CBIS®
Christian Brothers Investment Services

MARKET PERSPECTIVE 3Q 2019

Value & Growth Strategies Since the Global Financial Crisis

Catholic Responsible Investments™

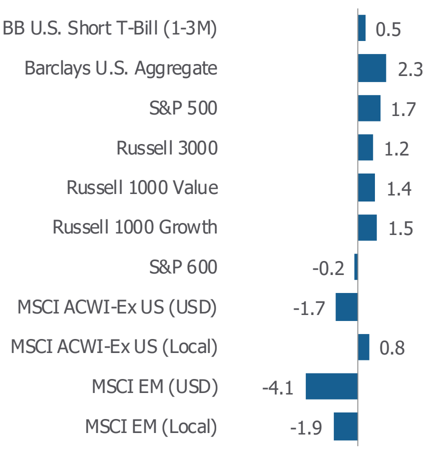
CAPITAL MARKETS REVIEW

The persistent outperformance of growth strategies since the Global Financial Crisis has prompted many investors to question whether they should abandon value strategies. Research provided by one of CBIS' sub-advisors suggests one should not abandon value too quickly.

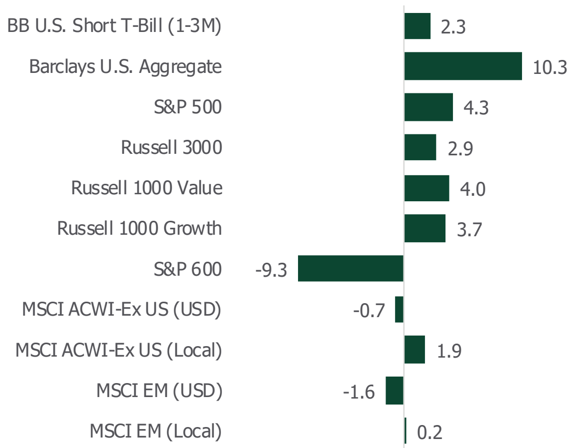
Capital Markets Review

I. GLOBAL OVERVIEW

Market Performance: 3 Month



Market Performance: 12 Month

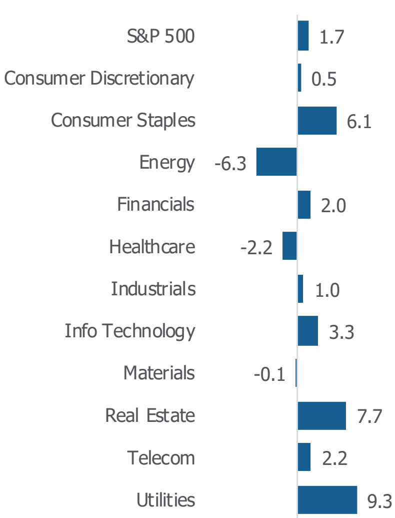


Source: FactSet

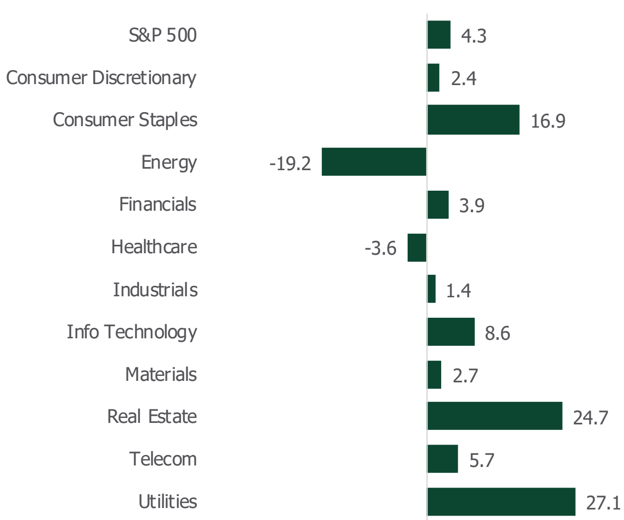
- Small Cap was the standout underperformer over the last 12 months; this is an unusual occurrence in the face of dollar strength and global weakness.
- Ever lower levels of bond yields drove outperformance of the bond market, though it is difficult to see this trend continue given the level of yields.
- Dollar strength and trade wars are posing a headwind for non-US stocks.

