Musings on Growth versus Value: A Global Perspective

The global equity markets have experienced wild gyrations in 2020 driven by unprecedented events. The equity market performance in the first quarter was one of the worst quarters in multiple decades, marking the end of the longest equity bull market in the US history. This was followed by a sharp reversal in the second quarter, with sustained positive returns into the third quarter. Underneath these huge market swings, however, there has been a switch in market leadership between companies that benefit from global economies reopening versus those that gain from a lockdown to contain the coronavirus. Similarly, value stocks have tried to make a comeback several times, only to fizzle out. As a result, growth stocks continue to outperform and if anything, recent economic disruption from Covid-19 has caused the magnitude of growth outperformance relative to value to reach unprecedented levels.

In this report, we delve into the factors that have led to growth outperformance. We also analyze if growth can continue to beat value and what could lead to a reversal in the market leadership. There is a common belief that the underperformance of Energy and Financials stocks, and outperformance of Information Technology stocks have led to the divergence in growth and value. So, will a reversal in Energy and Financials lead to value outperformance? Value stocks tend to be correlated with economic cycles, and hence, we believe that a broad-based economic recovery could lead to a more balanced performance between growth and value. However, given the reduced weighting of Energy stocks, higher return in just this sector is unlikely to lead to value outperformance. Similarly, the Financials sector has also become less significant than in the past and they face a tough macro environment of low interest rates. Hence, we believe that a cyclical recovery that also includes Materials and Industrials is more likely to lead to a sustained value rally.

Value and Growth Methodology

We use MSCI's definition of growth and value styles. MSCI employs a two-dimensional framework for style segmentation, in which value and growth are represented by multiple factors. The value investment style is defined by the following three variables.

- Book value to price ratio
- 12-month forward earnings to price ratio
- Dividend yield

The growth investment characteristics are defined using the following five variables.

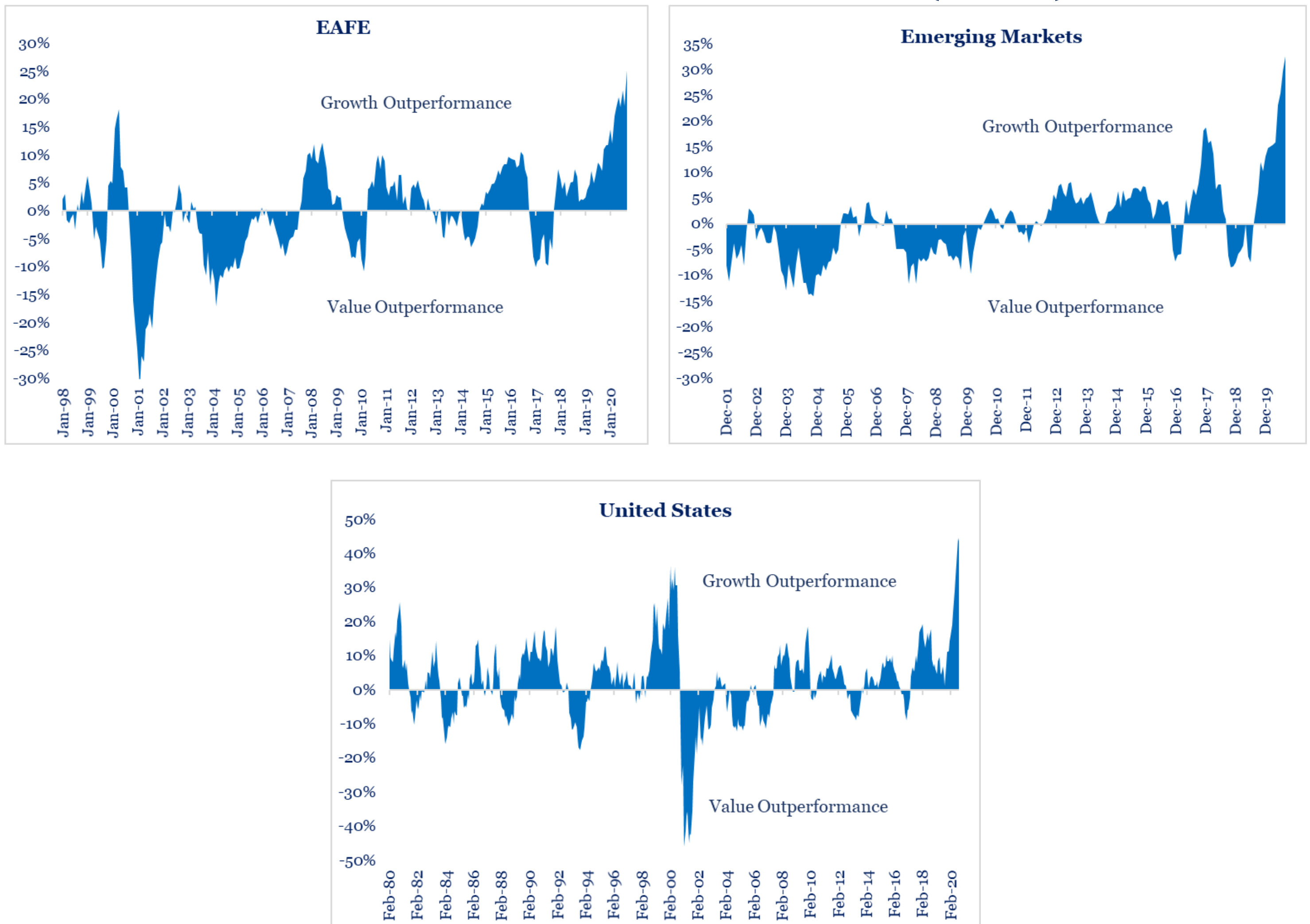
- Long-term forward earnings per share (EPS) growth rate
- Short-term forward EPS growth rate
- Current internal growth rate
- Long-term historical EPS growth trend
- Long-term historical sales per share growth trend

