M&G Value Equities team

The value rally, nine months on

July 2021

- The value rally since September 2020 has been driven by a decrease in the valuation of growth stocks rather than an increase in that of value stocks, in our view, as well as by upgrades to earnings forecasts of the cheapest stocks.
- We believe the market environment is becoming more favourable for the value style: the decline in bond yields could be ending, the global economy is recovering and mega-cap growth stocks are likely to experience increased challenges.
- Even after the rotation into value, the valuation gap between cheap and expensive companies remains wide and we think there are many attractive opportunities among value stocks for selective investors.

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Style rotation in 2021

The value style has returned to favour in 2021, after more than a decade of underperformance. The positive coronavirus vaccine news in November last year, which offered the possibility of an end to COVID restrictions and a return to normal, is most often cited as the catalyst for this rotation. However, value stocks have been outperforming the wider market since September 2020 (see Figure 1). Investors are reminded that past performance is not a guide to future performance.

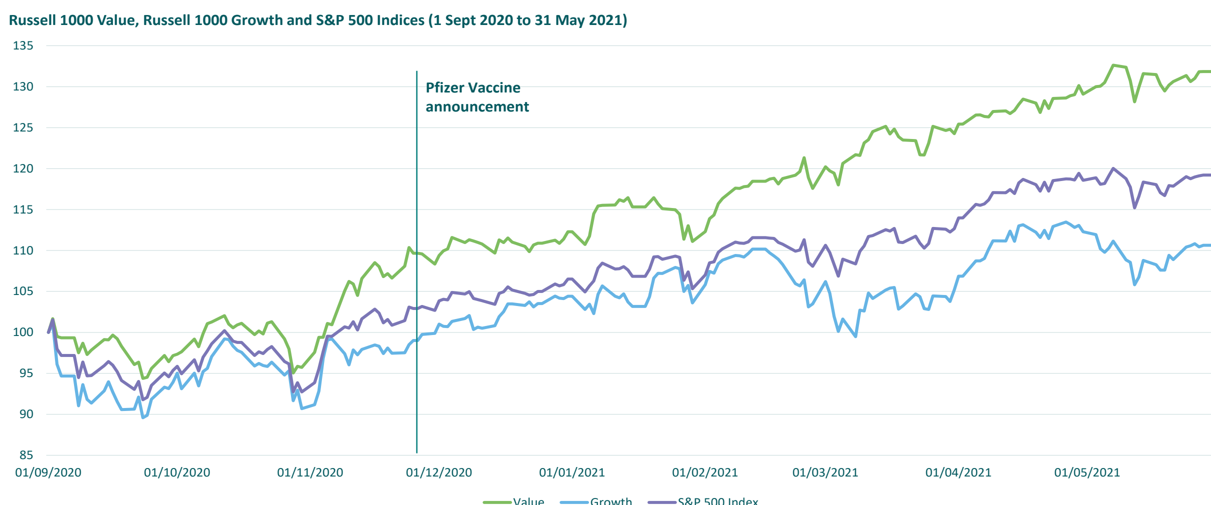
We have argued for some time that we didn't need a catalyst for a style shift. We believed that the attractive valuation could in itself be a strong enough driver for a rotation away from 'growth' towards value, and we feel this has been the case since Q4 2020. The big question now is: can this rally continue?

Earnings recovery

If we look closely at the value rally so far, we can observe that the rotation has not been driven by an increase in the valuation of unloved value stocks (see Figure 2). Rather, there has been a decrease in valuation at the growth end of the US market. This decrease has thus far been fairly modest. In our view, growth stocks are still expensive, and their valuations can only be justified by the zero-interest rate environment. We believe that the elevated valuations of the most expensive stocks in the market are unlikely to increase further, especially now we could be witnessing the end of the multi decade-long decline in government bond yields, and could possibly see higher yields.

