MARKET CYCLE ANALYSIS
(March 2020)

In our view, the Big Growth and Small Value performance cycle is linked to the business cycle and yield curve. We also believe the flattening yield curve and cyclical shift from investment-driven growth to consumption-driven growth points to Big Growth outperformance in the later stages of a bull market.

Key Points

- As the market cycle matures, market breadth narrows and investor preferences shift from Small Value equities towards Big Growth equities, leading to Big Growth outperformance in the later stages of the bull market.

- This phenomenon is rooted in the nature of the business cycle: In the early stages of economic recovery, growth is driven by investment. This supports outperformance for Small Value indices, which tend to be dominated by capital-intensive, investment-driven sectors. As the economic cycle matures, growth is increasingly driven by consumption. This supports outperformance for Big Growth indices, which are dominated by services-focused sectors leveraged to consumption.

- Transition from investment-driven growth to consumption-driven growth is heavily influenced by the yield curve, with a steep yield curve in the early part of the cycle supporting capital-intensive investment through cheap and easy credit, and the flattening yield curve at the end of the cycle favouring service-oriented businesses (i.e. balance sheet light) leveraged more to consumption.

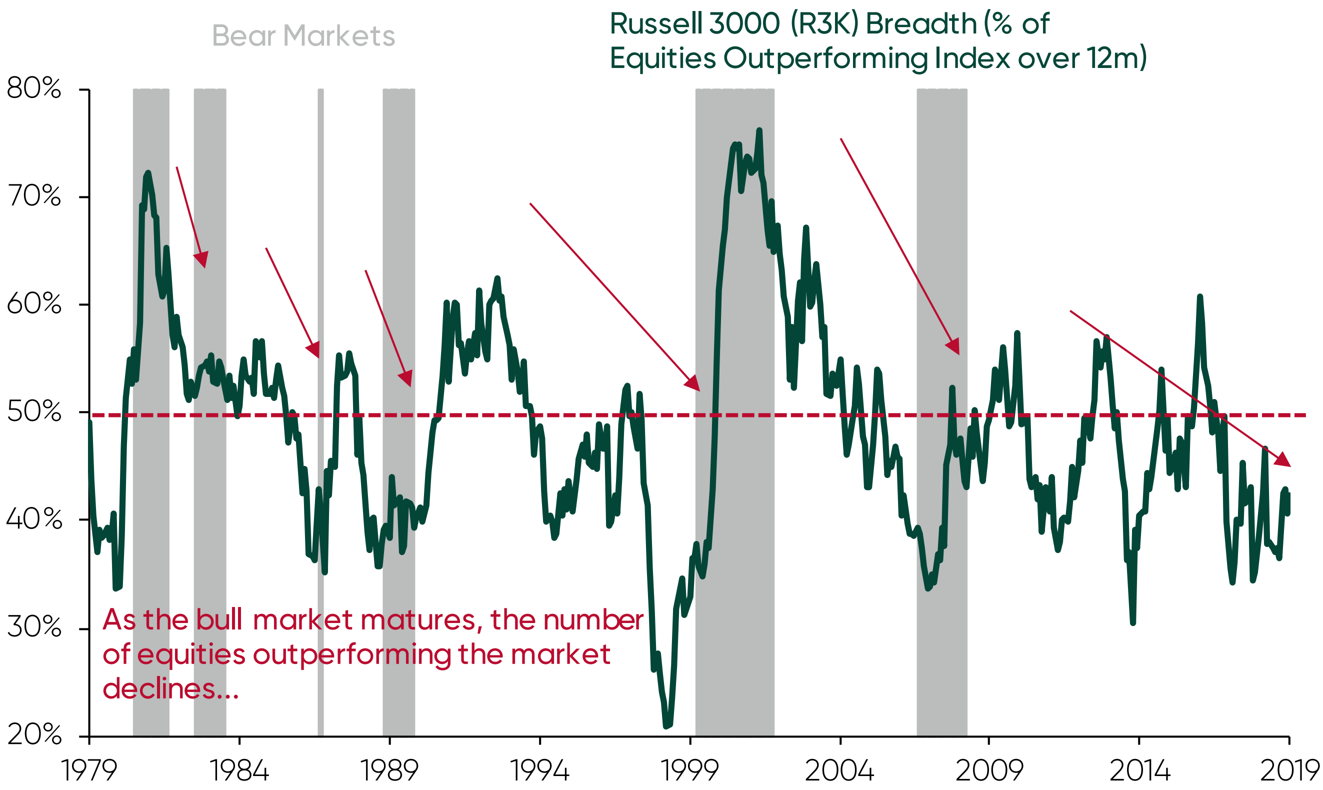
- With the early-cycle “capex snap-back” well behind us and the yield curve flattening, economic activity has shifted from investment to consumption. This suggests service-oriented, consumption-driven business will continue to fare better than capital-intensive, investment-driven.

Market Breadth and the Growth vs. Value Cycle

In the first stages of a new bull market, most equities outperform the market average, with Small Value equities leading the way. However, as the bear market "bounce" effect fades and the bull market matures, market breadth (defined as the percentage of constituents beating the market average) declines as investors abandon high-beta winners of the early bull and instead focus on blue chip growth equities which aren't as dependent on a cyclical rebound in economic activity to drive earnings.

