On the Minds of Investors

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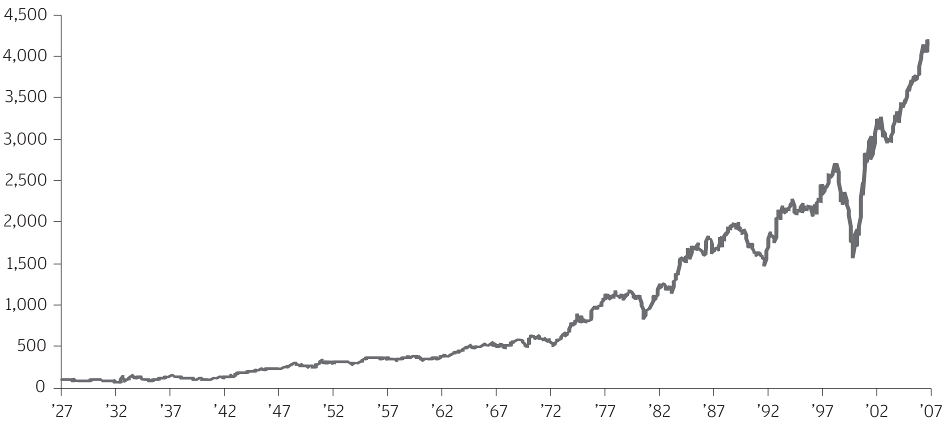
What would it take for value to outperform again?

The danger of extrapolating the past

From 1927 to 2007, buying shares that were cheaper than the rest of the market (value* investing) led to very significant outperformance (**Exhibit 1**). That cheap stocks should be preferable to expensive stocks seems so logical that, by 2007, it was widely assumed that value investing was the best approach for long-term investors.

EXHIBIT 1: RELATIVE PERFORMANCE OF US VALUE VERSUS GROWTH

Relative index level rebased to 100 at Jan 1927



Source: Fama French, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 January 2020.

However, that orthodoxy has been shaken to its core in recent years. Since 2007, cheap stocks have underperformed more expensive stocks, which have been able to grow their earnings at a faster pace. This underperformance has now gone on for so long that many believe value investing is dead and growth investing—buying companies that deliver fast sales growth—is the new religion.

Investors tend to extrapolate the recent past. In 2007, they thought value stocks would keep outperforming, while today they mostly expect growth stocks to continue to lead the pack. But backing the current favourite isn't always the best strategy. Just think of the return for someone who bet on Leicester City topping the Premier League in 2016 relative to someone who bet on the All Blacks winning the last Rugby World Cup.

* MSCI defines value as stocks which are cheap based on price-to-earnings, price-to-book and dividend yield metrics, relative to the market.

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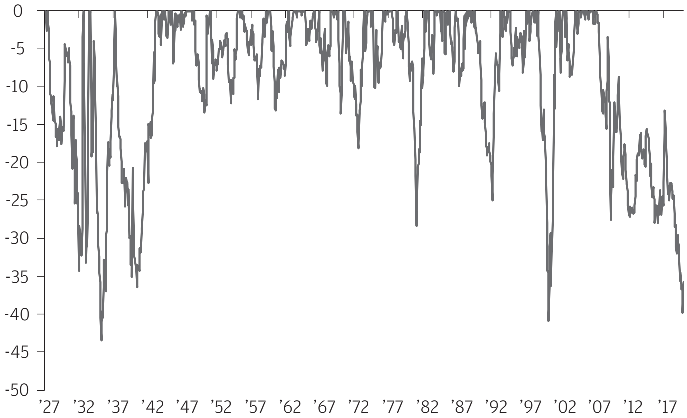
The underperformance of value relative to growth since 2007 is now approaching levels only seen during the 1930s and the dot com bubble. After such significant periods of value underperformance the snap back in favour of value has historically been large and quick (**Exhibit 2**), cautioning investors against being underweight value stocks after such a long period of underperformance.