Based on the above variables, MSCI calculates value and growth z-scores to determine the overall style characteristics of each security. However, non-value does not necessarily mean growth, and vice versa. In addition, some securities can exhibit both value and growth characteristics while others may exhibit neither. By the same token, some securities may be only value or growth. In the US, Russell uses a similar methodology using two growth (medium-term forecast earnings growth and five-year historical sales growth) and one value (price to book) characteristics. Based on both methodologies, however, value stocks tend to be cheaper while growth stocks are those that can grow earnings at a faster pace.

Historical Performance

In Exhibit 1, we present the performance of growth versus value styles in the international developed (EAFE), emerging markets (EM) and the United States. The line, in these charts, represents the difference in performance between growth and value on a rolling 12-month basis. Since the Global Financial crisis, growth has tended to outperform value, and the pandemic has further enhanced the divergence in performance. In the past one year ending September 2020, growth has outperformed value by 26.8 percentage points (pp) in EAFE and 32.5pp in EM. In the US, the outperformance is even greater at 46.3pp based on MSCI and 42.5pp according to Russell data.

Exhibit1. Historical Growth vs. Value Performance (% Points)



Source: Bloomberg, MSCI, Russell, HGP

The last time growth outperformed value by a similar magnitude was during the TMT (Telecom, Media and Technology) bubble. At that time, growth outperformed by approximately 21pp in international developed markets, and 36pp in the US. However, as the bubble burst in March 2000, there was a sharp reversal with value outperforming growth by 37pp and 45pp in the US and international developed markets, respectively by mid-2001.

Subsequently, over the 7-year period through the Global Financial crisis, value outperformed growth on average 5.6pp per year in the international developed markets and 5.2pp in emerging markets while the magnitude was much higher

at 9.7pp in the US. Since 2007, growth has sustained its solid performance with annualized 3.9pp of outperformance in international developed markets, 3.2pp in EM and 7.4pp in the US.