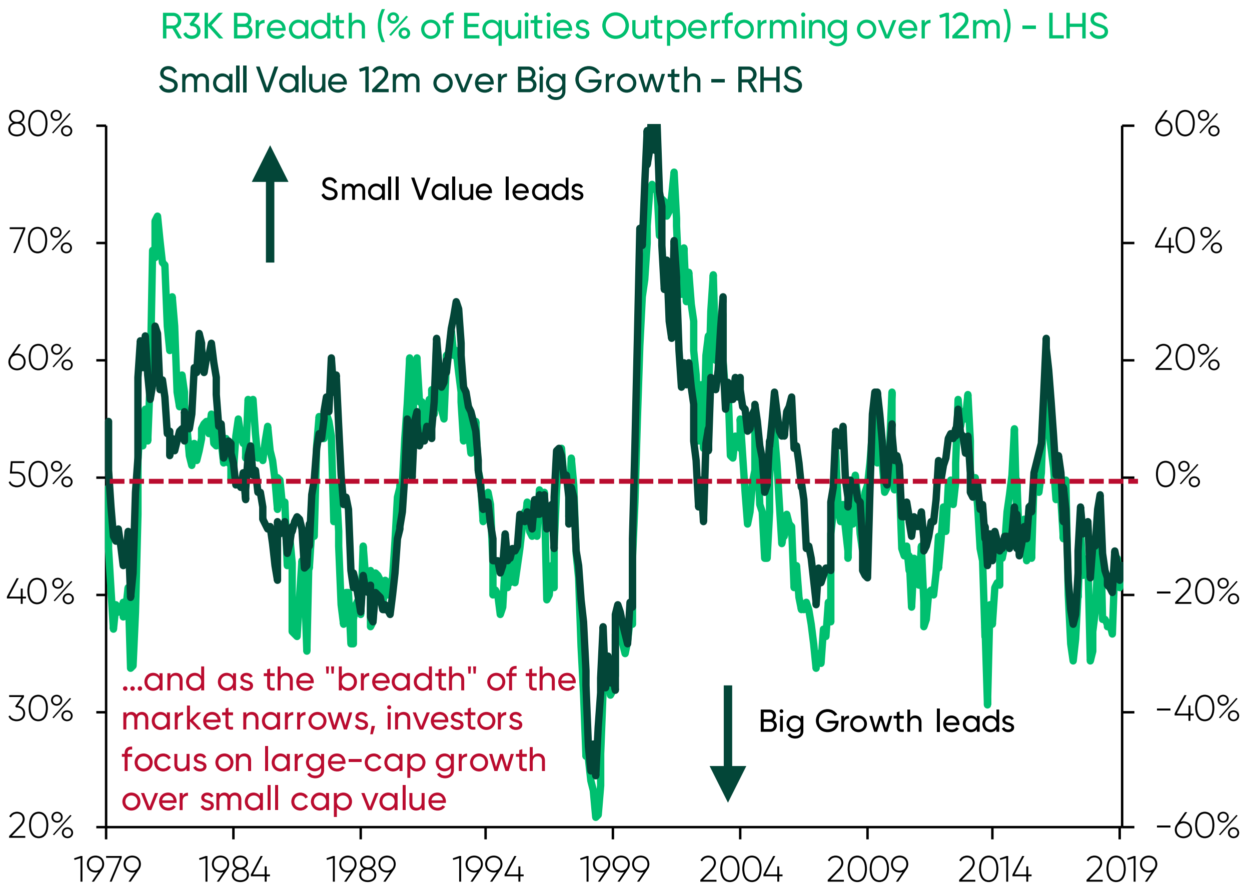
Exhibit 1 shows how market breadth declines as the bull market progresses, and Exhibit 2 shows the strong *inverse* relationship between market breath and Big Growth relative returns vs. Small Value.

Exhibit 1: Market Breadth Narrows as Bull Market Matures



Source: FactSet as of 31/12/2019. Bear Markets shown are US Bear Markets.

Exhibit 2: Big Growth* Outperforms as Breadth Narrows



Source: FactSet as of 31/12/2019. Right vertical axis depicts percentage of outperformance of small value over big growth.

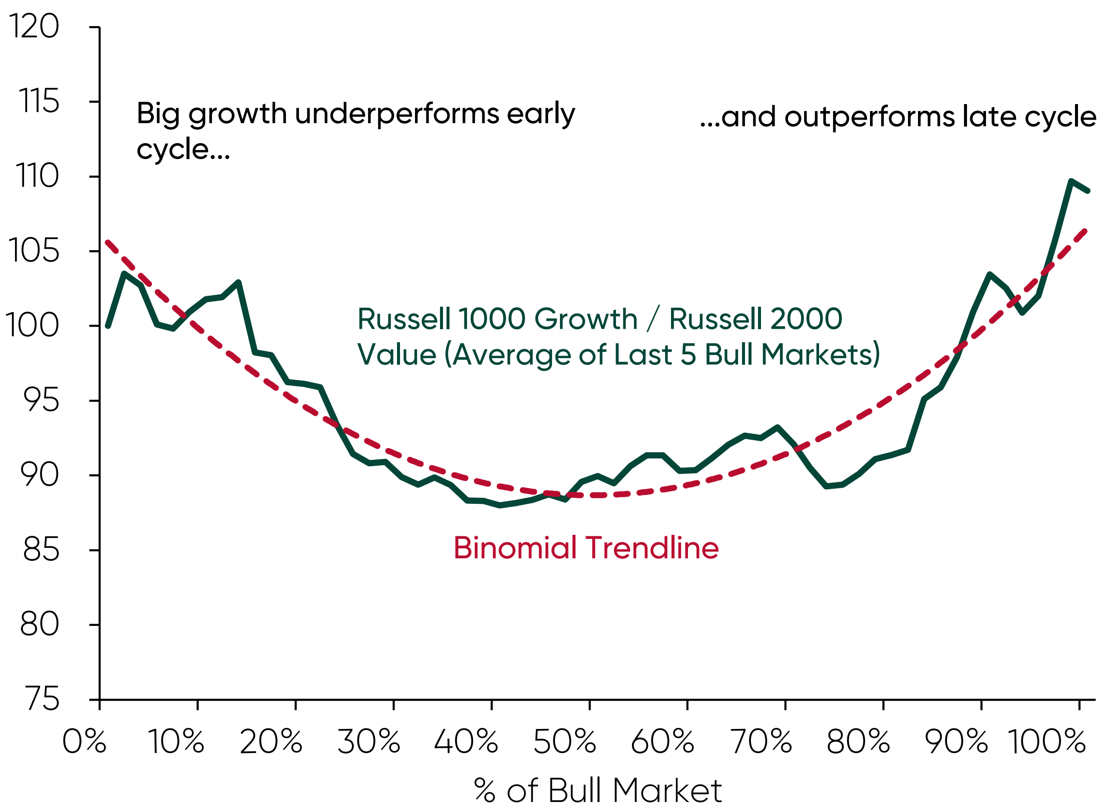
It is also worth noting that declining market breadth is an important driver for the relative returns of both style and size independently: Growth outperforms Value—regardless of size—*and* Big outperforms Small—regardless of style. This is illustrated in exhibits 10 and 11 of the appendix, which compare market breadth to Growth vs. Value and Big vs. Small, respectively.

**Unless stated otherwise, charts and data referencing "Big Growth" are based on the Russell 1000 Growth index while "Small Value" is based on the Russell 2000 Value.*

Growth vs. Value and Consumption vs. Investment

As market breadth narrows as the bull market matures, this results in Big Growth outperformance in the later stages of the bull market. This is illustrated in Exhibit 3, which shows the average trajectory of the Russell 1000 Growth over Russell 2000 Value during the last 5 bull markets, with the duration of each bull market normalised on a percentage scale (i.e. 0-100%). Based on the historical trend, Big Cap Growth generally underperforms for the first half of the bull market, and then outperforms for the remainder.