EXHIBIT 2: US VALUE DRAWDOWN RELATIVE TO GROWTH

% drawdown from market peak in value versus growth relative performance



Source: Fama French, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 January 2020.

Is this time different?

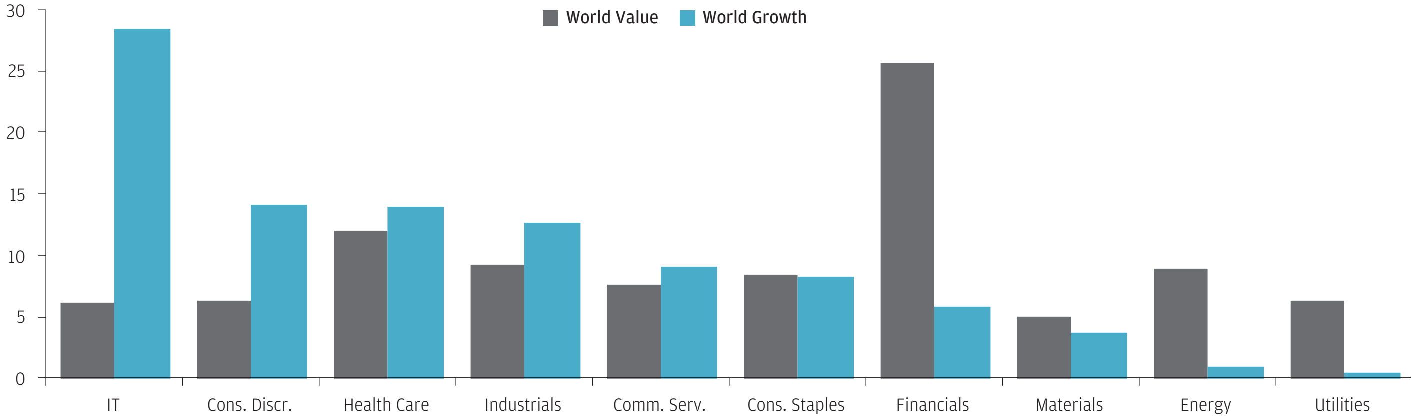
Financials are the largest part of the value index, whereas technology stocks make up the largest part of the growth index (**Exhibit 3**). So a large part of the underperformance of value stocks since 2007 can be put down to the financial crisis of 2008 and the low interest rate environment that has persisted in its aftermath.

Both net interest margins and loan growth have been low relative to the past. Post-crisis regulation has increased capital levels, improving financial stability but 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 the importance of scale in sales and trading. Financials have had a tough time against this backdrop, creating a few winners, who gained market share, but also many losers.

Some technology stocks, on the other hand, have benefited from significant disruption, allowing them to deliver phenomenal sales and user growth. Consider that in 2007, the first iPhone was unveiled, Netflix launched its video streaming service and online retail sales accounted for only 3% of overall US retail sales compared with 11% today. Likewise, global online advertising accounted for less than half the overall spend on newspaper advertising in 2007. Today, advertisers spend more than four times the amount online than in newspapers. Facebook had only just become available beyond universities, Uber didn't exist and most people thought a tweet was how birds communicated, not politicians.

EXHIBIT 3: MSCI WORLD VALUE AND GROWTH SECTOR WEIGHTS

% of total market cap



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Real estate is not included in the sector breakdowns due to the small size of the weight in each index. Past performance is not a reliable indicator of current and future results. Data as of 31 December 2019.

With the benefit of hindsight, it's no surprise that financials have struggled to keep pace with the biggest tech stocks since 2007. In an environment of low interest rates and slow growth, investors were willing to pay up for disrupters that could deliver significant growth. Some of those large tech names have delivered incredible performance, but one has to question whether these returns can be replicated over the coming years (**Exhibit 4**).

EXHIBIT 4: SELECTED US STOCK MARKET RETURNS SINCE 2007

Equity	Total return since 2007 (%)
S&P 500	175
Alphabet (Google)	481
Microsoft	630
Apple	2,499
Amazon	4,674
Netflix	9,889

Source: Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

While the outperformance of technology over financials has been key to the outperformance of growth over value, other sector disparities have been important drivers of value's underperformance too. Growth has a much larger exposure to consumer discretionary stocks than value and value has a much larger exposure to energy stocks than growth.