On the other hand, the stock prices of companies at the cheaper end of the market have been supported by

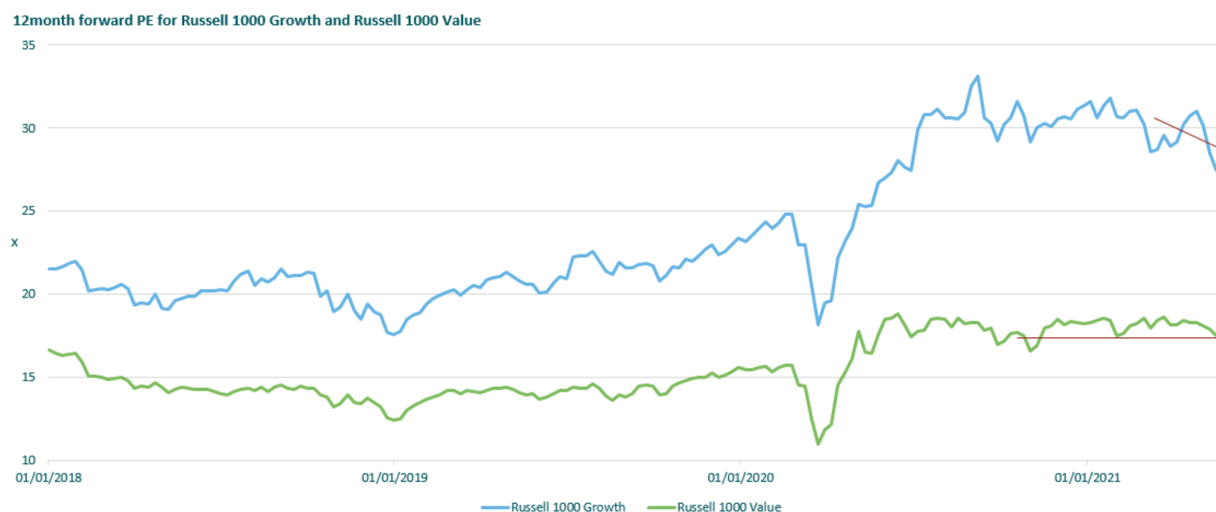
Figure 1: US Value rally since September 2020



Past performance is not a guide to future performance.

Source: Refinitiv Datastream, 31 May 2021. Rebased to 100 on 1 September 2020.

Figure 2: Decrease in valuation of US growth stocks, rather than increase for value stocks



Past performance is not a guide to future performance.

Source: Refinitiv Datastream, May 2021

upgrades to their earnings forecasts (see Figure 3). The cheapest quartile of the market has seen the biggest increase in earnings revisions, whereas the most expensive has seen the smallest.

Another often overlooked market dynamic is stock correlation. Over the past couple of years, US mega-cap stocks, such as Apple and Amazon.com, have driven the market. Investors could keep up with the market simply by holding these high-flying stocks. But their dominance has reduced lately and we are seeing better dispersion in the market. Analysis by Bernstein reveals that the percentage of US stocks that have beaten the market in the prior 12 months is now above 50%, the first time in more than five years (*Bernstein, Fund Management Strategy, April 2021*). We think this means a broader range of strategies have the opportunity to outperform and it could be extremely positive for stock pickers like us.

In addition, as value has returned to favour, we are seeing the style's negative correlation with momentum reduce. In our opinion, all of these developments are positive for value stocks. But we also think they are extremely supportive for actively managed value strategies as they increase the possibility of careful stock selection to be rewarded with share price performance.

A more favourable environment for the value style?

In recent years, the macroeconomic environment has been challenging for troubled value stocks. The steady decline in interest rates globally has been beneficial for growth stocks because of the low discount rate applied to their future earnings. Meanwhile, stocks offering reliable income (so-called 'bond proxies') have been attractive for those searching for yield in a low interest rate environment. However, we believe the backdrop is changing.

