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Columbia Threadneedle Investments

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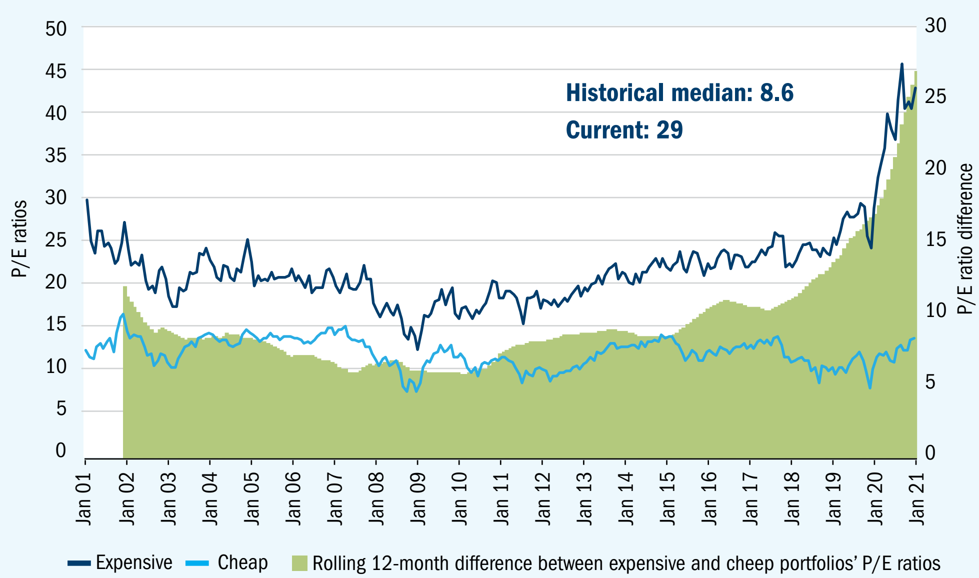
Does the value rotation have staying power?

The prospects of improving economic growth and rising rates have driven a much-observed cyclical rotation as investors bet that assets that benefit from a strengthening economy and a pickup in inflation will outperform growth stocks. From here, the key question is, will this trend continue? Here's why we believe it will.

Valuation spreads remains elevated

In our view, even after the big recent gains for cyclicals and cheap stocks, there is a strong case for further upside for value as life gradually returns to normal. As of the end of April, the valuation spread — the difference between the forward P/E ratio of the most expensive and the cheapest stocks — was 4.1 standard deviations above its historical average since 2001 (Exhibit 1). That is, value stocks continued to trade at a large discount versus the market average (40%) and the expensive basket (66%). As this valuation spread narrows, we expect value stocks to continue to outperform. Importantly, while the steep discount of value stocks makes them very attractive, for any returns to be justified and sustained over a longer horizon, they must eventually be supported by fundamentals.

Exhibit 1: Value stocks continue to trade at a large discount

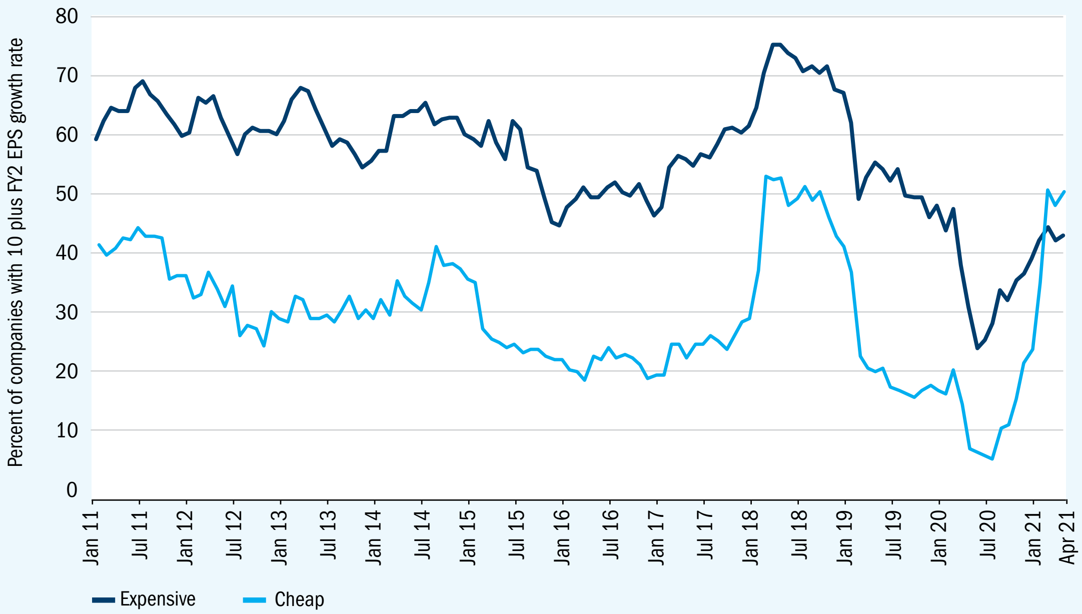


Source: Columbia Threadneedle Investments; Russell 1000 universe; Stocks are grouped into five equal-sized buckets based on their relative Composite Value ranking within corresponding sectors; The composite value includes four elements: deep value, earnings yield, cash flow yield and shareholder yield; The median fiscal year two P/E ratios are calculated.