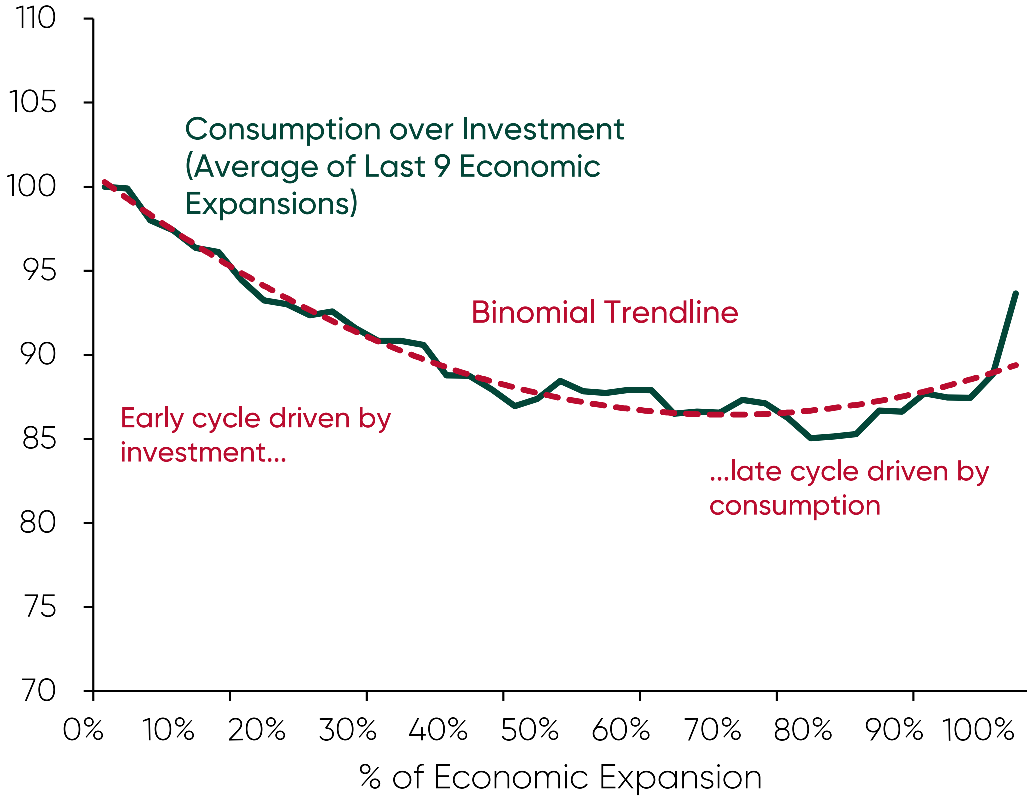
Exhibit 3: Big Growth vs. Small Value in Bull Markets



Source: FactSet, rebased to 100 at beginning of each bull market. Covers bull markets from 1982 through the most recent completed bull market in 2007.

However, this phenomenon is not simply a function of investor sentiment—it is also rooted in the fundamental nature of the economic cycle. In the early stages of economic recovery, economic growth is driven by investment. As the expansion matures, investment slows and growth is increasingly driven by consumption. This phenomenon is illustrated in Exhibit 4, which shows the consumption-to-investment ratio during the last 8 economic expansions, with the duration of each expansion normalised on a percentage scale.

Exhibit 4: Consumption vs. Investment During Expansions



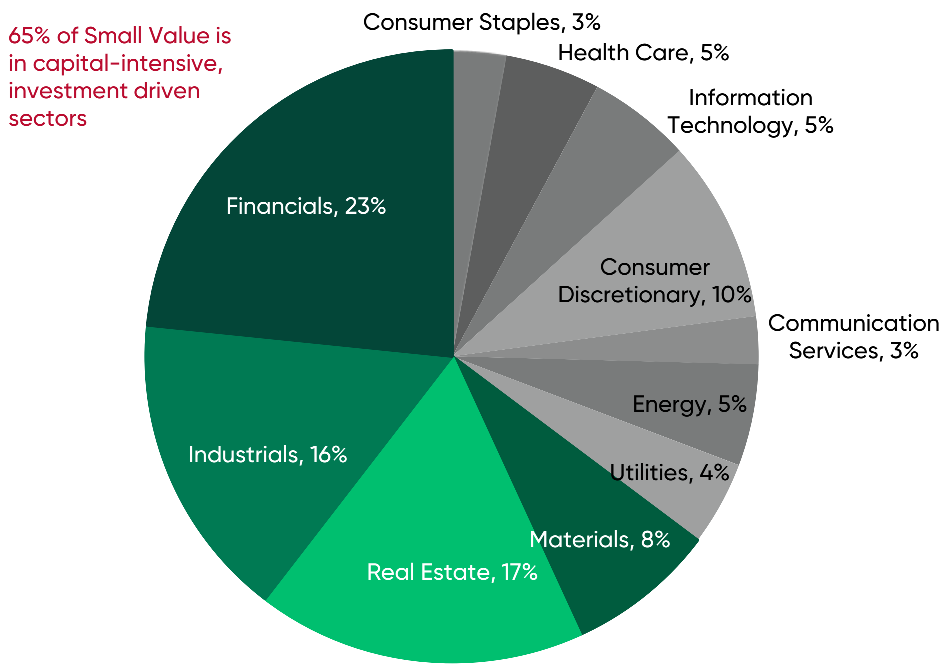
Source: US Bureau of Economic Analysis; Personal Consumption Expenditures / Private Fixed Investment. Rebased to 100 at the beginning of each economic expansion. Covers economic expansions from 1954 through the most recent completed economic expansion in 2007.

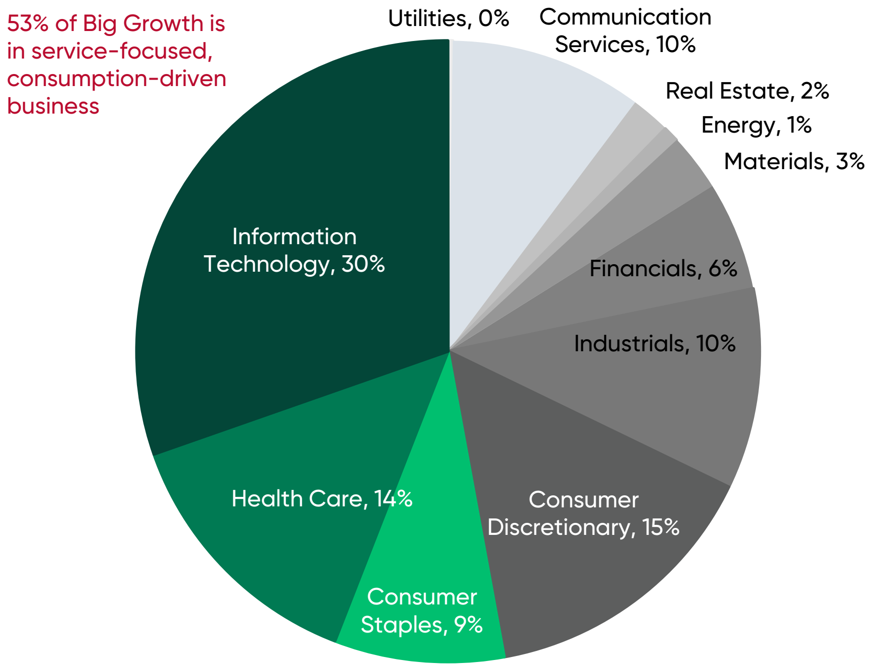
There is a visual similarity between the Growth vs. Value trajectory during bull markets and the Consumption-to-Investment ratio during economic expansions. This is no coincidence—it is rooted in the sector composition of Big Growth and Small Value indices.

