How much longer can "value" be on the outer?

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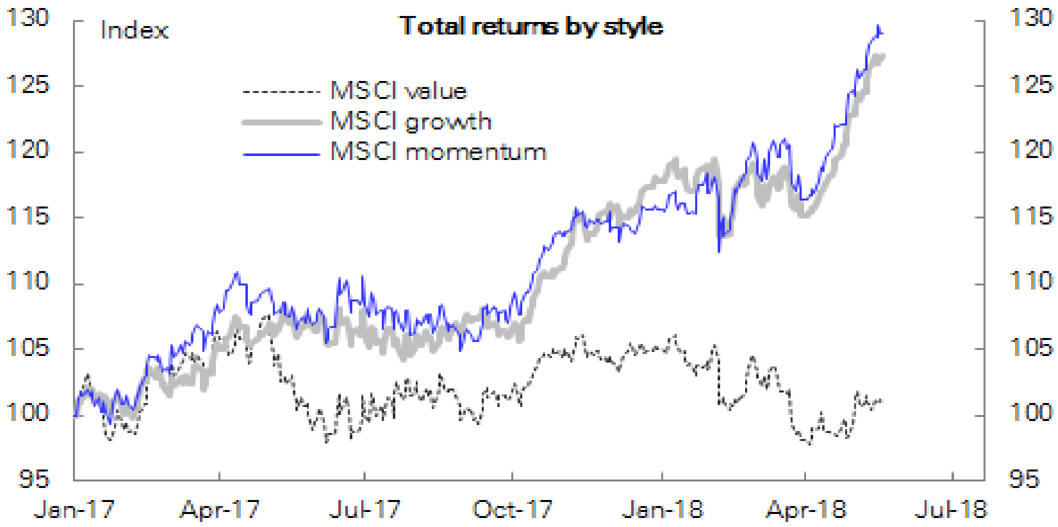
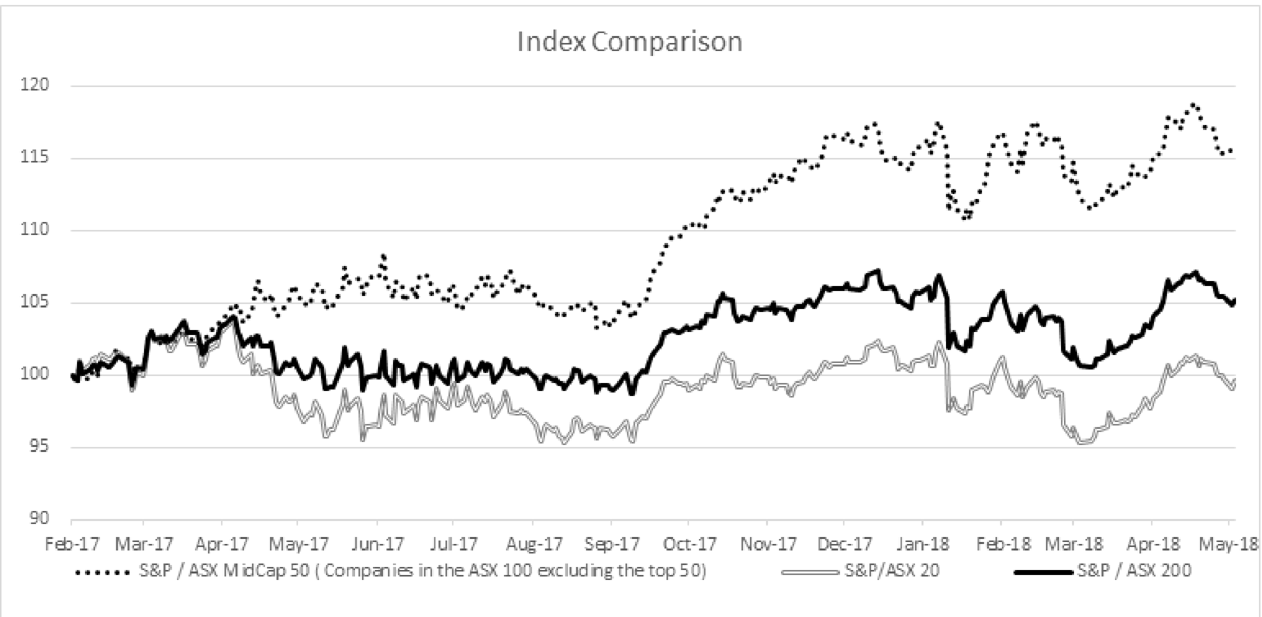
Benjamin Franklin warned of the dangers of group think and being swept up by momentum. This sentiment may be prescient when considering the recent performance of the Australian stock market. Since its low in February 2016, the S&P / ASX 200 has risen by around 28%, which appears to be a consistent and positive market performance. But when we look beneath the surface a massive divergence is revealed.

