On the Minds of Investors

May 2020

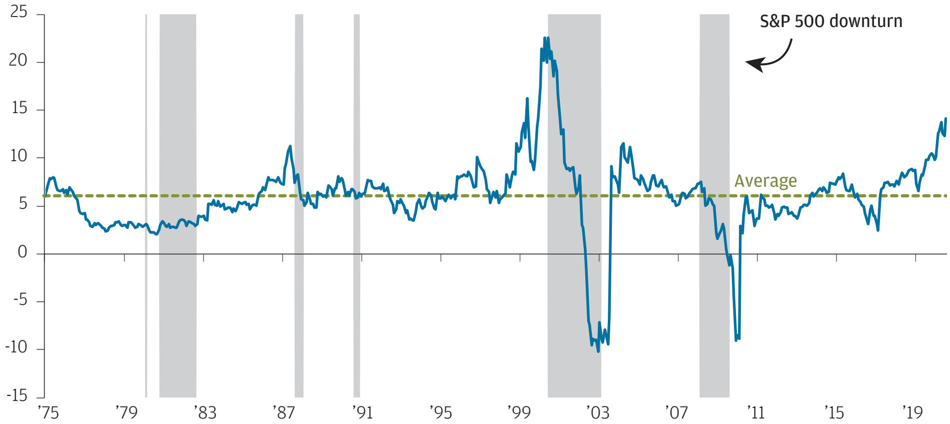
Does this recession favour growth stocks?

Prior to the current downturn, we thought investors may benefit from diversifying their portfolios with government bonds, macro funds and liquidity funds. We also thought a focus on quality stocks and avoiding overweight allocations to equities, mid/small cap and growth stocks would help protect performance in a downturn[1]. While most of those ideas have helped, growth stocks have continued to outperform value stocks.

We thought that value stocks might outperform growth stocks in a recession because the valuation premium on growth stocks relative to value stocks had reached levels not seen since 2000. This led us to believe that growth stocks might underperform, as they did during the bursting of the dot-com bubble in the early 2000s, when the valuation premium on growth stocks compressed relative to value stocks (Exhibit 1).

EXHIBIT 1: MSCI WORLD GROWTH AND VALUE PRICE-TO-EARNINGS (P/E) GAP

MSCI World growth minus 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 30 April 2020.

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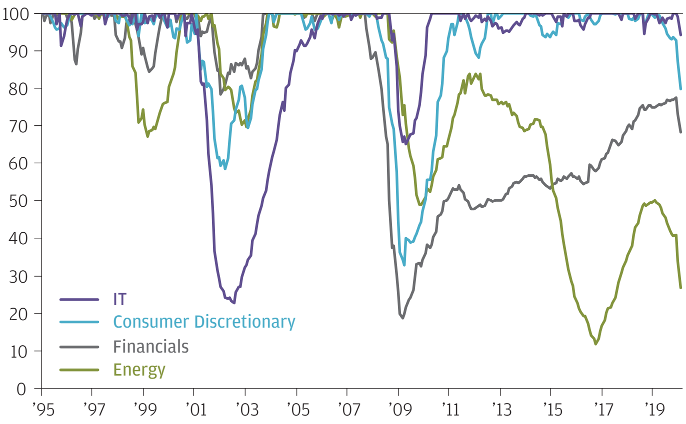
* See *"Portfolio Considerations for Investors Concerned About a Downturn"* (On the Minds of Investors, 3 September 2019).

In fact, the PE on growth stocks has fallen relative to the PE on value stocks in both of the last two recessions. However, while growth stocks underperformed during the bear market in the early 2000s, value stocks underperformed during the last recession. Value underperformed because earnings for value sectors, such as energy and financials, fell by more than earnings for growth sectors, such as technology and consumer discretionary—offsetting the price-to-earnings (P/E) compression of growth stocks relative to value. The outperformance of growth stocks' earnings in the last recession was in contrast to the early 2000s, when technology and consumer discretionary earnings fell by more than financial and energy sector earnings (Exhibit 2).

EXHIBIT 2: MSCI WORLD TRAILING EARNINGS PER SHARE DRAWDOWN, BY SECTOR



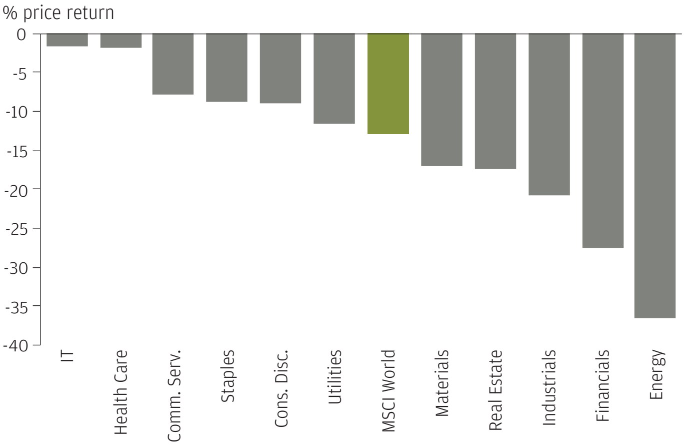
Source: IBES, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Trailing earnings per share are in US dollars. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

So far though, during this recession, growth stocks have outperformed value stocks as earnings expectations for value stocks have fallen by more than for growth stocks, and the valuation premium on growth stocks hasn't compressed relative to value.

