LPL RESEARCH
WEEKLY MARKET COMMENTARY

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VALUE COMEBACK?

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KEY TAKEAWAYS

After underperforming most of the last decade, value has shown signs of life recently.

We are a bit skeptical that the recent value resurgence is the beginning of a sustainable reversal in trend.

A potential pickup in economic and earnings growth, interest rates, and oil prices are key factors to watch to monitor this trend.

THEMES

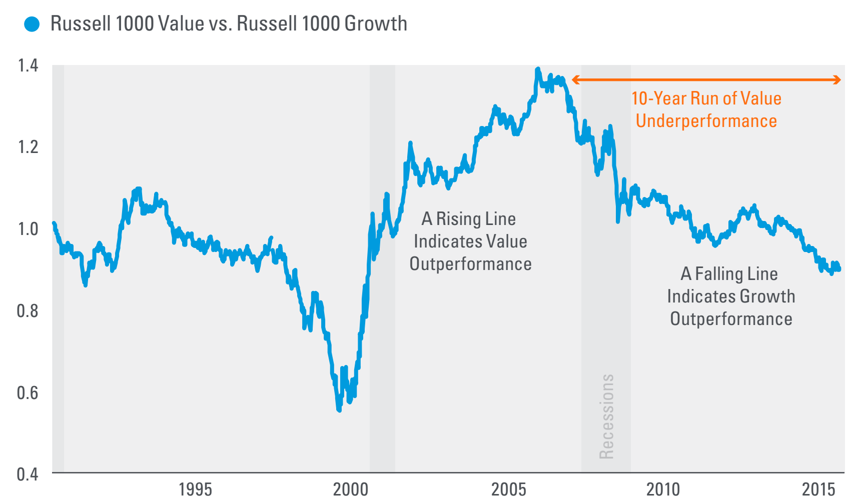
There are many different ways to slice up the equity market beyond the traditional style boxes, which has given rise to the "smart beta" trend. The industry has mostly given us growth and value investments, but when possible, we generally prefer to invest across broader themes (discussed in our *Thought Leadership* piece in October 2015).

Value stocks have staged a comeback versus growth after a long losing streak. Based on the Russell 1000 style indexes, growth has outpaced value for the better part of the last decade. Other than the period between April 2012 and July 2013, it's been all growth all the time since 2006 [Figure 1]. But value has shown signs of life recently, causing some to speculate that we are at the beginning of a sustainable reversal in trend. The Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by 2.6% year to date. Here we discuss whether the value comeback is sustainable.

EVALUATING VALUE VS. GROWTH: SECTOR MIX

When looking at the growth value question, we like to start by comparing the largest value sector (financials) to the largest growth sector (technology). (We identify growth and value sectors by taking the difference between weights in the growth index and the value index.) Financials is the biggest value sector, carrying 23% more weight in the Russell 1000 Value Index than its growth counterpart

1 VALUE HAS LAGGED GROWTH FOR THE BETTER PART OF 10 YEARS



Source: LPL Research, Haver Analytics 04/22/16

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

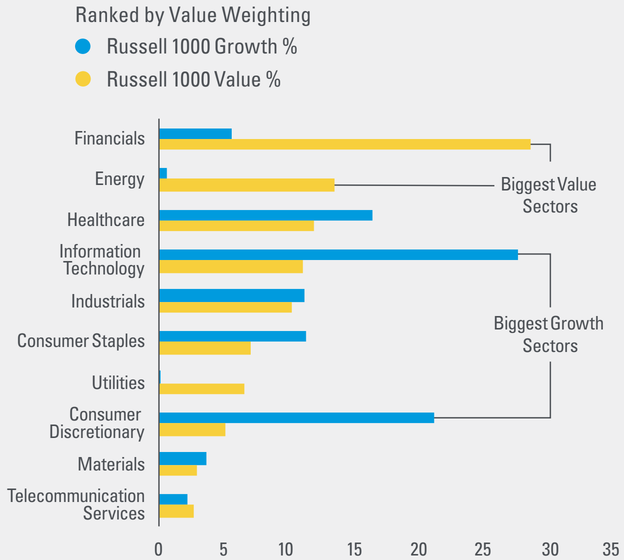
(energy is second at 12.9%). On the growth side, technology (16.5%) and consumer discretionary (16%) carry the biggest weight differentials. If you get these sectors right, you stand a very good chance at getting the growth versus value decision right (sector weightings for these indexes shown in Figure 2).

We currently like the technology sector more than financials, which favors growth, in large part due to the financial sector's struggles with low interest rates (more on that later). We are starting to warm up to energy as global oil production has fallen and oil prices have rebounded; and we have cooled some on consumer discretionary as the business cycle matures. Put all that together and the scales tilt slightly toward growth.