II. US EQUITY MARKETS

Market Performance: 3 Month



Market Performance: 12 Month

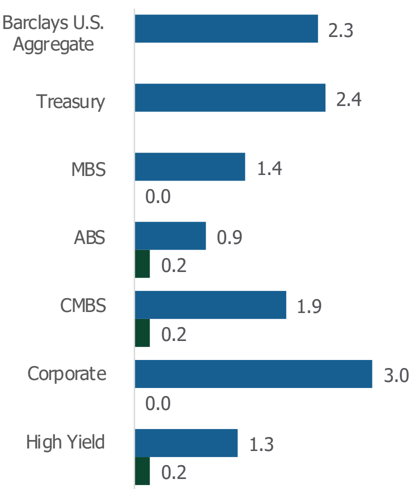


Source: FactSet

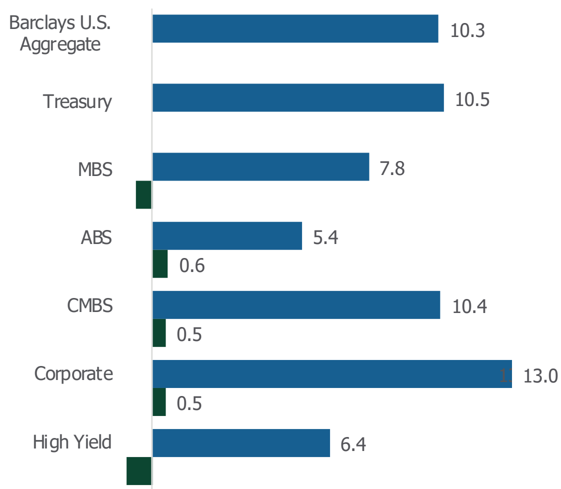
- Utilities and Real Estate have benefitted from the tailwind of lower yields and the desire for "bond substitutes" within the equity markets.
- Decline in oil prices have generated a headwind for the energy sector.

III. FIXED INCOME MARKETS

Market Performance: 3 Month



Market Performance: 12 Month

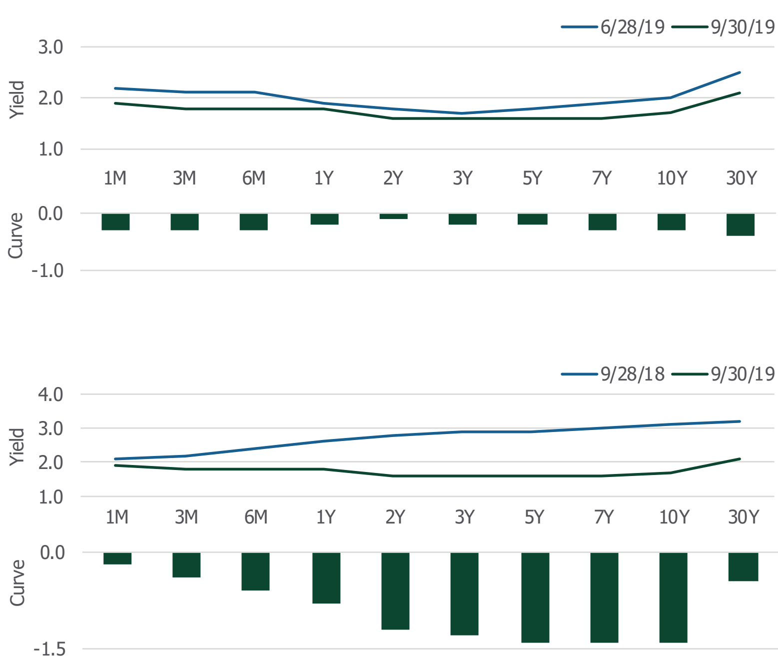


Source: FactSet

Absolute Return   Duration-Adjusted Excess Return

- Absolute returns have been strong across the fixed income sectors.
- The MBS sector underperformed on a relative basis due to increased interest rate volatility and overall decline in yields.
- High Yield continues to recover from the relative drawdown in the second half of 2018.

