Has Value's Run Just Begun?

Part 5: The Value in Rising Rates

JUNE 2021

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Snapshot

- Rising interest rates are a sign that central banks want to temper inflationary pressure and slow economic growth.
- U.S. value stocks outperformed their growth counterparts during a period of rising rates over the last nine months.
- We believe that higher expected interest-rate earnings on fixed-income investments (bond yields) could generate further tailwinds for value.

When the U.S. Federal Reserve increases its overnight lending rate for banks (the federal-funds rate), it effectively increases all other lending rates—and signals that the central bank is trying to temper building inflationary pressure and accelerating economic growth. This can have a range of implications on equity and fixed-income markets.

For fixed-income investors, rising interest rates provide an opportunity to generate higher returns as yields (the rate of interest paid to bond investors) move higher. Recently, for example, the yield on 10-year U.S. Treasurys jumped from an all-time low of about 0.5% in August 2020 to approximately 1.7% at the end of May 2021. On the other hand, most equity markets tend to struggle in rising-rate environments. As investors took advantage of the chance to earn higher returns on fixed-income investments (which do not require the level of risk typically associated with equities), valuations of growth stocks diminished over the nine months ending May 31.

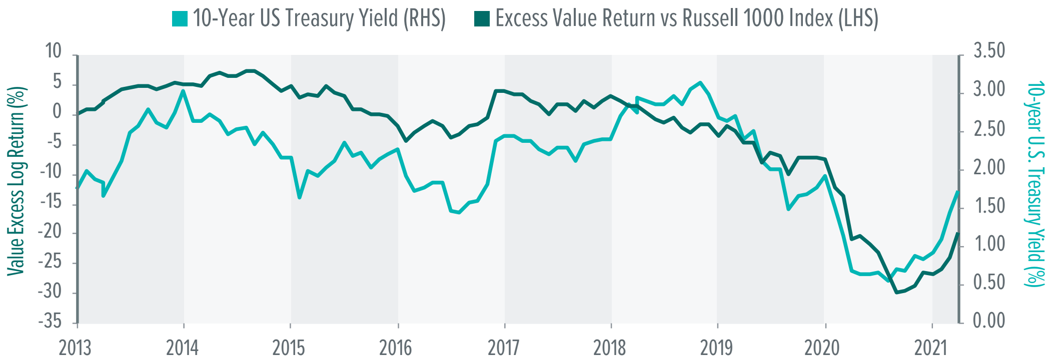
Value stocks, however, behaved quite differently during that period—rebounding along with the rising interest rates to ultimately outpace the long-favored growth stocks, with the Russell 1000 Value Index returning 33.89% and the Russell 1000 Growth Index gaining just 10.90%. We believe that value stocks will continue to gain as higher interest rates continue to make the future cash flows of growth stocks less attractive.

Value and rates: Is there a connection?

Over the past eight years, value stocks (as measured by the Russell 1000 Value Index versus the Russell 1000 Index) have moved in tandem with long-term interest rates (measured by the 10-year US Treasury yield) as the outlook for each have been generally in sync. This is illustrated in Exhibit 1.

All references to performance are in U.S. dollar terms unless otherwise noted.

Exhibit 1: Value Returns vs. Interest-Rate Returns



Source: FactSet, MSCI, SEI. Data as of 3/31/2021. Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

This is not to say that investors should expect interest-rate movements to impact equity markets in the same way all the time; there are a variety of factors that can influence market trends such as economic growth and inflation expectations. With that said, there are consistencies in the ways investors have tended to behave in a given interest-rate environment.

Rising rates: Bad for most equities…but worse for growth and quality?

