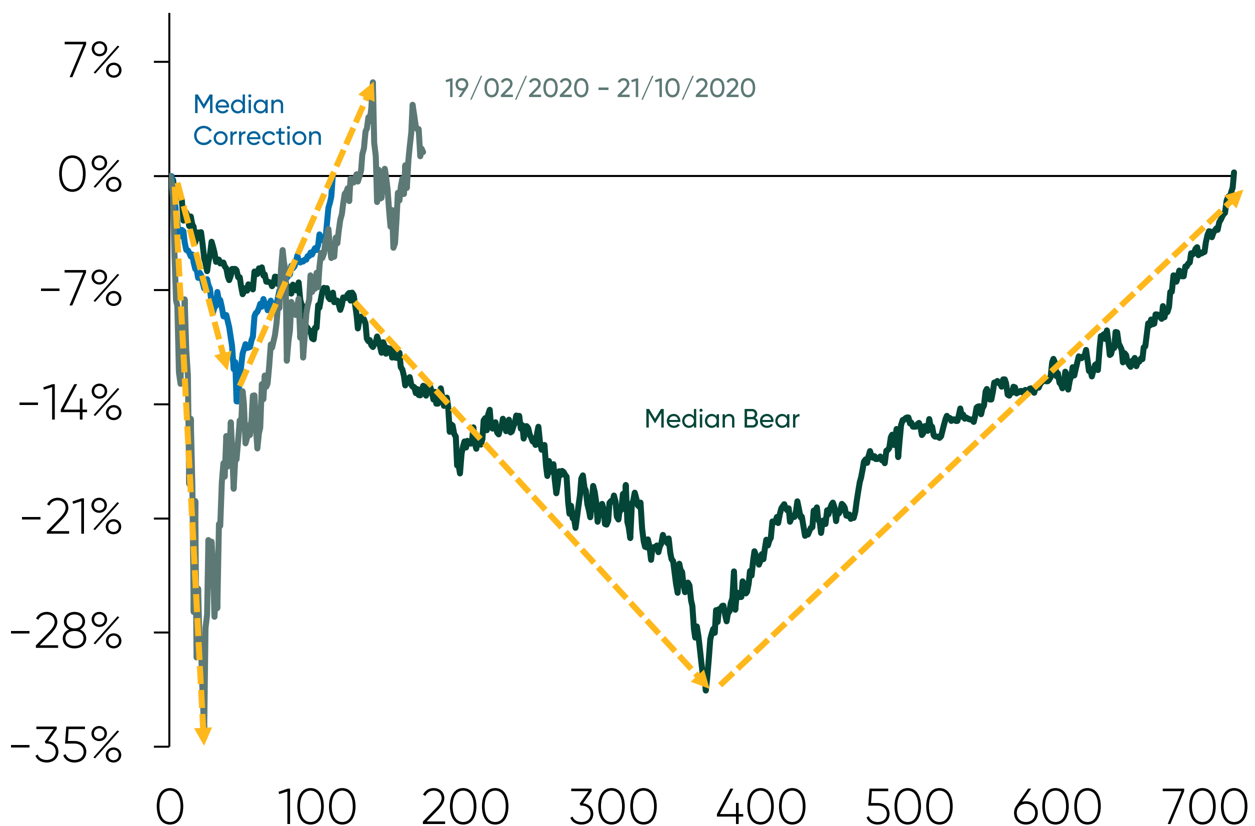
MARKET CYCLE ANALYSIS - GROWTH VS VALUE

- **The current market environment continues to support portfolio positioning towards higher-quality, Growth-oriented equities.**
- **Fisher Investments dedicates extensive research resources to identifying and monitoring the key drivers that could lead to a shift in leadership towards cyclical, Value-orientated companies.**
- **These drivers are assessed using a combination of quantitative and qualitative analysis: market cycle, macro-economic and fundamental research at both the category and company level.**

COVID-19 caught global investors by surprise in early 2020. The unprecedented global economic disruptions the pandemic caused sent markets reeling, ending the longest bull market in modern history. Late in Q1 2020 investors began to envision a brighter economic future as uncertainty surrounding the virus, institutional responses to the outbreak and the associated impact on the global economy began to fade. Equities rebounded with near-unprecedented speed, and in Q2 2020 the market recovery firmly took hold recovering the majority of Q1's losses, making 2020's bear market the shortest in history.

Our market cycle analysis would typically suggest a dramatic shift in leadership was likely ahead, as Small Value often leads in the early stages of a new bull market. History, however, is only ever a rough guide, as unique events drive each market cycle. While Q1's downturn certainly had the magnitude of a bear market, many of its features (such as speed, leadership, sentiment and volatility) were more consistent with a massive late-cycle correction (Figure 1). The distinction is critically important for portfolio decision making, as the categories that lead prior to corrections frequently lead on the way out.

Figure 1: Part Bear, Part Correction



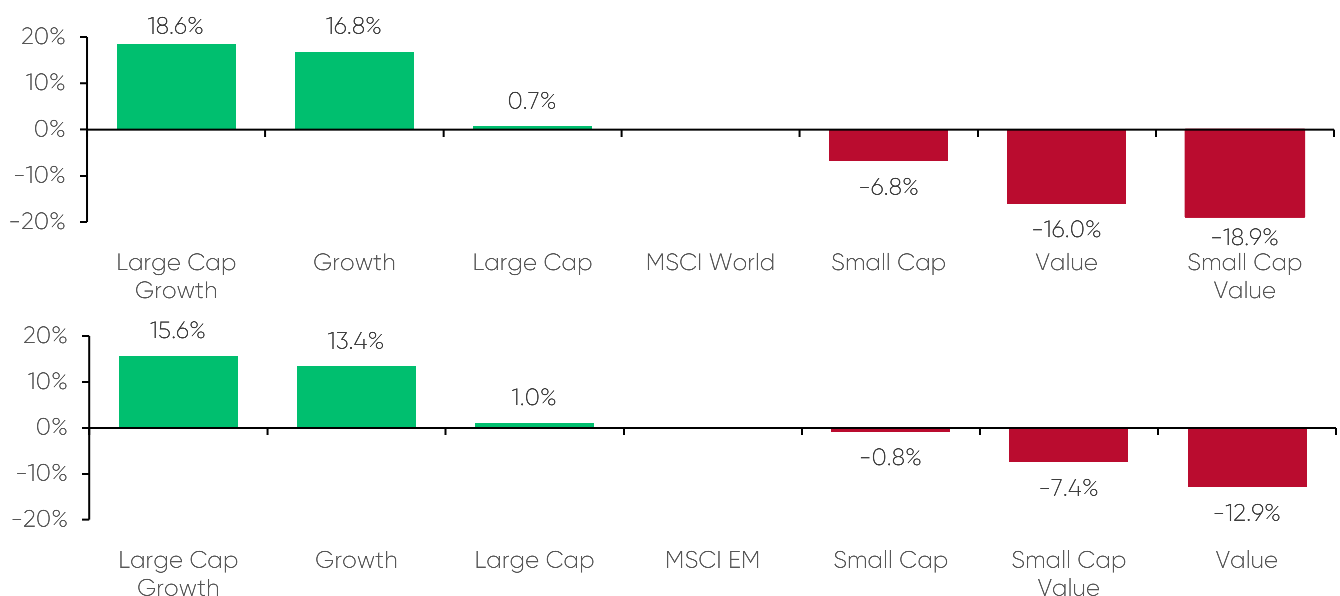
Source: FactSet as of 21/10/2020. Median S&P 500 price index, median correction and bear market returns, daily, 10/03/1937 – 21/10/2020.

