Not all value stocks are valued the same

December 2021

Research Signals

At the conclusion of the two-day policy meeting ending 15 December, the Federal Open Market Committee (FOMC), as widely expected, stated that it will accelerate the taper of its bond purchases and anticipates raising the federals funds rate target around mid-2022. Throughout 2021, the value/growth cycle has reacted to the trend in yields as equity and bond markets priced in developing inflation and economic growth expectations. As value stocks stage a comeback in this anticipated increasing rate environment, we take a closer look at the traditional value sectors and find nuances between cyclical and defensive value stocks.

- Cyclical Energy and Financials sectors have outstripped the market and further outpaced defensive Healthcare, Consumer Staples and Utilities sectors to date in 2021
- During the recent expansion in corporations' stock buyback programs since early 2020, the steadier pace of share repurchases by cyclical value sectors has provided a tailwind heading into 2021
- Defensive value sectors have seen a higher drag from negative revisions and greater uncertainty in current fiscal year earnings estimates

Recent market trends

We have written several **articles** and monthly **key drivers** reports highlighting a resurgence in the performance of value factors following an **extended period** of underperformance in US markets, tying the trend in value versus growth performance to that of interest rates. Over the past year, the yield on the US 10 year treasury note has fluctuated as vying forces from macroeconomic activity, US Federal Reserve policy and inflation expectations have impacted the outlook on interest rates. We dig deeper into value sector performance to highlight varying responses from cyclical (Energy and Financials) versus defensive (Healthcare, Consumer Staples and Utilities) value stocks.

To begin with, we set the stage with a long term view of the relative performance between value and growth stocks. We use the iShares Russell 1000 Value ETF (IWD) and iShares Russell 1000 Growth ETF (IWF), respectively, sourced from the IHS Markit ETF Analytics database, to represent each theme. (Note that dividends and fees are included in the performance results.)

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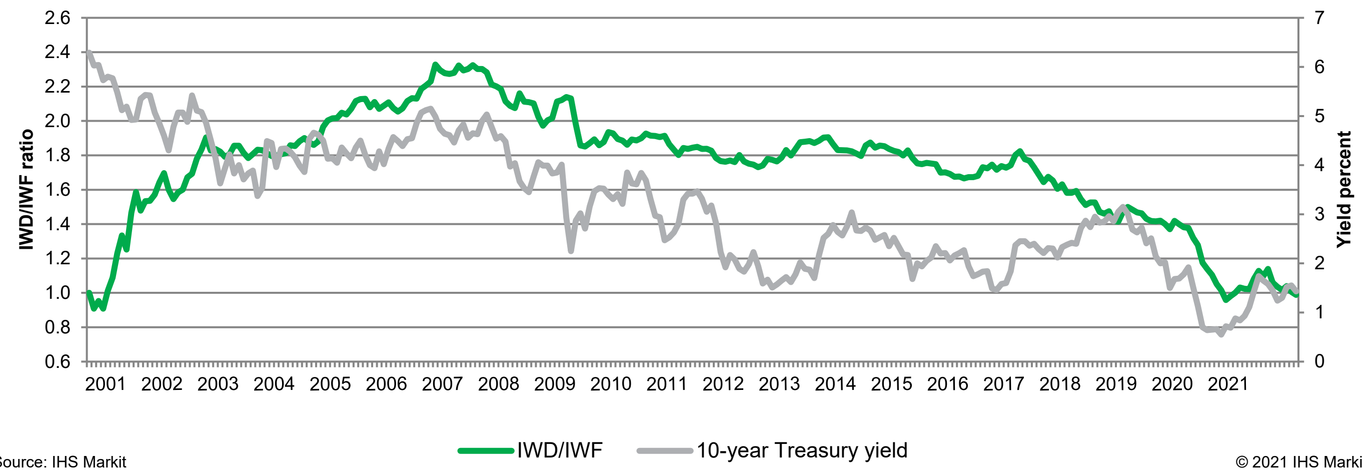
We analyze the value versus growth cycle with respect to interest rates based on the ratio of IWD relative to IWF overlaid with the trend in 10-year Treasury yields (Figure 1). The value cycle coming out of the internet bubble peaked in the second half of 2006 and held steady through mid-2007 before interest rates started their long term downtrend. The ensuing extended period of growth outperformance is identified by the decreasing trend in the ratio, coincident with declining interest rates, which is expected given the benefits of low-rate environments for growth stocks in terms of discounting future cash flows.

