It’s still a good time for value to shine

The value versus growth dynamic has been a fixture of equity investing for generations, often prompting debate as to which one is “better.” We advocate strategic exposure to both styles in diversified, long-term portfolios, combined with tactical overweighting of one or the other as conditions may warrant, and periodic rebalancing. With the global economic recovery from COVID-19 still in its early days and a supportive market backdrop in place, we believe the value trade that began in earnest last fall continues to offer attractive opportunities for investors.

Global Equities Team
Nuveen

STYLE LEADERSHIP SHIFTS OVER TIME

Historically, both value and growth equities have taken turns leading the market, sometimes for extended periods and by wide margins. In fact, the overall record is one of parity rather than dominance. During the three decades ending 31 December 2019 — just prior to the COVID-19 outbreak — the Russell 1000 Value and Russell 1000 Growth indexes each outperformed the other in 15 of 30 calendar years, or 50% of the time.

Growth held sway in the most recent decade, beating value by an average of 6% per year. This trend continued throughout much of 2020 as investors shunned value shares amid the worsening pandemic and the severe recession that accompanied it.

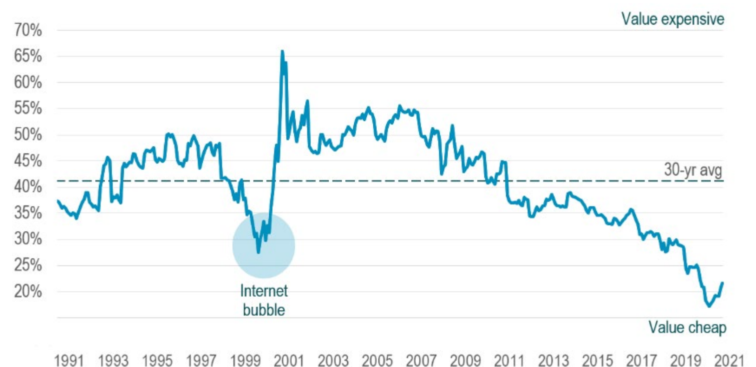
The tide began to turn last fall as the economy showed signs of rebounding faster and more vigorously than anticipated, bolstered by the government’s massive fiscal and monetary stimulus programs and later, FDA approval of effective vaccines. Longer-term interest rates jumped and the U.S. Treasury yield curve steepened. These conditions fueled a powerful rally in value stocks, which gained nearly 40% from last August through May 2021, outpacing growth shares by 15 percentage points.

WHY WE SEE VALUE IN VALUE NOW

Despite this strong run, value continues to trade at historic discounts to growth, as shown in Figure 1.

Figure 1. Valuations remain extremely attractive

Price-to-book, Russell 1000 Value vs. Russell 1000 Growth



Source: FactSet as of 31 Mar 2021. Index data does not reflect taxes, transaction costs, investment management or other fees and expenses that would reduce performance in an actual account. It is not possible to invest in an index. **Past performance is no guarantee of future results.**

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.
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We believe this valuation gap creates attractive opportunities for investors, although valuation alone is not a basis for expecting value to sustain its recent outperformance to the same degree or for any particular length of time.

That caveat notwithstanding, valuations combined with current market dynamics suggest that value's rally since last fall still has room to run over the near to medium term, at least. Among the variables favoring value are an accelerating global economy, stronger relative earnings growth and higher (but not too high) interest rates and inflation.

- **Accelerating global growth.** The speed and magnitude of the economic downturn in 2020 and the unprecedented policy response make it difficult to compare the current cycle to previous ones. What's clear is that the global recovery is still in its early days, meaning value and other cyclical areas of the market have the opportunity to benefit further from the favorable economic conditions that have buoyed their performance since last fall.

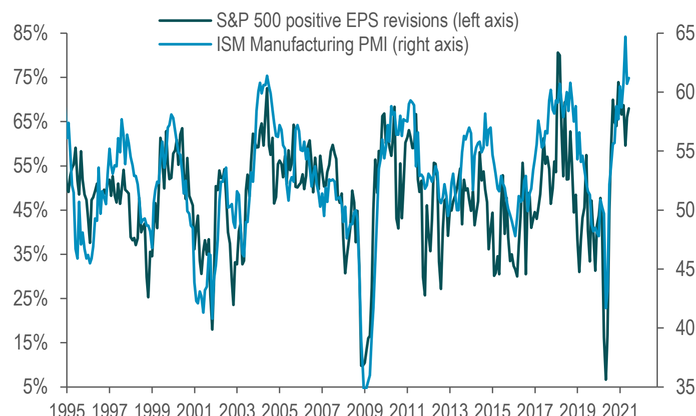
  In particular, as shown in Figure 2 below, upgraded GDP forecasts and a continued positive trajectory for global Purchasing Managers' Indexes (PMIs) should support value as fiscal and monetary policy remains accommodative, consumers increase spending and companies invest to relieve bottlenecks in their supply chains. We believe the uptrend in PMIs could last through the next three to four quarters.