2020 HAS DEFIED CONVENTION

Let us first consider the drivers of early-cycle Small Value outperformance. In our view, the phenomenon is rooted in the nature of the business cycle. In the early stages of economic recovery, investment drives growth. This supports outperformance for Small Value indices, which capital-intensive, investment-driven sectors tend to dominate. Banks play an important role in facilitating early-cycle investment, taking advantage of steeper yield curves supported by accommodative central banks that lower reference rates to stoke lending. Banks borrow at the lower short-term rates and extend credit to borrowers over longer time periods at higher rates. This yield spread influences bank profitability and subsequently the propensity to lend. As the economic cycle matures, consumption increasingly drives growth. An improving consumer position typically supports outperformance for Large Growth categories, which are dominated by services-oriented (balance-sheet-light) businesses leveraged more to consumption. The yield curve's flattening, which typically characterises a late-cycle environment, reduces access to cheap and easy credit for investment-driven Small Value firms.

Given that Small Value equities are typically more leveraged than Large Growth firms, these companies are often left fighting for survival as brutal recessions wear on and lenders become increasingly cautious, threatening their solvency. The businesses that do survive are often deeply discounted and with yield curves generally steep at the beginning of the economic cycle, Small Value tends to lead markets higher. But in early 2020, global shutdowns forced equities to price in recession very quickly. Small Value never suffered the sustained beating that typically sets up its early bull market surge, and central banks' massive quantitative easing programs are restricting long rates, compressing yield curves and keeping lenders loan wary of lower-quality Value firms. Additionally, it is cyclicals that have seen their prospects change most dramatically in 2020 as near-term earnings uncertainty weighs more heavily on businesses with thinner margins and inconsistent growth profiles. Large Growth companies are generally better capitalised and thus better equipped to deal with earnings uncertainty, and a smaller subset of Growth industries have actually seen their business models directly benefit from COVID (e-commerce, parts of Health Care as examples), whereas some Value industries have struggled mightily (hospitality, restaurants, airlines, certain REIT categories, and others). All of this combined for sizeable Growth leadership throughout the bear market and subsequent recovery, surprising many investors (Figure 2).

Figure 2: Large Growth has Led Global Markets YTD



Source: Factset as of September 2020. YTD performance of different size & style iterations of the MSCI World & MSCI EM relative to their respective headline index.

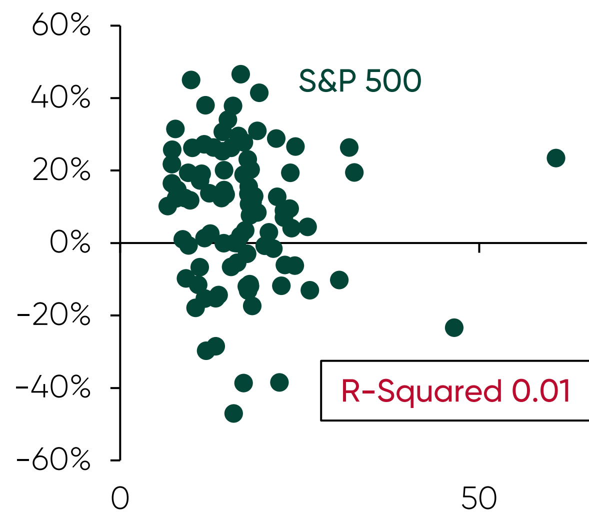
Concerns now center on the growing performance dispersion between Growth and Value, with many claiming elevated valuations of the former signal an imminent leadership reversal. Performance and valuation spreads certainly suggest there is an increasing potential for cyclicals to eventually regain leadership, yet these sorts of mean-reversion arguments lack fundamental underpinning and are difficult to time, in our view. Valuations alone have never been good timing tools or predictors of equity market returns, and historically there has been no correlation between valuations and equities' short-term forward price movement. Looking at S&P 500 calendar-year returns following the 10 highest start-of-year price-to-earnings (P/E) ratios, there is no discernible pattern (Figure 3). Similarly, since 1926 there is nearly zero relationship between start-of-year P/E ratios and returns over the following year (Figure 4).

Figure 3: S&P 500 One-Year Returns Following History's 10 Highest Trailing P/E Ratios

Year	P/E Ratio at Beginning of Year	Calendar Year Return
2009	60.7	23%
2002	46.5	-23%
1999	32.6	20%
2003	31.9	26%
2000	30.5	-10%
2001	26.4	-13%
1992	26.1	4%
1998	24.4	27%
2018	24.3	-6%
2020*	23.9	4%
Average	**34.0**	**5.8%**
Median	**30.5**	**4.3%**

*Data as of 30/09/2020

Figure 4: Relationship Between P/E Ratio (Y0) and Returns Over the Following Year (Y+1)



Source: Global Financial Data as of 30/09/2020. Based on S&P 500 annual index price in USD from 31/12/1926 to 30/09/2020 and S&P 500 P/E Ratio from 31/12/1926 to 30/09/2020. P/E is based on last twelve months of earnings. R-squared represents the % of total variation in one-year returns that can be explained by P/E ratios at the start of the year.

