

Investment Commentary—October 2015

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As Wall Street traders prepared for their late August vacations, the U.S. stock market was rather quiet. After reaching all-time closing highs in mid-July, market indices had drifted slightly lower but were still up for the year. An August 20th CNBC headline proclaimed, *"S&P 500 is having a dull year, and that's good for investors."* That day and the next few turned out to be anything but dull, as the 500 stocks in the index proceeded to lose 10% of their collective value in just over two trading sessions. Taking into account the speed of the decline, it was the worst stretch for U.S. stocks (and most other stock markets) since the depths of the financial crisis.

The precipitous drop was triggered by Beijing when authorities there initiated an unexpected devaluation of the yuan and then tried, but failed, to contain plunging Chinese stocks. Events in China rattled markets on several counts but with the Shanghai stock market largely walled off from the rest of the world, plummeting Chinese share prices may have been the least of investor worries. The currency devaluation was more troublesome, with many fearing that it was the first step in a protracted effort. A sustained devaluation would hurt neighboring countries that compete with Chinese manufacturers, leading to markedly lower prices for Asian exports. While that would benefit consumers, it might also unleash a bout of harmful global deflation.

More than anything else though, the events of mid-August triggered a crisis of confidence in President Xi Jinping's economic leadership. Doubts had been brewing for the better part of a year, due in large part to Beijing's role in stoking a bubble in Chinese stocks and its disjointed response when the bubble burst. Paul Krugman bluntly articulated what many were thinking when he wrote, "if its [China's] leadership is really as clueless as it has been looking lately, that bodes ill, not just for China, but for the world as a whole." Earlier in the year, as the Chinese economy was decelerating, many took solace in the idea that Xi had various levers he could pull to maintain a reasonable level of growth. Not the official seven percent target to be sure, but perhaps four or five percent—sufficient to ensure that the slowdown would not have a dramatic impact outside China's borders. That no longer looks like a sure bet.

As mid-September rolled around, global stock markets seemed to have come to terms with events in China and the S&P 500 index had recovered more than half of the ground lost in the initial decline. Then the Federal Reserve held its September meeting and Janet Yellen joined President Xi in the doghouse. Throughout the summer the Fed chairwoman had worked assiduously to prepare markets for an interest rate increase in

the fall or early winter. Economic data, which looked weak earlier in the year, had picked up steam and there was a consensus that the Fed could begin to lift rates in September. But after the stock market correction that proposition was in doubt. This was the context for a widely anticipated speech on August 29th by Vice Chairman Stanley Fischer. In that speech he laid out a detailed case that inflation will soon climb toward the Fed's target of 2%. For many, the takeaway from Fischer's remarks was that the Fed remained confident in the strength of the U.S. economy and was ready to move on rates.

However, when the Fed did meet in September, the ensuing announcement as well as Yellen's comments to the press struck a note of caution, especially in relation to events in China and the possibility that weakness abroad could restrain inflation and growth in the U.S. Stock investors seemed to ask themselves, "What does the Fed know that I don't know?" and drove share prices lower. By the end of the quarter, the S&P 500 index was retesting the late August lows.

Before reading too much into the market decline it's important to remember that valuations have been overextended for some time. As we wrote three months ago, *"It's been over three years since the S&P 500 had a 10% correction. That's significantly longer than the usual time between corrections, so we wouldn't be too surprised if the drama in Europe [the standoff over Greek debt, since resolved] or the wild swings in Chinese stocks prompt a pullback."* For the most part, this has been a painful but overdue and ultimately healthy correction. We must confess though that we're significantly more pessimistic about China than we were six months ago. It has been a major engine for global economic growth for over two decades and that era appears to be drawing to a close. China constitutes about one sixth of the world's economy but accounts for a much larger share of global infrastructure spending—from roads and bridges to power plants and factories. The explosion of Chinese investment in infrastructure created a seemingly insatiable demand for oil, gas, coal, copper, nickel, cement, chemical additives and a wide variety of industrial goods and services. While that demand will likely continue to grow, the rate of growth is decelerating sharply.

