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SUMMARY

- Growth stocks have outperformed Value for 15 years.
- However, macro conditions potentially starting to favor Value, in our view.
- Relative price momentum change needed for confirmation.
- We will 'lean not leap' into any 'regime change.'

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Warming Up to a 'Value Rotation'

"Being too far ahead of your time is indistinguishable from being wrong" – Howard Marks, Oaktree Capital Management

One of investors' hardest tasks is navigating a 'regime change' – a profound change in the macroeconomic factors that drive relative outperformance of certain types of stocks or other assets. Successful navigation involves both accurate interpretation of economic data, as well as how the Fed's reactions to that data may impact earnings and valuation multiples. This layered nuance leaves ample room for error, in our view. Being 'early' in positioning for a potential regime change can be indistinguishable from being 'wrong'. Thus, we take a cautious, humble approach to identifying and adjusting for potential regime changes in Riverfront portfolios. Instead of 'leaping', we try to 'lean' into a burgeoning theme as we start to see both fundamental and technical confirmation.

Good Reasons for 15-year Outperformance by Growth Stocks

One example is the decades-long debate concerning when 'Value' stocks might start to structurally outperform 'Growth.' US large-cap Value (as defined by the S&P 500 Value Index) has significantly underperformed its Growth equivalent for 15 years, as shown by the chart below. We attribute this to two main factors. The first was subdued economic growth since 2008's Great Financial Crisis, which caused cyclical business models to struggle, and placed a greater premium on high growth business models, especially technology.

Chart 1: Value a Long-Term Loser vs. Growth

Rebased to 100 at start

Source: LSEG Datastream, RiverFront. Data weekly as of September 5, 2024. Chart right shown for illustrative purposes only. Past performance is no indication of future results.

More recently, sharply rising interest rates since 2021 placed pressure on Value and cyclical balance sheets, which tend to have higher levels of debt and shorter maturities.

Regime Shift Alert: Macro Backdrop May Start to Favor Value Stocks

It appears to us the macro environment may be in the early stages of a potential regime shift towards Value. Moderating inflation data and the Fed's increasingly dovish posturing both seem to be suggesting a shift away from a "higher for longer" mindset around interest rates. The key is whether the Fed has pulled off a 'soft landing' and avoided recession, or whether a downturn is just around the corner. Interest rate shifts impact the economy with a lag, and we do not yet know the full economic impact of the 5%+ Fed funds rate that has been in place for over a year now. We place a higher probability on a soft landing, because we believe the US economy is exhibiting low financial stress and economic indicators are resilient. We think the most likely outcome is a mildly 'reflationary' environment – one where inflation remains contained but does not quickly fall to the Fed's 2% target.

Although the combination of lower rates and moderate inflation would likely be a tailwind for all equities, we think it is one where Value stocks that have faced a headwind in the higher interest rate environment will thrive. Lower rates and moderately elevated inflation create steady nominal economic growth, which fuels sustainable revenue growth and enables refinancing for credit-sensitive companies, in our view. Thus, it is possible to foresee a potential rotation into 'Value'-oriented sectors and themes, such as energy, industrials, small-caps, and/or Japanese equities. It is worth noting that we do not expect prices of the 'Magnificent 7' tech companies to necessarily drop in this environment, but instead to cede leadership to relatively cheaper Value stocks over time.

Our assessment of Q2 earnings, discussed last week, is also consistent with a scenario of a Value rotation. While growth-heavy US large-cap continues to be the strongest segment for earnings, an improvement in more Value-oriented market segments is evident. As the Fed unveils its interest rate plans, we will continue to monitor the situation and adjust portfolio exposures accordingly.

Portfolio Conclusions: Still Favoring US Large Cap stocks; Starting to Lean into Value-oriented Themes

As Howard Marks stated so eloquently, to be early is indistininguisable from being wrong. Although we currently maintain our bias to Growth stocks, we have contemplated a Value rotation since at least 2020, recognizing that the market does not cleanly rotate from one state to another, and the migration has many unpredictable twists and turns. It is always tempting to try and "call the bottom" in asset classes, whether absolute or relative. Our preference is to continue to monitor the macro and earnings environment, and to slowly 'lean' into Value-oriented themes within our portfolios as we gain confirmation of a trend change. Looking at the relative strength picture in Chart 1 above, it is clear that such a conclusive long-term trend change has not yet taken place... but a nearer-term bottom may be forming.

Two of our key risk processes - proactive risk management and position sizing - should help temper any excessive enthusiasm around a Value rotation, nascent as it may be. We must remain disciplined, as any negative data points could start to point to an economic slowdown and quickly change the market narrative...as we experienced in early August. Our team's motto of 'Process Over Prediction' suggests healthy skepticism is warranted for any fundamental belief we may form, and having a risk team that looks impartially at our assumptions is critical to navigating potential regime shifts.

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Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

US large cap equities include equities of companies with a market capitalization of over $10 billion. Although large cap equities are generally considered to be safer securities, large cap equities are still subject to the risks associated with stocks.

Definitions:

Reflation is a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. The term may also be used to describe the first phase of economic recovery after a period of contraction.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

The energy sector is a category of stocks that relate to producing or supplying energy. The energy sector or industry includes companies involved in the exploration and development of oil or gas reserves, oil and gas drilling, and refining. The energy industry also includes integrated power utility companies such as renewable energy and coal.

US Equities include stocks listed in the United States. Stocks represent partial ownership of a corporation. If the corporation does well, its value can increase, and investors can share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Small/mid-cap equities, MLPs, REITS and alternatives equities are types of US Equities and assume further risks described below.

Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

When referring to being “overweight” or “underweight” relative to a market or asset class, RiverFront is referring to our current portfolios’ weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios.

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