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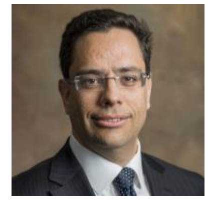
VALUE PAIN—IS IT PEAKING (OR DO I JUST WANT IT TO STOP)?



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WHAT HAPPENED TO THAT VALUE RALLY?

The markets give, and the markets take away, and this has been a year when markets have given little joy to value investors, with 2016's value rally now feeling like an eternity ago. Talk of inflation, cyclicals, and cheap multiples have long since been drowned out by column inches on disruption, AI, and cryptocurrencies, leaving value investors looking like the uncool kids in class once again.

The outperformance of growth stocks is well documented and has been especially sharp this year (Figure 1), as investors renewed the chase for growth in what remains a relatively low-growth world. Therein lies the opportunity, however, because value investing will never die, no matter how large the gig economy gets and how parabolic the Bitcoin price chart becomes.

Figure 1: Value Stocks Continue to Struggle

			Annualized		
Performance to October 31, 2017 (U.S.$)	**YTD 2017**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
MSCI World Growth Index	24.00	25.81	10.25	13.13	5.66
MSCI World Value Index	13.80	21.11	7.20	11.21	3.66
Growth Outperformance	**10.20**	**4.70**	**3.05**	**1.92**	**2.00**

U.S. Treasury Yields vs. MSCI World Value/Growth

December 31, 2002–September 30, 2017

Sources: MSCI and FactSet.

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ROTATION—WHAT TO LOOK OUT FOR

So what's the catalyst for a rotation? When is it going to happen? Why should I sell my shiny secular stocks and buy scary cheap things? That is, of course, *the* question, and one that we would love to have a definitive answer for.

However, precision timing rarely works, so we are staying patient and keeping our eyes on factors which may indicate we're closing in on an extreme, given extremes rarely persist. The following is a template for where we are looking to see how close we may be to a level playing field being reestablished, or maybe even a playing field that favors the uncool kids once again. Here's what we're thinking and monitoring:

Performance of value stocks—Versus growth, value has been abysmal in 2017, with relative returns collapsing the value/growth chart back to historical lows in many places of the world. This is somewhat unusual in the context of a normal "late cycle" and has in part been attributed to a new era of technological disruption (think Amazon versus Toys R Us). Regardless, it's become extreme in the context of history.

The real economy, inflation, and interest rates—We appear to be on the cusp of full employment in Japan and the U.S., with a modest wage cycle brewing and sentiment rising for corporates and consumers. While the interest rate cycle has been painfully slow to inflect for reasons too complex to put into this short note, we would expect policymakers to tighten from this point onward, if only to reintroduce the ability to apply two-way policy when it's needed again. If this happens, we believe many segments of value will look a lot more attractive to investors.

Valuation matters—Over the past two years, we have seen fear (remember China worries and that oil price collapse?) turn to cautious optimism, which has now turned into full-on optimism in some segments of the market. The outpouring of relief has been long awaited by equity investors, but there are signs that risk management and valuation sensitivity is going to be more important in 2018 than it perhaps has been in 2017. Valuation spreads have been rising on the juggernaut of information technology and growth outperformance. The penalty for missing earnings has been creeping up, and valuations are less attractive than they once were. This all leans toward focusing on bottom-up research, valuation-based analysis, and an avoidance of hype. Here we feel well equipped as always.

STAY PATIENT AND YOU WILL BE REWARDED

The conclusion? It feels like we're closer to the style environment being more favourable to value investors once again. Perhaps some volatility (remember volatility?) and a few bumps in the data would speed this along, especially if it comes in the form of any disruption to the high-flying growth stocks and their earnings. Add in any cyclical warmth impacting interest rates, and value may begin to shine once more.

Regardless, valuation counts over the long term, and we remain comfortable in our current discomfort.

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