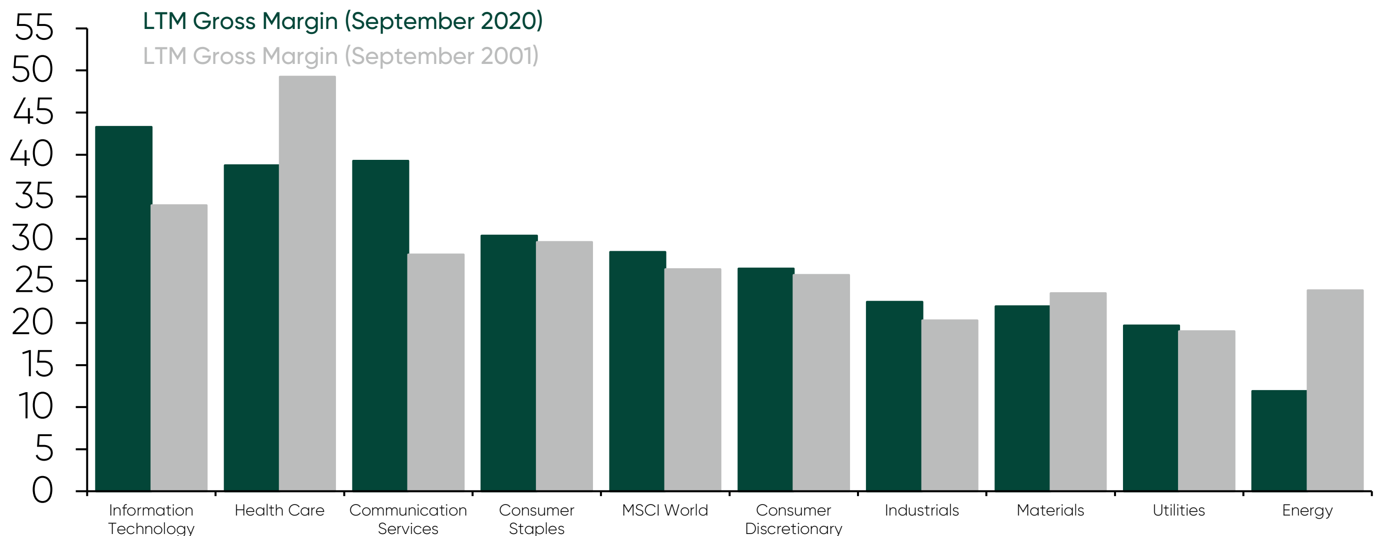
TECH BUBBLE COMPARISON

In early 2000 Ken Fisher highlighted a few key indicators that signaled an equity bubble was set to burst. At the time, Tech equities were trading at 2.5 times the S&P 500's average price-to-book (P/B) ratio. The last period that saw P/B values at these extremes was the oil shock of 1979. Even at that time Energy was trading at just over 2 times the S&P 500's average P/B, and whilst valuations aren't generally predictive, at extremes they can be telling. In early 2000, they suggested the Information Technology sector was overvalued. Today this indicator is flashing once again, which does give cause for concern, but current valuations alone are not enough to signal the imminent underperformance of the Tech sector. In the months prior to the Tech bubble bursting, many Tech firms were burning through cash at an alarming rate and offering no clear strategy on how they aimed to become profitable in the long term. Margin debt soared 75.4% in the 12 months to March 2000 showing a rise in speculative behavior, low-quality IPO activity spiked, and general euphoric sentiment became consensus among investors. This combination of extreme sentiment, poor fundamentals and historical precedent prompted Fisher Investments to take defensive action in portfolios.

Since the equity market trough in March 2020, outperformance of Tech and Tech-like equities has been massive, building on leadership during the downturn and the preceding bull market. Elevated valuations of these Growth-orientated categories have led some to draw comparisons to the late 1990s Tech bubble, yet a look at fundamental drivers reveals faults in this argument, suggesting to us that Tech's large market share does not reflect an unsustainable bubble. It is true that certain valuation metrics are high relative to history,

but the wide profit margins associated with large Tech and Tech-like companies are generating consistently high earnings growth for investors. Indeed, Tech boasts the highest profit margins of all sectors (Figure 5), and today is comprised of some of the world's largest, most profitable firms. We would argue that recent Tech and Tech-like outperformance is centered on these large, high-quality, high-profit-margin companies, in stark contrast to the late-1990's Tech bubble when investors were clamoring for unprofitable firms with little more than a vague business plan. We believe this outperformance likely continues as Tech & Tech-like equities have uniquely benefitted from the COVID-19 pandemic. In this unprecedented time, investors are willing to pay premiums for Tech & Tech-like stocks carrying earnings growth far above the broad market average.

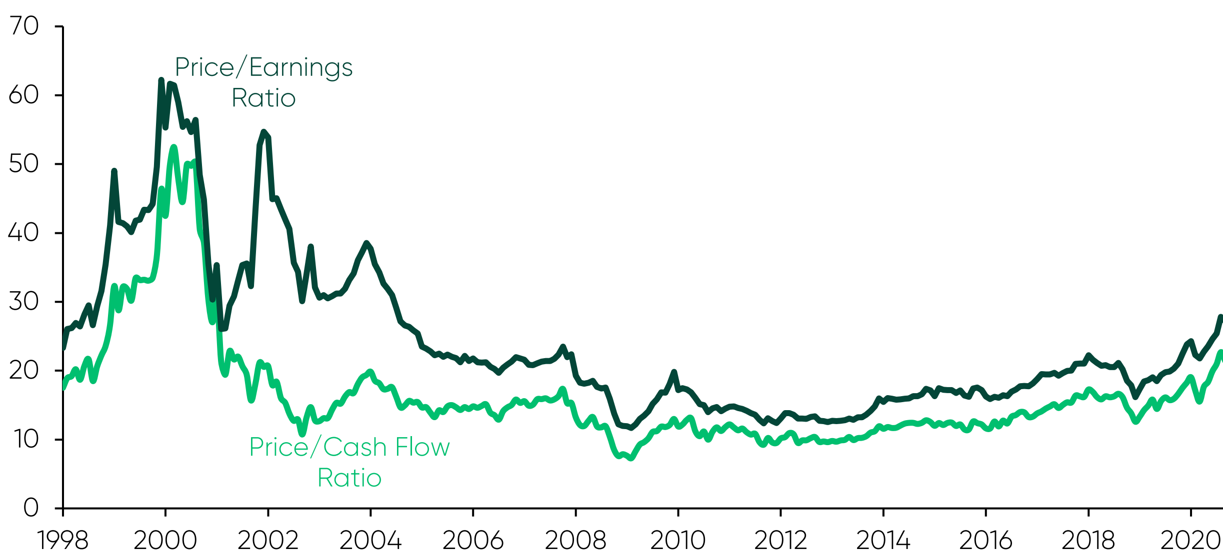
Figure 5: Last Twelve-Month Average Gross Margins (%)



Source: FactSet, Inc. as of 30/09/2020 using monthly data.