65% of the MSCI World Small Value Index falls in the Materials, Industrials, Real Estate and Financials sectors (see Exhibit 5). These Small Value sectors are capital-intensive and primarily driven by investment—characteristics which lend themselves to early-cycle outperformance. In contrast, 50% of the MSCI World Big Growth Index is in Information Technology, Consumer Staples and Healthcare (see Exhibit 5). These growth sectors are mostly service-oriented businesses and are primarily driven by consumption—characteristics which support late-cycle outperformance. The "Big Growth" and "Small Value" categorisation is a reflection of these sectors' fundamental characteristics.

The Small Value sectors are leveraged to the most cyclical segments of the economy (i.e. investment), tend to be mature, commoditised industries where long-term growth is a function of nominal GDP and market share (e.g. real estate, copper, credit). They are also highly capital-intensive, leading to heavy dependence on debt-financing and low rates of return on assets. Higher volatility, lower growth potential, greater leverage and weaker returns naturally lead to lower valuations and structurally lower growth rates.

Exhibit 5: MSCI World Small Cap Value and MSCI World Large Growth Sector Weights





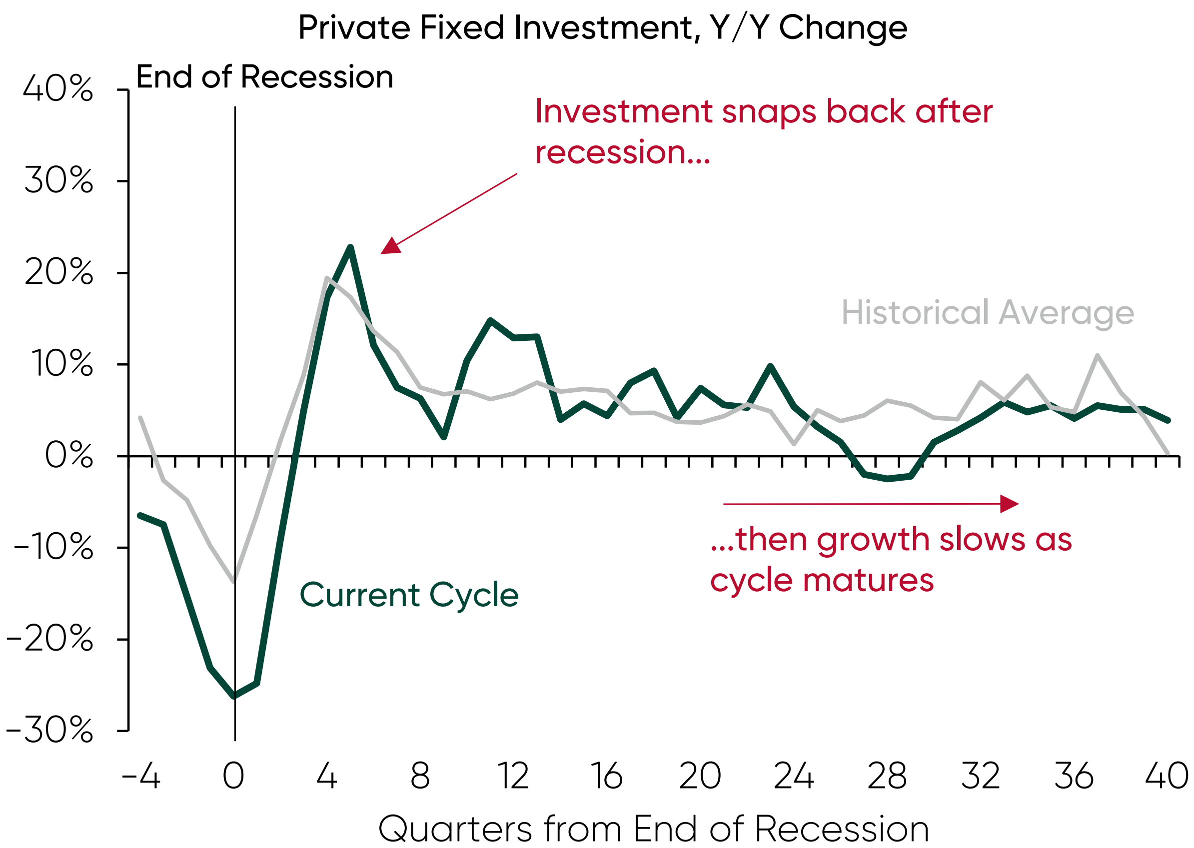
Source: FactSet as of 31/12/2019.

In contrast, the Big Growth sectors are less cyclical, less capital intensive, and generally aren't constrained by nominal GDP—growth can also be driven by innovation, new product development and rising market penetration (as the markets aren't as mature). This leads to structurally higher growth rates and premium valuations.

Consumption vs. Investment and the Yield Curve

In the early stages of the economic recovery, there is an initial "capex snap-back" due to inventory restocking and pent-up demand for capital equipment—typically this results in accelerating investment growth for the first year of the recovery. This is illustrated in Exhibit 6 which shows the average trend in investment growth during the last 9 economic cycles, as well as investment growth in the current period—which has now slowed to a typically late-cycle growth rate.