In 2007, the US produced 5 million barrels a day of oil compared with 13 million today, as a result of the shale boom. This change in the supply dynamics of the energy market has lowered energy prices, benefiting consumers more than the large oil companies. Those betting against value should consider that, on the one hand, energy prices may not remain so subdued in the long term (**Exhibit 5**), while on the other hand, the rising importance of environmental considerations could continue to weigh on the valuations of energy producers.

Overall, growth stocks have outperformed since 2007 as a result of significant disruption and structural shifts, combined with an environment of **slow** economic and loan growth, and **low** interest rates and commodity prices, which have held back energy and financial stocks.

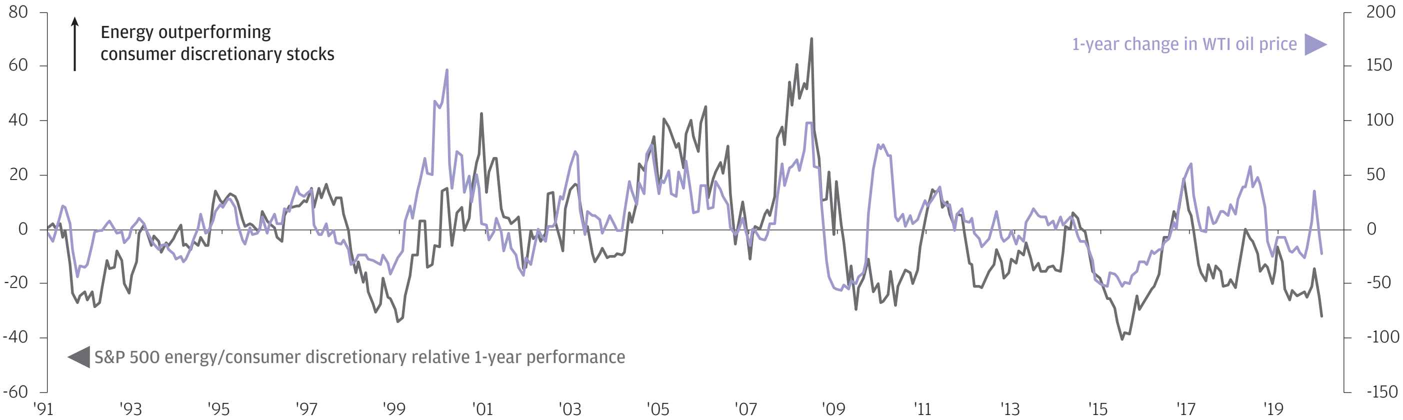
Value could outperform in two out of three economic scenarios

As we see it, there are three possible scenarios for the economy and value could outperform in two of them. The three scenarios are a continuation of the existing slow and low economic backdrop, a downturn/recession and reflation.

If we remain in this "slow and low" environment, then growth stocks may continue to outperform. However, in either a recession or a reflation scenario value stocks could outperform.

EXHIBIT 5: S&P 500 ENERGY AND CONSUMER DISCRETIONARY RELATIVE ONE-YEAR PERFORMANCE AND OIL PRICE

% change year on year of relative index level (LHS); % change year on year (RHS)



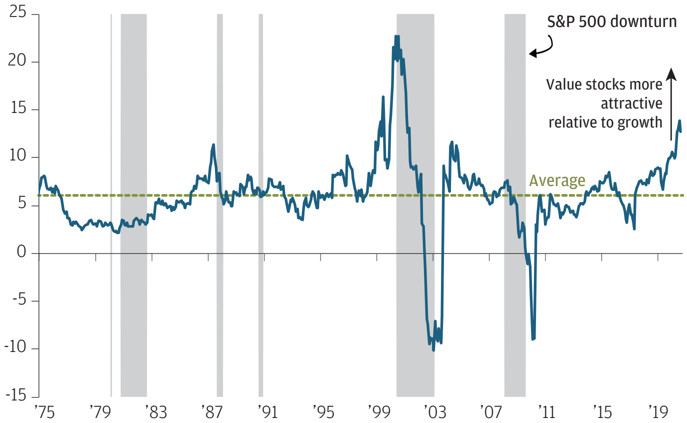
Source: Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

