Seek Quality as Bull Market Matures

July 7, 2021

Key Takeaways

- Market internals such as the breadth of the equity market are demonstrating minor divergences, but the overall market signal remains healthy.
- A pickup in volatility over the next six to nine months is likely as investors face questions about the durability of fiscal stimulus, tapering and inflation as well as the strength of economic and earnings growth.
- We believe you can own both growth and value stocks in a rising rate environment as long as your growth companies are coming through with the expected growth. The more important thing to think about at this juncture is a shift from low-quality to high-quality stocks.

Assessing the Outlook for U.S. Equities

U.S. equity markets were up double digits in the first half of the year, continuing a strong recovery from the COVID-19 induced bear market in early 2020. Growth stocks staged a comeback in the second quarter but value maintained its performance advantage year-to-date on increasing progress in the reopening of the economy. To help investors gauge what is ahead for equities, we spoke recently with ClearBridge Chief Investment Officer Scott Glasser. Here are some highlights from the conversation.

Are you surprised stocks have done so well coming out of the coronavirus pandemic?

Scott Glasser: Forecasting over the last 18 months has become dramatically more difficult than in prior years, and that's very much a function of the enormous liquidity, whether it be fiscal or monetary, that's been unleashed as a response to COVID-19. Equity performance is being propelled not only by the strength of vaccinations and reopening, but more of a flood of fiscal and monetary stimulus, which was needed but which distorts some of the traditional ways that we think about bear markets, bull markets and cycles as a whole.

Given the tremendous recovery in the economy, should this give the new bull market more room to run?

SG: A lot of people will say we've started a new bull market. We had a bear market and now we started a new bull market. I don't view it that way, I view this as an exogenous shock to the global system that caused the bear market. The bull market that we're in right now I see as more of a continuation of the bull market that we had been in, which has been a long bull market rather than the start of something new. That might seem minor, but it has more significant repercussions as to what the outlook might be and what the expectations might be the next couple of years. My view is that in that context, we're actually in the later stages of a bull market where the most significant gains are probably behind us. My expectation is for the market to close the year higher than it is now.

There are some minimal divergences underneath the surface. I like to think the market and the market averages are almost like your temperature or your heartbeat, but you really don't know until you look beneath the surface, think of it almost like getting an X-ray. Until you get an X-ray of the market, you really don't know about its health internally. And when I look at internal measures and things that are important to me, like the breadth of the market, how many stocks are participating, I see some minor divergences, but for the most part, I see a very healthy market.

One of the other things that I look at that tends to either refute or confirm where we are in terms of the overall market is what different sectors are doing. If we were rolling over, at the later stages of the bull market, one would expect that sectors like consumer staples and some of the more defensive sectors as a whole would be performing better. And in fact, they're underperforming quite dramatically.

What about the volatility picture? Are you concerned that investors have become complacent?