The slowdown in China is hitting certain sectors (especially energy, materials and industrials) and certain countries (especially emerging market countries that rely heavily on natural resource extraction) quite hard, but the U.S. economy should hold up reasonably well. Notwithstanding last week's lackluster jobs report (which may keep the Fed on the sidelines even longer) the economic data continues to be strong. With U.S. GDP growth coming in at 3.9% in the second quarter, the rolling four-quarter increase in GDP has exceeded 2.5% for five straight quarters. The Bureau of Labor Statistics reported in early September that job openings had reached a record 5.8 million, exceeding the previous high water mark by an impressive 400,000. While problems in China will be a bit of a headwind, some of that impact will be offset by gas prices that may be in the \$2 range for quite some time. In short, the U.S. appears more and more to be the lone bright spot in the global economy.

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One of the most notable aspects of the difficult year in the stock market is that value strategies—those based on finding undervalued companies—have, by a fairly wide margin, underperformed growth strategies—those based on finding rapidly growing companies with less regard for share price. According to Morningstar for example, through September 30th mutual funds categorized as “large cap growth” generated an average return of -2.95%, while those categorized as “large cap value” came in at a woeful -8.35%. Over the entire bull market, going back to March of 2009, growth has considerably outperformed value. Using Morningstar data again, cumulative returns for large cap growth outpaced large cap value by something on the order of 94% to 70% from January 1, 2009 to September 30, 2015¹.

It’s not a coincidence that the bull market has been kind to growth stocks. For one thing, the excitement of booming share prices tends to make investors want to chase “home runs” by finding rapidly growing companies. Beyond that, two of the dominant aspects of the last six years have been mediocre GDP growth and low interest rates. A weak economy dampens earnings growth across the board. Investors that want to see some minimum absolute level of earnings growth—at least 10% for example—are pushed to look more at the kind of companies favored by growth strategies.

Low interest rates help growth strategies for an entirely different reason. Consider two companies—one is growing earnings at 15% a year and the other is growing earnings at a more sedate 5%. Projecting ten years into the future, the cumulative impact on earnings becomes rather dramatic. The question is, how much should one pay now for earnings that won’t materialize for ten years? Professional investors are trained to apply a “present value” formula using a “discount rate” (think of the discount rate as an interest rate). The critical point is that lower discount rates amplify the importance of earnings five, ten or fifteen years into the future. Since the earnings of a high-growth company would be expected to dwarf the earnings of a more modestly growing firm in these “out years,” the high-growth company looks more appealing in a low-rate environment.

There is a significant amount of research suggesting that over long periods of time “value stocks” tend to outperform “growth stocks.” The quotation marks are important as most of this research is based on categorizing stocks by simple measures such as price to book value. The idea is that value strategies focus on buying stocks at a low price, whereas growth strategies tend not to focus too much on share price as long as earnings are expected to grow quickly. As a result, stocks that are lower in price relative to an objective measure (such as earnings or book value) will tend to be favored by value strategies, while stocks that are higher in price will be more correlated with growth strategies. While this is certainly true, it is also an enormous simplification of a very complex process. That said, the data are pretty robust. For example, over long periods of time,

¹ These figures come from chaining together the average large value and large growth returns reported by Morningstar for each year. The result isn’t the same as the average category return over the period but it’s likely to be a good estimate.

stocks with a low price to book value ratio have had a tendency to significantly outperform stocks with a higher price to book value ratio, and with the additional advantage of lower volatility.

Of course, past performance is no guarantee of future returns and your mileage may vary. Still, with growth outperforming by a considerable margin since 2009, and with research suggesting that over the long haul value has an edge, there's reason to think that the tables may turn over the next several years. That would be very good news for our clients, whose portfolios tilt significantly toward value. As with so many aspects of the stock market, performance of value vs. growth tends to run in cycles. It's notoriously hard to predict exactly when the current phase of the cycle will end. By historical standards however, growth strategies have had a pretty long run, so the wait may not be long.

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