- **Stronger positive earnings revisions.** The improving economic landscape augurs well for U.S. corporate profits. Figure 3 (above, right) illustrates the strong correlation between upward S&P 500 earnings revisions and U.S. manufacturing PMI readings. And while both value and growth stocks are poised to see EPS grow substantially over the next 12 months, consensus estimates call for a more than 10-percentage-point advantage for value (+34.4%) over growth (+24.0%) in 2021.

> *While both value and growth stocks should see earnings grow substantially over the next 12 months, consensus estimates show value with a big advantage.*

Figure 3. PMI and earnings are closely correlated

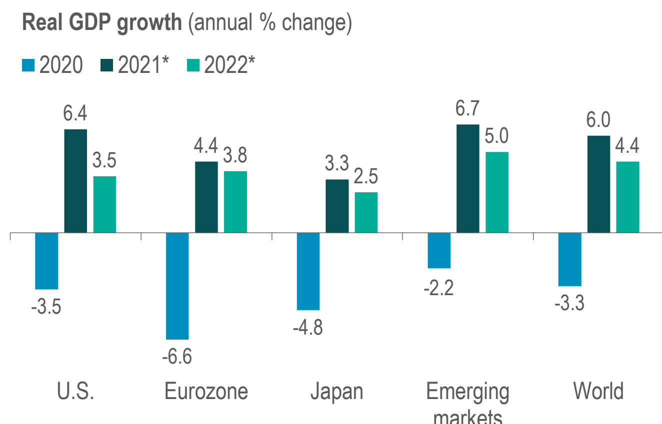
U.S. ISM and S&P 500 positive EPS revisions since 1995



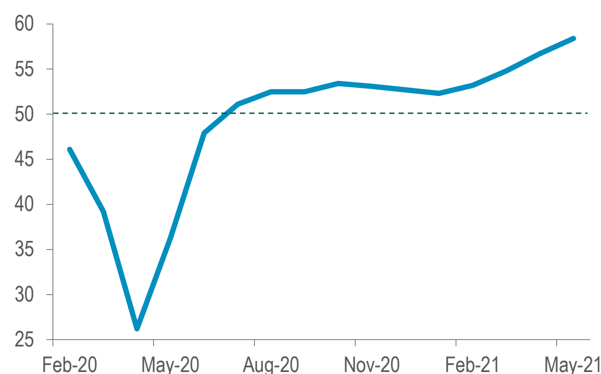
Source: Cornerstone Macro. Earnings revisions (up as % of total) via I/B/E/S.

Based on the Russell 1000 Value and Growth Indexes, the inflection point for value's faster earnings growth occurred in the fall of 2020 amid vaccine optimism and the early days of economic

Figure 2. Global GDP growth forecasts and PMI trends are supportive of value



Source: *IMF World Economic Outlook*, Apr 2021. *Projections.

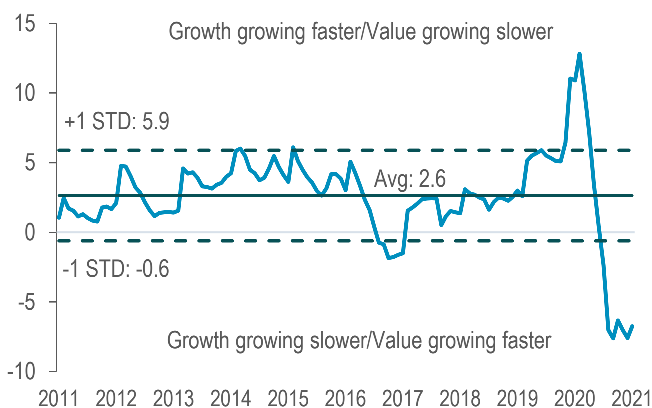


Source: JPMorgan.

reopening (see Figure 4). Since the beginning of 2021, that dynamic has been sustained, with the energy (value), materials (value/core) and financials (value) sectors seeing especially large revisions, benefiting from the cyclical rebound. Overall, we expect second-quarter results will represent peak earnings growth for this cycle.

