



# Why This “Value” Recovery May Have Only Just Begun

Economic recovery and earnings momentum should be set to sustain the rotation back to value.

July 2021

## KEY INSIGHTS

- We believe the economic recovery, earnings momentum, and attractive valuations can keep the “value” recovery going.
- The valuation spread between value and growth stocks has only just moved from extremes.
- For investors seeking a balanced portfolio, we believe value is an important component of an investment strategy.



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Value as an investment style is enjoying a revival. After being described as moribund by some, we started to see a rotation from “growth” to “value” in late summer 2020, accelerating in November on the news of Pfizer’s COVID-19 vaccine. The outperformance of value has continued

year-to-date (Figure 1), as economies have opened up and economic and earnings growth have bounced. However, some are questioning the durability of this rally, while others are asking whether they have missed the opportunity to participate in the recovery.

## “Value” Has Outperformed as Economic Growth and Cyclical Companies Earnings Have Rebounded

(Fig. 1) Value has outperformed growth by 7.8% since September 1, 2020



**Past performance is not a reliable indicator of future performance.**

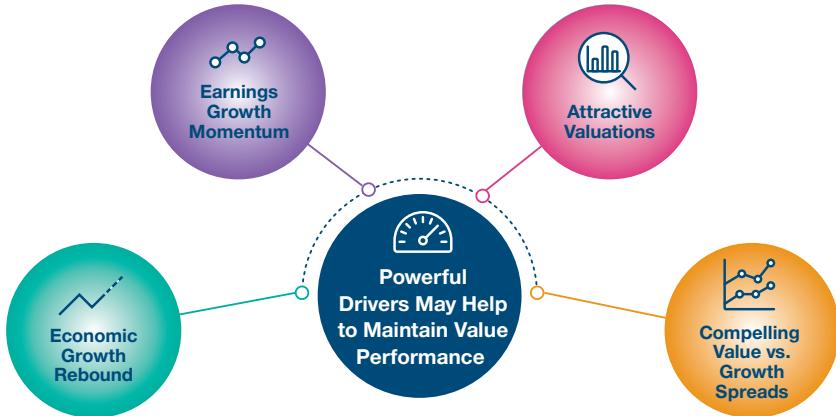
September 1, 2020, to June 30, 2021.

Sources: MSCI and FactSet. Financial data and analytics provider FactSet. Copyright 2021 FactSet.  
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We believe there are several factors that can help sustain the rotation back to “value.”

## Four Reasons Why This Value Recovery May Have Only Just Begun

Powerful drivers look set to support rotation back to value



For illustrative purposes only. Subject to change.

Source: T. Rowe Price.

Encouragingly, we believe there are several factors that can help sustain the rotation back to an investment style that has underperformed for so long.

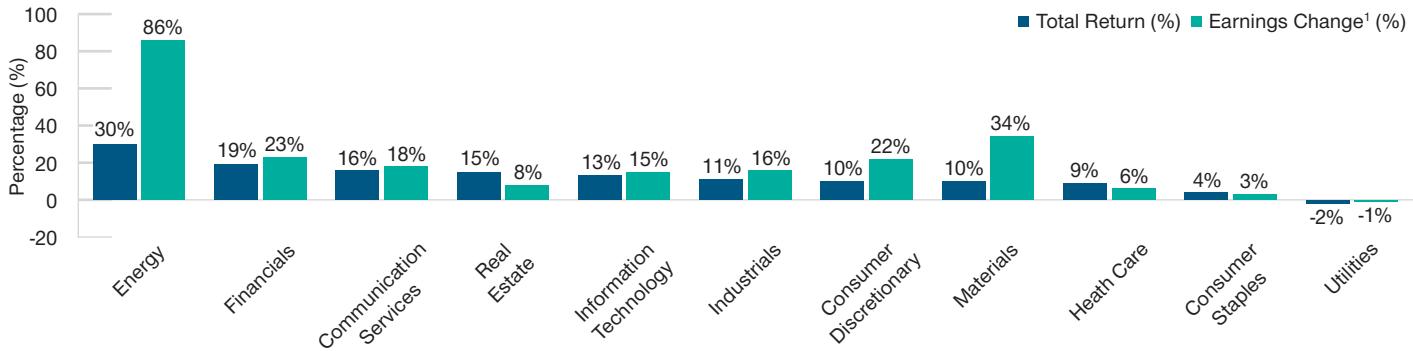
### Economic Recovery, Earnings Improvement, Attractive Valuations, and Valuation Spreads vs. Growth Stocks Provide Positive Backdrop

