ClearBridge Investments

Growth Challenges Are Value Opportunities

November 1, 2018

Key Takeaways

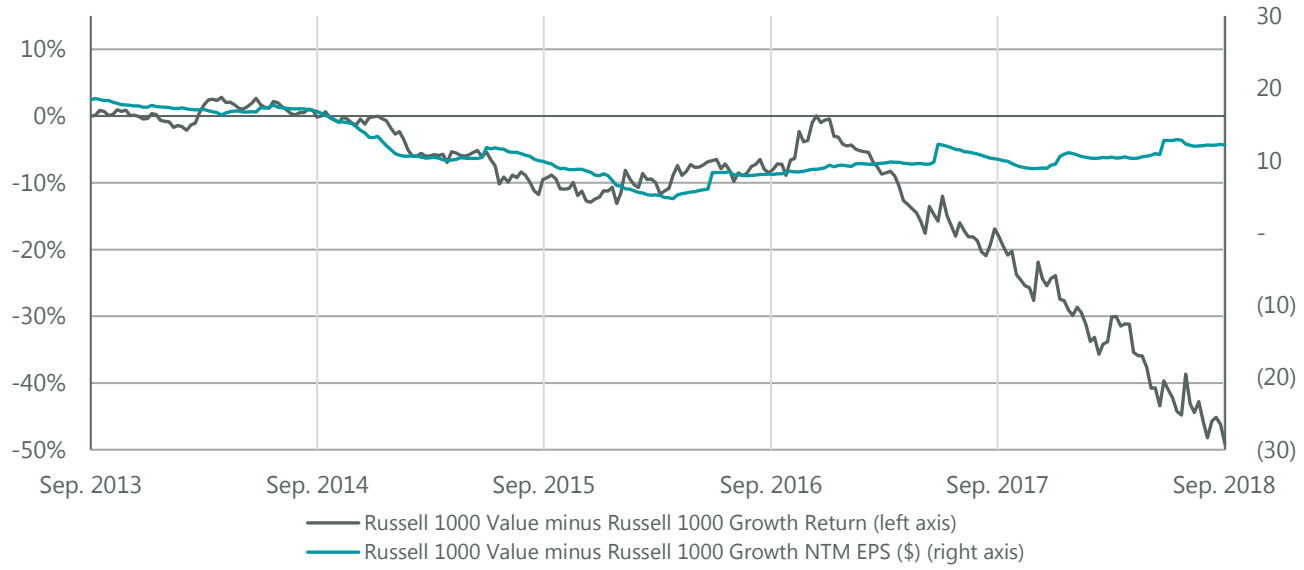
- Slowing earnings growth, negative estimate revisions and continued multiple compression could create an acute challenge for U.S. momentum.
- The continued rise in interest rates suggests we are in the early stages of a bond bear market, which could intensify as central banks withdraw liquidity.
- Low correlations of value to growth and momentum have surfaced true value stocks, where prices have fallen below business value.

Value investing often boils down to a trade-off. You have historically earned an attractive long-term return, but you must endure painful parts of the journey. Currently, growth and momentum investment styles have converged to beat most value disciplines over this market cycle, and the resulting underperformance for value has intensified since the beginning of 2017. However, market conditions are changing. The continued rise in interest rates suggests we are in the early stages of a bond bear market, which could intensify as central banks withdraw liquidity.

A Period of Collapsed Correlations

The frustration with this cycle has really come since the beginning of 2017 when market correlations that are rooted in fundamental logic and history simply collapsed. This collapse has been characterized by a major positive correlation between U.S. growth and momentum on the winning side, and an almost allergic negative correlation between these and pretty much everything else, which has lost. Include value on the losing side, which suffered as valuation multiples for the winners expanded while the losers' compressed. This multiple-driven gap in relative performance between growth and value occurred even though underlying fundamental metrics, like earnings growth, did not widen (Exhibit 1).