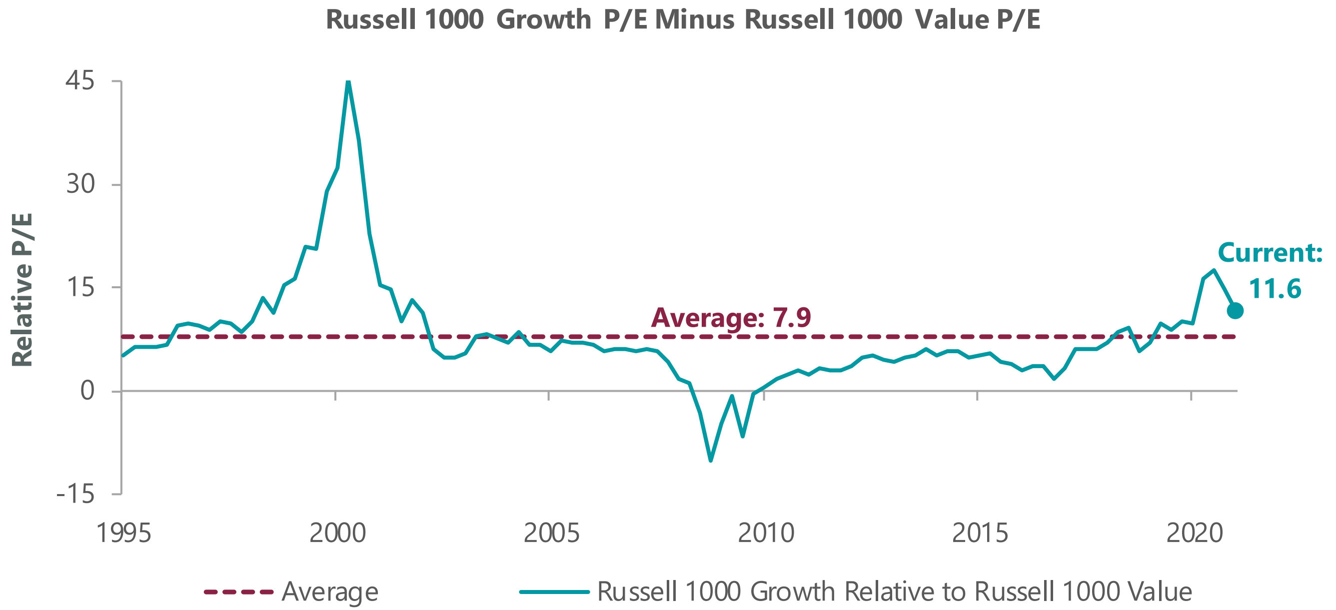
SG: Volatility has been low and typically with a flood of liquidity, you get lower volatility. I do expect a pickup in volatility both this summer and then into the fall. I'll reference back in 2013, when we saw significant talk of tapering in terms of interest rates and a backup of 130 basis points in the 10-year Treasury. During that year, volatility was actually the best performing asset class. I'm not calling for that, but I do think it's reasonable to expect a pickup in volatility over the next six to nine months as we face questions about the durability of fiscal stimulus, tapering and inflation in general as well as the durability of growth. Obviously we're not going to spend the next three years analyzing an 8% GDP, we're going to come back to some normal level over the next couple of years. The question is how long does it take to get this kind of above-average growth back to normal and how does the market react during those periods?

What is the significance of the shifting market leadership we have seen to start 2021?

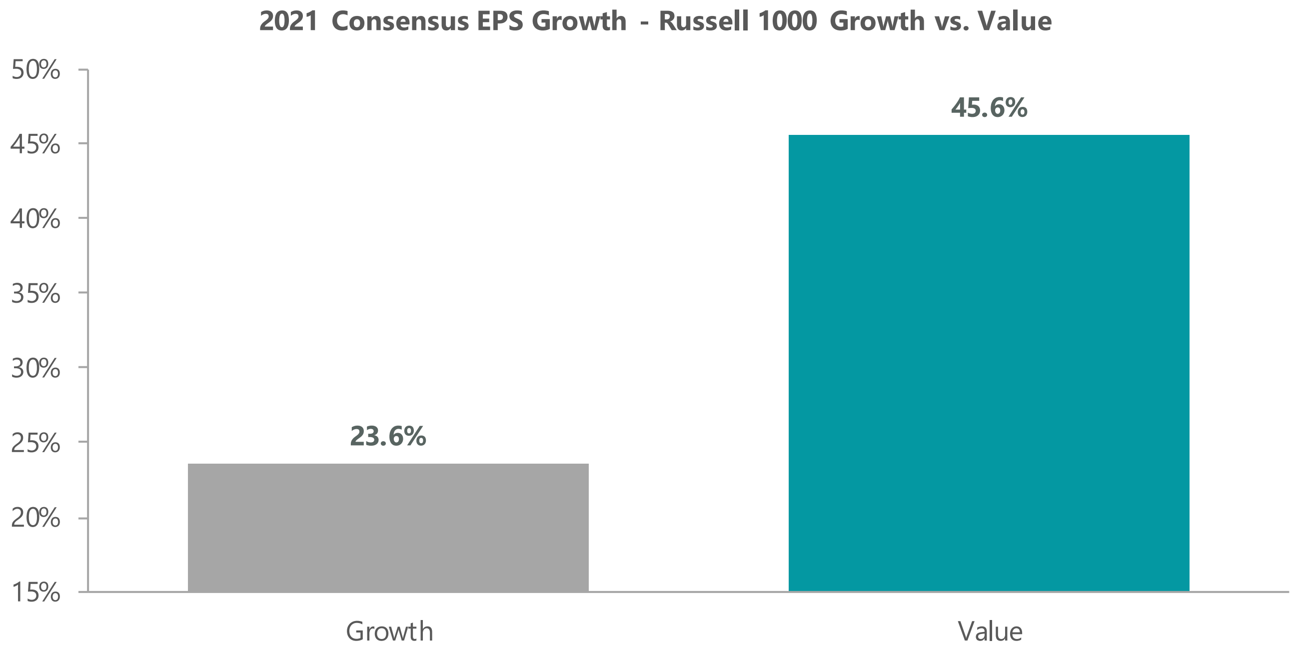
SG: Over the last six to nine months, we've absolutely seen value do better than growth. That's partly a function of the starting point, where growth had significantly outperformed value over the last several years. Combine that with an expectation for a resurgence in both economic growth and a reflation driven by huge fiscal stimulus, which is helpful to a lot of the more commodity-driven and value-oriented places like energy, and investors should think of fiscal stimulus as propelling value.