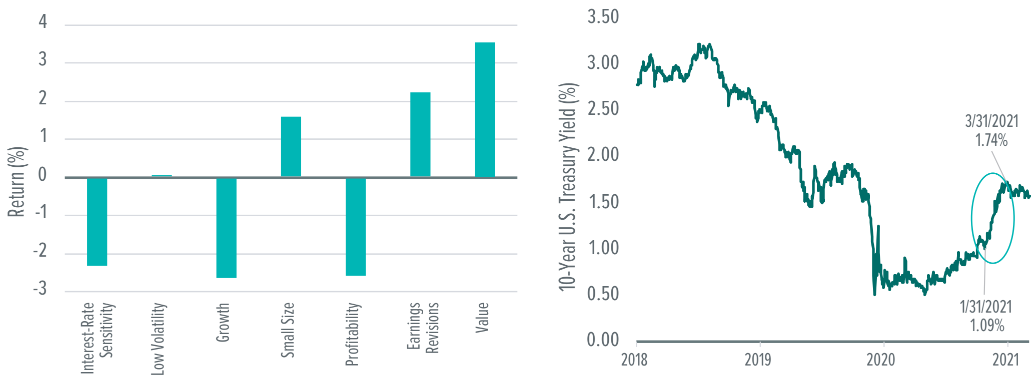
When interest rates are on the decline, investors typically flock to companies with faster-than-average earnings growth while disregarding valuation measures. Therefore—because lower interest rates tend to boost the current value of a company's future expected cash flow—growth stocks generally have performed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

During higher interest-rate environments, on the other hand, investors have tended to regard valuation measures as important (we believe they are always important). Because while rising rates may reflect a healthier economy, they can also diminish the future value of a company's earnings—making high-priced shares particularly unattractive to investors. The conventional wisdom, then, is that during periods of rising rates, value stocks with strong existing cash flows (which may have been overlooked when interest rates were low) have the potential to outperform growth and quality stocks (companies with high-quality fundamental characteristics) as investors grow more sensitive to valuations.

Another reason value tends to fare better in rising-rate environments is because of discounted cash flows. For stable compounders (quality stocks) and growth companies, future discounted cash flows are high when discounting at a low rate. For value companies, a low discount rate is irrelevant because their distant cash flows are small. Therefore, while all three asset classes may suffer from rising rates, value stocks would likely suffer less than quality and growth.

Exhibit 2 looks at the effect that rising rates had on several equity factors. Each factor can be thought of as an attribute of a security that can be used to help explain returns. The favorability of each factor may change as the economic cycle progresses through different stages. As you may expect, value stocks were the primary beneficiary of rising rates over the two months ending March 31. Small-capitalization stocks, which tend to be more value-oriented than large caps, also performed well during the period.

Exhibit 2: Effect of Rising Rates on Equity Factors



Source: SEI based on data from MSCI, Axioma and FactSet. Returns quoted in USD. Data spans 1/31/2021 to 3/31/2021. The metrics are composites of underlying ratios that SEI has determined to be appropriate measures of each factor. Global equities are represented by securities across all countries and capitalisation ranges, consistent with the MSCI ACWI Index. Data refers to past performance of liquidity-weighted top-tercile portfolios vs. the capitalisation-weighted benchmark and rebalanced quarterly. Past performance is not a reliable indicator of future results.

Outlook

We believe there is likely some short-term synchronization between returns to value and interest rates in the current market environment. Fixed-income markets are signaling improved growth prospects on the tail of higher interest rates. On the inflation front, inflation expectations are higher in the short term than in the long term which should provide a tailwind in the near future. If the acceleration in measured, and inflation proves stronger and longer-lasting than investors expect, bond yields could climb appreciably from today's levels and generate further tailwinds for value.

Glossary

Composite metrics are metrics whose values are defined by a combination of quantitative assessments.

Discounted Cash Flow is a method used to estimate the value of an investment based on its future cash flows.

Earnings revisions refers to stocks whose earnings estimates show momentum in being revised higher.

Growth stocks exhibit earnings growth above that of the broader market.

Interest-rate sensitive stocks are likely to move higher or lower due to changes in interest rates.

Low-volatility refers to stocks that are less volatile than the broader market.

Profitability refers to stock that generates profits more efficiently than the broader market.

Small size refers to stocks with a market-cap smaller than the broader market.

Value stocks are those that are considered to be cheap and are trading for less than they are worth.

Index Definitions

MSCI ACWI Index measures the equity performance of large- and mid-cap stocks within the developed and emerging markets.

Russell 1000 Value Index measures the performance of U.S. large-cap value stocks.

Russell 1000 Growth Index measures the performance of U.S. large-cap growth stocks.

All references to performance are in U.S. dollar terms unless otherwise noted.

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