More recently, we see a sharp drop in interest rates at the onset of the COVID-19 pandemic in early 2020 as central banks and governments around the globe asserted massive monetary and fiscal support to limit the economic impact of the pandemic, adding another leg down to value's underperformance. Yet, in September 2020, value stocks rebounded alongside interest rates, as prices oscillated amid mounting concerns about increasing inflation and the implication on monetary policy at the same time that new strains of COVID-19 continued to threaten economic growth.

However, current economic data has indeed pointed to an annual inflation rate of 6.8% in November, its highest level since 1982, and an increase in producer prices of 9.6% from a year earlier, the highest level in over a decade. With these data points in hand, the FOMC announced on 15 December that it will accelerate the taper of its bond purchases to a revised plan that will see purchases fall to zero in the second half of March 2022. Revised forecasts also suggest a majority of FOMC participants anticipate that it will become appropriate to raise the federals funds rate target around mid-2022.

Figure 1

Value versus growth relative performance and interest rates



Source: IHS Markit

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Drilling down to recent sector performance, we next compare results between defensive and cyclical value sectors. We use the Sector SPDR ETFs to proxy each sector – Energy (XLE), Financials (XLF), Healthcare (XLV), Consumer Staples (XLP) and Utilities (XLU).

Looking at performance for 2021 through November (Figure 2), we find that Energy stocks far outpaced the remaining value sectors, with a cumulative return of 49%. This compares with the SPDR S&P 500 ETF return of 23%. Financials were also highly favored, exceeding both the remaining sectors and the benchmark with a 30% cumulative return. On the other hand, the defensive sectors trailed the cyclicals and the benchmark, with an average cumulative return of 11%. Cumulative aggregate flows into the two sets of sector ETFs (Figure 3) also clearly points to an investor preference towards Energy and Financials.