Exhibit 6: Investment Growth During Expansions

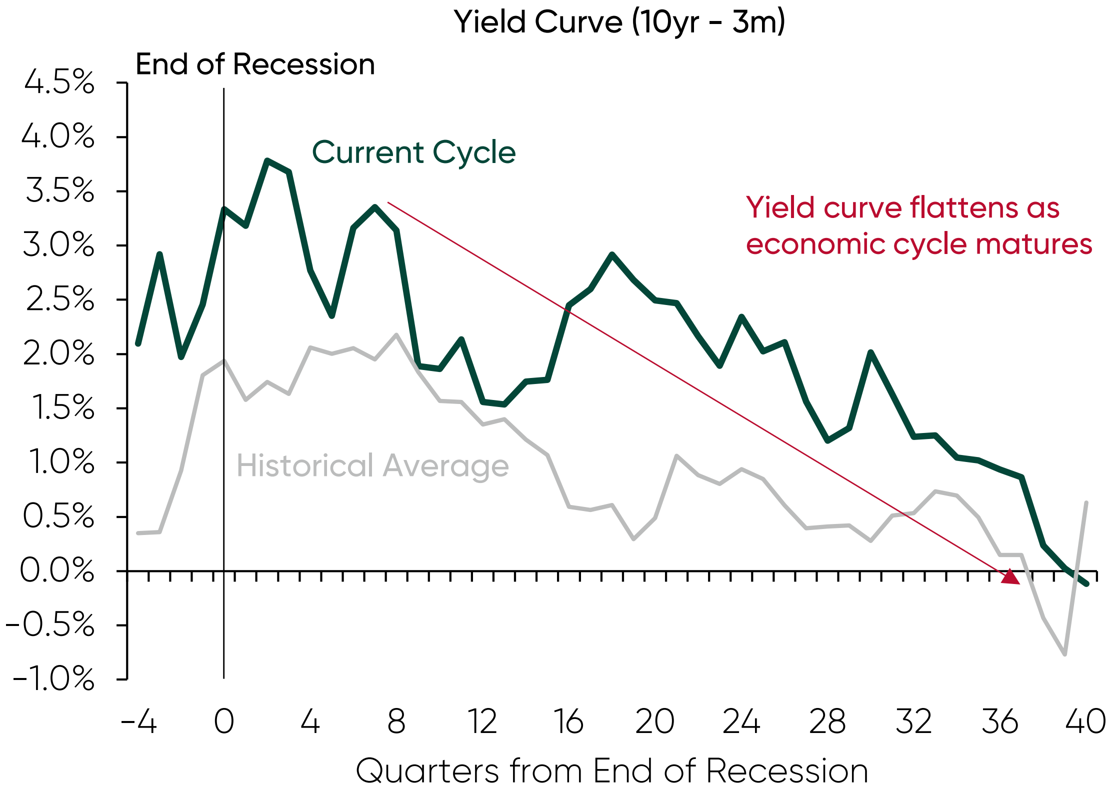


Source: US Federal Reserve as of 31/12/2019. Covers US economic expansions from 1954 through the most recent completed economic expansion in 2007.

To a large degree, this early-stage "capex snap-back" is enabled by low interest rates and a steep yield curve. Low interest rates make capex more attractive, and a steep yield curve incentivises banks to make financing available—which is particularly important for smaller companies, which have limited access to capital markets and are generally more reliant on bank lending.

Typically, the yield curve steepens during the recession as the central bank cuts the policy rate, and remains steep early in the recovery as expectations for stronger growth push long rates higher. As growth improves and inflation accelerates later in the cycle, the central bank hikes short rates and the yield curve begins to flatten. This is illustrated in Exhibit 7, which shows the trajectory of the yield curve (measured as the 10-year - 3-month yield spread) during the last 9 economic cycles, as well as the yield curve in the current cycle. The yield curve began to narrow in the mid-2010s, and based on historical trend, is likely to stay relatively flat for the remainder of the expansion.

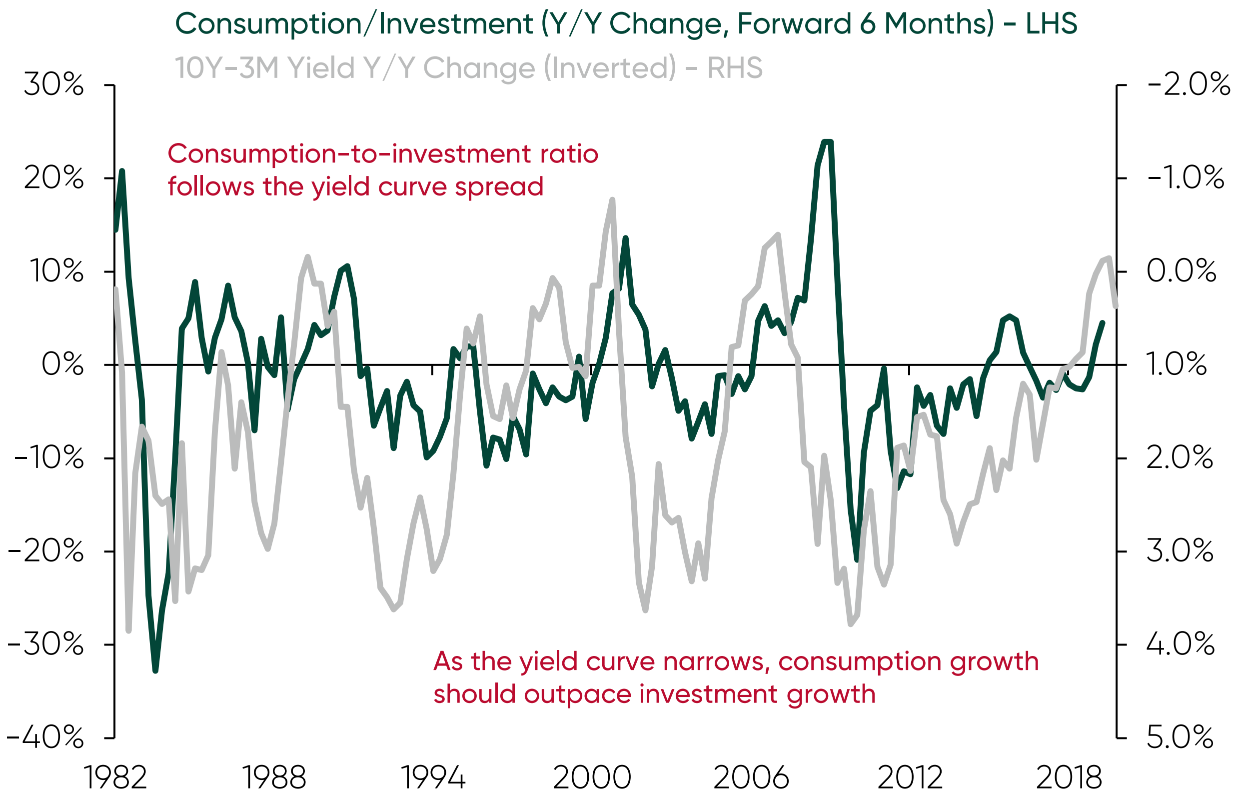
Exhibit 7: Yield Curve During Economic Expansions



Source: FactSet Economics as of 31/12/2019. Covers economic expansions from 1954 through the most recent completed economic expansion in 2007. Based on US Yield Curve.