Recession

When investors extrapolate the past and expect stocks that have delivered fantastic growth in the past to continue to do so in the future, the gap in valuation between growth stocks and cheaper value stocks can become particularly extended. Today, the gap between the price-to-earnings (P/E) ratio on growth and the P/E ratio on value stocks is higher than it has been 97% of the time since 1975, and is the highest since 2000 (**Exhibit 6**).

EXHIBIT 6: MSCI WORLD GROWTH AND VALUE PRICE-TO-EARNINGS (P/E) GAP

MSCI World Growth minus MSCI World Value trailing 12-month P/E



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

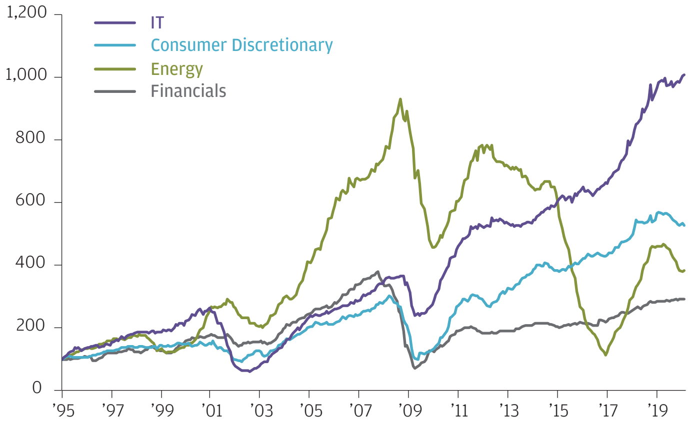
The problem is that earnings in many growth sectors, such as technology and consumer discretionary, are highly cyclical, rising and falling with the economy. While it's true that some of these stocks have delivered strong growth in a slow growing economy, that's not the same thing as expecting them to continue to deliver strong earnings growth during a recession. For example, corporate technology budgets, advertising and retail spending have almost certainly not become immune to recessions just because they have shifted online or to the cloud. Yet they are priced for continued strong earnings growth, so even slower earnings growth could hurt their valuation, let alone an actual decline in earnings.

It's true that many value stocks are cyclical too. But earnings among value stocks start from a much lower base today. As the recession in 2001 showed, earnings for growth sectors, including technology and consumer discretionary, can fall by more than earnings for value sectors, such as financials and energy—particularly if there's no commodity or financial bubble prior to the recession (**Exhibit 7**). With no obvious commodity or financial bubble today, and with earnings in the energy and financial sectors still well below their 2007 levels, compared to earnings in the technology and consumer discretionary sectors that are well above their 2007 levels, growth stocks could see a sharper decline in earnings than value stocks when the next recession hits, as they did from 2000-2003.

