac is not a car to scorn.*
> *Beep, beep. Beep, beep. His horn went beep, beep, beep.*
> *Now we're doing a hundred and twenty, as fast as I could go.*
> *The Rambler pulled alongside of me as if I were going slow.*
> *The fellow rolled down his window and yelled for me to hear,*
> *Hey, buddy, how can I get this car out of second gear?*[4]

[4] For a delightful three-minute video with the original music, see https://www.youtube.com/watch?v=enqNl7tdLR4.