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Growth and Value Battle it out as the S&P 500 Moves Higher

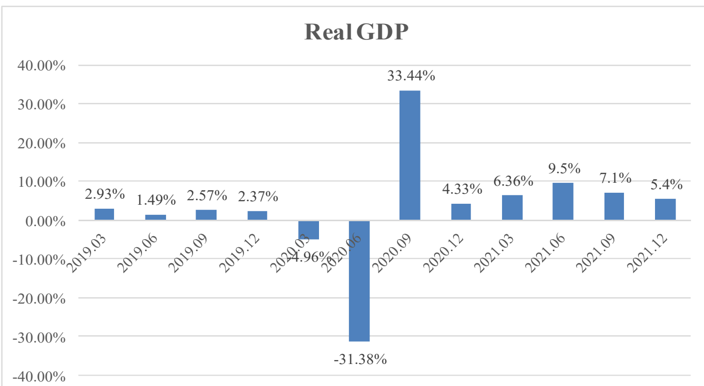
- Value and cyclical stocks outperformed the market earlier in the year, but the jumbo tech stocks have recently come back strongly.
- The recent strength in super cap growth stocks coincided with the 10 year U.S. Treasury bond yield sinking to 1.3%, down from the recent high of about 1.7%.
- Inflation has been running hotter than expected. Discussions have been growing that the Fed will have to taper its bond buying program sooner than previously expected.
- There is growing debate whether this will be a strong and protracted cyclical rebound or one where economic growth soon loses momentum. Value stocks will shine in the former scenario, while growth stocks will perform best in the latter scenario. We're hedging our bets.
- First quarter S&P 500 operating earnings were up 143% from the depressed year earlier level during Covid-impacted 2020. Second quarter earnings are now coming out and more big gains are expected.
- The S&P 500 has had a total return of 15.3% through the first half of 2021. Ongoing gains are likely to be less impressive.

The S&P 500 Value Index rose 29.2% between August 2020 and May 2021, while the S&P Growth Index was up only 13.4%. The strong performance of cyclical and other value stocks during this period reflected optimism that the pandemic would be contained and that there would be a strong economic rebound as businesses reopened. Aggressive measures by the government to provide liquidity to all segments of society helped generate forecasts of rapid growth which we now see being realized. At the same time that economic optimism drove value stocks higher, bond yields also increased as investors moved out of the "safe assets" that were being held during the darkest period in early 2020. The 10 year U.S. Treasury bond yield bottomed in July/August 2020 at 0.5%. By April and May of this year the 10 year U.S. Treasury was trading with yields of 1.7%/1.6%.

In the latest turn of the markets, the capitalization of the five largest tech companies—Apple, Microsoft, Amazon, Alphabet and Facebook, has increased more than $1 trillion since the beginning of June. In fact, over the past two months, the S&P 500 index, which is market cap weighted, has entirely caught up to a measure of the S&P 500 when all the stocks are equal weighted. Just a handful of big stocks are generating all of the performance lately as the rest of the market sags. It is not a coincidence that the resurgent strength of these huge secular growth tech companies coincides with a decline in bond yields and weakness in value stocks. Uncertainty regarding the sustainability of rapid cyclical growth has arisen because of a rise in inflation similar to one last seen during the 2008 spike in oil prices. Discussion is now increasing about the possibility that the Fed will need to reduce bond purchases sooner rather than later, although no one yet seems to be considering an increase in short-term interest rates. The rush back into big cap tech appears crowded and the rally may fizzle out if general economic growth remains strong. Technical indicators do suggest that these stocks are at a near term peak. Also, the yield on the 10 year U.S. Treasury bond appears to be getting support at the 200 day moving average and may move back higher.