FINANCIALS AND INTEREST RATES ARE KEY

Financials have struggled in recent years for many reasons, but one big reason, at least since the Federal Reserve (Fed) lowered its target federal funds rate to zero and embarked on multiple rounds of quantitative easing (QE), has been low interest rates. Low interest rates impair bank profitability by reducing returns on loans, and hurt other financial firms by reducing returns on cash and bonds (think insurers and brokerage firms). The strain on banks and financial firms is a detriment to the sector overall, and, as a result, contributes to underperformance in value. This connection explains why the drop in interest rates has closely mirrored relative performance of value versus growth [Figure 3].

2 FINANCIALS AND TECHNOLOGY KEYS PIECES OF GROWTH-VALUE DEBATE



Source: LPL Research, FactSet 04/21/16

S&P 500 GICS sectors used for sector classifications.

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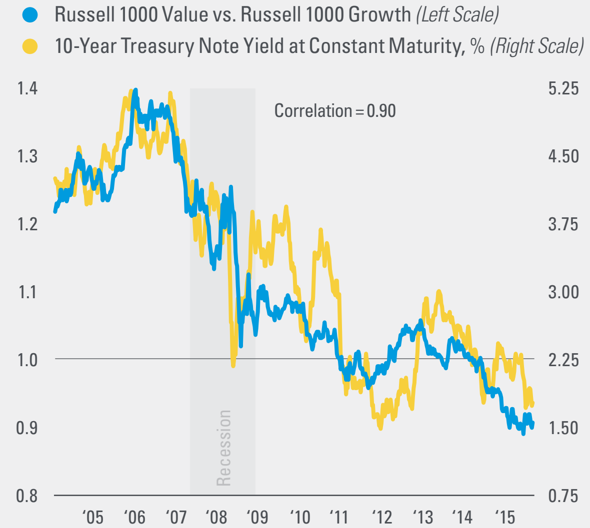
3 VALUE RELATIVE PERFORMANCE HAS SUFFERED FROM LOWER INTEREST RATES



Source: LPL Research, Haver Analytics 04/21/16

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Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

The next biggest value sector, energy, is also a factor in value continuing to lag behind growth. In fact, the fit between the chart of crude oil and value's relative performance over the past couple of years is just as tight as that of the interest rate chart.

Recently, the tide has started to turn. Oil prices, interest rates, and the financial sector (which are all related) have all moved higher together, fueling better value performance. We see limited near-term upside to all of these, which prevents us from moving aggressively into value at this point.

SLOW GROWTH ENVIRONMENT

One of the main arguments against value (and in favor of growth) in recent years has been the slow global growth environment. When there is not a lot of growth in the economy or corporate profits, then it logically follows that the market would pay a premium for the companies that are generating growth (what we have referred to as motorboats, which can grow without a macro tailwind, as opposed to sailboats, which need economic growth to grow).

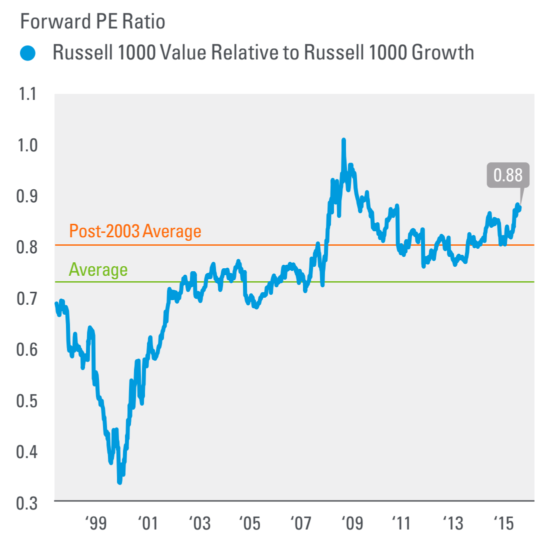
The data support this. Over the past 25 years, when economic growth is slow (real gross domestic product [GDP] below 2.5%), growth outperforms value by an average of 4.1%, and beats value two-thirds of the time. The Institute for Supply Management's (ISM) Manufacturing Purchasing Managers' Index (PMI) tells the same story. In years when the ISM Manufacturing Index is below average (under 52), growth outperforms value by an average of 3.3% and beats value 64% of the time. And when S&P 500 profits grow at below-average rates (below 7%), growth outpaces value by an average of 6.4%, and beats value 64% of the time.

Value prefers stronger economic and profit growth than we are experiencing today, another check in the growth column. We may not have above-average economic growth this year, but we do expect better economic growth this year than last (as noted in our *Outlook 2016* publication); and based on consensus estimates, we believe earnings have a reasonable chance of returning to average growth rates by year-end. This is hardly a strong case for value, but it does suggest keeping allocations fairly well balanced.

IS THERE VALUE IN VALUE?

Valuations are another consideration in the style decision. Naturally, value stocks will be cheaper than growth almost all of the time because valuations are used to classify the securities. Since the late 1990s, only once was the Russell 1000 Value Index more expensive on a forward price-to-earnings

4 VALUE STARTING TO LOOK A BIT EXPENSIVE



Source: LPL Research, FactSet 04/21/16

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The PE ration (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with a lower PE ratio.

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

(PE) basis than the Growth Index: May 2009. Value earnings were depressed—much more so than growth—immediately following the financial crisis, putting upward pressure on value's PE ratio.

Although valuations do not have a lot of predictive value month to month, we would suggest that for intermediate- to longer-term investors, value looks expensive. The Russell 1000 Value Index is trading at a 12% discount to its growth counterpart, compared to its 18-year average discount of 27%. Even if the tech boom is removed—a period when growth was dramatically overpriced—and we just look at the last two economic cycles (2003 and the present), value is still currently 8% more expensive than its average [Figure 4].

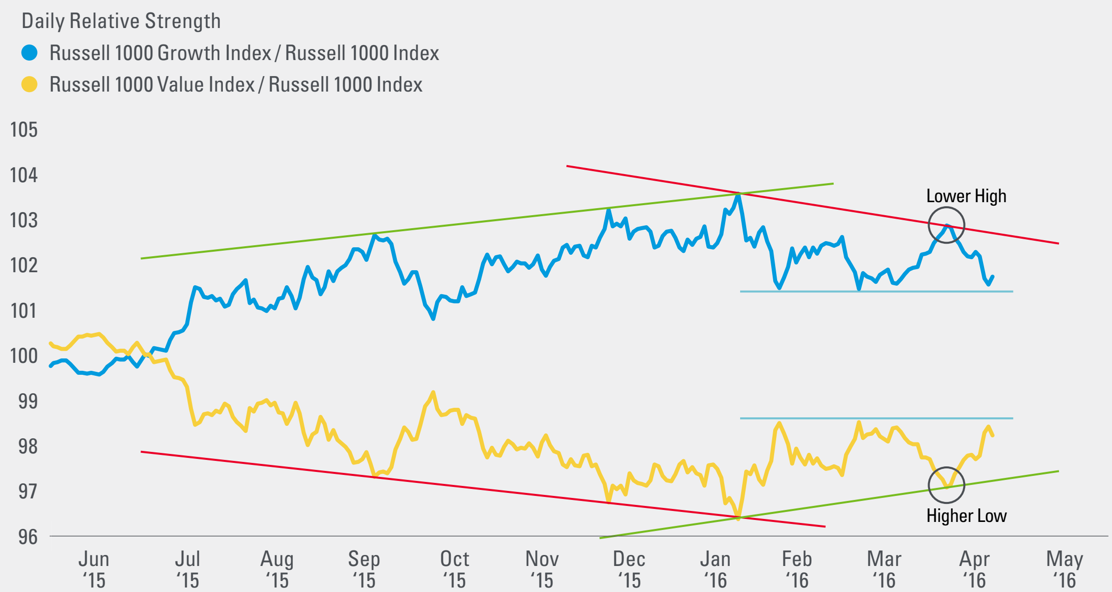
TECHNICAL TAKE

From the perspective of technical analysis, the Russell 1000 Value Index's relative strength trend compared with the style-neutral Russell 1000 Index has been moving higher since January 2016, while the Russell 1000 Growth Index's relative strength trend is moving lower. This means that the Russell 1000 Value is outperforming the Large Cap Index, whereas the Russell 1000 Growth is underperforming. The latest leg of the value rebound has been driven by technology sector weakness after disappointing earnings last week (April 18–22, 2016), coupled with financials' recent strength.

The daily relative trend line for the Growth Index initially reversed in January 2016, and since then has made a lower high, confirming a downtrend. Correspondingly, a higher low for the Russell 1000 Value Index relative strength line confirms an uptrend [Figure 5].

The longer trends may have reversed, but they are near major areas of support and resistance, indicated by the blue lines in Figure 5. Should the blue lines give way, this would be further confirmation that value's relative strength is suggesting a major longer-term change in trend. Should the trends cross resistance/support, it would suggest another leg higher for value's relative performance.

5 VALUE TECHNICALS IMPROVING



Source: LPL Research, Bloomberg 04/22/16

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CONCLUSION

After growth outpaced value for the better part of the last decade, value is starting to show signs of life. We are a bit skeptical that the recent value resurgence is the beginning of a sustainable trend reversal, but we acknowledge that the scales have started to tilt a bit more toward value and its run may not be over. A potential pickup in economic and earnings growth, rising interest rates, and higher oil prices are key factors we will be watching to monitor this trend, in addition to valuations and technical analysis. ■

INDEX DESCRIPTIONS

The Standard & Poor’s 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Purchasing Managers’ Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

The Russell 1000 Index measures the performance of the large cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Russell 1000 Value Index measures the performance of the large cap value segment of the U.S. equity universe.

The Russell 1000 Growth Index measures the performance of the large cap growth segment of the U.S. equity universe.

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