The magnitude of growth dominance had extended for a prolonged period even before the pandemic. The crisis has caused the outperformance to reach unprecedented levels. However, even then value comeback has occurred only in fits and starts. Value has tried to make a comeback several times this year – March, May, and July – but has not lasted. So, what is going to tip the scale in favor of value for a sustainable period? Are we overdue for a reversal? Can growth outperformance sustain for a longer period?

Sector Composition

It is often said that growth and value outperformance has been driven by outperformance of Information Technology and underperformance of Energy and Financial sectors. In Exhibit 2, we compare the sector breakdown between growth versus value in MSCI EAFE, EM and US indices. It is true that growth indices have a much higher representation in Information Technology sector while there are more Financials and Energy stocks in value. If you include technology stocks in Consumer Discretionary and Communications, then there is an even greater weighting of such tech-like companies in growth. For example, Amazon and Alibaba in Consumer Discretionary as well as gaming companies such as NetEase and NCSoft in Communications. Interestingly, Communications companies in EAFE are traditional telecom and wireless companies, and hence they tend to be value stocks. In general, Information Technology, Consumer Discretionary and Communications – sectors that have tech and tech-like companies – constitute 68% and 75% of the EM and US growth indices, respectively, but only 30.9% of EAFE. By contrast, Health Care and Consumer Staples constitute a larger portion of the EAFE Growth index while in the US, majority of the stocks in these sectors are considered value.

Exhibit 2. Sector Breakdown

September 30, 2020	MSCI EAFE			MSCI EM			MSCI USA		
Sectors	**Growth**	**Core**	**Value**	**Growth**	**Core**	**Value**	**Growth**	**Core**	**Value**
IT	14.2%	8.6%	2.7%	21.1%	18.5%	15.4%	43.7%	28.8%	10.5%
Discretionary	12.4%	11.9%	11.3%	30.4%	20.2%	8.1%	16.6%	12.2%	6.9%
Communications	4.4%	5.5%	6.7%	16.7%	12.7%	8.0%	13.2%	10.7%	7.6%
- Subtotal	**30.9%**	**26.0%**	**20.7%**	**68.1%**	**51.4%**	**31.5%**	**73.5%**	**51.6%**	**25.0%**
Health Care	20.0%	14.4%	8.4%	5.6%	4.3%	2.8%	13.0%	14.1%	15.4%
Staples	17.5%	11.9%	6.0%	6.7%	6.1%	5.3%	2.4%	6.7%	11.9%
- Subtotal	**37.5%**	**26.3%**	**14.4%**	**12.4%**	**10.4%**	**8.1%**	**15.4%**	**20.8%**	**27.3%**
Industrials	15.6%	15.2%	14.9%	3.1%	4.4%	5.9%	5.2%	8.1%	11.7%
Materials	6.0%	7.6%	9.3%	5.3%	6.9%	8.9%	1.6%	2.5%	3.7%
Real Estate	1.9%	3.1%	4.4%	0.9%	2.4%	4.1%	1.9%	2.8%	3.8%
Utilities	0.8%	4.0%	7.4%	0.8%	2.0%	3.4%	0.1%	2.9%	6.4%
Energy	0.6%	2.8%	5.1%	2.1%	5.4%	9.4%	0.1%	1.9%	4.0%
Financials	6.8%	15.1%	23.9%	7.4%	17.2%	28.8%	2.3%	9.4%	18.0%
- Subtotal	**31.7%**	**47.8%**	**64.9%**	**19.5%**	**38.2%**	**60.4%**	**11.2%**	**27.6%**	**47.6%**

Source: MSCI, Bloomberg

On the flip side, the value index has a higher concentration of Energy and Financial stocks in all three indices. However, the importance of these sectors have declined over the last decade while other cyclical sectors such as Materials and Industrials have become more important. For example, at the end of 2011, just the Energy sector was more than 12%

of the EAFE value index while today it is less than half of that at about 5%. Similarly, as recently as in 2017, the Financials sector had 35% weighting, which has now fallen to 23.9%. By contrast, Materials and Industrials combined were 13% in 2011 and in 9 years, it has almost doubled to 24%.