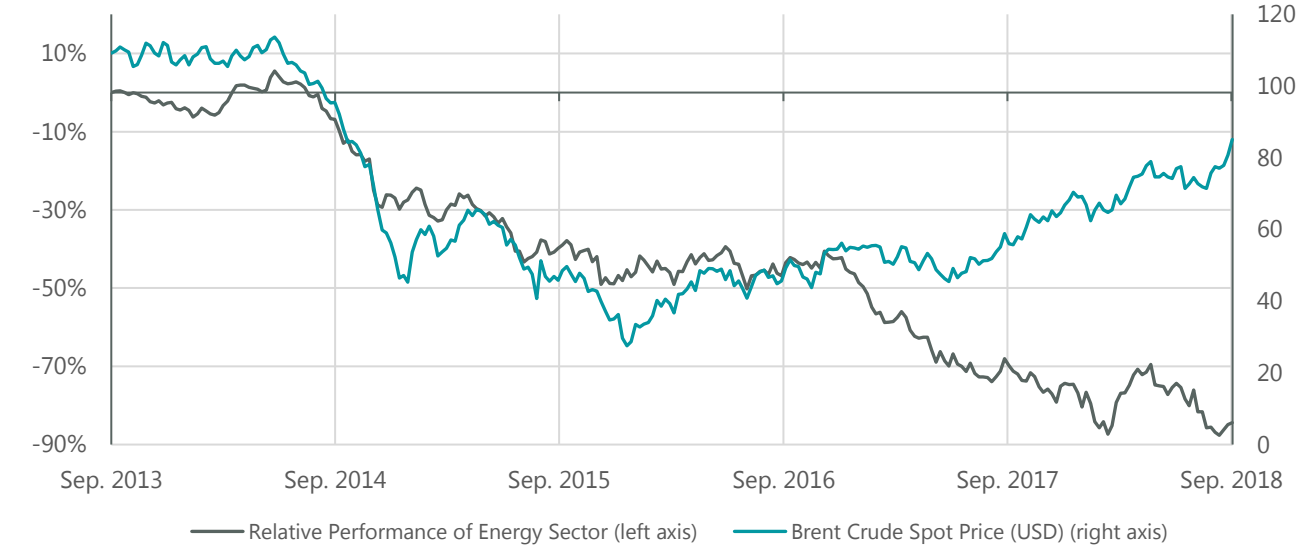
Exhibit 1: Value Underperforming Growth Despite Stronger EPS Growth Expectations



As of September 30, 2018. Source: ClearBridge Investments, Bloomberg LP.

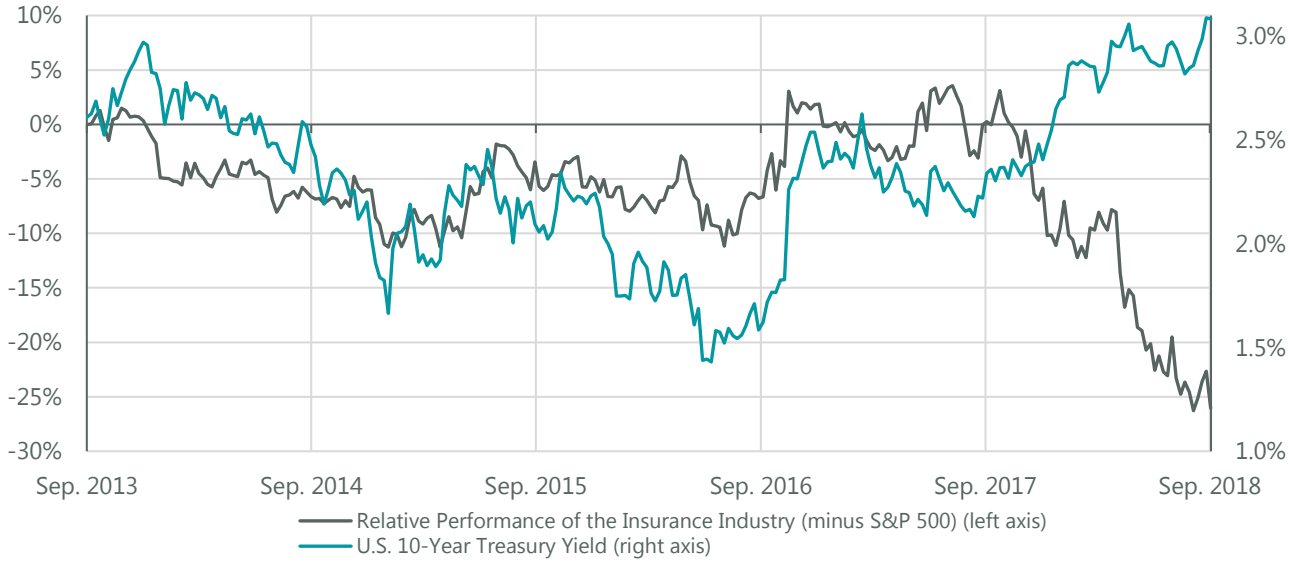
This shift away from fundamental logic hit two key sectors in particular, financials and energy, which are otherwise enjoying improving fundamentals. Generally, if you buy a stock below business value and realized expectations in fundamentals improve and start to exceed embedded expectations, you will enjoy price and value convergence. Energy stocks have *not* benefited as oil prices rallied strongly, and financials, particularly insurance companies, have *not* enjoyed higher interest rates, as historic correlations and logic would have suggested (Exhibits 2 and 3).