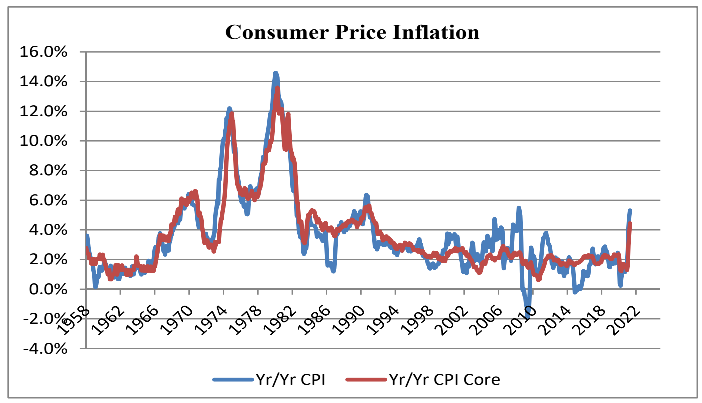
The gyrations of the market reflect the odd effects of the pandemic on the economy and high uncertainty. What we do know is that the economic growth is currently very strong and inflation is high. The economy contracted sharply in the first half of last year, but has come roaring back since the 3rd quarter of 2020. Growth for the first quarter of this year was a solid 6% and the current consensus forecast is that real GDP will expand at a 9% annual rate in the second quarter and will remain strong into 2022. The consensus forecast of real GDP growth for all of 2021 and 2022 is 6.6% and 4.0%, respectively. But all forecasts are subject to certain assumptions, and these forecasts are likely based on expectations that the Federal Reserve will remain highly accommodative through 2022 because Chairman Powell has said he has no plans to remove accommodation. However, very clearly, recent inflation figures have increased discussions that monetary policy will need to change despite Powell's assurances that it won't.

Chart 1



Source: Federal Reserve, Factset

Chart 2

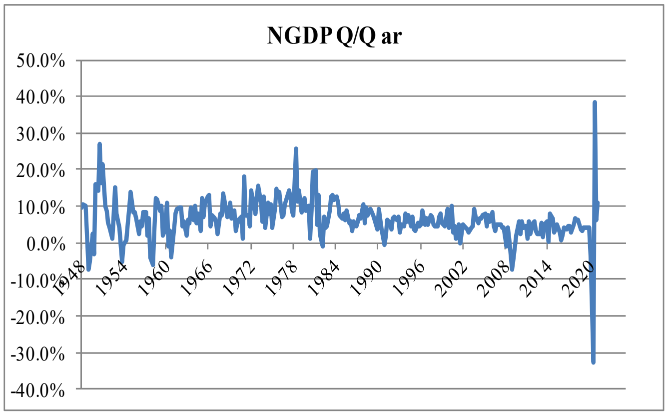


Source: Federal Reserve

The consumer price index rose a rather shocking 0.9%, month-to-month, in June, and is now up 5.3% on a year-to-year basis (Chart 2). Even the so-called core index, which excludes more volatile food and energy prices, was up 4.5% year-to-year. The Fed views these price increases as "transitory" since there have been many supply disruptions, like the shortage of computer chips and a resultant decline in auto production. Used car prices have risen sharply and even car rentals have become shockingly expensive since the car rental companies sold much of their car inventories during the pandemic in order to raise liquidity. It is true that these types of bottle necks and shortages will resolve themselves, but low interest rates have contributed to a sharp increase in home prices. And now, home rental prices, which are about 40% of the consumer price index, are increasing at a faster pace. Furthermore, government income transfers financed by Fed money creation have unquestionably increased consumer spending power. These forces are difficult to weigh against one another, but there are reasons to doubt that inflation is as bad a problem as the recent data might suggest.

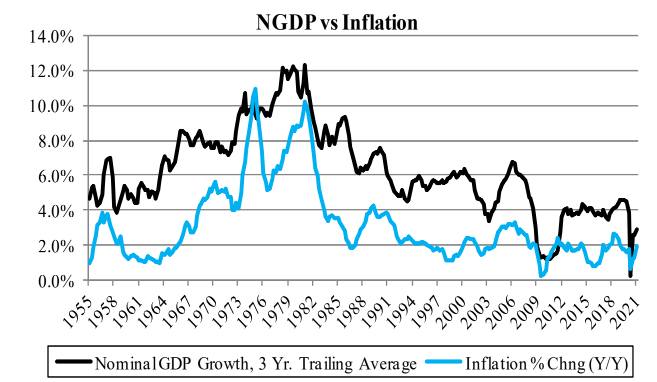
Permanent changes in the price level are the result of sustained periods of spending--nominal GDP (NGDP), in excess of the economy's ability to produce real goods and services and, from that perspective, things don't look that bad. We can see that nominal spending spiked to an unprecedented 38% annual growth rate in the third quarter of 2020 (see Chart 3 below), but that only followed a 33% drop in the second quarter. Such extreme short-term swings are not determinative in terms of inflation. Permanent changes in the price level come from a sustained period of spending like that measured by the three year trailing average of NGDP shown in Chart 4. So the extreme short-term spending swings seen in Chart 2 obfuscate and not illuminate. Over the past three years nominal GDP has grown at a mere 2.9% average rate, which surely suggests that underlying inflation pressure is still below 2%.