Figure 2

ETF NAV (with dividends and fees) 2021 performance

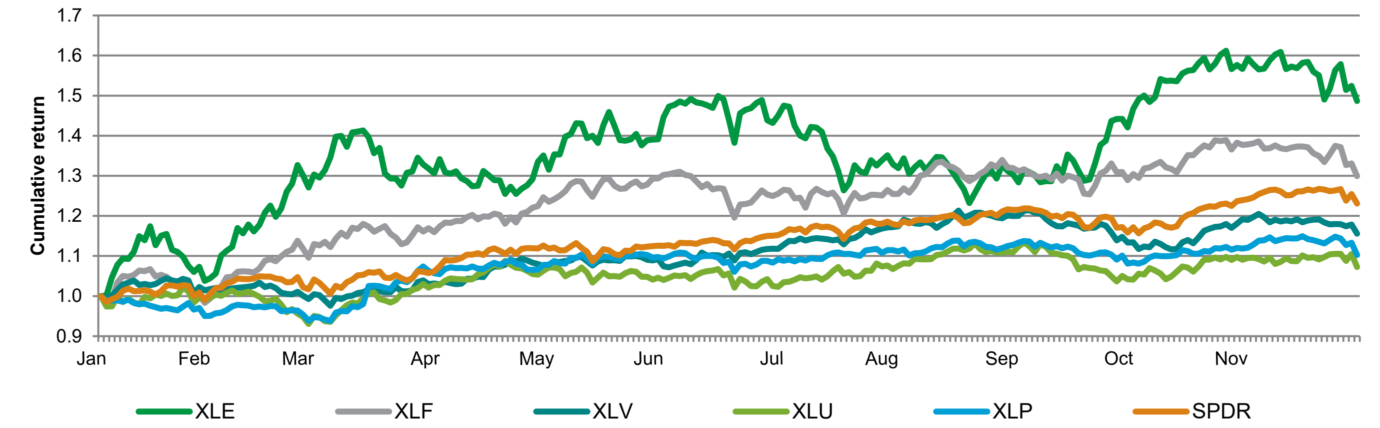

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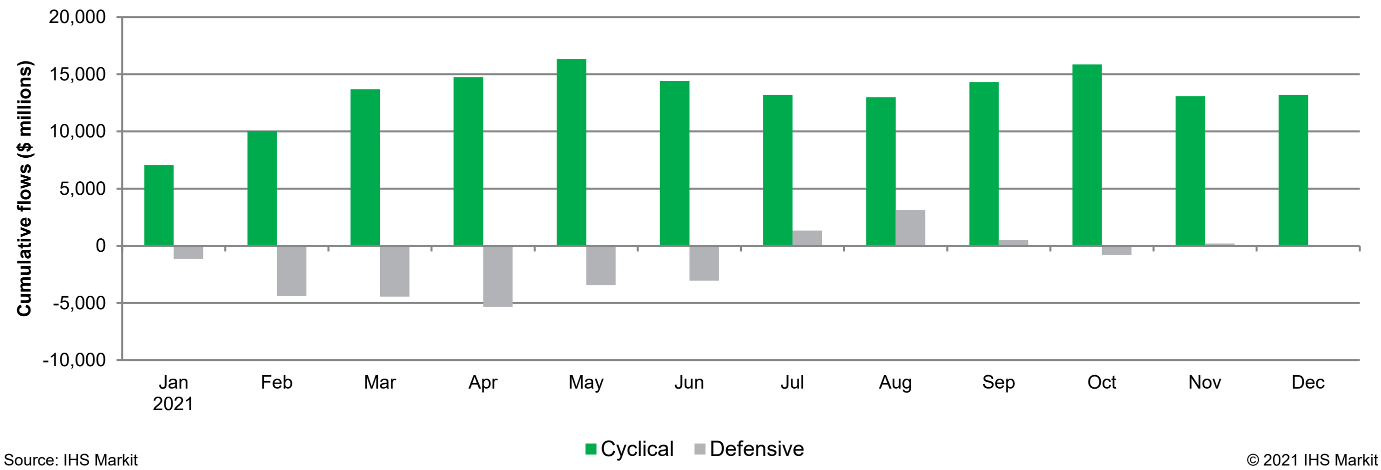
Figure 3

ETF flows



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Sector attributes

We turn now to noteworthy developments in a handful of cyclical and defensive sector attributes over the course of the past two years. First, one way that investors can judge a corporation's outlook for their share price is from the perspective of stock repurchases. A company may decide to buy back its shares from the marketplace if it considers the stock price to be undervalued relative the company's prospects. According to a recent Wall Street Journal **article**, companies in the S&P 500 repurchased more than two-and-a-half-times the value of stock from the second quarter of 2020 through the third quarter of 2021 as corporations were flush with cash after conserving cash at the onset of the pandemic and subsequent Fed purchases of securities.

To this end, we use our Percent Change in Shares Outstanding factor, ranked to favor firms with lower one-year percentage change in quarterly common shares outstanding, to analyze the relative positioning of the two groups of sectors. The universe of stocks in our analysis is comprised of our US Total Cap universe, which consists of approximately 3,000 names capturing 98% of the cumulative market cap.

Using our Stock Screener, we filter for stocks which have had a reduction in their share count over the past two years, and aggregate counts across the cyclical and defensive sectors (Figure 4). We observe that, following an initial bump up in early 2020 during the initial pandemic-driven market declines, Consumer Staples, Healthcare and Utilities firms saw a larger reduction in the number of firms reducing share counts, while Financials and Energy firms maintained a steadier pace, providing a tailwind heading into 2021. We also find that investors favored stocks with the most attractive Percent Change in Shares Outstanding ranks, as confirmed by decile 1 minus decile 10 spread performance (Figure 5) which was particularly strong in 2021, with an average spread of 3.4% and outperformance in all but three months.