Furthermore, measures such as forward P/E and price-to-cash-flow ratios indicate that Tech valuations, though somewhat elevated above recent years, remain reasonable relative to the peak levels seen in early 2000 (Figure 6).

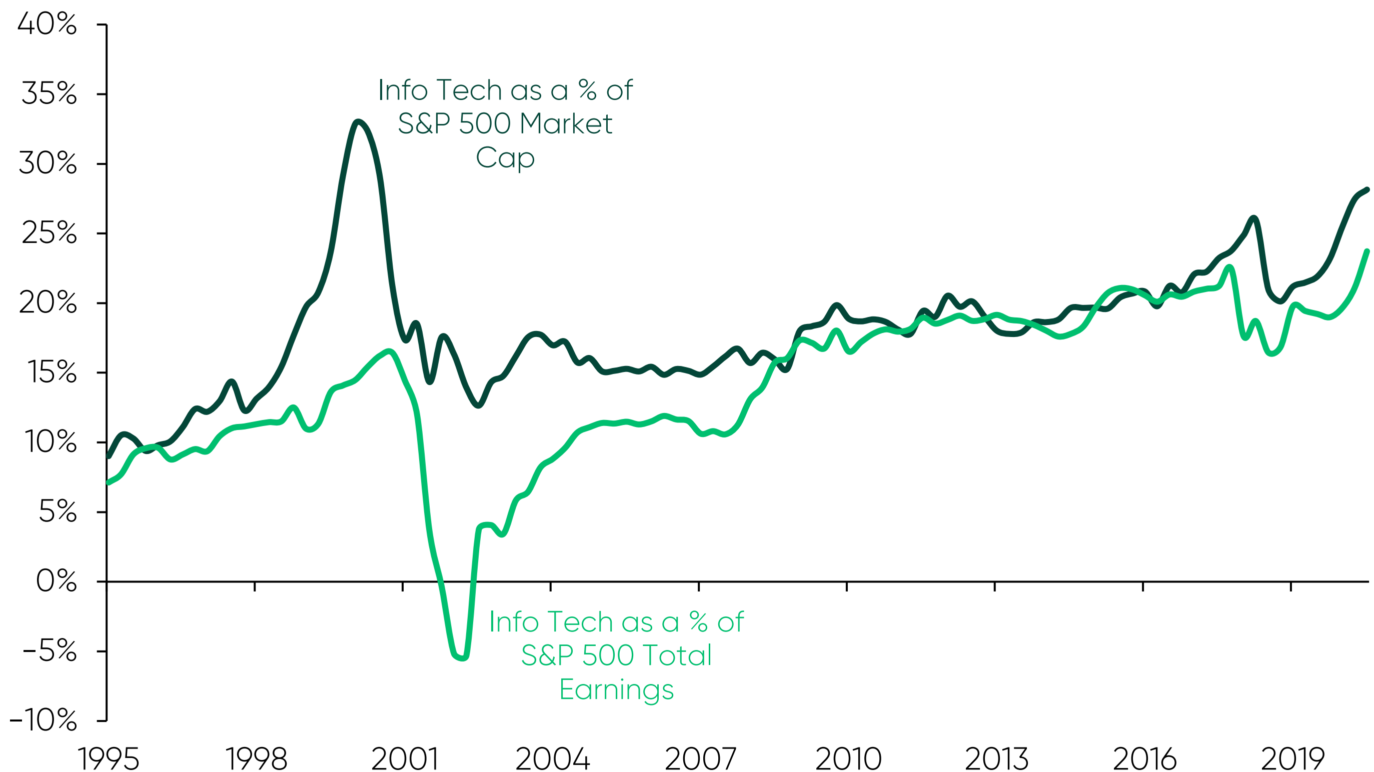
Figure 6: S&P 500 Technology Price-to-Earnings and Price-to-Cash Flow



Source: FactSet, Inc. 31/12/1997 – 30/10/2020 using monthly data. Price/Earnings ratio references the 12-month forward P/E.

Tech sector earnings are actually expected to modestly grow in the calendar year 2020 compared to estimates of -20% y/y declines in earnings for the broad S&P 500. Further, the Tech sector's growing share of overall market capitalisation has moved in close proximity to its share of overall earnings for many years, only recently slightly disconnecting. This is quite different from the late-1990s Tech bubble, which saw share prices completely disconnected from earnings as profit-starved Tech companies reached nearly 35% of the S&P 500's market capitalisation (Figure 7). The relative fundamental case for Tech and Tech-like stocks has improved in 2020, not deteriorated, and at this point we feel valuations appear reasonable given the above-average quality of firms that the Growth-orientated Tech sector currently represents.

Figure 7: Info Tech Earnings and Market Cap as % of the S&P 500



Source: FactSet, Inc. S&P 500 and S&P 500 Information Technology (Sector) Indices Market Value and Trailing 12M Net Income from 31/03/1995 to 30/09/2020.

SPACS IN 2020 VERSUS THE DOTCOM IPO MANIA

An additional parallel that can be drawn between recent history and the Tech bubble is new issuance activity. Recently, Special Purpose Acquisition Companies (SPACs) have been garnering attention for acquiring a host of Tech and Tech-like companies, which has led to comparisons to the froth and fervor of IPO activity in 2000. We aren't convinced these comparisons are warranted. For context, SPACs are a way for private companies to go public without the traditional (costly & lengthy) processes tied to an IPO. Essentially they are shell companies designed to acquire existing, privately owned firms using funds raised on public markets. According to one SPAC tracker, there have been 147 deals so far in 2020 for a total of $56 billion USD, more than the previous 10 years combined. However in 2000, which remains IPOs' peak fundraising year, there were 445 IPOs, raising $108 billion USD. So whilst SPACs have indeed boomed in 2020, the numbers today are a fraction of what they were during the dot-com era. Additionally, equity markets are significantly larger now. The S&P 500's market capitalization in 2000 was around $12 trillion USD, compared to over $29 Trillion USD today.