Of course, the unusual thing about this recession is that it is being caused by people being forced to stay at home. As a result, some growth stocks in the technology, consumer discretionary and communication services sectors are perceived to be beneficiaries from the current shift to home working and online commerce. There is also a view that the current situation could lead to a longer-term shift towards more working from home and an acceleration in the existing trend towards consumption and advertising taking place online.

Meanwhile, some cyclical value sectors, such as energy stocks, have suffered from the unusually large decline in demand for oil, while financials have been hit by lower interest rates and worries over potential loan losses (Exhibit 3).

EXHIBIT 3: MSCI WORLD SECTOR PERFORMANCE YEAR-TO-DATE



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Price return in US dollars. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

Undoubtedly, this unusual type of recession will hit some value stocks particularly hard. But is it safe to assume that some cyclical growth stocks will be less affected by this recession, or may even benefit because of the shift to working and shopping online?

Are growth stocks really as defensive as assumed?

As of the end of April, consensus expectations are for earnings for the US Russell 1000 growth index to be 19% higher by the end of 2021, compared with end of 2019 earnings. Technology earnings are expected to be 18% higher and consumer discretionary earnings are expected to be about 4% higher over the same period, helped by online retail sales.

It's feasible that higher demand for cloud computing, online retail and advertising could allow those earnings expectations to be delivered upon. However, if this recession leaves a dent in consumer and corporate balance sheets then overall household and corporate spending could end up lower for some time.

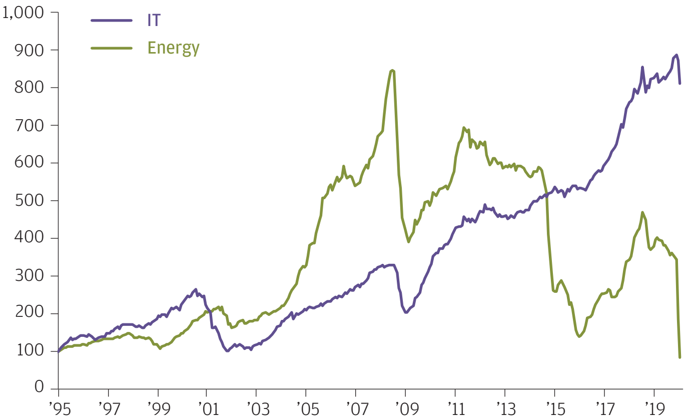
It may, therefore, be too optimistic to expect technology, online consumer discretionary and online advertising businesses to continue to deliver strong growth against a recessionary backdrop. While some of these growth businesses may be able to take a greater share of the profit pie, the pie itself may end up being smaller. There is a risk that markets have so far focused more on the share of the pie, and not enough on its overall size.

The key point is that in a recession, overall household and corporate spending tends to decline and it is unclear to what extent technology and online businesses will be able to offset that decline in the coming quarters. This recession will be a very good test of whether some technology and online business models are really as defensive as the market currently believes.

In contrast to the optimism about the outlook for growth stocks, earnings expectations for some sectors that have sold off the most, such as energy, already include a lot of bad news (Exhibit 4).

EXHIBIT 4: MSCI WORLD ENERGY AND IT 12-MONTH FORWARD EARNINGS PER SHARE

Index level, rebased to 100 in 1995



Source: IBES, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

Be careful not to overpay

Not only are earnings expectations still high for some growth stocks, even if those strong earnings growth expectations are delivered on, valuations for growth stocks look quite elevated compared with levels reached during the last recession. So, even if growth businesses do prove to be much more resilient to this recession and do prove to have a better long-term growth outlook than some value businesses, that may already be in the price.

Clearly, finding good investments is not just about finding companies that can thrive but those which can beat expectations. For example, nobody doubts that the New Zealand All Blacks are one of the greatest sporting teams in history, but that doesn't mean it's easy for them to exceed expectations to win practically every game they play.

Of course, given the choice between cheap growth stocks and only slightly cheaper value stocks with less long-term growth potential, as was the case in 2008, with the benefit of hindsight one should have chosen the growth stocks. But the choice today is much less obvious, with a lot of good news already factored in to the valuation of growth stocks (Exhibit 5).