Figure 4

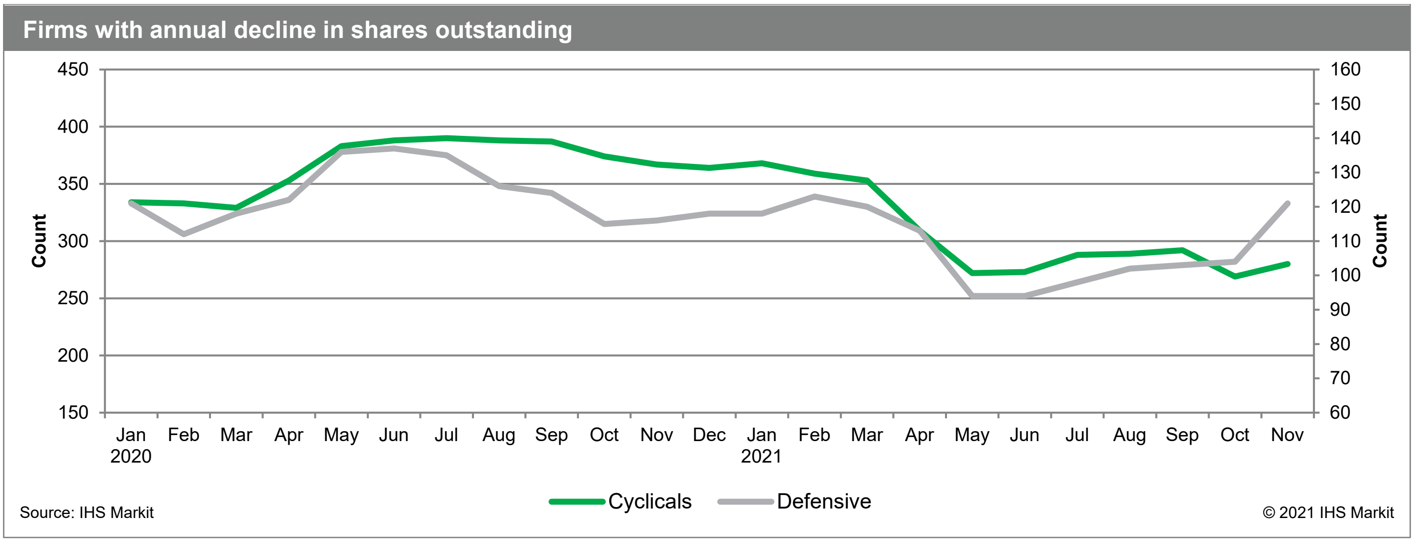
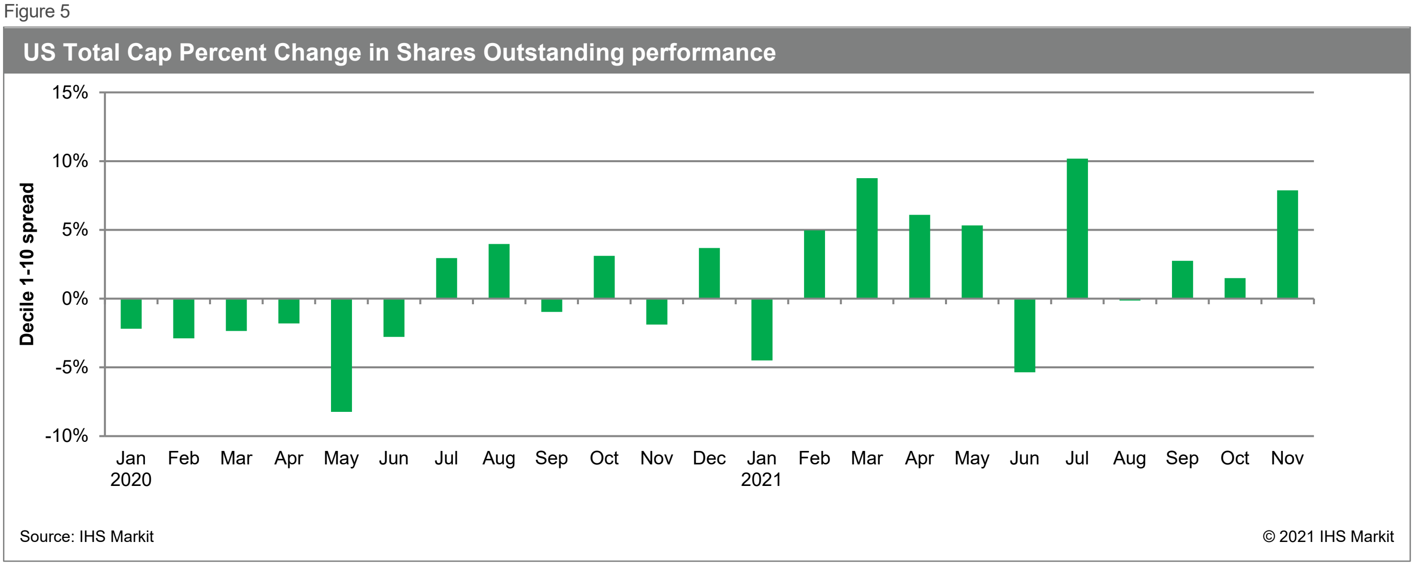