There are also qualitative differences, as not all of the companies targeted by SPACs are startups. Many of these firms are coming from private equity portfolios and are returning to public markets after a turnaround, making them generally more mature and time-tested. We aren't arguing that the SPAC world is froth-free, but it seems more like niche euphoria similar to that of Biotech equities in the early 2010's or bitcoin in 2017—isolated frenzies that didn't spill over into broader markets. We have often found wisdom in the saying that IPO stands for "it's probably overpriced," and we suspect the same logic applies to SPACs. Most see only a limited number of good targets and may not be buying at an attractive price—particularly if they are buying from private equity or hedge funds, which are trying to turn a large profit of their own. Some SPACs may not even find a company to buy before time runs out. We largely agree with those who find the whole arena to be rather speculative, with investors seduced by the prospect of quick riches. We prefer to focus our efforts on categories of equities that are buoyed by durable macro-economic tailwinds and strong fundamentals, rather than participating in IPOs or SPACs.

KEY DRIVERS OF VALUE LEADERSHIP

Whilst valuations alone are not particularly useful in evaluating the current market environment, we are closely monitoring a number of additional factors that we believe could suggest a reversal in style leadership.

- **Above-Trend Economic Growth:** Value companies benefit more from an accelerating economic trajectory, with improved volume and higher operating leverage. Due to complications associated with COVID-19, we expect economic growth to initially bounce back quickly but subsequently remain modest as many nations struggle to reopen. Growth companies likely benefit in this environment as their sales and earnings are less dependent on a strong economy for success, and investors seek out firms consistently able to grow earnings.
- **Accelerating Inflation:** Value companies generally thrive in periods of rising inflation as the most Value-orientated sectors (Financials, Energy, Materials) benefit from rising prices, and higher rates and commodity prices. However, inflation currently remains well below pre-bear market levels (Appendix 1), likely contributing to continued Growth outperformance. In order to see a meaningful rise in inflation, the recent boom in money supply would need to translate to an acceleration in the velocity of money. Velocity is currently low as funds are not being pushed into the broader economy (Appendix 2).
- **Steepening Yield Curve:** A steep yield curve boosts banks' net interest margins and increases their propensity to lend, leading to improved access to credit—the lifeblood of many Value-orientated companies. In the current environment, with narrow yield spreads globally, Growth companies are set to fare relatively better given they are far less reliant on credit to grow. Growth companies consistently lead Value in times of tight access to credit (Appendix 3).
- **Increased Market Breadth:** Value tends to outperform as breadth increases across global markets, but current market conditions are showing the opposite (Appendix 4). Large mega-cap firms primarily in Growth-orientated sectors have been leading the current market rally, signaling that strength is coming from the top whilst overall stock performance has been mixed.
- **Loss of US Equity Leadership:** The United States comprises a disproportionate amount of Growth-orientated equities—particularly in Tech and Tech-like categories. Conversely, Value equities constitute a higher weight in UK, German, Italian and Japanese equity markets. If market performance shifts in favor of other global developed markets, a style leadership change could take place.

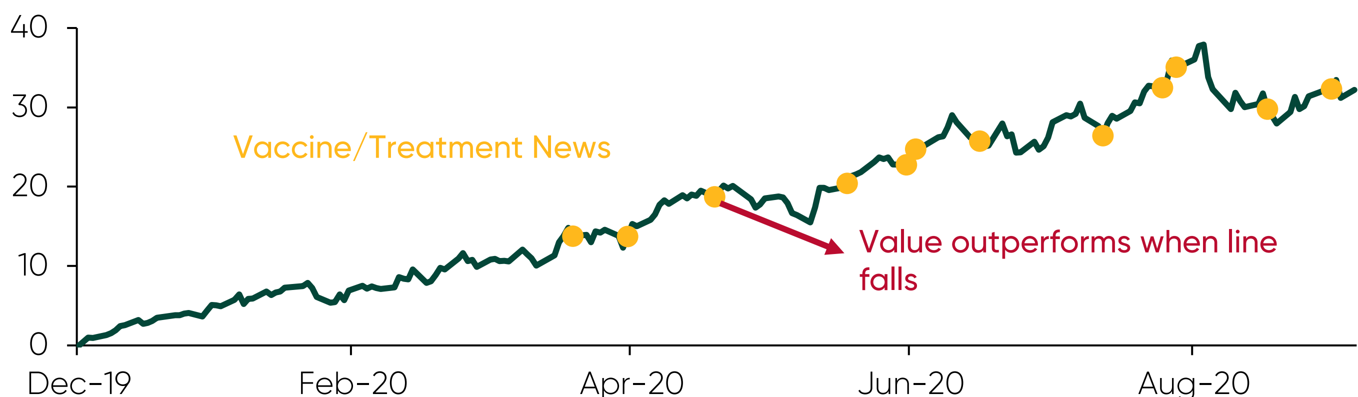
As of the time of writing, none of these indicators signal a near-term leadership change. Of course, 2020 has been filled with many surprises, so a style shift is entirely possible. But it remains unlikely, in our view.

COVID-19 VACCINE DEVELOPMENT AND VALUE RALLIES

Another popular theory underpinning a Value reversal is the successful development of a COVID-19 vaccine. The suggestion is that economic growth would receive a shot in the arm, boosting cyclicals and re-opening plays in particular (airlines, retail, restaurants, hotels etc.). It is true that Value equities have outperformed temporarily on positive news related to vaccine and treatment development, but these rallies have been short-lived (Figure 8). We believe that high-quality Growth companies should continue to lead, but investors should be vigilant for changing economic and market conditions that could signal a shift in leadership.

