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Market Ethos

The latest market insights from the Richardson Wealth team

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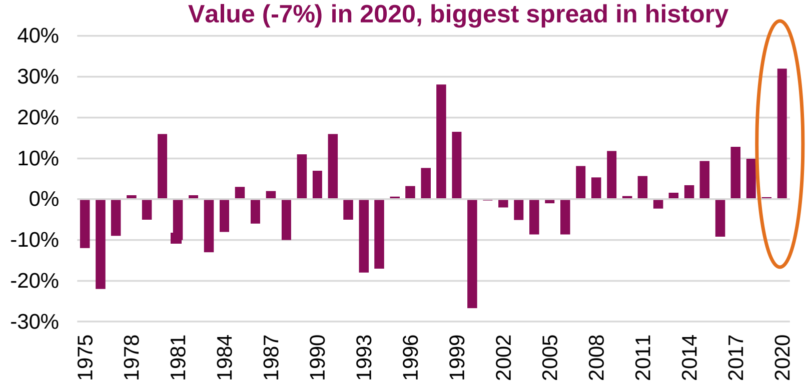
The great rotation?

Craig Basinger, Derek Benedet, Chris Kerlow, Alexander Tjiang, Brett Gustafson

This year has seen an historic divergence between the economy and the stock market, and also within equity markets themselves. There is no question that the COVID-19 pandemic and the response in fighting it has unfairly impacted many industries while many others remain unscathed or have even benefitted. Those industries in which people are typically in close proximity (restaurants, bars, gyms, shopping malls etc.) have suffered while those that can continue operating without any social gatherings were spared. Certainly, life can be unfair on many fronts, but this seemingly random criteria is particularly cruel.

This divergence has manifested in the equity markets as well, accelerating some pre-existing trends and abruptly changing others. This can be seen in the contrasting performance this year of Growth versus Value stocks. To be frank, Growth has outperformed Value by more so far this year than any year in the past (indices were created in the mid 1970s).

Chart 1: S&P 500 Growth (+25% YTD) has crushed Value (-7%) in 2020, biggest spread in history



Defining value and growth is often in the eye of the beholder, which could be a whole different Market Ethos. In this report we will rely on S&P which splits the S&P 500 into S&P 500 Growth and S&P 500 Value. Companies with growth characteristics including higher sales growth, earnings growth and momentum are placed in the Growth bucket. Companies with lower price-to-book, price-to-earnings and price-to-sales ratios are placed in the Value bucket.

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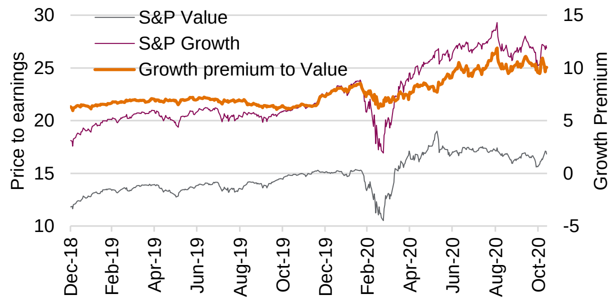
Growth has been dominant over Value for numerous reasons this year given changing behaviour and market dynamics. The Growth category consists of more technology companies, which have benefited from the pandemic-induced changes such as streaming, cloud usage and enabling more of us to work effectively from home. Plus, Growth stocks have more of their cash flow further out into the future. With yields falling due to the recession/pandemic, the discount rate on these future earnings is less, making them worth more. Growth companies are also, on average, less sensitive to the economy compared to Value companies. Given we are in a recession, this too has benefited Growth.

Chart 2: Relative valuations of Growth vs Value are Stretched, with the premium in the 99th percentile over past 20 years

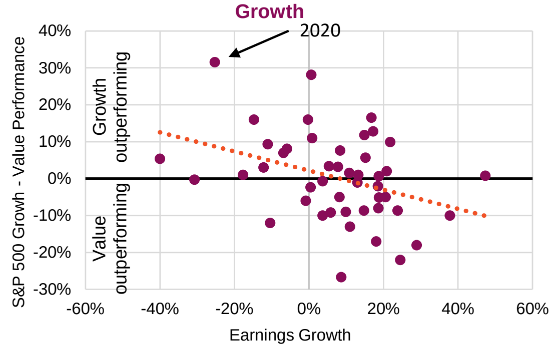


It is fair to say that this has been a perfect storm for Growth at the expense of Value. This divergence can be seen in other areas beyond just the S&P 500 style indices. Canada's TSX and European equities have a much bigger value tilt than the overall S&P 500. This style difference between major indices is evident in the year-to-date price performance with the S&P 500 +10%, TSX -2%, and Europe -8%.

Has the rotation started?

On the news from Pfizer (Monday, November 9) that its vaccine showed better-than-expected efficacy (90%) a short period after the second dose, the Growth-vs-Value trend reversed. This past week saw the S&P 500 Growth index was flat while the S&P 500 Value index rose +5.6%.

Chart 3: Negative earnings growth favours Growth



Pfizer's news surprised the market both in terms of the vaccine's projected timing – now expected in Q1 instead of Q2 (based on the Good Judgement forecasts) and in terms of its efficacy. The news also triggered a change in views about the economy's recovery; that it could get closer to "normal" sooner than expected from this terrible pandemic, thereby prompting the reversal of this trend.

If this rotation out of Growth and into Value has started, it could last for some time. The relative valuations of Growth versus Value is in the 99th percentile based on data over the past two decades for the S&P 500 style indices (**Chart 2**). Growth, which normally trades at a premium, is at 27x based on forward estimates. Value is at 17x, over 10 multiple points cheaper. This is extreme. If this reverted to the more historical norm of 5 multiple points, that implies a 19% decline in Growth or 29% rise in Value (or a less dramatic combination of both).

Furthermore, during years with negative S&P earnings growth, the Growth style tends to outperform (**Chart 3**). This is likely due to growth being scarce so companies that have some growth get a premium. On the flipside, when earnings growth is robust, the Value style tends to outperform. We highlighted 2020 on the chart and it is worth noting that if current consensus estimates hold for 2021, the S&P 500 will enjoy a 40% earnings growth rate.

Investment implications

One week does not a trend make. The vaccine news has been good but it likely won't be a straight line back to normal. Any setback, such as rising case counts (which are clearly rising at the moment), or further stumbling on future government stimulus, could easily reinforce the growth-over-value dominance.

However, this will turn. **And the equity market, which is really an aggregate of everyone's future expectations, will likely start favouring Value over Growth long before any of us *stick a needle in our arms.*** While not abandoning those high-flying Growth names all together, since September we have continued to recommend investors take profits and redeploy into Value. It is not too late.

Please speak to your Advisor to determine if this strategy is applicable to your portfolio

Source: Charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise noted.