Chart 3



Source: Federal Reserve, FVCM

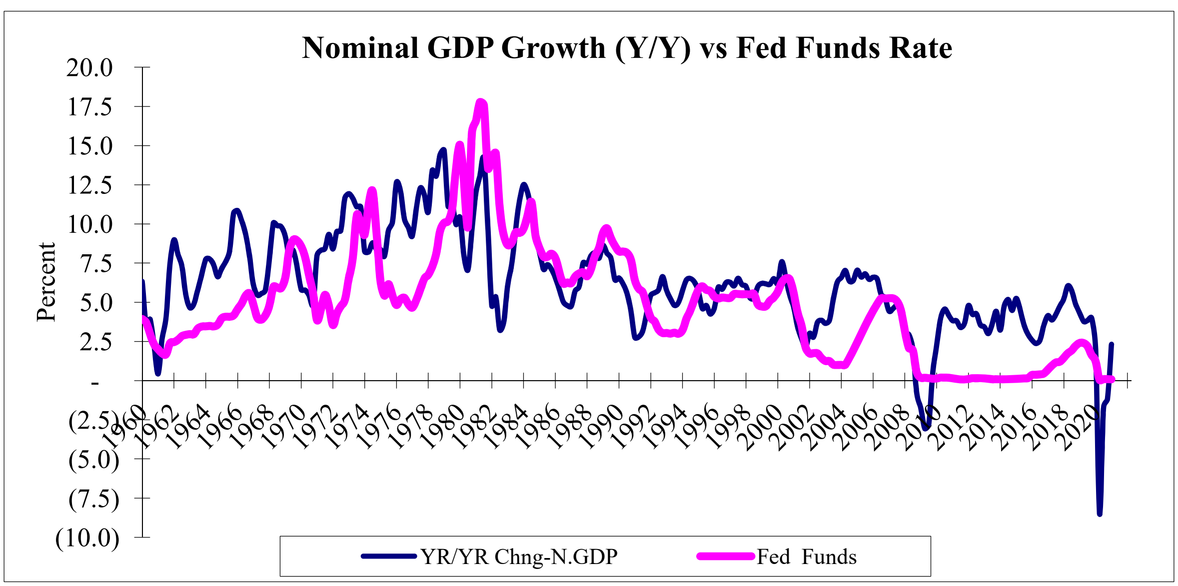
Chart 4



Source: Federal Reserve, FVCM

As we've discussed, changes in 10 year U.S. Treasury bond yields are paralleling expectations about growth and the push and pull between value and growth stocks. The following chart explains a good part of this story. Look carefully at Chart number 5. The Fed's changes in the short-term fed funds interest rate clearly *follow* changes in nominal GDP. Historically, the Fed's monetary policy has typically been a reaction to changes in growth rates. The Fed cannot determine in advance whether it should be raising or lowering rates, and rates can rise for some years before growth is undermined. Second, notice that, prior to 1980, nominal growth rates were greater than the fed funds rate and both were in an upward trend. Once then Fed Chairman Paul Volker raised interest rates above nominal growth rates, the relationship reversed and both started to trend lower—along with inflation. Chairman Powell is clearly aware that the Fed's attempt to raise interest rates between 2004 and 2008 was followed by a financial crisis and a collapse in spending. Nominal GDP actually turned negative during the '08-'09 crisis. And, after a meager attempt to "normalize" short-term interest rates between December 2015 and December 2018, when the fed funds target went from 0.13% to 2.13%, spending started to weaken, and the Fed quickly reversed gears and started cutting rates in July 2019. With Covid, we ended up with an even deeper decline in nominal spending than occurred in '08-'09.

