Value Stocks: Could Higher Interest Rates Ignite an Improvement?

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Snapshot

- US value stocks have outperformed their growth counterparts during periods of rising rates over the last eight years.
- Despite the recent correlation, there appears to be little relationship over the longer term between US interest rates and the performance of value stocks.
- We believe that a diversified portfolio that encompasses value and growth stocks is a prudent way for investors to pursue their financial goals.

Value stocks in the US continued to lag their growth counterparts in 2019, as the Russell 1000 Value Index rose 26.5% during the year, while the Russell 1000 Growth Index gained 36.4%[1]. Some investors believe that higher US interest rates could be an eventual trigger for the return of value stock outperformance, but is there any correlation between the two?

The short answer is that it's hard to say: Forecasting the effect of interest-rate moves on equity markets is challenging. Trends change continuously and can be influenced by several factors, including economic growth and inflation expectations. However, we can make some observations based on recent history.

When US interest rates are on the decline, investors typically flock to companies with faster-than-average earnings growth while disregarding valuation measures. Therefore—because lower rates tend to boost the current value of a company's future expected cash flow—growth stocks often perform best amid falling interest rates and rising company earnings.

During higher US interest-rate environments, on the other hand, investors tend to regard valuation measures as more important. While rising rates reflect a healthier economy, they can also lessen the future value of a company's earnings—making most investors less willing to buy stocks with high price-to-earnings multiples. The conventional wisdom, then, is that value stocks with strong existing cash flows (which may have been overlooked when rates remained low) have the potential to outperform growth stocks when rates are rising and investors are growing more sensitive to valuations.

Interest rates and performance history

In the short-term, it's virtually impossible to say for sure whether, when or with what speed US interest rates will move higher or lower.

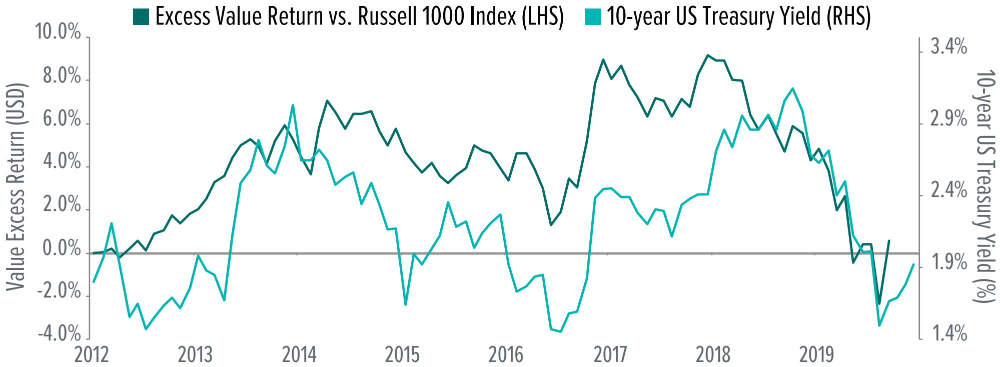
US interest rates had been expected to increase until recently, due to the easing of US-China trade tensions and the softening of concerns about global economic growth. This expectation seemed to reverse in January on heightened worries about long-term effects of the coronavirus outbreak.

[1] Source: Russell

More importantly, we have seen substantial reflationary traits globally over the long-term that include greater fiscal stimulus and a monetising of budget deficits by central banks—particularly the US Federal Reserve.[2] These drivers would typically be long-term positives for equities in general.

Over the past eight years, the excess return of value relative to the Russell 1000 Index has been correlated with the 10-year US Treasury yield, as the outlook for long-term rates and returns to value have been generally in sync. This is illustrated in Exhibit 1.

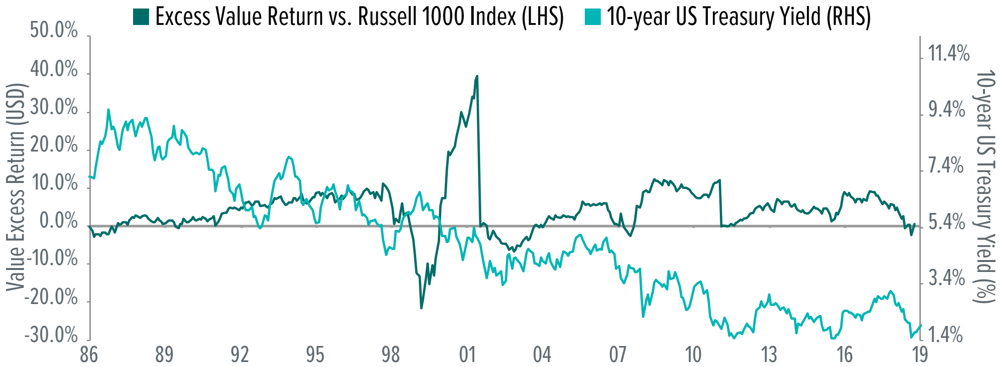
Exhibit 1: Recent Correlation



Source: FactSet, MSCI, SEI
Data as at 31/12/2019
Past performance is not a reliable indicator of future results.

Exhibit 2 shows that over the last 30-plus years, however, there appears to have been little long-term correlation between the excess return of value versus the Russel 1000 Index and the 10-year US Treasury yield (Exhibit 2).

Exhibit 2: Less Reliable Long-Term Relationship



Source: FactSet, MSCI, SEI
Data as at 31/12/2019
Past performance is not a reliable indicator of future results.

So while we believe there is likely some short-term synchronization between returns to value and yields in the current market environment, the long-term relationship is less clear. In fact, when we implement SEI's strategic approach and attempt to forecast returns for the longer term, there appears to be no relationship at all.

[2] Source: US Federal Reserve, European Central Bank, Bank of Japan

Our outlook

Given the vast uncertainties facing investors, we believe that long-term success is better positioned by a diversified portfolio that encompasses both value and growth—while also taking value's historical long-run outperformance to mind.

We expect the interest rate on the 10-year US Treasury bond yield to move higher from here; although we also think it would be hard to see yields increase much beyond 2.25% if US inflation remains reasonably contained. Of course, a little bit of humility is called for when it comes to predicting bond rates. Last year's sharp decline was largely unexpected, particularly for US Treasurys at the longer end of the yield curve.