Figure 5



Next, we focus on analyst outlook for cyclical and defensive sectors. The first factor we examine is Net # of Revisions for Fiscal Year 1, which favors firms which have seen the highest number of analysts raising current fiscal year estimates versus lowering over the past month. In this case, we screen for stocks which have had negative revisions and aggregate the counts for the cyclical and defensive sectors over the past two years (Figure 6).

Not surprisingly, an elevated number of analysts reduced their earnings estimates across both groups of sectors in early 2020 given the uncertainty of the pandemic. However, the defensive sector counts remained in a similar channel throughout 2021, while the cyclical sector counts trended below pre-pandemic levels and have remained in this lower range through November 2021, suggesting a relatively more positive outlook from analysts.

Investor dollars aligned with this theme, as Net # of Revisions for Fiscal Year 1 factor performance (Figure 7) also indicates a relatively consistent investor preference for firms with upwardly revised estimates since 2020, especially in 2021 which posted only one month of underperformance. While not shown here, results for fiscal year 2 revisions closely resembled that of the current year estimates.

Figure 6

Firms with negative FY1 earnings estimate revisions

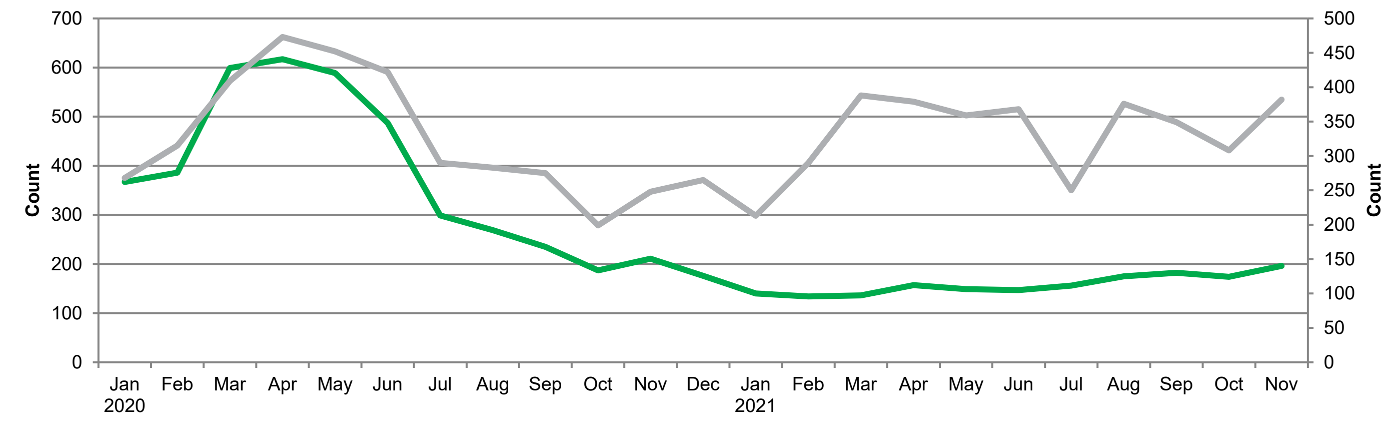


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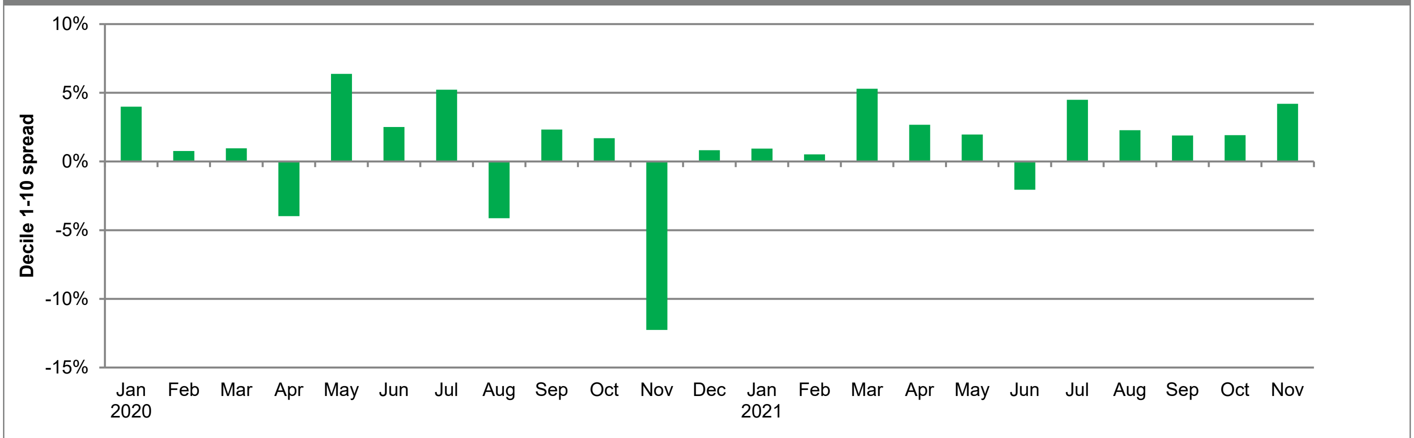
Figure 7

US Total Cap Net # of Revisions for Fiscal Year 1 performance



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Lastly, we review the dispersion in analyst estimates given the increasing amount of uncertainty around earnings estimates since the start of the pandemic and other more recent concerns on the implications of increasing inflation and tightening monetary policy. For this analysis, we use Std Dev of FY1 EPS Estimates-to-Price to filter for stocks with the highest dispersion in estimates relative to price residing in the bottom decile of factors rankings.

The count of stocks in the defensive sectors has seen a relatively steady increase since March 2020. On the other hand, the count of stocks in the cyclical sectors cycled in a tighter range through September 2020 and has been on a general decline since that time, suggesting higher consistency in analyst outlook. While this signal has not been as consistently rewarded as the previously cited factors, it still confirms a higher level of attractiveness for Financials and Energy stocks. We again note that fiscal year 2 results closely tracked that for current year estimates.