Chart 5



Source: Federal Reserve, FVCM

Fed policy is different today than in past decades because of high debt levels globally. Even small increases in interest rates depress spending. This is why the Fed is willing to keep rates ultra low even while the economy picks up. The Fed is afraid that if they raise interest rates, spending will collapse under the weight of debt. Even spending overseas will be affected since foreign central banks typically follow the Fed in order to defend their currencies and the debt problem is a massive global problem that has grown over decades. The Fed has engineered a huge increase in the money supply, a giant increase in bank reserves, and kept interest rates at rock bottom because they don't want nominal spending to go negative, which could lead to a surreal environment where interest rates go negative for debts denominated in dollars--the global reserve currency. If the Fed is successful, nominal growth will remain moderately strong for at least the next several years and enable the real debt burden to decline.

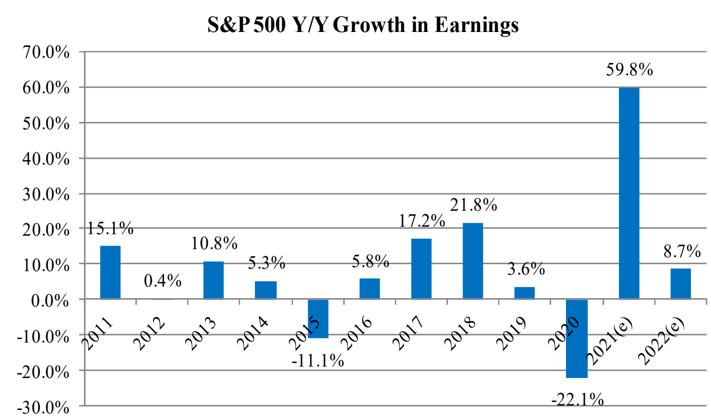
S&P 500 earnings are estimated to rise 8.7% in 2022 on top of a 59.8% increase in 2021. Is that bad? One of the buzz phrases being thrown around as justification for the resurgence in large cap tech stocks is that the economy and corporate earnings are now approaching "peak growth" and that growth rates will moderate going forward. Of course this must be the case, but 8.7% earnings growth still seems reasonable. There are no signs at all that suggests a recession or anything close to it is on the horizon. The yield curve, which is one of the surest indicators of future growth, remains positive despite the recent decline in yields on the long end of the curve. The Purchasing Managers Indexes remain very strong. Liquidity is plentiful, household balance sheets (as opposed to Federal debt) are strong, and there are more jobs available than there are people available to fill them. The economy is in a unique boom situation and our 8.7% earnings growth estimate for 2021 is probably conservative. Further good gains are likely in 2023. Even if the Fed starts to tighten monetary policy in 2022, the expansion is likely to continue for some years, as is typically the case. This scenario is attractive for value stocks.

Table 1: S&P 500 Earnings

	Revenue	Operating Earnings	Special Items	GAAP Earnings
2011	1,052.83	96.44	9.49	86.95
2012	1,092.37	96.82	10.31	86.51
2013	1,116.81	107.30	7.10	100.20
2014	1,163.32	113.01	10.70	102.31
2015	1,127.13	100.45	13.92	86.53
2016	1,150.68	106.26	11.71	94.55
2017	1,231.57	124.51	14.63	109.88
2018	1,343.01	151.60	19.21	132.39
2019	1,415.01	157.12	17.65	139.47
2020	1,362.39	122.37	28.24	94.13
2021(e)	1,600.78	195.51	16.24	179.27
2022(e)	1,738.21	212.49	17.74	194.75