EXHIBIT 7: MSCI WORLD TRAILING EARNINGS PER SHARE AND EARNINGS PER SHARE DRAWDOWN, BY SECTOR

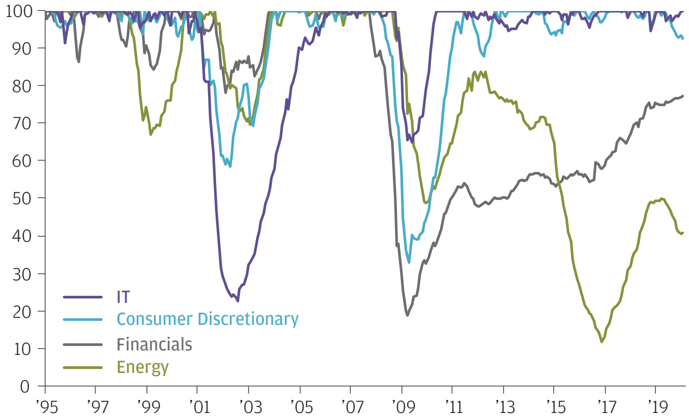
MSCI World trailing earnings per share

Index level, rebased to 100 in 1995



MSCI World trailing earnings per share drawdown

% drawdown from maximum

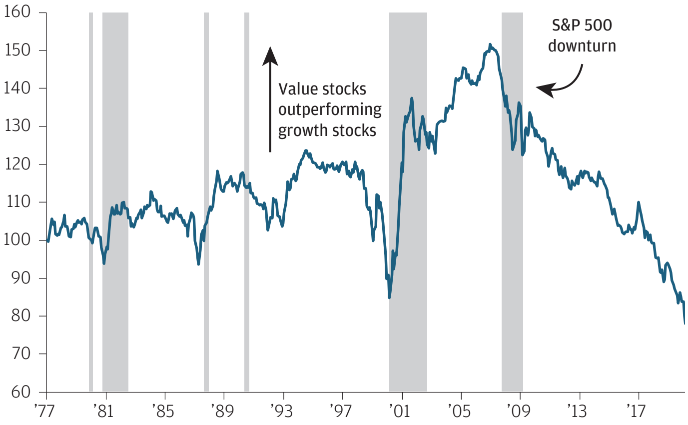


Source: (All charts) IBES, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Charts shown are based on trailing earnings per share in US dollars. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

With growth stocks historically expensive relative to value stocks, and given the potential for earnings to fall by more in the key growth sectors than in the already depressed value sectors, growth stocks could underperform during the next recession. This wouldn't be at all unusual. While value underperformed in the last bear market as the financial and commodity bubble burst, value has tended to outperform in prior bear markets. This has particularly been the case when growth had significantly outperformed in the preceding bull market, as it did in the late 1990s and has again done this time (**Exhibit 8**).

EXHIBIT 8: MSCI WORLD VALUE/GROWTH RELATIVE PERFORMANCE AND S&P 500 DOWNTURNS

Relative index level, rebased to 100 in 1977

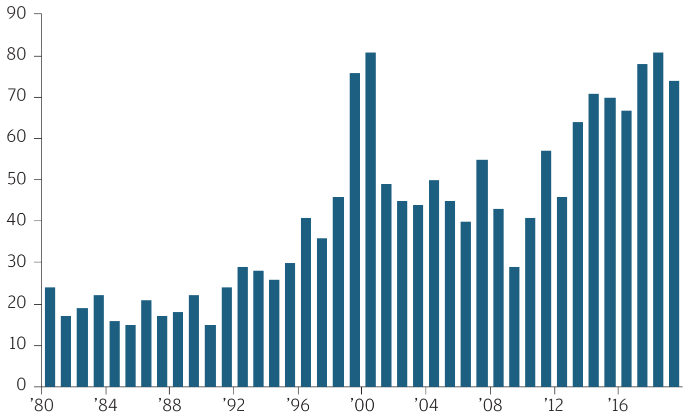


Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Index levels are calculated using price indices in local currency. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

In boom times investors are often willing to fund businesses that don't make any money, but during a recession investors are historically more likely to want to own companies with strong balance sheets that can withstand a downturn. The number of companies listing who don't make any money has reached levels not seen since the dot com bubble, which may serve as a warning that some young growth stocks could be particularly vulnerable during the next recession (**Exhibit 9**).

EXHIBIT 9: US INITIAL PUBLIC OFFERINGS WITH NEGATIVE EARNINGS

% of all initial public offerings per calendar year



Source: Pitchbook, Jay Ritter, University of Florida, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 December 2019.

