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Weekly commentary

The Renaissance of Value?

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June 27, 2016

Key takeaways

- While investors have long argued over many anomalies in equity markets, no anomaly has generated as much interest (or controversy) as the value premium, or the finding that over the long run, value stocks outperform growth stocks.
- The truth probably lies between these two extremes, though I lean toward the first group because I have seen convincing evidence that earnings for value companies do implode in recessions, and recover correspondingly sharply in recoveries.
- Going forward, I expect value to outperform growth. Since mid-February, as energy and mineral prices have risen, value has outperformed growth in the U.S. and has performed in line with growth in Europe and in emerging markets, though there has been a very sharp two day reversal in Europe in the wake of the Brexit referendum.

Full commentary

While FFTW focuses primarily on fixed income, we find it interesting to take an occasional look at equity markets on account of the significant linkages between the two markets. This piece focuses on the equity market.

While investors have long argued over many anomalies in equity markets, no anomaly has generated as much interest (or controversy) as the value premium, or the finding that over the long run, value stocks outperform growth stocks. Both the source and the magnitude of this outperformance have been hotly debated, with most debaters falling into one of two camps. Those who believe that the higher return of value stocks are compensation for some unseen risk (perhaps they carry with them some tail risk that materializes when the economy hits a particularly bad patch, as it did in 2008), and those who believe that the higher return of value stocks are a reflection of human frailties, and accrues on account of systematic biases in investors' behavior. We might call the first camp the Fama-French camp[1], and the second the Lakonishok camp[2].

The truth probably lies between these two extremes, though I must confess that I lean toward the first group because I have seen convincing evidence that earnings for value companies do implode in recessions, and recover correspondingly sharply in recoveries. In fact, it can be shown[3] mathematically that over the very long term, growth and value indices must experience the same rate of per-share earnings growth, and hence the same price return. Any difference in total return is driven entirely by the difference in their dividend yield. But math is math and markets are markets, and in the long run, as Keynes famously remarked, we are all dead, sometimes because of what markets do to us in the short run.

The past seven and a half years have not been kind to the theory. From the end of 2008 to last Friday, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by about 30%, and the MSCI Emerging Markets Growth Index has outperformed the MSCI Emerging Markets Value Index by about the same amount. While the Stoxx Europe Total Market Growth Index has outperformed the Stoxx Europe Total Market Value Index by a staggering 60%. These differences are for price returns; accounting for differences in dividend yields lowers the performance differentials to about 20%, 10% and 40% respectively.

Now the worm appears to be turning. Since mid-February, as energy and mineral prices have risen, value has outperformed growth in the U.S. and has performed in line with growth in Europe and in emerging markets. Even though the trend reversed sharply last Friday in Europe on the back of Thursday's Brexit vote (the Stoxx 600 Growth Index outperformed the Stoxx 600 Value Index by 196 basis points). The reversal was, however, far more muted in the U.S. Just as one swallow does not make for spring, one reversal does not kill a trend. While we have seen false starts to a value rally in the past (in 2012-2013 in the U.S. and in 2013-2014 in Europe), the slowing of economic growth, along with the recovery in energy and commodity prices, has led to a bias in favor of value indices relative to their growth counterparts. On the growth side, scandals at various pharmaceutical companies have soured both the public and Congress on the industry and the exceptional returns of the sector have ground to a halt.

1. See "The Cross-Section of Expected Stock Returns" By Eugene Fama and Kenneth French, Journal of Finance, 1992
2. See "Value and Growth Investing: Review and Update" by Josef Lakonishok and Louis Chan, Financial Analysts Journal, January / February 2004
3. See "The Source of Value" by Thomas Philips, Journal of Portfolio Management, Summer 2002

This week's market developments

Tuesday, June 21
- Japan All Industry Activity Index increased to 1.3% m.o.m. (s.a) for May
- UK Public Sector Net Borrowing Ex Banking Groups increased to 9.7b for May
- Germany ZEW Survey Expectation for Economic Growth index increased to 19.2 for June

Wednesday, June 22
- US FHFA House Price Index decreased to 0.2% m.o.m. (s.a.) for Apr
- US Existing Home Sales increased to 5.53m (s.a.a.r.) for May

Thursday, June 23
- Eurozone Markit Manufacturing PMI index increased to 52.6 (s.a.) for June (preliminary result)
- US Markit Manufacturing PMI increased to 51.4 (s.a.) for June (preliminary result)
- US Initial Jobless Claims decreased to 259,000 (s.a.) for the week ending June 18
- US Leading Index decreased to -0.2% (m.o.m.) for May