Figure 8

Firms with the highest FY1 earnings estimate dispersion

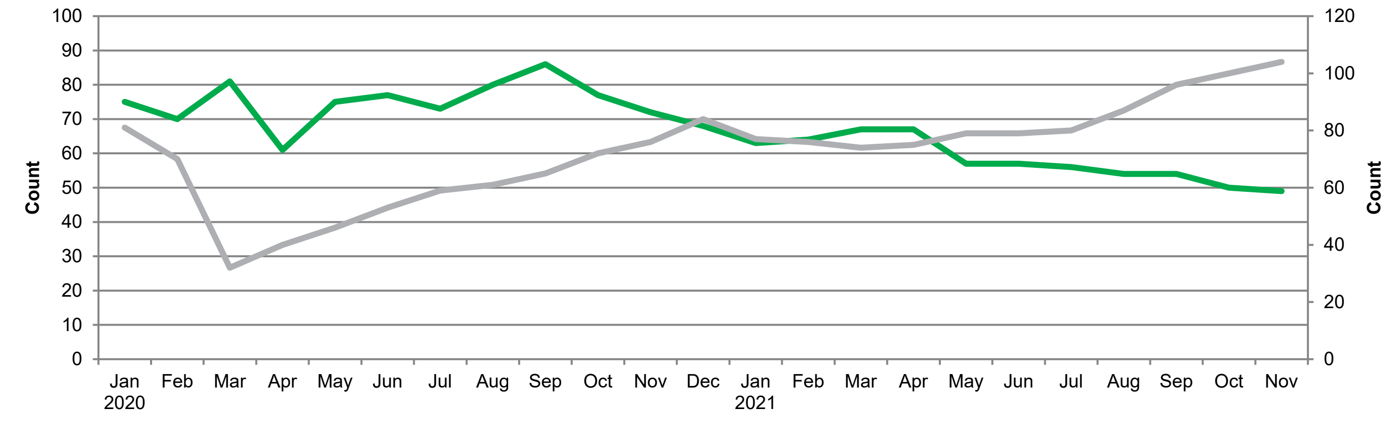

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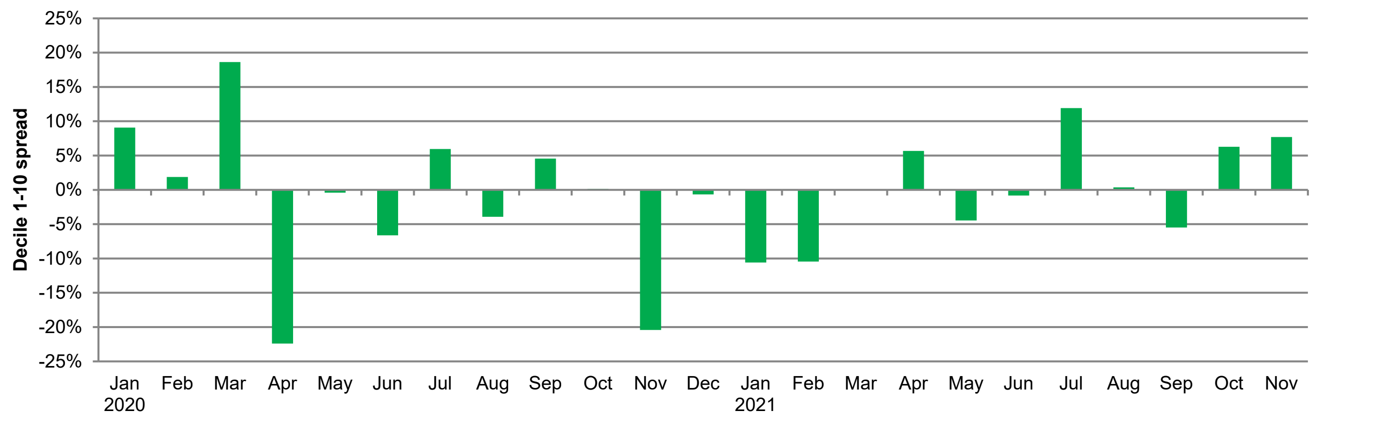
Figure 9

US Total Cap FY1 EPS Estimates Dispersion performance



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In summary, on closer inspection of value stocks in anticipation of an increasing rate environment, we find differences in investors' preferences for cyclical versus defensive value stocks. Since 2020, in a prolonged period of extremely easy financial conditions, stock buyback programs have proliferated, with a steadier pace of share repurchases associated with cyclical value sectors. At the same time, defensive value sectors have seen a higher drag from negative revisions and greater uncertainty in current fiscal year earnings estimates, combining to support pronounced outperformance of Energy and Financials over Healthcare, Consumer Staples and Utilities.

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