Source: S&P Global, FVCM

Chart 6



Source: S&P Global, FVCM

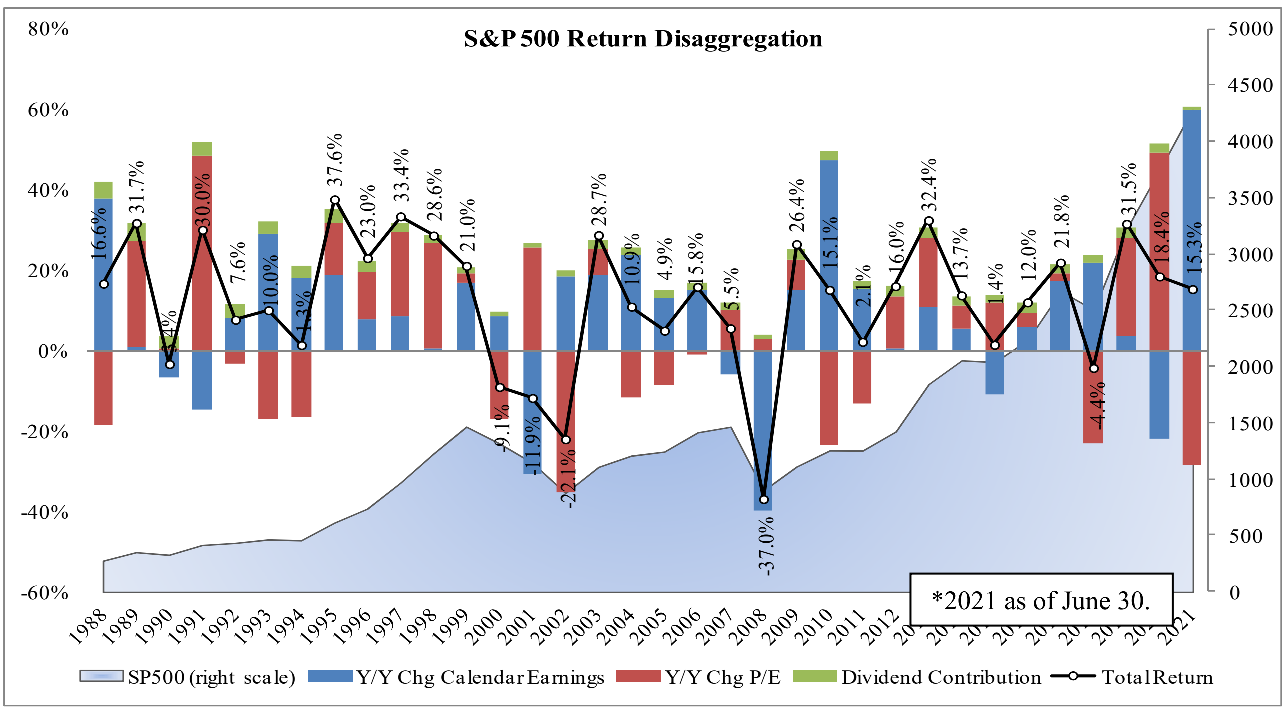
The forward P/E ratio for the S&P 500 as of the start of 2021 was 19.2 and it's currently about 21, which is not excessive in this environment. Stock prices tend to rise as long as earnings are rising regardless of the direction in interest rates. With the Fed committed to keeping interest rates lower for longer, the odds look good for the economy, corporate profits and value and cyclical stocks.

Table 2 S&P 500	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Price (Beginning of Year)	1,848.36	2,058.90	2,043.94	2,238.83	2,673.61	2,506.85	3,230.78	3,756.07
Earnings (forward)	113.01	100.45	106.26	124.51	151.60	157.12	122.37	195.51
P/E Ratio	16.4	20.5	19.2	18.0	17.6	16.0	26.4	19.2

Source: S&P Global, FVCM

The 15.3% return for the S&P 500 during the first half of 2021 reflects the 60% increase in earnings estimated for calendar 2021, offset by a lower valuation (P/E). Stock returns can be thought of as being derived from three sources: 1. Changes in earnings; 2. Changes in valuations; and 3. Dividends (see Chart 7). Typically, a big decline in earnings, such as during a recession, is partly offset by an increase in the P/E ratio. Conversely, when earnings near a peak, valuations tend to contract. In other words, P/E ratios act like a shock absorber when earnings move in short-term extremes. Over long periods, an upward trend in earnings is paralleled by an upward trend in stock prices and valuations play a minor role. As we previously noted, earnings growth next year is expected to be in a fairly normalized range of 8%-to-10%. We would not expect P/E's to meaningfully expand once earnings growth normalizes, so the broad stock market should increase in measure similar to the 8%-to-10% increase in earnings. Dividends may add another 2% to returns. This may not sound particularly exciting, but considering the alternatives in the bond markets and elsewhere, such expected returns appear attractive. In terms of the value versus growth competition, value will have an edge and likely beat the broad indexes if the Fed stays very accommodative as is currently expected. But if the Fed starts tightening monetary policy sooner than currently expected and general economic growth starts to falter, the large cap growth stocks will again likely dominate.

Chart 7



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