Just how much value remains in value shares?

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For the last six months or so, value shares have outperformed on a relative basis. But a recent pause in this trend has many questioning the sustainability of the growth to value rotation. For the reasons outlined below, we think the relative outperformance of the value style has further to run.

In respect to relative valuations, it's evident that value shares and indices are at historical lows relative to their growth counterparts. The question we now turn to is as follows: What might cause that gap to close?

It might sound counterintuitive, but strong economic growth should set in motion a sequence of events that benefits value-style investing more so than growth-style investing.. Leading economic indicators are signalling a magnitude of coming growth that's likely to stir interest rates from their slumber. As with most recoveries, the growth is demand-led.

The US consumer has built up an excess of savings well beyond their usual bank balances. Further stimulus payments, compliments of President Biden and his weighty fiscal policy, will only deepen their pockets. And once vaccines have been widely distributed, the theory goes, it's a good bet that those consumers will have the confidence to spend their disposable income. This is not a phenomenon unique to the US; consumers in other developed markets also have more cash to spend than usual.

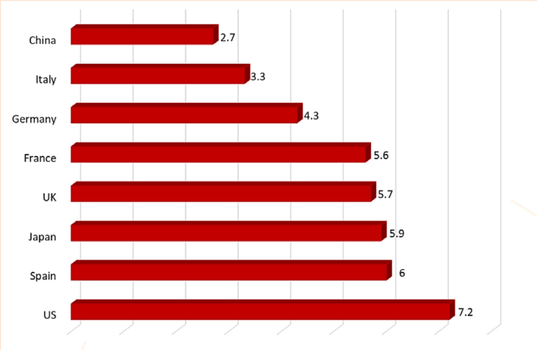
If these pent-up savings combine with freedom of movement, it's the sectors that were battered by the pandemic (think hospitality, energy, travel, brick-and-mortar retailers, all of which fall into the value bucket), that stand to experience the greatest earnings revivals. That's the single most important driver needed to sustainably reverse the fortunes of value investors.

The supply side of the growth equation looks equally poised to support a strong economic rebound. Inventory levels fell off a cliff during the pandemic as businesses scaled back their production. However, with new orders rushing in, US manufacturers must quickly put their people and equipment to work. That should be good for employment and capital investment, the two important prerequisites for the virtuous cycle that causes sustainable growth.

With consumer demand set to rise rapidly and supply chains under pressure to meet their needs, the stage is set for higher inflation. That creates a floor for interest rates and stokes expectations that they may rise.

In addition to the higher demand for materials that comes with accelerating global growth, there's a spreading belief that US dollar strength may have reached a ceiling. That would make dollar-based commodity prices more affordable, providing further demand impetus. If the tailwinds experienced by resource companies are seen as sustainable, banks stand to benefit from the additional cashflows resource companies are producing.

Figure 1: Excess savings as a % of GDP



Source: Bloomberg

Value-style investing began its comeback in Q3 2020, but in relation to the damage it has absorbed over the last decade, the rotation may have only just begun. Research from Bank of America Merrill Lynch shows that when value outperforms growth, it does so for a period of about 60 months. So far, we've had 7 months.

We believe the dynamics we've highlighted above have a structural, longer-term feel to them that will level the playing field between value and growth investing. And given the upside on offer from the former, we think it prudent to tilt the international exposure in our multi-asset funds towards value. We will continue to pragmatically weigh up the inherent risks to achieve the best risk-adjusted returns for our clients going forward.