The relationship between investment and the yield curve is further illustrated in Exhibit 8, which shows the year-over-year change in the yield curve spread (measured by the 10-year rate minus 3-month rate, with the axis inverted), and the forward-looking change in the consumption-to-investment ratio. The chart shows that as the yield curve narrows, consumption tends to grow more quickly than investment moving forward.

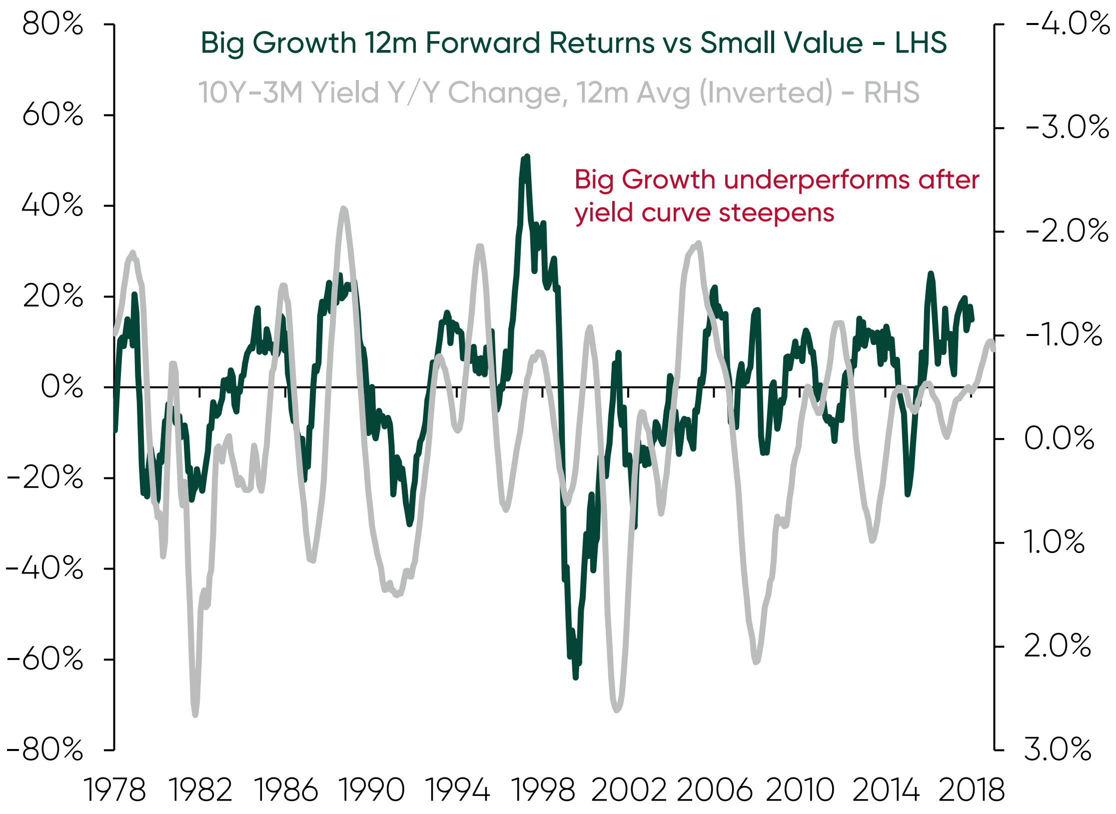
Exhibit 8: Yield Curve and Consumption-to-Investment Ratio



Source: US Bureau of Economic Analysis and FactSet as of 31/12/2019. Based on US Yield Curve.

It stands to reason that if the yield curve drives the consumption-to-investment ratio, and Big Growth represents consumption-driven sectors while Small Value represents investment-driven sectors, then the yield curve should drive growth vs. value relative returns. The relationship between the yield curve and Big Growth vs. Small Value is illustrated in Exhibit 9, which shows the 12-month moving average year-over-year change in the yield curve spread vs. Big Growth's 12 month forward relative return vs. Small Value. Historically, when the yield curve is flattening, Big Growth outperforms Small Value 65% of the time over the next 12 months, with 3.6% average outperformance. In contrast, when the yield curve is steepening, Big Growth outperforms less than 40% of the time, with 4.2% average underperformance (Exhibit 12 in the appendix illustrates this in more depth).

Exhibit 9: Yield Curve and Big Growth vs. Small Value



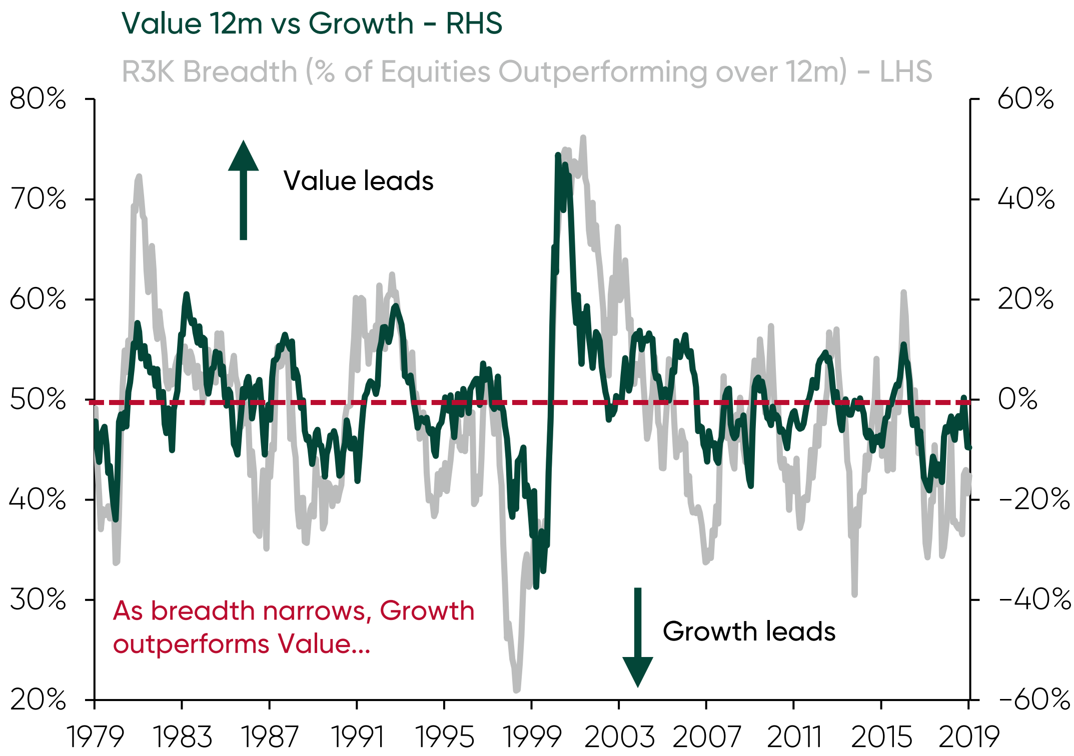
Source: FactSet as of 31/12/2019. Based on US Yield Curve.