In our last T. Rowe Price Insights (Why the Future Now Looks Brighter for Value Investing) in November 2020, we spoke of the possibility that “the world could be set for a cyclical bounce in 2021.” This proved accurate, but even we have been

surprised by how much economies have rebounded. Economic recoveries historically have favored value areas, and this one has been no different with traditional value sectors leading the way (Figure 2). Much of this has been due to a meaningful improvement in earnings estimates, especially for sectors like energy, financials, and materials. Growth-oriented areas have also seen a rise in earnings expectations, but nothing like for value areas of the market. This has not been only limited to U.S. equity markets; value has outperformed across most equity markets.

## Leadership From Traditional Value Sectors

(Fig. 2) Energy, financials, and materials have seen the biggest increase in earning expectations



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December 31, 2020, to June 30, 2021.

<sup>1</sup>Based on 12-month forward earnings. Actual future outcomes may differ materially from estimates.

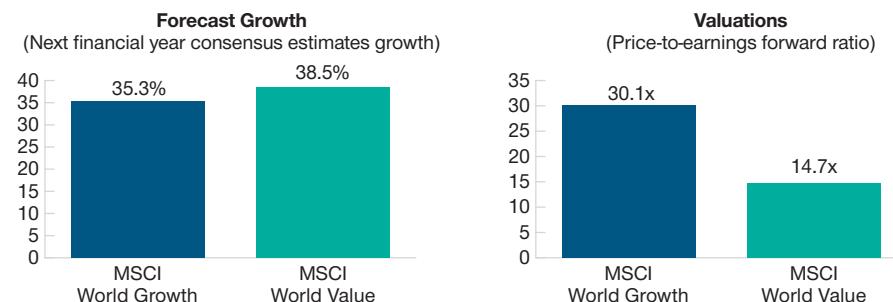
Sector performance returns are for the MSCI World Index. Earnings Change are provided by FactSet.

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We expect this momentum to be maintained as a combination of lower valuations and better earnings estimates can potentially support the rally.

## Value Offers Both Higher Potential Earnings Growth and Lower Valuations

(Fig. 3) Lower valuations and better potential earnings growth support value-oriented stocks



As of June 30, 2021. Actual future outcomes may differ materially from estimates.

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We expect this momentum to be maintained as a combination of lower valuations and better earnings estimates can potentially support the rally (Figure 3). This positive backdrop is further enhanced by ongoing fiscal stimulus, massive pent-up demand, and the prospects of fully reopened economies, which should all help maintain earnings growth over the short to medium term.

Even though value has outperformed growth over the last six months, we believe this has just started to shift the

needle in terms of long-term performance. This only represents the early recovery from the extreme valuation spreads seen when the crisis hit, in our view. Valuation spreads (or differences) between growth and value reached unprecedented levels then, in the order of around 4 standard deviations, higher than both the global financial crisis (GFC) and the technology, media and telecoms (TMT) bubble in 1999–2000.

The performance of value and growth indices shows a similar pattern of a sharp recent recovery, but we are still

## Value's Recent Outperformance is Modest in the Longer Term Context

(Fig. 4) After a decade of “growth” dominance, we may be starting to see a reversal



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As of June 30, 2021.

Blue shaded areas represent “growth stocks” outperformance period. Grey shaded areas represent “value stocks” outperformance period.

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Despite the recent change in fortunes, we believe there are still many areas that offer opportunities.

in a position where the attractiveness of value remains. Figure 4 shows the performance differential between the MSCI World Value Index and the MSCI World Growth Index. So far, we have only seen a partial recovery from the deepest and most prolonged period of value underperformance for at least 50 years.

Valuation spreads have now moved from these extremes but remain attractive compared with their normal pattern, at around 1 standard deviation.

### **Yield Curve Steepening and Building Inflationary Pressures Favor Value-Oriented Areas of Market**

More fundamentally, we have talked in the past about how inflation is needed to deliver a more sustained rotation to value. Here, we see fiscal deficits as a likely source of upward pressure on interest rates and inflation. U.S. consumer prices accelerated by the most in nearly 13 years in May (+5.0% year over year) as pent-up demand combined with higher prices for goods stoked inflationary pressures. While the recent surge in prices can partly be attributed to the low levels of inflation at the start of the coronavirus pandemic, we have also seen a sharp increase in demand for items such as automobiles, hotels, and flights as economies have reopened.