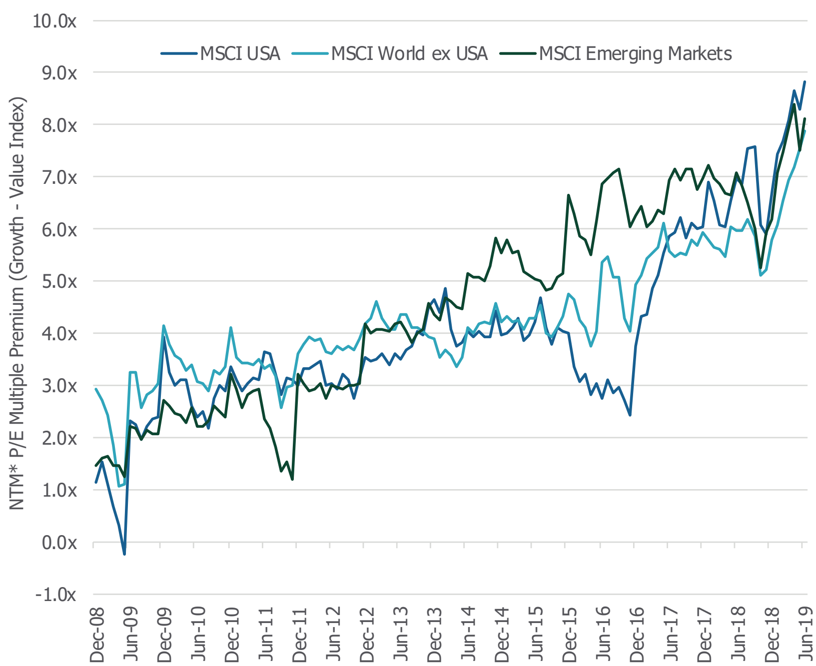
Treasury Yield Curve



Source: Bloomberg

- The economic effects of the trade war have led to a significant decline in interest rates.
- Absent additional fiscal stimulus, the expectation is for a reduction in the Fed Funds rate.

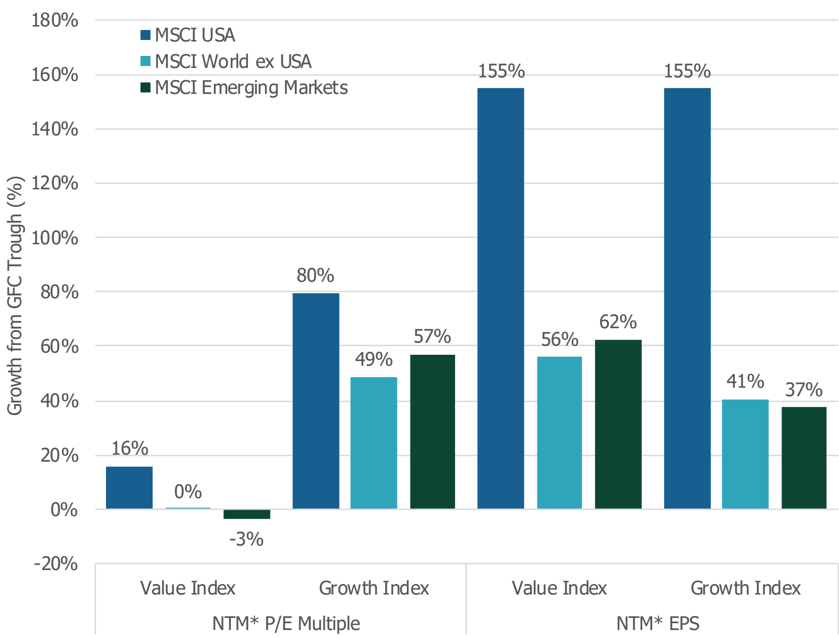
IV. NEXT TWELVE MONTHS' P/E MULTIPLE DIFFERENCE (Growth – Value Index)



Source: MSCI, FactSet, Causeway Analytics

- The Price-to-Earnings ratio of growth stocks has increased relative to value stocks across the globe.
- The differential in P/E reached a post Global Financial Crisis high.
- This differential implies significantly higher earnings growth rates for growth companies compared to value companies.