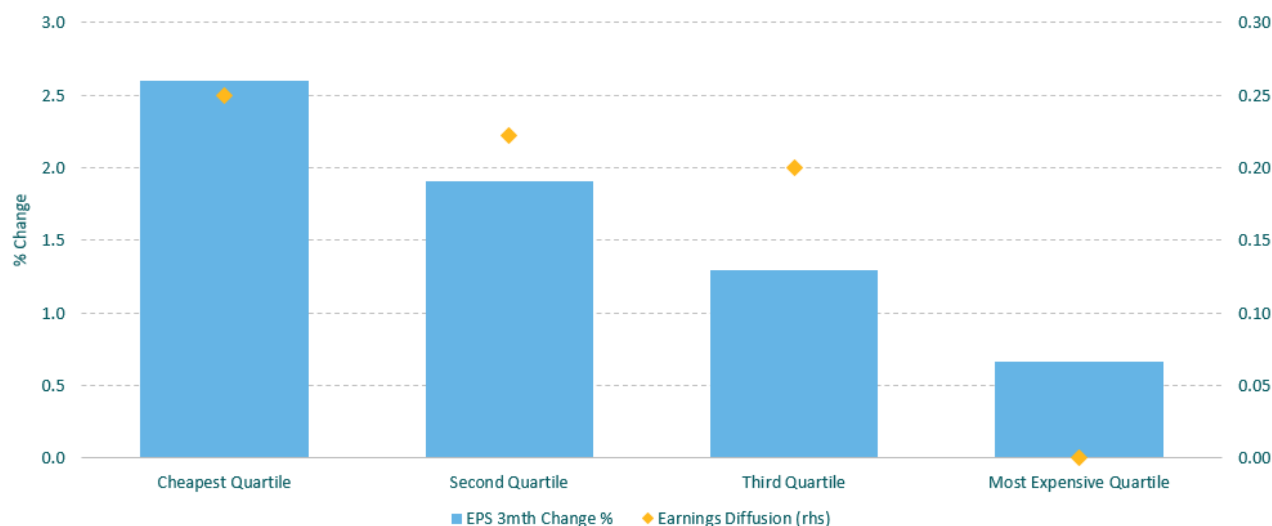
Investors now appear more concerned about rising inflation than falling interest rates. While the degree of change is a topic for discussion, the direction of travel for interest rates is arguably upwards. We feel that even if interest rates do not go up by much, at least we are seeing the end of the sustained downtrend. In our view, this puts value stocks on a steady footing. And if we see any meaningful uplift in interest rates from here, we believe it could only be a boost to the style.

The COVID-19 crisis saw governments and central banks, led by the US, introduce unprecedented amounts of stimulus to support their economies. This has resulted in one of the strongest recoveries in recent history. In our view, this environment could be favourable for value, as inflation and economic growth have typically been positively correlated with the value style. However, we are seeing opportunities across a broad spectrum of businesses, not just in economically sensitive, cyclical sectors. An increase in investor risk appetite as we regain a level of normality could also be a strong tailwind for value.

Another big feature of the past decade was the rise of the mega-cap technology companies, commonly known as the FAANGs (Facebook, Apple, Amazon, Netflix and Google). They have been able to achieve exponential growth, often through monopolistic positions. However, we are starting to see potential limits to their growth as well.

Figure 3: Cheapest stocks have seen the biggest earnings revisions

Global Earnings Revisions by valuation quartile – 3 month change (%)



Source: Credit Suisse HOLT®, Bloomberg, M&G, April 2021

Recent news of a global coordinated minimum corporate tax strategy is targeted in part at these giant digital businesses and could curb their growth.

We believe the increasing crossover in their business segments and competition among them may also dampen their earnings power. While we are not arguing that these companies' growth will cease, we think that growth might be harder to come by. We are already observing increased capital investment being needed for incremental growth. After a decade of share price appreciation, we believe that we are unlikely to see further market leadership by these mega caps.

Valuation gap remains wide

While we believe the environment is becoming more favourable for value, we think the ultimate driver for a continued value rotation remains the valuation. Despite the outperformance in the past nine months or so, the valuation dispersion between the expensive and cheap ends of the market remains extremely high.

At this level, we think we do not need to see a large shock to challenge the tendency to extrapolate the abnormal growth or apparent stability of some of the most highly valued companies today. If this were to happen, we could likely see more focus returning to cheaper, unloved companies that have real assets and healthy balance sheets.

We are excited by the quality and the breadth of investment opportunities we can find in the cheapest end of the market today. By only searching for opportunities in the bottom quartile of the market, we are able to capture considerable exposure to the value style. At the same time, our rigorous focus on company fundamentals, in particular financial strength, means we do not have to compromise on growth or quality characteristics. In our view, this approach enables us to identify good quality companies for our portfolios without having to sacrifice the valuation discounts.

We feel as active value managers, the current environment is one that is favourable for both the value style and stockpicking. We believe that our disciplined investment approach can provide a good exposure to the value style while helping us to avoid stocks with weak balance sheets (which could be potential 'value traps') and having concentrated cyclical exposure.

In a world where many stockmarkets are trading at record highs and many assets are on rich valuations, we believe that value stocks represent an attractive alternative. As value investors, we are naturally drawn to a "good deal" -- and we think there are still plenty of selective genuine bargains to be found among value stocks.

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July 2021

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