The yield curve is particularly important for the financial sector—the biggest component of Small Value indices. When the yield curve is steep, net interest margins are wider, which makes banks more profitable. Thus there is a particularly strong relationship between the yield curve spread and financial sectors relative returns, which is illustrated in Exhibit 13 in the appendix.

Outlook

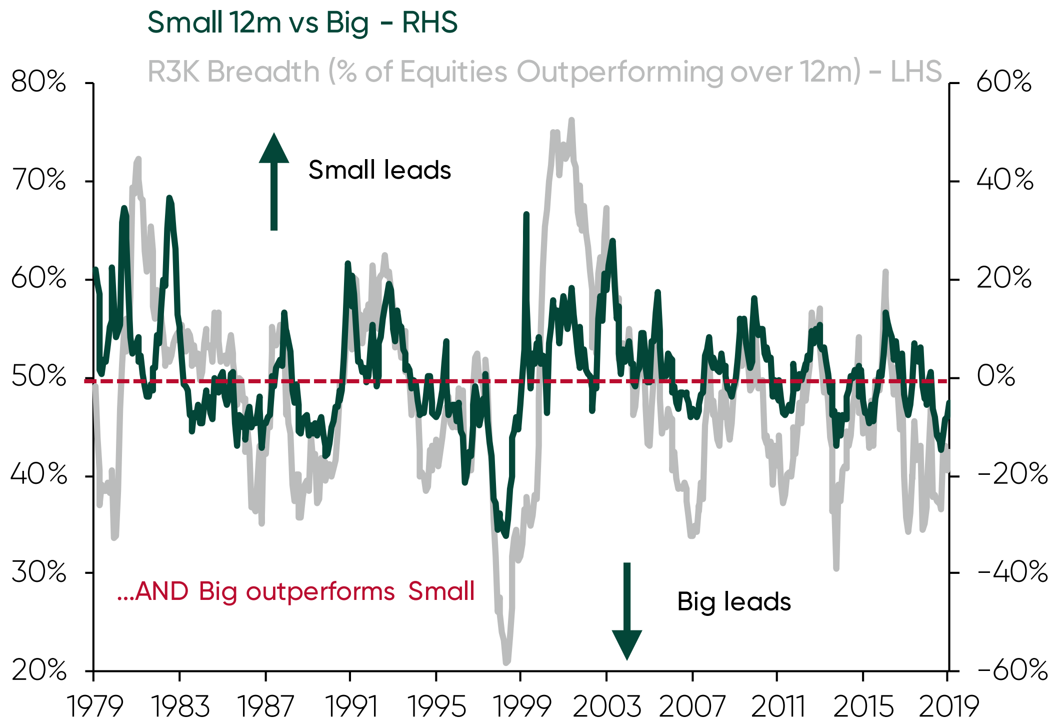
Ultimately, as the market cycle continues to mature, we expect the yield curve to remain relatively flat and the economy to shift from investment-driven growth to consumption driven growth. As such, capital intensive sectors will likely lag while service-oriented, consumption-driven sectors will likely lead, driving outperformance for Big Growth equities.

Appendix
Exhibit 10: Breadth & Growth vs. Value



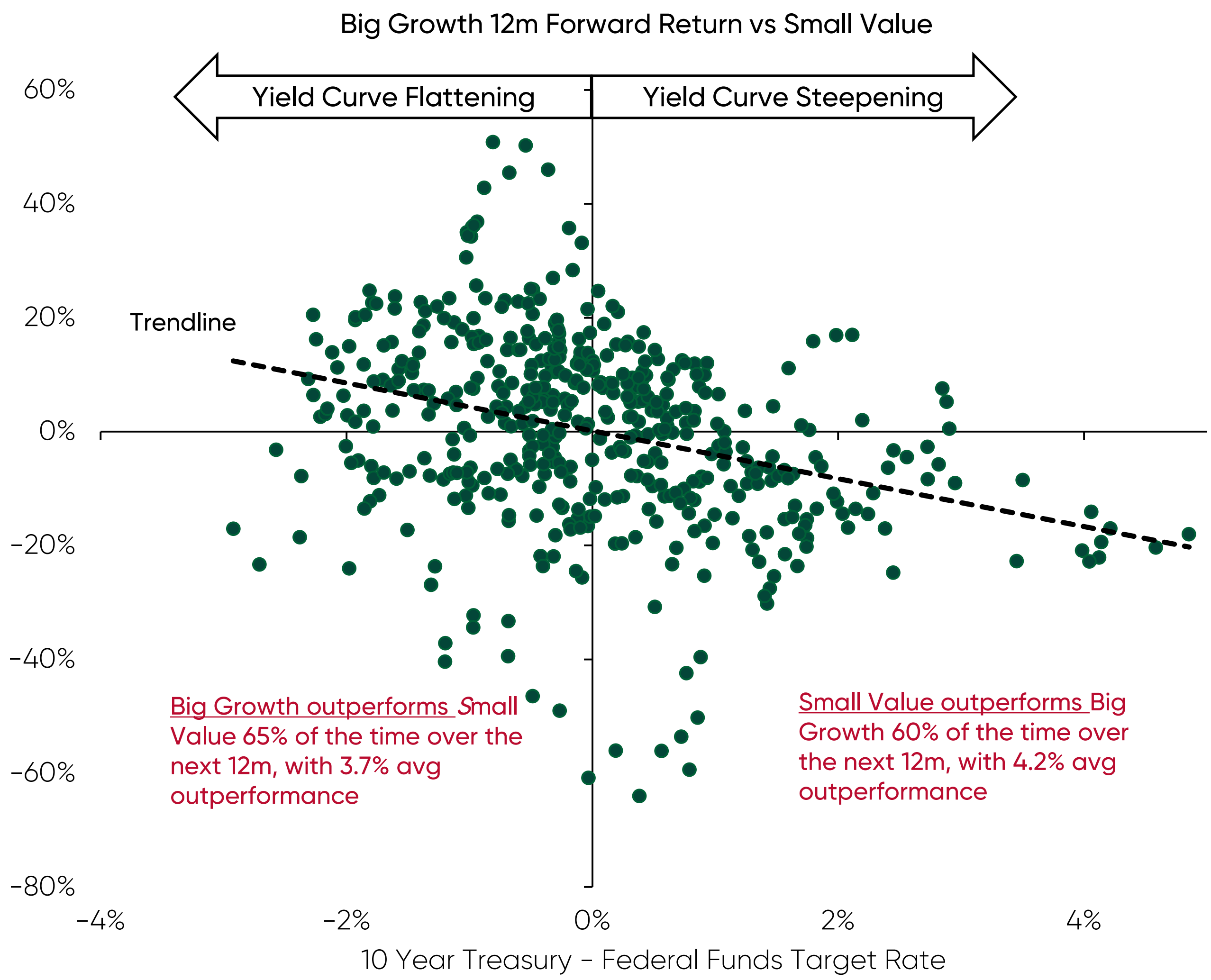
Source: FactSet as of 31/12/2019. Right vertical axis depicts 12 month relative return of value over growth.

Exhibit 11: Breadth & Big vs. Small



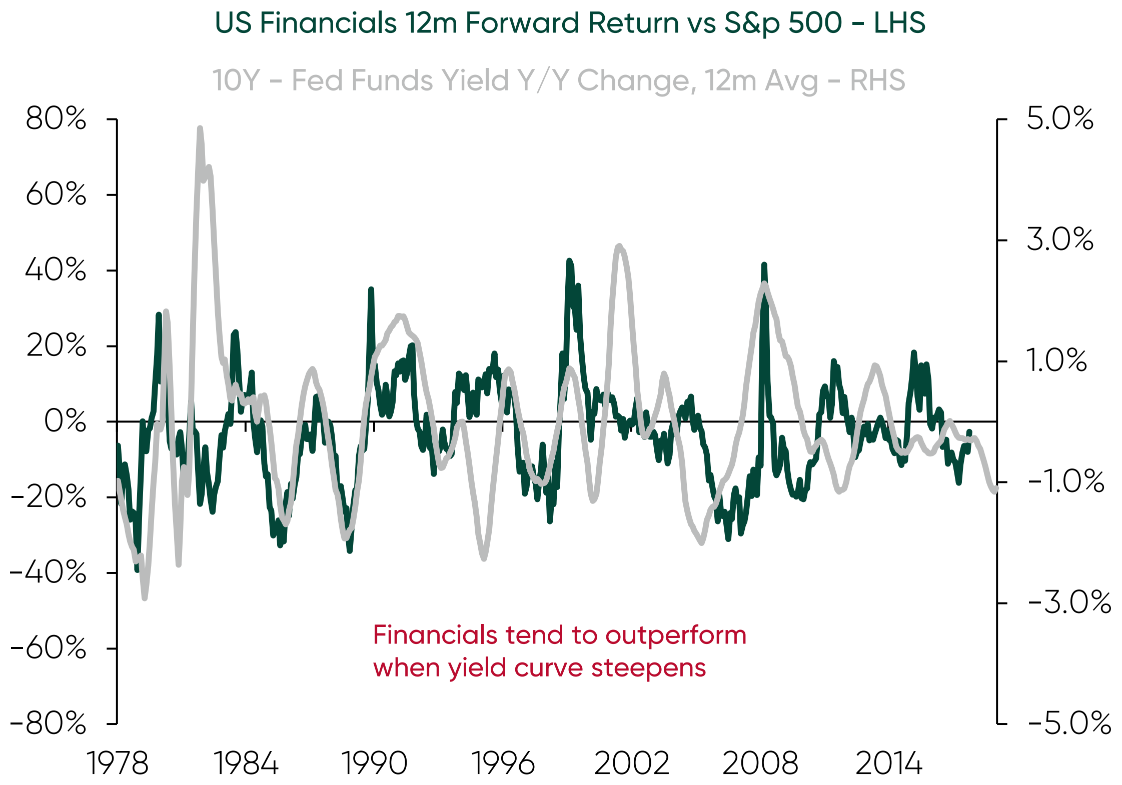
Source: FactSet as of 31/12/2019. Right vertical axis depicts 12 month relative return of small over big.

Exhibit 12: Yield Curve and Big Growth vs. Small Value



Source: FactSet as of 31/12/2019. Based on US Yield Curve.

Exhibit 13: Yield Curve and Financials vs. S&P 500



Source: Global Financial Data and FactSet as of 31/12/2019. Based on US Yield Curve.

DISCLOSURES

Fisher Investments Europe Limited (FIE) is authorised and regulated by the Financial Conduct Authority. It is registered in England, Company Number 3850593. FIE is wholly-owned by Fisher Asset Management, LLC, trading as Fisher Investments (FI), which is wholly-owned by Fisher Investments, Inc.

Fisher Investments (FI) is an investment adviser registered with the securities and Exchange Commission. As of 31 December 2019, FI managed over $120 billion, including assets sub-managed for its wholly-owned subsidiaries. FI and its subsidiaries maintain four principal business units – Fisher Investments Institutional Group (FIIG), Fisher Investments Private Client Group (FIPCG), Fisher Investments International (FII), and Fisher Investments 401(k) Solutions Group (401(k) Solutions). These groups serve a global client base of diverse investors including corporations, public and multi-employer pension funds, foundations and endowments, insurance companies, healthcare organisations, governments and high-net-worth individuals. FI's Investment Policy Committee (IPC) is responsible for investment decisions for all investment strategies.

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 31 December 2019.

FI is wholly owned by Fisher Investments, Inc. Since Inception, Fisher Investments, Inc. has been 100% Fisher-family and employee owned, currently Fisher Investments Inc. beneficially owns 100% of Fisher investments (FI), as listed in Schedule A to FI's form ADV Part 1. Ken Fisher beneficially owns more than 75% of Fisher Investments, Inc. as noted in Schedule B to FI's Form ADV Part 1.

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.

The foregoing information constitutes the general views of Fisher Investments and should not be regarded as personalised investment advice or a reflection of the performance of Fisher Investments or its clients. Investing in financial markets involves the risk of loss and there is no guarantee that all or any capital invested will be repaid. Past performance is never a guarantee nor reliable indicator of future results. Other methods may produce different results, and the results for individual portfolios or different periods may vary depending on market conditions and the composition of a portfolio or index. The value of investments and the income from them will fluctuate with world financial markets and international currency exchange rates. If you have asked us to comment on a particular security then the information should not be considered a recommendation to purchase or sell the security for you or anyone else. We provide our general comments to you based on information we believe to be reliable. There can be no assurances that we will continue to hold this view; and we may change our views at any time based on new information, analysis or reconsideration. Some of the information we have produced for you may have been obtained from a third party source that is not affiliated with Fisher Investments. Fisher Investments requests that this information be used for your confidential and personal use.

This material may also be found posted on the Fisher Investments Europe web-site at www.fisherinvestmentseurope.com. If your firm wishes to be removed from receiving these materials in the future or wishes to pay for this material, please contact Fisher Investments Europe.