Figure 8: Value Rallies on Vaccine News Have Been Fleeting

Date	Company	Drug	Announcement	LCG	SCV	SCV - LCG
4/17/2020	Gilead	Remdesivir	STAT article reporting that early data suggests patients are responding to treatment	1.8%	4.7%	2.8%
4/29/2020	Gilead	Remdesivir	Positive data on two Remdesivir trials	3.1%	5.3%	2.3%
5/18/2020	Moderna	Vaccine	Positive preliminary results from an early stage trial	2.3%	7.8%	5.5%
6/16/2020	RECOVERY Trial	Dexamethasone	UK trial found this modestly reduces death risk	2.0%	2.6%	0.6%
6/29/2020	CanSino	Vaccine	China approves CanSino vaccine for military use	1.0%	4.1%	3.1%
7/1/2020	Pfizer/BioNTech	Vaccine	Positive initial data from early stage trials	1.3%	-1.9%	-3.2%
7/15/2020	Moderna	Vaccine	Positive "T-cell" response, good antibody response since previous update	0.4%	4.1%	3.7%
8/11/2020	Russia	Vaccine	Approved COVID vaccine for volunteers outside of clinical trials	-1.5%	0.0%	1.5%
8/24/2020	US	Plasma Therapy	FDA emergency authorization of plasma therapy	0.5%	2.2%	1.8%
8/27/2020	Abbott	COVID-19 Ag Card	FDA emergency authorization of Abbott's 15-minute COVID test	-0.2%	0.8%	1.0%
9/16/2020	Lilly Eli & Co	COVID Antibody	Mid-stage trial data shows antibody cut rate of hospitalization in mild to moderate cases	-1.3%	1.0%	2.4%
9/30/2020	Regeneron	COVID Antibody	Early-stage trial for COVID Antibody shows positive implications for vaccine	0.8%	0.3%	-0.6%
			Average	0.9%	2.6%	1.7%
			Median	0.9%	2.4%	2.0%
			Frequency (+)	75.0%	91.7%	83.3%



Top table source: Fisher Investments Research, FactSet, as of 08/10/2020. Performance based on Russell 1000 Growth and Russell 2000 Value, total returns from 17/04/2020 to 30/09/2020. Bottom chart source: FactSet, based on S&P 500 Growth & Value indices, using daily data to 05/10/2020, indexed to 100 on 31/12/2019.

Taking a closer look at "Operation Warp Speed", the partnership between the US Government and private companies to develop a vaccine and therapeutics for COVID-19, we have identified three potential scenarios that might play out (Appendix 5). Under the best-case scenario the entire US population could be vaccinated by July 2021. However, this scenario completely ignores the potential issues associated with mass production of an effective vaccine, distribution and ultimate delivery to the populace (many of whom have mixed feelings about mandated vaccination). In our view the successful development of a vaccine lacks the power, short of a huge positive surprise with zero distribution issues, to cause a meaningful shift in equity category leadership.

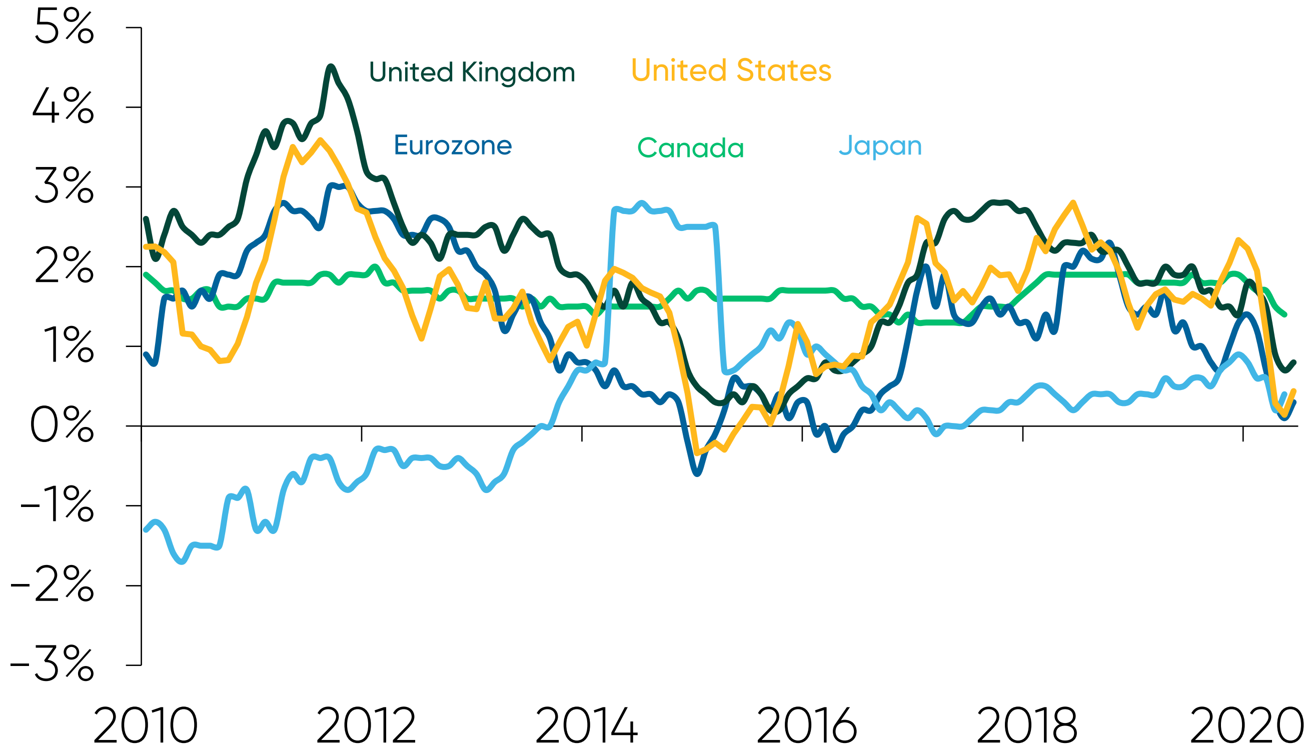
OUTLOOK

We believe that mean reversion shouldn't form the basis of a tactical investment decision. Valuations are not predictive, can stay persistently high for much longer than appreciated, and arguably they are currently justified for large Growth equities within Tech and Tech-like categories.

Though uncertainty and volatility have been central themes of 2020 so far and we remain diligent, we do not see a fundamental case for a material style leadership change at this juncture. Technically a new bull market has begun, but the recent bear market behaved more like a severe correction and Growth has continued to lead, with markets now behaving more like a late-stage bull. In our view, the economic environment favors Growth over Value for the foreseeable future, given a backdrop of modest economic growth, low inflation, a flat yield curve, tight access to credit and late-cycle sentiment. The quintessential Value sector, Financials, is facing significant headwinds tied to the macroeconomic environment and depressed interest rates globally, whilst weak expected bank lending impacts other Value-orientated categories particularly hard, given their typically lower-quality balance sheets. In contrast, several Growth-orientated segments of the market have arguably benefitted from the COVID-induced market downturn and associated restrictions on businesses and social activity. Growth equities skew toward large, high-quality firms in the Technology sector, and high-margin Tech-like sub-industries in Communication Services, Consumer Discretionary and Health Care. Whilst we currently maintain our preference for these areas in portfolios, this is not a permanent bias and we continue to closely monitor potential signals that changes in style leadership are afoot.