The mix and changing fortune of certain sectors could certainly tilt the performance in favor of value versus growth. For one thing, Energy and Financials could make a come-back. Second, the much-loved Information Technology sector could lag. Third, the cyclical sectors such as Materials and Industrials could rise thus providing a tailwind to value stocks. We explore each of these factors in greater detail.

Changing Dynamics in Energy Supply and Demand

Over the last 15 years, change in supply dynamics have had a meaningful impact on oil prices. In 2007, the US produced 5 million barrels a day of oil compared with 13 million today, thanks to the shale boom. Meanwhile OPEC contribution to global oil supply remained flat around 32.5-34m barrels per day even when global demand increased from 85mbd to more than 100mbd over the last decade. The pandemic, however, has led to a collapse in global oil demand to 79mbd in April, a level last seen in 2003. Consequently, the US benchmark West Texas Intermediate briefly dropped below zero in April 2020.

These negative developments have led to a significant decline in the representation of energy sector in major equity indices. Despite a modest economic recovery, oil-and-gas companies have been hammered by a sustained drop in consumption of gasoline and jet fuel as millions of people work from home and avoid driving and flying. IEA forecasts that global consumption of petroleum and liquid fuels will average 92.8mbd for all of 2020, down by 8.6mbd from 2019, before increasing by 6.3mbd in 2021. Furthermore, the industry faces difficulty attracting investments as the rising importance of environmental considerations have continued to weigh on the valuations of energy producers.

While it feels like doom and gloom for the energy industry, there are several undercurrents moving in its favor. First, oil prices could find some support from a weaker US dollar. Secondly, the pandemic has forced producers and service providers to cut costs across the board while adopting digital technologies. This should provide further operating leverage to the business should oil prices recover from here. Lastly, there is an ongoing shift from fossil fuel to clean energy, and many oil companies have invested heavily in low-carbon alternatives while sustaining its legacy oil and gas operations. Hence, the oil majors are banking on greener fuel as oil demand may have already peaked. Investors tend to reward low-carbon alternatives and hence, the question is when do such alternatives make the stocks more socially acceptable. Nevertheless, at current exposure of 5-9% in value indices, the Energy sector on its own is unlikely to contribute significantly to a value rally.

Low Interest Rates and Financials Sector

A large part of the underperformance in financial stocks since 2007 can be put down to the financial crisis of 2008 and the low interest rate environment that has persisted in its aftermath. Both net interest margins and loan growth have been low relative to the past. Post-crisis regulation has also been cumbersome; this has increased capital levels and reducing banks' return on equity. In addition, some banks have had to compete in extremely competitive lending markets, while regulatory and technological changes have increased costs. Financials stocks and in particular, banks have had a tough time against this backdrop.

The situation has only become worse with the pandemic. Monetary stimulus during this pandemic has driven interest rates even lower, putting further pressure on financials. However, as the US 10-year treasury yield bottomed at 50bps in early August and climbed back up to almost 80bps, Financials have outperformed. Furthermore, a positive yield curve has also helped. The Financial sector has substantial weighting in the value indices and hence, higher returns would help value stocks. However, we believe that the zero-interest rate environment is here to stay for a while. As

Federal Reserve Chair Jay Powell recently stated, “The Fed is not even thinking about thinking about raising rates”. Such an environment may not be conducive for financial companies.

Are we in a Technology bubble?

The IT sector had already outperformed before the pandemic, and if anything, the recent disruption has catapulted these stocks to even greater heights. As the coronavirus pandemic shut down much of the economy and pushed an increasing share of life online, technology companies benefitted. Several companies in the US have gone public to take advantage of this favorable market condition. There have been 286 IPOs in the US in 2020, with 69 just in September. Some of the recent IPOs are reminiscent of the TMT bubble era. For example, Cloud software company, Snowflake went public on September 16 at $120 a share. The stock opened at $245 and closed at almost $254, up nearly 112% in one day!