Shift in fundamental expectations

The lack of growth has been a constant headwind for value's underperformance in recent years, but there are some signs that this tide has turned. Since the second quarter of 2020, the number of names in the cheapest equity bucket with more than 10% forward EPS growth has been steadily rising from 7% to 50% (Exhibit 2). That is not necessarily a surprise on its own given the strength of the recovery and abundance of positive revisions across the market. More notably, at the end of March, for the first time in two decades, there was a higher percentage of companies with high growth rates in the cheapest bucket than in the most expensive bucket.

Exhibit 2: The number of cheaper stocks with EPS growth above 10% is near a 10-year high

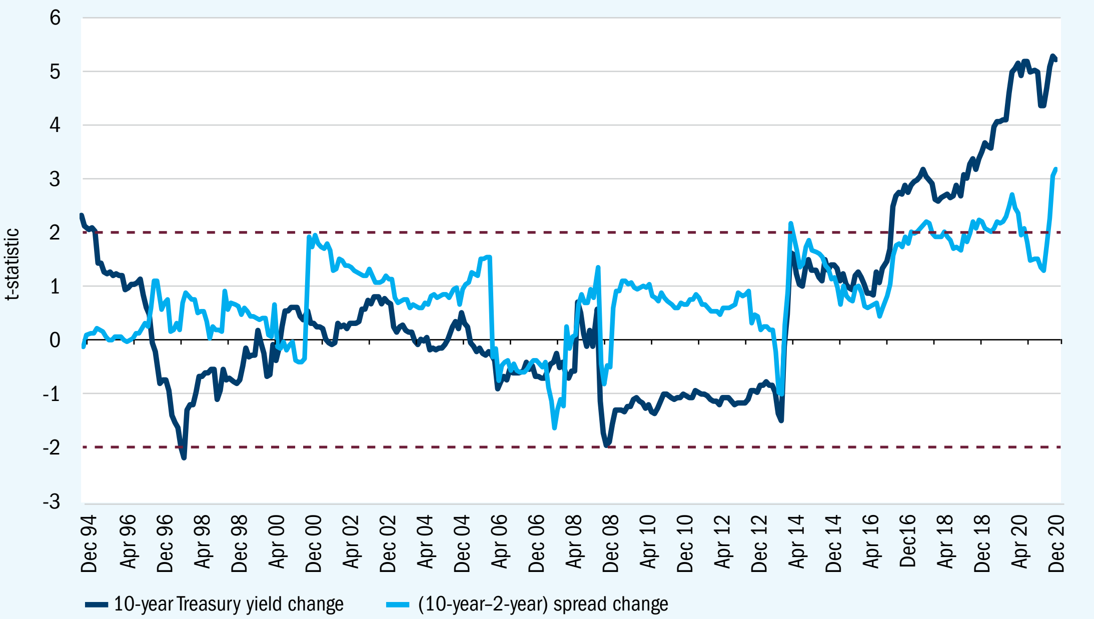


Source: Columbia Threadneedle Investments; Russell 1000 universe; Stocks are grouped into five equal-sized buckets based on their relative Composite Value ranking within corresponding sectors; The composite value includes four elements: deep value, earnings yield, cash flow yield and shareholder yield; Estimated future compounded 2-year annual growth rate compares recent reported year and next estimate year.

Stronger links with rising interest rates

Continued progress in COVID-19 vaccinations and massive government stimulus are fueling a strong economic recovery. According to the International Monetary Fund, the U.S. economy is forecast to expand 6.4% in 2021 — its fastest growth rate since 1984. The prospects for improving growth and rising inflation expectations are driving long-term interest rates higher, which tend to benefit cyclical and other deep value stocks. More important, the link between value and interest rates seems more notable since the Great Recession (Exhibit 3).

Exhibit 3: Value's sensitivity to rate changes and spread changes has become more significant



Source: Bloomberg, Columbia Threadneedle Investments. The regressions are based on monthly data over a rolling 5-year period, and includes two independent variables: the market as a control variable (t-statistic not shown) and one rates variable. The dependent variable is the monthly quintile return spread for composite value strategy in the Russell 1000 universe (sector neutral, top 20%–bottom 20%, square root of market value weighted); The composite value includes four elements: deep value, earnings yield, cash flow yield and shareholder yield.

We believe that there's still significant runway for the value rally to continue, although some choppiness can be expected, as evidenced by the recent market pullback in value amid heightened global COVID-19 concerns. And while recent value rallies have been a fraction of the duration and magnitude of their historical (pre-financial crisis) averages, macro, sector-specific, and fundamental trends suggest this value run has the potential to stick around.

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