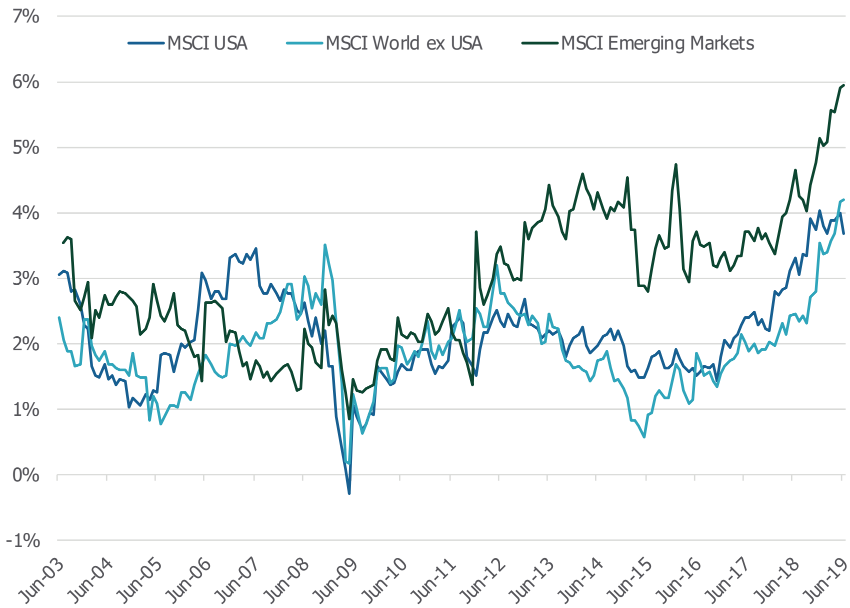
V. P/E GROWTH VS. EPS GROWTH



Source: MSCI, FactSet, Causeway Analytics
*Next 12 Months

- Growth price multiples have grown considerably faster than value.
- Interestingly, earnings of value companies have grown at the same rate as growth in the US, and faster than growth companies outside of the US.

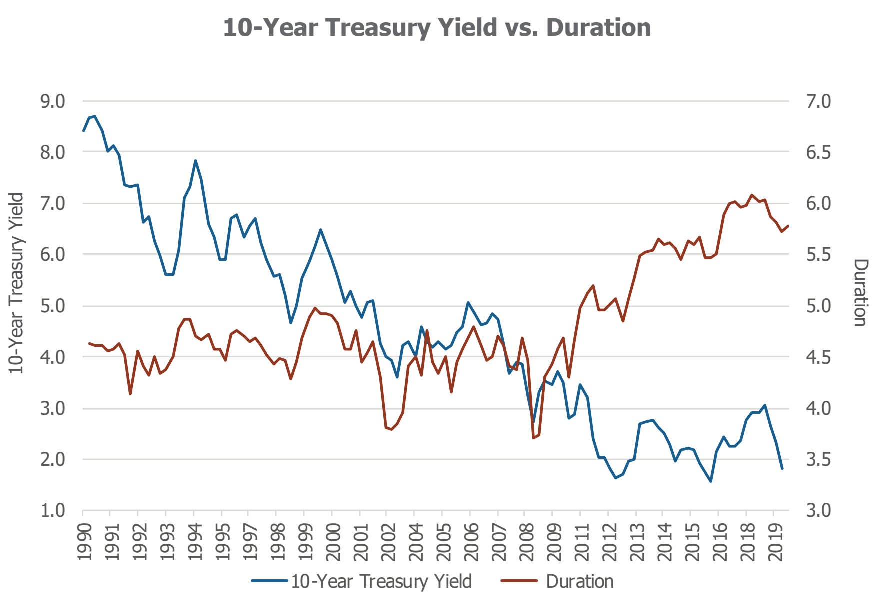
VI. IMPLIED PERPETUITY GROWTH RATE DIFFERENTIALS (Growth – Value Index)



Source: FactSet, Bloomberg, MSCI, Causeway Analytics

- Future earnings growth expectations are overly inflated for growth versus value.
- The price of value companies implies negative earnings growth into perpetuity, a highly unlikely event.
- The significant decline in interest rates may be behind this price differential as growth companies have a longer earning duration than value.

VII. BOND MARKET DURATION OVER TIME



Source: Bloomberg, Federal Reserve Economic Data

- The duration, or interest rate sensitivity, of the bond market has increased significantly since the Global Financial Crisis.
- This same dynamic impacts the equity market and potentially the growth value divergence we have witnessed.
- Interest rate sensitivity across all markets has increased.

Market Musings

We have highlighted the performance differential between growth and value for quite some time. While investors have focused on the difference in the US market, this has been a global phenomenon. While the differential narrowed during the third quarter, global growth indices have continued to outperform year to date by approximately 500 basis points. The persistent outperformance of growth since the Global Financial Crisis has prompted many investors to question whether they should abandon value strategies. Research provided by one of our sub-advisors, Causeway, suggests one should not abandon value too quickly.

Since the end of the Global Financial Crisis, global growth stock price-to-earnings ratios have steadily increased at a far greater pace than value stocks. We are now seeing valuation premiums of growth versus value that are at peaks since the Global Financial Crisis. (Exhibit IV). It is widely believed that the outperformance of growth versus value is due to the higher rate of earnings growth for this sector. However, facts do not bear this out. Earnings growth has been the same for both value and growth stocks in the US, but elsewhere the earnings growth of value stocks has exceeded that for growth stocks. (Exhibit V)

Since actual earnings growth cannot explain the difference in performance, the difference must be related to earnings growth expectations. Causeway imputed the future earnings growth rates for the various indices given current levels of P/E. Despite the reduction in earnings growth we have witnessed more recently current valuations imply negative growth rates in earnings into perpetuity. (Only the US growth index and Emerging Markets growth index exhibit positive implied earnings growth rates.) Moreover, the spread between implied perpetual growth rates between growth and value stocks have reached all-time highs. (Exhibit VI) Certainly, the risks of global recession have increased due to the trade wars between the US and China, but it is hard to reconcile an expectation of declining earnings into perpetuity. And, the valuation gap between growth stocks and value stocks implies significant pessimism regarding value with corresponding optimism regarding growth stocks.

I suspect something else is at play to drive the valuation difference between these two sectors of the stock markets. We are all familiar with the notion that bond prices increase as interest rates decline. What we tend to forget is this relationship impacts stock prices as well. Stock prices are simply the discounted present value of future earnings. As the discount rate decreases, and assuming earnings remain the same, the stock price will increase. Since growth stocks have a greater percentage of their earnings in the future, the duration, or interest rate sensitivity of their stock prices to interest rate changes, will be greater than for value stocks. The decline in interest rates may be a significant driver of the valuation difference between growth and value stocks over recent history.

While I am on the topic of interest rates, I can't help but comment on the increased interest rate sensitivity of the markets. As mentioned above, the duration of a security measures the price sensitivity of the security to changes in interest rates. The greater the duration, the greater the interest rate sensitivity. We know that long maturity bonds have a greater duration than short maturity bonds. What is not as well known is that as interest rates decline, the duration of a non-callable bond increases. That is, as rates decline, security prices become ever more interest rate sensitive. The price of a 30-year bond today is 15% more interest rate sensitive than if interest rates were 5%. (Exhibit VII) shows how the bond market's duration has increased since the early 1990's. The US bond market is approximately 25% more interest rate sensitive today than it was in 1990. Since stock prices also have a duration, though not as easily calculated as a bond, the interest rate sensitivity of an investor's entire portfolio has increased since the Global Financial Crisis.

The investing community has become addicted to ever lower levels of interest rates. In the near term, the central banks continue to feed the addiction. Fundamental valuations will continue to be stretched. But just like a rubber band, at some point these extreme conditions will break, and we will move towards normality. I don't know when, but I suspect it will be a quick, violent snap, just like a stretched rubber band. Therefore, do not give up on value! It may help moderate the adjustment that must inevitably occur.

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