Exhibit 3. MSCI USA Information Technology: Price to Earnings Ratio

Source: Bloomberg

In addition, there have been numerous Special Purpose Acquisition Company (SPAC) deals lately reaching $48 billion so far in 2020 compared with $14bn in 2019. SPAC, also known as blank check company, is a shell company that has no operations but plans to go public with the intention of acquiring or merging with a company utilizing the proceeds of the SPAC. These issuances have been so popular in the US that the London Stock Exchange is also exploring how to attract these companies to the UK. Given these activities it is possible that there are pockets of overvaluation. However, broad sector valuation is nowhere close to the levels around TMT bubble (Exhibit 3) just yet.

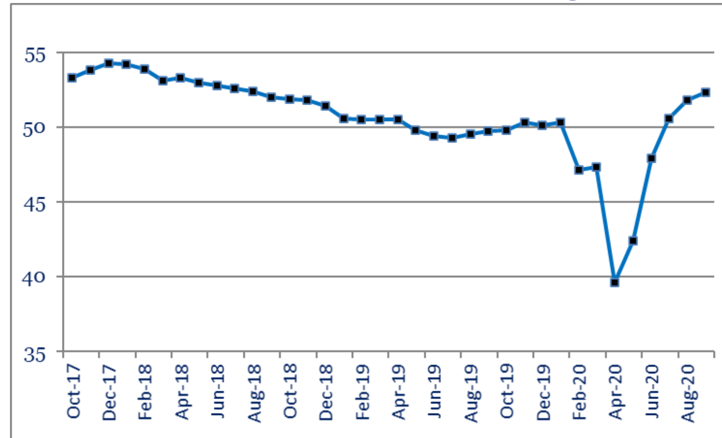
What could drive the Cyclicals Higher?

Many governments were swift to respond to the economic slowdown caused by the virus-led lockdown. The unprecedented level of stimulus that followed, is beginning to show some positive effects. As presented in Exhibit 4, global PMI has picked up and risen above the pre-pandemic level. The International Monetary Fund (IMF) recently stated that the developments in the second and third quarters were somewhat better than expected, allowing for a small upward revision to their global forecast for 2020.

According to the IMF, one factor that has contributed significantly to the improved outlook is a snapback in global trade. The U.S. posted its widest monthly trade deficit in more than a decade in August, as imports of consumer goods set a monthly record. The resilience of global commerce is lifting major economies such as China and Germany; it is also easing fears that the coronavirus pandemic could permanently displace global supply chains. However, the recovery has been uneven. Manufacturing and trade are returning rapidly toward precrisis levels, as households continue to buy imported goods, often supported by government cash. Meanwhile, the recovery has been

sluggish for local service providers such as restaurants and movie theaters, as people continue to social distance to contain the coronavirus.

Exhibit 4. Global Manufacturing PMI



Source: Bloomberg

The IMF has warned that the period of recovery from the crisis would be "long, uneven and uncertain". There are concerns that those unemployed will be permanently displaced. Meanwhile many countries are experiencing a second wave of the coronavirus. They advise that countries able to access finance should borrow as much as needed to protect the public from the crisis and limit the extent of economic contraction. Similarly, the Federal Reserve Chair, Jay Powell has also warned that providing too little support for the economy would be far more dangerous than offering excessive help. And the World Bank Chief Economist Carmen Reinhart has advised that developing countries to take on additional debt to fight the virus.

Hence, any economic recovery in the foreseeable future remains dependent on expansionary fiscal and monetary policies. Until there is a broad-based economic recovery, we believe that value resurgence is likely to stall once again. In our view, given the reduced weighting of Energy stocks and a tough environment for Financials, value revival will depend on recovery in Materials and Industrial companies.