The term "Bipolar" best describes the performance of "growth" and "value" as the graph below[1] highlights. Momentum has been with the growth stocks.



Source: Deutsche Bank, May 2018

In a similar vein, mid cap stocks have outperformed large cap shares over the same period.



Source: Bloomberg May 2018[2]

[1] Past performance is not a reliable indicator of future performance

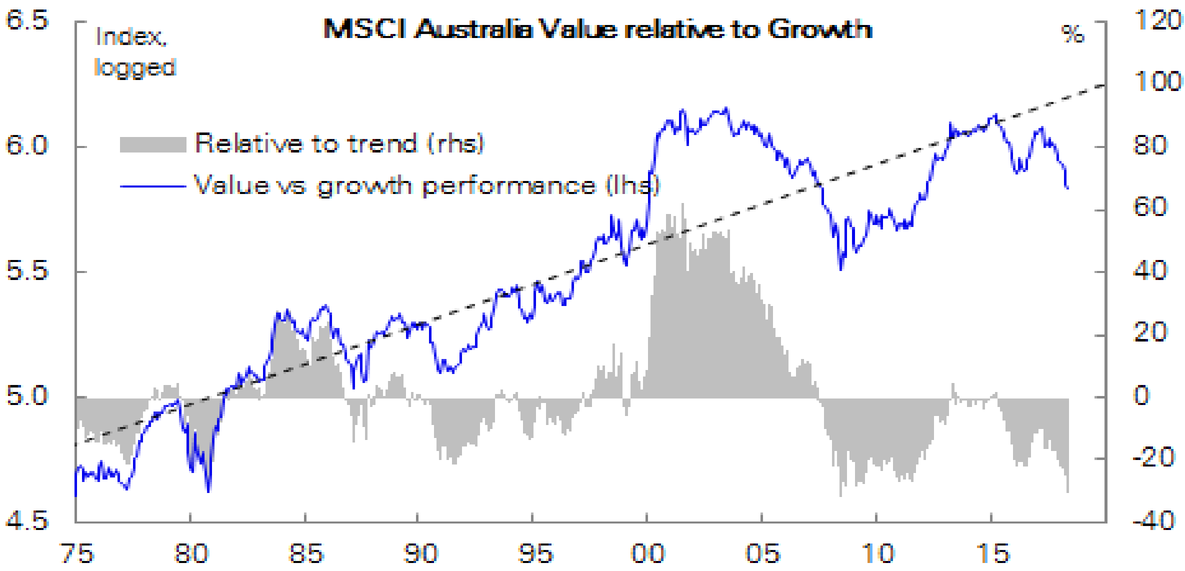
[2] See previous reference.

Growth stocks generally have high perceived earnings growth, both short and long term, a history of strong eps growth and strong sales growth. Often they will be market darlings and trade on very high PE multiples as their earnings are expected to keep growing at a faster rate than the market. Growth typically perform well in times of optimism, favourable economic conditions, and when investors are looking for high returns and are much less risk averse. Thoughts about preservation of capital generally diminish in these periods.

Value stocks generally have much lower perceived earnings growth potential and therefore higher payout ratios and dividend yields due to the lack of growth options. They usually trade on low price to book, and price to earnings multiples, at what is thought to be less than their intrinsic value. Sometimes they will be companies in industries suffering a cyclical downturn and experiencing challenging times.

Australian "value" type stocks have recently been in a period of very sluggish earnings performance for reasons including, but not limited to, earnings disappointment, digital disruption and myriad problems in the financial sector, banking in particular. And because many of the "value" type stocks are also typically high yield, they, along with bond proxy type stocks, appear to have been negatively impacted as investor attention seems to be focussed on rising US bond yields.

Historically there has been a cyclical relationship between value and growth as the chart below highlights. This divergence has accelerated recently with "value" clearly out of favour and the relativity looks about as stretched as it has been in recent history.



Source: Deutsche Bank, May 2018[3]

But will value come back? Can investors expect a cyclical style rebound as has been evident in the past?

Our view is that the price of growth stocks has risen more than the growth forecast in their earnings, which appears to be driven by sentiment and momentumurrent. Market thematics seem to be quite "crowded", and we do not expect such a stretched historical relationship to keep expanding permanently.

There is also the prospect that value could rebound quickly if investor sentiment turns negative or risk appetite declines.

3 Past performance is not a reliable indicator of future performance

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