EXHIBIT 5: MSCI WORLD GROWTH AND VALUE FORWARD PRICE-TO-EARNINGS (P/E) RATIO

Price to 12-month forward consensus expected earnings

Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

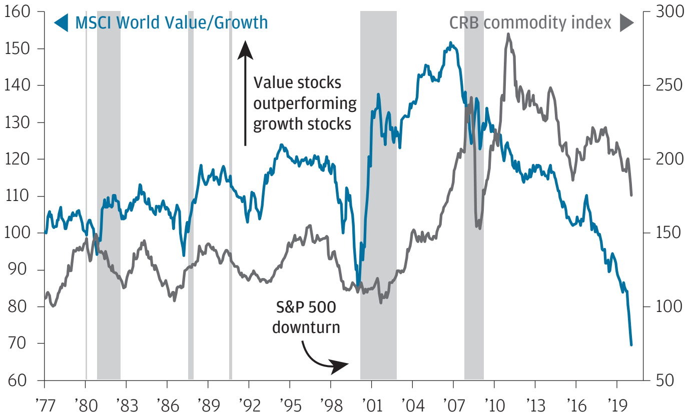
Which stocks will lead the recovery?

When social distancing measures are eventually sustainably lifted, those businesses that have been hard hit could see a much stronger bounce in profits than businesses with earnings that have proved defensive during the recession. Also, once the recession is over, we will find out how much of the current market share gain of online businesses is permanent. We may, for example, still work from home a bit more often than we used to, but go back to doing some of our shopping offline.

Of course, those companies that don't survive won't see any bounce. So a focus on survivors—quality companies with strong balance sheets—is essential to avoid value traps. For example, some oil companies may not survive this recession. However, looking forward over the next few years, it seems unlikely that oil prices will stay as low as they currently are. When oil prices rise, the currently beaten-up energy companies that do manage to survive could see a strong share price rally. As Exhibit 6 shows, the decline in commodity prices has hurt value stocks, but when commodity prices rise again it has often been good for the relative performance of value.

EXHIBIT 6: MSCI WORLD VALUE/GROWTH RELATIVE PERFORMANCE AND CRB COMMODITY INDEX

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



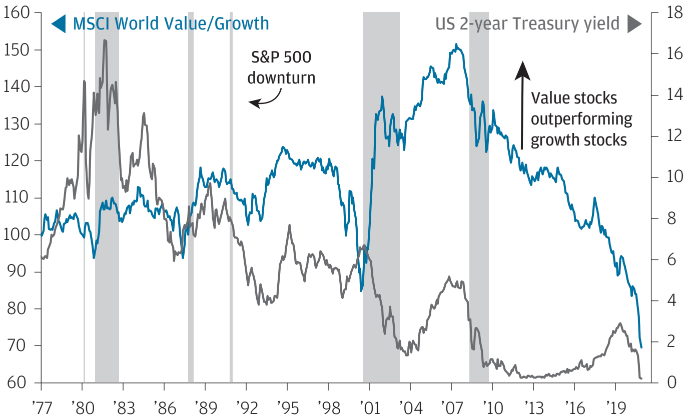
Source: MSCI, CRB, Refinitiv Datastream, J.P. Morgan Asset Management. Index levels are calculated using price indices in local currency. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

That said, one should be aware that in some regions, oil and commodity producers only make up a small part of the market and therefore may not be enough on their own to lead to value indices outperforming.

Another thing that has hurt value stocks has been the poor performance of financials, which make up a large share of most value indices. Value stocks tend to underperform when interest rates fall and outperform when they are rising. So the recent decline in interest rates, along with expectations that financial sector earnings will be hit by the recession, has also contributed to value's underperformance (Exhibit 7).

EXHIBIT 7: MSCI WORLD VALUE/GROWTH RELATIVE PERFORMANCE AND US 2-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 30 April 2020 .

The economic backdrop could remain a headwind for financial stocks if rates remain low for a long time, like they did following the last recession. But at least interest rates are unlikely to fall much further. And once the recession is over, loan loss provisions will come down, boosting bank profitability even without higher interest rates.

It's also worth noting that from 2000-2002, as the P/E on growth stocks declined from the excesses of the dotcom bubble, value stocks outperformed growth stocks, despite the fact that interest rates were falling. So value doesn't always need higher interest rates to outperform.

Nevertheless, one should be aware that unless financial stocks start to outperform it will be hard for value indices to beat growth given the large weighting of financials in most value indices. If financial indices were to continue underperforming the market, a more selective approach within value stocks and sectors may be necessary.

Don't put all your eggs in one basket

It's not clear when value stocks will outperform again and they face potential headwinds, such as low interest rates. But betting everything on growth stocks continuing to outperform, particularly when valuations are high, is not without its own risks. The last time growth outperformed value by this much was prior to the bursting of the dotcom bubble in 2000. Value subsequently outperformed growth over the next seven years and the initial underperformance of growth was both quick and painful.

So, while the outlook is uncertain, we believe that having a balance of reasonably priced growth and quality value stocks in portfolios may make more sense than putting all your eggs in the growth basket.

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