Value Stocks Are Back… Or Are They?

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What Needs to Happen for Investors to Fully Embrace Value Again

After years of underperformance, long dormant value stocks have begun to show signs of life. Since the relative low of the Russell Value to Russell Growth index on August 27 of this year, the value index has been improving. Banks, quintessential value stocks, have been leading the market, with the KBW Bank Index outperforming the S&P 500 by nearly 1300 bps through November 15.

At Westwood, we have been cautiously rotating our equity exposure to include more value-oriented stocks. While these incremental increases mark a decision point in our allocation, we continue to focus on companies with high–quality balance sheets and solid future prospects as we remain thoughtful and studied in our approach. While value stocks are showing proverbial “green shoots,” the global picture remains unclear, and an ability to remain tactical and quality-focused in our positioning provides some insurance should this trend slow or reverse.

What does the world have to look like for value stocks to continue to do well? In a word, it has to continue to grow. Chief among the reasons for Value’s bump is the perception of improved global growth looking forward. Cyclical tailwinds lift all boats, and value areas of the market, with their discount, are likely to see greater improvement and price multiple expansion. The steepening yield curve portends higher future growth overall and it also benefits many financial related companies and especially banks.

The equity market remains pretty richly valued, and this gives us pause. While simply returning to trend-line growth would result in solid single–digit growth in the U.S., global threats like rising populism, the siege on globalization and the continuation of widespread negative interest rates compel us to pay close attention to the downside. Without an uptick in global growth, the outperformance of value sectors will be short–lived.

Events in Europe and China, in particular, have the potential to strongly affect the global market one way or the other. Will the U.S.-China trade war come to a mutually beneficial conclusion? Will we see fiscal stimulus in Europe, particularly in Germany? If so, these events would further strengthen our conviction in and our allocation toward value-oriented equities. But should these situations deteriorate further, value stocks would likely fade and growth stocks would reassert themselves.

We see some encouraging signs for value stocks, but we are in a global protectionist environment and this seems unlikely to change. As such, only a substantial global pick-up in cyclical factors such as global PMIs would convince us to completely embrace value stocks. Until then, we remain selective and balanced in our overall equity exposure, while positioning the fixed income elements of our portfolio in anticipation of continued steepening.

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