Figure 4. Value has an earnings growth advantage

EPS growth (%), Russell 1000 Growth minus Russell 1000 Value



Sources: Russell, Refinitiv, FactSet, Credit Suisse.

- **Higher (but not too high) interest rates and inflation.** Value stocks tend to perform better when interest rates go up, which isn't surprising given that rates typically climb as economies expand. Higher rates are especially beneficial for financial stocks, which make up more than 20% of the Russell 1000 Value Index but only 2% of its Russell 1000 Growth counterpart. Meanwhile, rising rates are a headwind for growth companies, because their longer-dated future cash flows must be discounted at higher rates, reducing the current value of those flows.

Rates have already increased significantly, with the bellwether 10-year U.S. Treasury yield hitting a 2021 peak of 1.73% early in the second quarter and the 10-year/2-year yield curve steepening from 45 basis points (bps) at the beginning of August 2020 to 144 bps at the end of May 2021. Since then, the 10-year yield has begun to stabilize, generally trading in a narrow range between 1.5% and 1.6% into June 2021. We expect it will resume its upward path and end the year above current levels, though not dramatically so.

Rising inflation, like rising interest rates, is also a typical feature of economic strengthening, and therefore often associated with better performance by value stocks. That said, inflation that runs too hot can derail a recovery. While both the Consumer Price Index and core PCE (the Fed's preferred inflation barometer) have registered some material upside surprises recently, we view these sharper increases as largely transitory, reflecting unfavorable base effect comparisons to last year's weak inflation data and/or the lingering impact of pandemic-related supply disruptions in the face of unleashed pent-up demand as the economy continues to reopen.

A BUILT-IN GROWTH BIAS AND THE NEED TO REBALANCE

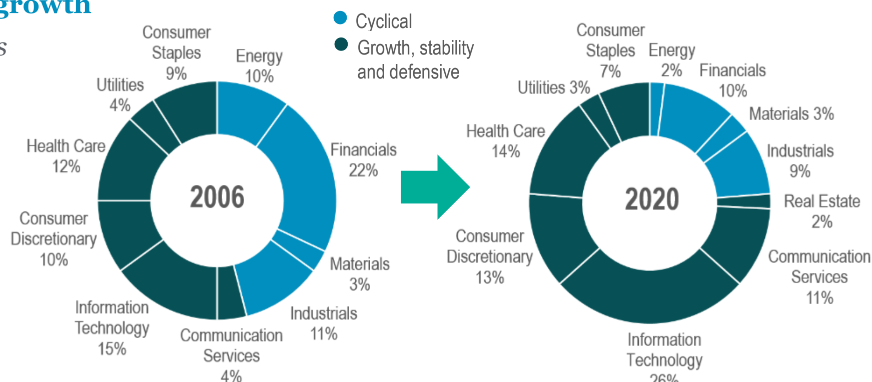
Beyond the more tactical case for favoring value now, it's important to recognize that growth's dominance over the past 10 years or so has created a growth bias in the composition of the broad equity market — with potentially serious implications for long-term portfolios, especially for investors who don't rebalance.

In Figure 5, note that cyclical and growth sectors within the market capitalization-weighted S&P 500 Index were fairly evenly balanced 15 years ago. Today, cyclical sectors account for just 24% of the S&P 500, meaning this ostensibly "core" benchmark in fact skews heavily toward growth-oriented names and sectors.

Figure 5. U.S. equity market skews toward growth

S&P 500 Index cyclical and growth sector weights

> *Cyclical sectors that used to represent nearly half of the S&P 500's market cap now make up less than one-quarter.*



Data source: Bloomberg. S&P 500 GIC sectors, 31 Dec 2006 vs. 31 Dec 2020.

Another way to look at this phenomenon: Without rebalancing, a portfolio that a decade ago allocated 50% of its assets to growth funds and 50% to value funds would now be weighted 66% to 33% in favor of growth — a function of the commanding outperformance by growth stocks during this 10-year period. The resulting portfolio’s diversification benefits would be diminished by significant overexposure to sectors like information technology, which alone makes up 45% of the Russell 1000 Growth Index.

CONCLUSION

Current and near-term projected levels of valuations, earnings, economic growth, inflation and interest rates represent the kind of market environment in which value has typically performed well. At the same time, there’s no assurance that value will maintain its advantage or match prior winning streaks, such as its exceptional multi-year run from 2000 to 2006. Performance drivers for both value and growth tend to be period-specific and hard to predict — which is why we favor a balanced approach to style exposure over time. For now, we continue to see opportunities in value that are too compelling to ignore.

For more information, please visit us at nuveen.com.

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