Friday, June 24
- US Housing Starts decreased to 1,164,000 (s.a.a.r.) for May
- US Durable Goods Orders decreased to -2.2% m.o.m. (s.a.) for May
- US University of Michigan Sentiment Index decreased to 93.5 for June

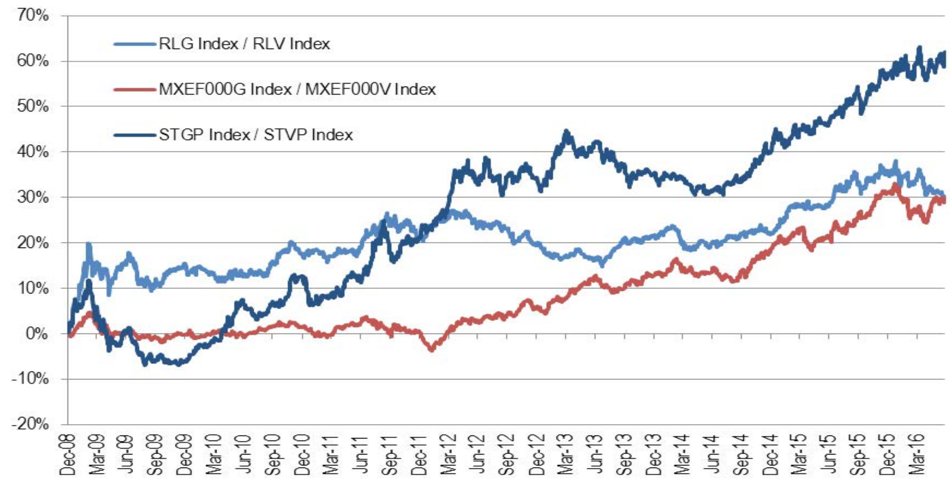
Source: Bloomberg, as of end June 24, 2016

In spite of Friday's reversal, I expect this worm to continue to turn. The value cycle tends to run for many years, and while it can be punctuated by bubbles (as in 1999) and market meltdowns (as in 2008), and while picking turning points in the cycle is never easy (it would have been tempting to call a peak in 2013, especially in Europe, but the cycle reversed itself in 2014), I feel confident in saying that, in spite of Friday's spike, the conditions are now in place for the value cycle to reassert itself, and for value stocks to outperform growth stocks for some years to come – long may they run!

The FFTW Weekly will not be published next week due to the July 4th holiday in the United States.

Chart of the week

The relative performance of value and growth indices



Source: Bloomberg

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on September 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.34 %	June 27, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.24 %	June 21, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.00 %	June 29, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.40 %	June 14, 2016

Source: Bloomberg

Next week's market developments

Monday, June 27

- Eurozone M3 Money Supply growth rate is expected to increase to 4.8% y.o.y. (s.a) for May
- Markit US Services PMI Business Activity is expected to increase to 52 (s.a.) for June (preliminary estimate)

Tuesday, June 28

- US Annualized GDP is expected to increase to 1.0% q.o.q. (s.a.a.r.) for 1Q
- US Consumer Confidence Index is expected to increase to 93.5 (s.a.) for June
- Japan Retail Trade Index is expected to decrease to -1.6% y.o.y. (n.s.a.) for May

Wednesday, June 29

- UK Nationwide House Price All Houses Index is expected to decrease to 0.0% m.o.m. (s.a.) for June
- UK Mortgage Approvals are expected to decrease to 65,000 for May
- US Personal Income is expected to decrease to 0.3% m.o.m. (s.a.) for May
- US Personal Spending is expected to decrease to 0.4% m.o.m. (s.a.) for May
- US Pending Home Sales Index is expected to decrease to -1.1% m.o.m. (s.a.) for May

Thursday, June 30

- UK GDP is expected to remain at 0.4% q.o.q. for 1Q
- Eurozone Core CPI is expected to remain at 0.8% y.o.y. (n.s.a.) for June
- US Initial Jobless Claims is expected to increase to 267,000 (s.a.) for the week ending June 25
- US Chicago Purchasing Manager Index is expected to increase to 51.0 (s.a.) for June

Friday, July 1

- Markit Eurozone Manufacturing PMI is expected to remain at 52.6 (s.a.) for June
- Markit UK Manufacturing PMI is expected to remain at 50.1 (s.a.) for June
- Markit US Manufacturing PMI is expected to decrease to 51.3 (s.a.) for June
- US ISM Manufacturing PMI is expected to increase to 51.4 (s.a.) for June

Source: Bloomberg, as of end June 24, 2016

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