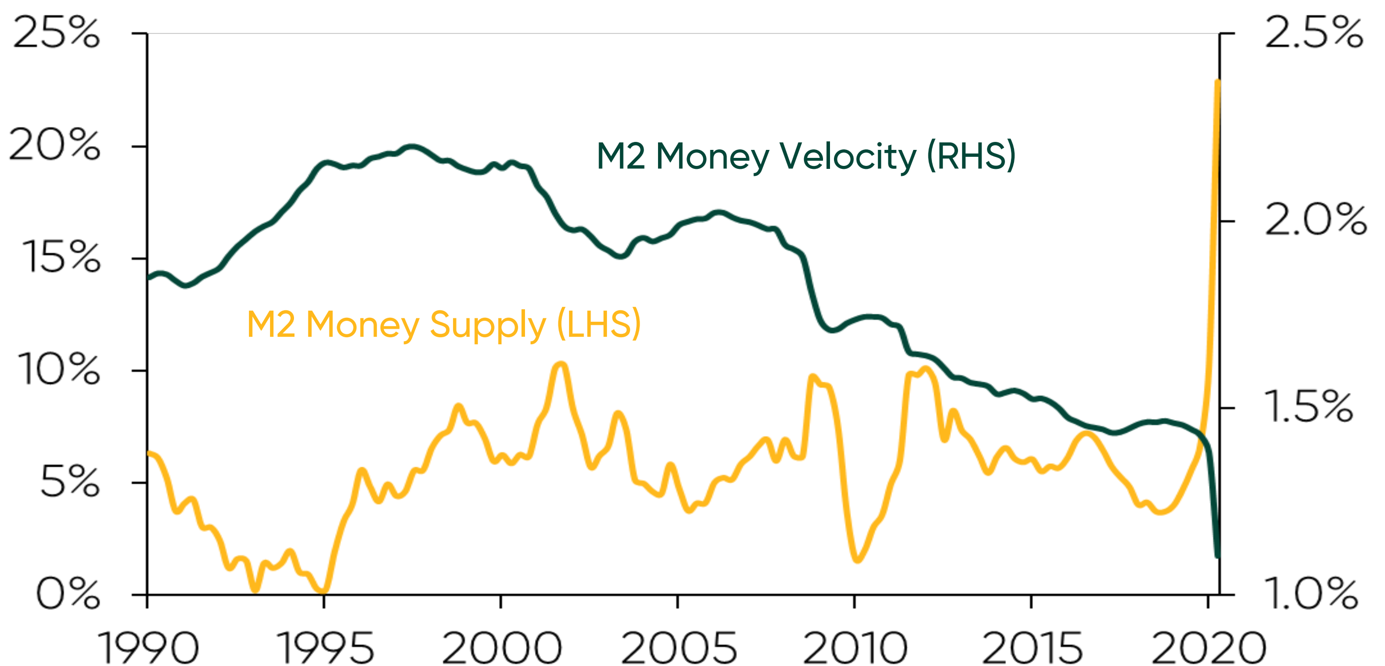
APPENDIX

Appendix 1 – Inflation Remains Low Globally



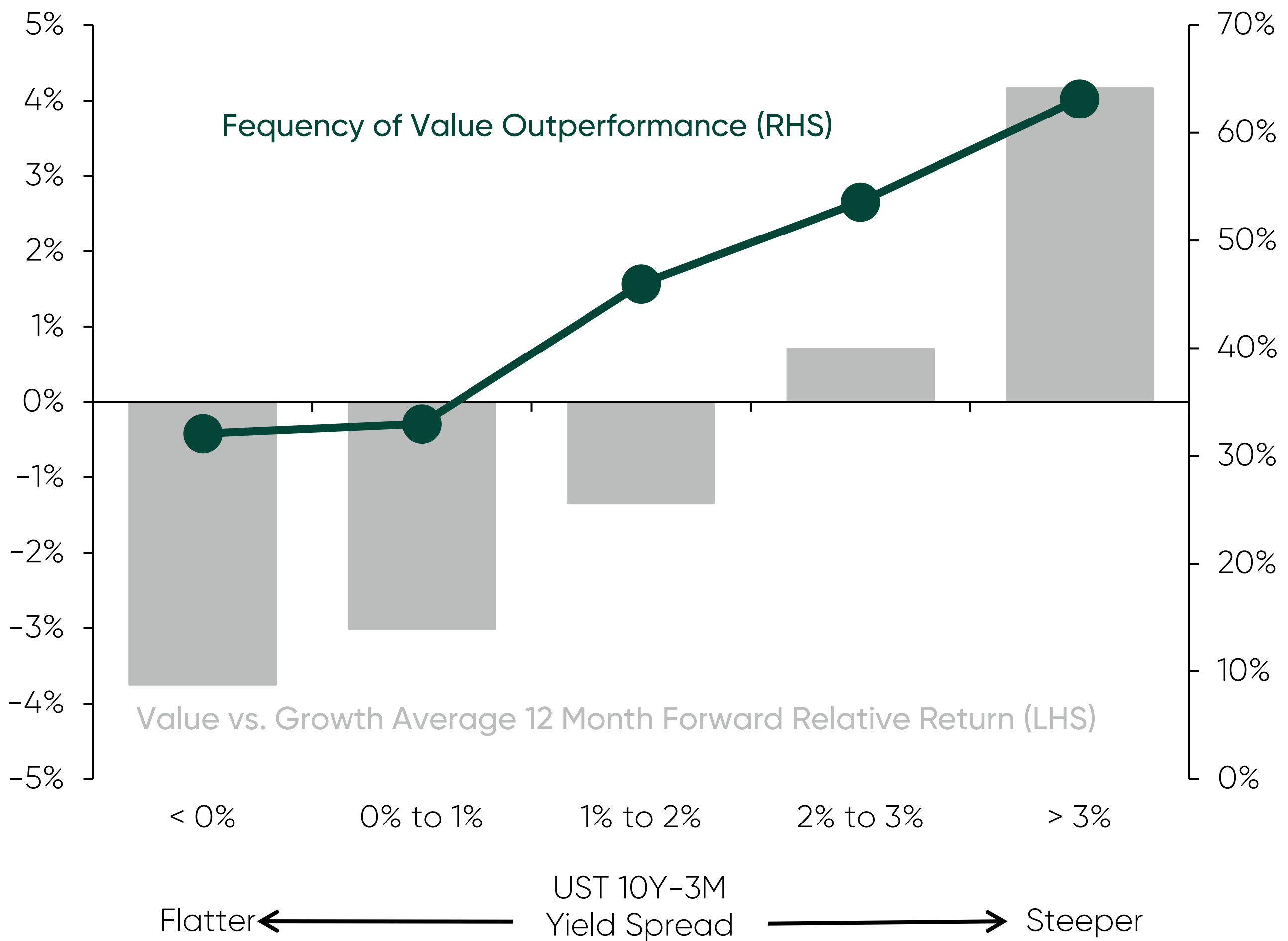
Source: FactSet, European Central Bank, Office for National Statistics, Ministry of Internal Affairs and Communications Japan and Federal Reserve Bank of St. Louis. Shows year-over-year change in core consumer price index levels. UK, Eurozone & United States as of 30/06/2020, Canada & Japan as of 31/05/2020.