Over the last month, we've seen a complete reversal as growth outperformed value by 500 basis points, which brings me back to the key point: you can have both growth and value doing well, and in fact, it's better for the overall market when you do have this rotation, when you're handing the baton off from one group to the other. Most of the portfolio managers at ClearBridge have taken on a more pro-cyclical tilt over the last six to nine months to benefit from what we see as a resurgence in economic growth probably for a several year period.

Exhibit 1: Fundamentals Favor Value



Data as of June 21, 2021. Source: Bloomberg.



Data as of June 21, 2021. Source: FactSet, Russell.

Are you worried about the impact of a rise in interest rates on growth stocks?

SG: We've done studies internally where you would expect as interest rates rise, that long duration assets, which are essentially growth assets, would be affected. And we saw that when you had a small backup in rates, those growth companies, if they continued to come through with that growth, did just as well as their value counterparts after an initial decline. So you can own both as long as your growth companies are coming through with the expected growth.

I think the important thing to think about is more of a shift from low quality to high quality. At the initial stages of the rebound, everything went up on the value spectrum and a lot of what went up were the lower-quality companies with weaker balance sheets and more operating leverage in their business models. At this point, I think those low-quality stocks have made their move and from a value versus growth perspective, your positioning should be more toward high quality versus low quality. Our thumbnail definition of high versus low quality is high-quality companies have better balance sheets and better sustainability of operating margins.

As an active manager, how are you approaching this shift in both style and quality?

SG: There is not as much trend following in the market or sector leadership in the market, it's rotating, so it does put the burden on the portfolio managers in terms of stock selection and active management. And I consider it a very positive thing for portfolio managers who are actively selecting stocks and for active management. We can go out and pick those stocks as opposed to playing some broader trends or overweighting a sector like technology, which was what a lot of managers did in the two years prior to the pandemic. It was an easier play then, now the universe is more selective and it's more incumbent upon the managers to be doing their research and picking stocks. If we do it well, active management as it has this year should continue to do very well compared to passive management.

What are your primary concerns heading into the back half of the year?

SG: Corporate earnings revision data is quite positive, so companies are managing fairly well. The question is at what rate do they have to put expenses back on the income statement, whether it be additional labor, whether it be inflation that they're paying more for in both products and wages. That is essentially the unknown question. My view is that growth will be more durable than people assume. Part of that has to do with the fact that we've got an uneven recovery globally. While we always focus on domestic economic numbers, the picture globally, because of the pandemic and because of the different responses of the various countries and vaccination rates, is quite uneven. Because of that, we're not getting the full force of a global recovery yet. So I think that sustains growth, beyond the initial recovery that we're seeing in the U.S.

The other factor is there are a lot of bottlenecks in the system. From a manufacturing standpoint, companies were either reliant on parts outside the U.S. that they are having trouble getting, or they couldn't staff up quick enough or couldn't get raw materials quick enough to meet demand, and that's created a number of bottlenecks. Those bottlenecks have created some inflation and also slowed down the pace of recovery. By slowing it down, it probably extends the expansion for a period of time.

About the Author

Scott Glasser
Chief Investment Officer, Managing Director, Portfolio Manager

- 30 years of investment industry experience
- Joined a predecessor organization in 1993
- MBA from Pennsylvania State University
- BA from Middlebury College

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960 | **ClearBridge.com**

Past performance is no guarantee of future results. Copyright © 2021 ClearBridge Investments. All opinions and data included in this document are as of the publication date and are subject to change. The opinions and views expressed herein are of the author(s) and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed.