LOOKING AT ROTATIONS WITH AN ECONOMIC LENS

Market Review **MAY 2021**

The distinction between value and growth stocks attracts a lot of attention in the intersection of asset management and research. Portfolio management decisions are usually not made without making some considerations for the two investment styles. Value stocks became famous on the belief that they pay investors a risk premium for owning them over a complete market cycle. The supposition that value outperforms over a lifecycle depends on the evidence in the data. In the early 1990s, value investing became more popular as research covering the 1960s to the 1990s found convincing evidence that value investments earn higher returns relative to other types of stocks. However, in recent times, the value premium has seemed to disappear.

But maybe economic conditions haven't been quite right for value performance in recent years, or even decades. Namely, inflation became a subdued variable throughout the last few decades. Certain fundamentals that characterize value stocks may be better suited for times of inflation. The experiences of the 1960s to the 1980s were times of rising inflation. Coincidently, that was an excellent era for value investments. Now that economies are beginning to print higher inflation figures again, value stocks may be poised to outperform.

There are many good reasons why value would outperform in an inflation environment. For one, growth stocks act like long-duration assets whose valuations depend on future and long-dated earnings. Valuations placed on growth stocks are much more sensitive to discount rate changes based on rising inflation expectations. However, value stocks usually receive immediate profits, so their valuations are less susceptible to changing rates. Balance sheet differences between the two investment styles can provide another explanation. Cash is a dilutive asset when there is inflation, and growth stocks tend to hold a lot of cash. Market valuations on growth can pause or even slip as inflation dilutes the value of the cash sitting on the growth stock balance sheets. Conversely, value stocks typically operate with high balance sheet debts, and debts get demonetized with inflation. The net worth of value stocks may rise with inflation since old balance sheet debts tend to shrink compared to the nominally rising cash-flows of value stocks.

As of late, the stock market has experienced a meaningful style rotation. Throughout much of the previous five months, the returns on the value style have accelerated while the returns on the growth style have stalled out. Such a change in sentiment is not that long-lived. Still, hundreds of billions of dollars in the fund management industry are betting on new life found in value stocks.

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Opposing views can exist when buyers and sellers meet to exchange trades. Those that have been buying value stocks may be operating under the presumption that inflation is finally out. They would have good reasons to think this way as the economy has run on public deficit spending for most of the prior two decades and trade wars have begun to intensify among global trade partners. But those thinking that inflation will remain tame have the tailwinds of technological change and demographics to ride on. Both are said to contribute as deflationary forces.

Ultimately, both value and growth stocks can provide key benefits to diversified portfolios. It is important to understand the various factors that drive these distinct types of stocks when crafting portfolio allocations. COVID-19 has brought significant change to global financial systems, economies, consumer behavior, and business practices in general, all of which impact the trends in equity market style and the resulting investment opportunities.

Asset Categories	US STOCKS	FOREIGN STOCKS	US BONDS	FOREIGN BONDS	HARD ASSETS	HYBRIDS
Monthly	1.03%	2.53%	0.47%	0.95%	5.40%	-0.30%
Year to Date	16.78%	10.34%	0.54%	-1.06%	17.56%	2.86%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING MAY 31, 2021.

US STOCKS

US Stock returns settled down in May, but were still able to advance. The group brought in gains of 1.0% on the month, which raised the year-to-date period return to 16.8%. Small-caps led in May with returns of 1.3%, while large-cap returns booked 0.9% in comparison. Similarly, small-caps lead for the first five months of this year with year-to-date returns around 20.3%.

FOREIGN STOCKS

Foreign Stocks outpaced US Stocks in May. The asset category returned 2.5% last month and has accumulated 10.3% for the first five months of 2021. Foreign stock indexes tend to have elevated allocations in value-styled stocks. If value stocks have finally come into season, then more return potential could be ahead for the foreign markets. Similar to the US markets, small-caps have been a leader in foreign stock markets with year-to-date returns running around 13.4%.

US BONDS

US Bond returns strengthened in May to keep the complete category in the black this year. Overall, US bond returns rose 0.5% last month to raise the year-to-date return to 0.5%. Gains in the entire category of bonds have come off of the returns of risk-based capital and inflation-protected capital. Risk-based returns in high-yield and bank loans have returned about 2.5% since the beginning of the year.

FOREIGN BONDS

Foreign Bonds experienced one of their better months this year in May. The category of global and emerging bonds rose by nearly 1.0% last month, which narrowed the year-to-date losses to almost -1.0%. This new turn of events may go on to prove that emerging market bonds became a neglected asset in a time when risk-based capital has been hot. Yields on emerging market bonds still appear attractive.

HARD ASSETS

Hard Assets moved higher in May, making them leaders in the reopening trade of the global economy. Precious metals had big-time gains in May, booking returns of 12.6% in a single month. That helped raise the year-to-date return on precious metals to 7.2%. Another leading segment of the category was energy assets. Master limited partnerships returned 6.0% last month, pushing their returns of the previous five months to over 30.0%.

HYBRIDS

Hybrids softened in May caused by weakness in the convertible bond category. Convertible bonds slipped last month to produce losses of -1.4%. That narrowed their year-to-date gains to 2.4% and put preferred stocks ahead for the year. The yield-friendly preferred stock category rose by 0.8% last month to place it at 3.4% year-to-date.

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