Appendix 2 – Money Supply Growth Offset By Weak Velocity



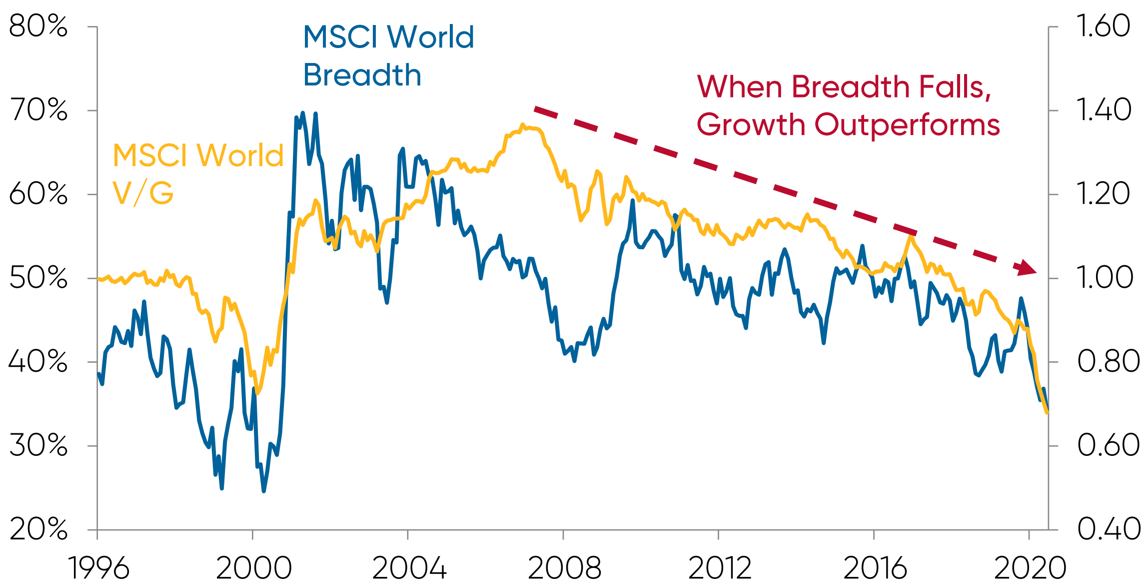
Source: FactSet, Federal Reserve Bank of St. Louis. Velocity of money as of 30/06/2020, M2 money stock as of 30/06/2020.

Appendix 3 – Narrow Yield Spread Favors Growth



Source: FactSet as of 30/09/2020. Shows Russell 3000 Value vs. Russell 3000 Growth forward 12-month relative performance starting 28/12/1978. Performance is shown as an average at different levels of the yield curve.

Appendix 4 – Falling Market Breadth Corresponds With Growth Leadership



Sources: FactSet and MSCI, 2020. As of 30/09/2020.

Appendix 5 – Three Potential Scenarios For "Operation Warp Speed"

Expected Major Vaccine Approval Dates

	2020			2021										
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Astrazeneca														
Pfizer														
Moderna														
Novavax														
JNJ														
Merck														
Sanofi														

Scenario 1: Vaccine Approval, Manufacturing & Distribution of Vaccine Work Smoothly with Minimal Problems

Operation Warp Speed: **Optimistic** Scenario	2020				2021											
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Millions Vaccinated	--	--	10	20	50	100	150	200	250	300	330	330	330	330	330	330
% of US Population	--	--	3%	6%	15%	30%	45%	61%	76%	91%	100%	100%	100%	100%	100%	100%
Herd Immunity Est	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%

Scenario 2: Vaccine Approval, Manufacturing & Distribution of Vaccine Has Some but Manageable Hiccups

Operation Warp Speed: **Consensus** Scenario	2020				2021											
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Millions Vaccinated	--	--	--	10	25	50	75	100	125	150	200	250	300	330	330	330
% of US Population	--	--	--	3%	8%	15%	23%	30%	38%	45%	61%	76%	91%	100%	100%	100%
Herd Immunity Est	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%

Scenario 3: Vaccine Approval, Manufacturing & Distribution of Vaccine Has Some Significant Setbacks

Operation Warp Speed: **Pessimistic** Scenario	2020				2021											
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Millions Vaccinated	--	--	--	--	5	20	40	60	80	100	125	150	175	200	225	250
% of US Population	--	--	--	--	2%	6%	12%	18%	24%	30%	38%	45%	53%	61%	68%	76%
Herd Immunity Est	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%

Source: US Gov't Operation Warp Speed initial estimates & guidance with Fisher Investments estimates for different scenarios as of October 2020.

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For purposes of defining "years with Fisher Investments," FI was established as a sole proprietorship in 1979, incorporated in 1986, registered with the US SEC in 1987, replacing the prior registration of the sole proprietorship, and succeeded its investment adviser registration to a limited liability company in 2005. "Years with Fisher Investments" is calculated using the date on which FI was established as a sole proprietorship through 30 September 2020.

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FIE delegates portfolio management to FI. FI's Investment Policy Committee is responsible for all strategic investment decisions. FIE's Investment Oversight Committee (IOC) is responsible for overseeing FI's management of portfolios that have been delegated to FI. Matters arising pursuant to FI's portfolio management policies are elevated to the IOC.

The foregoing information has been approved by Fisher Investments Europe.

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