Reflation

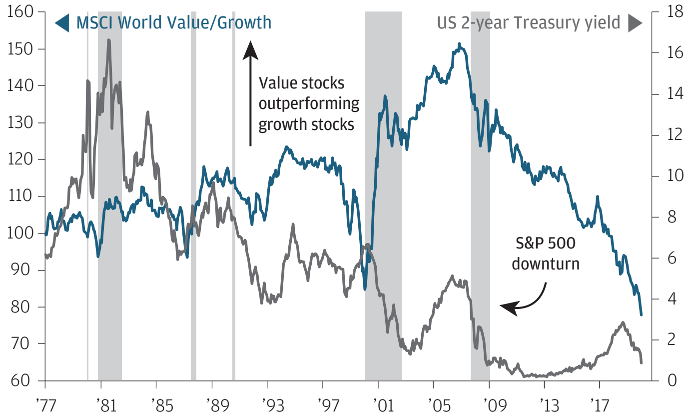
While value stocks would be likely to fall by less than more expensive growth stocks during a recession, for them to outperform in rising markets it has historically helped if economic reflation takes hold, with economic growth strong enough to cause interest rates and commodity prices to rise.

While higher interest rates don't always cause value stocks to rise by more than growth stocks, as seen during the brief period in this cycle where interest rates increased, higher interest rates do often benefit financial stocks, and therefore also support value investing (**Exhibit 10**).

Rising commodity prices have also historically tended to coincide with the outperformance of value stocks, while weak commodity prices have contributed to value's underperformance in recent years (**Exhibit 11**).

EXHIBIT 10: MSCI WORLD VALUE/GROWTH RELATIVE PERFORMANCE AND US TWO-YEAR TREASURY YIELD

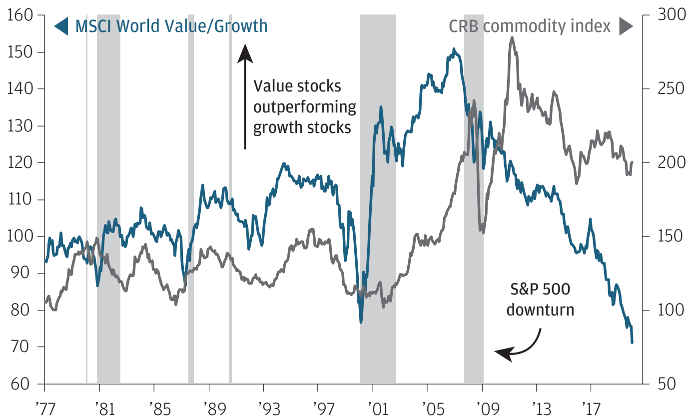
Relative index level, rebased to 100 in 1977 (LHS); % yield (RHS)



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Index levels are calculated using price indices in local currency. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

EXHIBIT 11: MSCI WORLD VALUE/GROWTH RELATIVE PERFORMANCE AND CRB COMMODITY INDEX

Relative index level, rebased to 100 in 1977 (LHS); index level (RHS)



Source: MSCI, CRB, Refinitiv Datastream, J.P. Morgan Asset Management. Index levels are calculated using price indices in local currency. Past performance is not a reliable indicator of current and future results. Data as of 29 February 2020.

Conclusion

With growth having outperformed value since 2007, investors who extrapolate that outperformance and take large overweight positions in growth stocks could be vulnerable to a period where growth stocks fall sharply and underperform value stocks. Value could outperform either in a recession or in a reflationary economic scenario that lifts interest rates and commodity prices.

While the possibility of a recession after the longest economic expansion in history is well understood, it is probably not fully priced into equity markets, with valuations for growth stocks still further above valuations on value stocks than has been the case for most of history.

A reflation scenario, on the other hand, is viewed by most investors as very unlikely. While we agree that in the near term higher interest rates and commodity prices are relatively unlikely, there is a tail risk that the reflation narrative could gain momentum if governments turn towards greater fiscal stimulus.

In addition, regulation has been a drag for financials over the last decade, while technology has been relatively lightly regulated and taxed. The next decade could well see a less accommodative tax and regulatory environment for some of the big technology names.

So investors with a big bias towards growth stocks over value stocks are vulnerable to recession, reflation and regulation. Therefore, it may be time to consider rebalancing portfolios to a more neutral balance between growth and value stocks after such a long period of growth outperformance.

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