Meanwhile, the already sizable fiscal stimulus that the government has injected into the U.S. economy is being supercharged by President Joe Biden's spending plans. The combination of the American Jobs Plan and the recently announced American Families Plan, the second phase of the "Build Back Better" platform, provides the potential for additional spending on infrastructure and could create the potential for stronger economic growth for a number of years ahead.

The broader investment perspective is whether these plans are a precursor to a permanent shift higher in fiscal spending, and whether they can be financed in a fiscally neutral way or

if it will result in a marked increase in budget deficits over the longer term. If this were to be the case, then the market potentially may focus on the longer-term implications for both interest rates and inflation. Also, if markets were to begin to expect that systematically higher rates of inflation were likely, this could well reverse many of the pronounced market trends that we have seen over the last decade and possibly herald a more prolonged value regime.

### **Opportunity Still Exists, With International Markets a Key Focus**

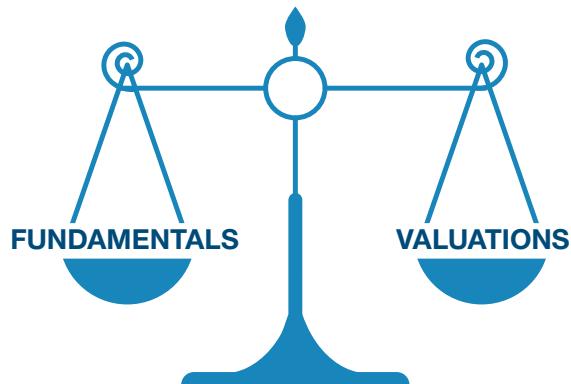
Despite the recent change in fortunes, we believe there are still many areas that offer opportunities. With valuations in the U.S. looking a little more expensive, we have been looking to international markets. Markets have often tracked vaccination trends, so weaker vaccination rates have meant that Europe, Japan, and parts of emerging markets have underperformed this year. India is a good example. We expect India to recover in the second half of 2021 as it should emerge from an extremely difficult period of infections. China, meanwhile, also offers the combination of a strong currency, cheap valuations, robust growth potential, and an increasing market sophistication. Our well-resourced research team, including investment professionals in our new Shanghai office, are helping us to uncover exciting opportunities, particularly in the mid-cap space.

On a sector basis, the reopening of economies is a key focus. Transportation is a good example, with European auto stocks looking attractive, while we also see good value in some airline and aerospace stocks. We also have exposure to the pharmaceutical industry. The industry has been out of favor due to uncertainties around health care reforms in the U.S. Stocks in this space have tended to be defensive and grow more slowly, but valuations are now back at 2011–2012 levels.

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## Balancing Both Fundamentals and Valuation Appeal Is Critical to Investment Success, Regardless of Investment Style

For investors seeking a balanced portfolio, we believe value is an important component



“...this rally may only just be beginning and could potentially herald a more sustained shift back toward value...

### A New Decade—Balancing Both Fundamentals and Valuation Appeal Is Crucial to Investment Success

As we look forward, we believe the coming decade will look very different from the last. Markets have tended to change significantly every 10 to 15 years. Since the GFC, a prolonged period of secular stagnation has been accompanied by low rates and subdued economic growth. Globally, an increasing move toward populism against a backdrop of rising inequality is widely seen as unsustainable. The pandemic has prompted more aggressive, expansionary fiscal and monetary policies, approaching modern monetary theory. Actions to address inequality and the “green agenda” could also provide impetus for even higher fiscal spending. These changes could help to improve economic growth, which in turn could put upward pressure on both interest rates and inflation. This environment would be favorable for cyclicals, financials, and consumption stocks, to the potential benefit of a value investing approach.

Value investors should, however, not forget the lessons that disruption and technological innovation have had on

many traditional industries—a trend that the coronavirus pandemic appears to have accelerated. Innovation has been widespread, disrupting sectors that have been overly represented in value. The sharp recovery rally in value stocks lifted all boats during this early phase, but going forward we expect it to be more nuanced.

More fundamentally, we believe it will be crucial to try to focus on the best companies at the right time in their cycle. The price you pay for each currency of earnings will always matter. Properly balancing fundamentals and valuations remains key. Importantly, with current valuations remaining attractive, an economic recovery in full flow, and earnings delivering above expectations, we believe this rally may only just be beginning and could potentially herald a more sustained shift back toward value as an investment style. For investors seeking a balanced portfolio, we believe value is an important component of an investment strategy.

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