Exhibit 2: Energy's Divergence from the S&P 500



As of September 30, 2018. Source: ClearBridge Investments, Bloomberg LP.

Exhibit 3: Insurance vs. S&P 500 Has Diverged from the 10-Year Yield



As of September 30, 2018. Source: ClearBridge Investments, Bloomberg LP.

Investors are facing a large potential trade-off right now: continue to bet on momentum and the S&P 500, which are showing signs of fatigue with the technology-led selloffs we've seen in October, or bet on change and take an active value bet in names with attractive value and optionality, but with negative momentum.

If you make the first choice, you will enjoy the comfort of being aligned with the prevailing market that has been plowing capital into U.S. momentum names and the S&P 500. If you want to minimize current relative performance discomfort, you must fully embrace this crowded choice by going passive, which means taking an active bet on momentum. But cycles are cycles. If history is not violated, as the overwhelming winner of the current cycle, passive S&P 500 returns should be relatively poor over the next market cycle. The more immediate risk is that, so far, we have only witnessed historic levels of passive and momentum *buying* within U.S. stocks. We have never seen this amount of crowded capital try to *sell*, although this month's market action is giving us some hints. It seems logical that the scale of the buying helped drive the shift in market dynamics we have witnessed since early 2017, and that a reversal on the sell side will cause an equal but opposite dynamic.

We think we are observing a change in markets that could trigger a reversal in the market cycle. For one, a continued rise in rates that ultimately normalizes the term premium would push the 10-year Treasury to roughly 5%. The current market hegemony would be severely challenged by this shift, and despite very few cracks in U.S. markets, we believe it is underway. Why?

Early Signs of Shift from Momentum and Growth

We are currently witnessing a massive shift in U.S. dollar liquidity as monetary and fiscal policy in the U.S. have shifted. Both debt-financed fiscal expansion and trade policy are inflationary, raising input costs and forcing U.S. monetary policy to tighten, with the resulting shift in global liquidity squeezing emerging markets (EM) and now exposing more vulnerabilities broadly as liquidity recedes.

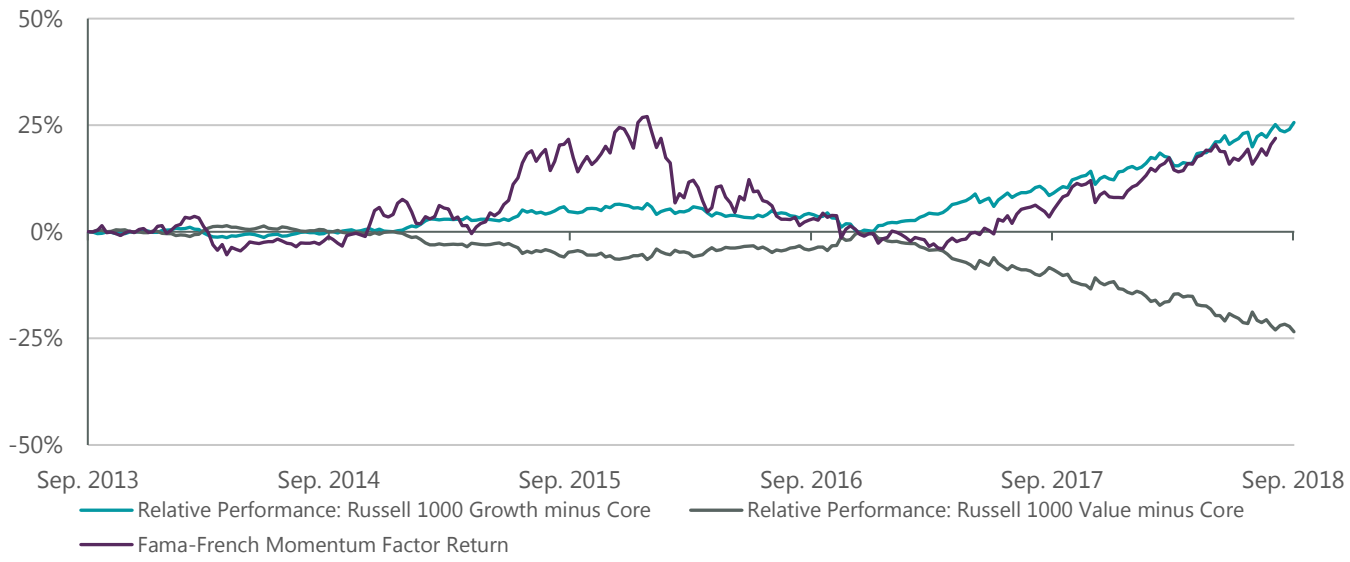
In every past cycle the locus of every crisis has been where debt has increased the most. This cycle it is in sovereign debt, which has enjoyed unprecedented demand from central banks and market flows. A term premium normalization would put monetary and fiscal policy in a bind, and we are closely observing global risk spreads to

see if liquidity concerns are spreading. So far it has been minimal, but the liquidity drain will accelerate in 2019.

For now, liquidity concerns have been mainly contained in EM stress, which has reinforced the dominance of U.S. momentum trends as capital has rushed to U.S. shores. However, as third-quarter earnings are showing us, the continuation of these trends is putting pressure on U.S. profit margins as capital intensity, labor costs and interest costs rise. On the last metric, U.S. corporate net debt has never been higher outside of a recession, and rising rates are a key long-term vulnerability.

Pressure on profit margins is a key risk factor, as earnings growth from the tax cut and faster U.S. economic growth have been offsetting value multiple compression to drive U.S. returns. Earnings growth will naturally slow in 2019, but we also expect material negative estimate revisions as margins come under greater than expected pressure. The combination of slowing earnings growth, negative estimate revisions and continued multiple compression could create an acute challenge for U.S. momentum. Given the crowding into mega cap U.S. momentum names, and the S&P 500 at large, liquidity is a key risk as investors feel the pain of missed expectations and the corresponding price weakness.

Exhibit 4: Tightly Correlated Relative Performance of Growth and Momentum



As of September 30, 2018. Source: Bloomberg LP, Dartmouth Tuck School of Business – Ken French Data Library.

The silver lining is that investors do have a choice. While growth and momentum are currently highly correlated, their correlation to value is historically low (Exhibit 4). In other words, the recent pain from negative momentum has surfaced true value stocks, where prices have fallen below business value. This provides the classic opportunity for active valuation managers to invest in names with cheap optionality, and much more upside than downside.

About the Author

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- 25 years of investment industry experience
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