Value versus Quality:
Will the style reversal be sustained?

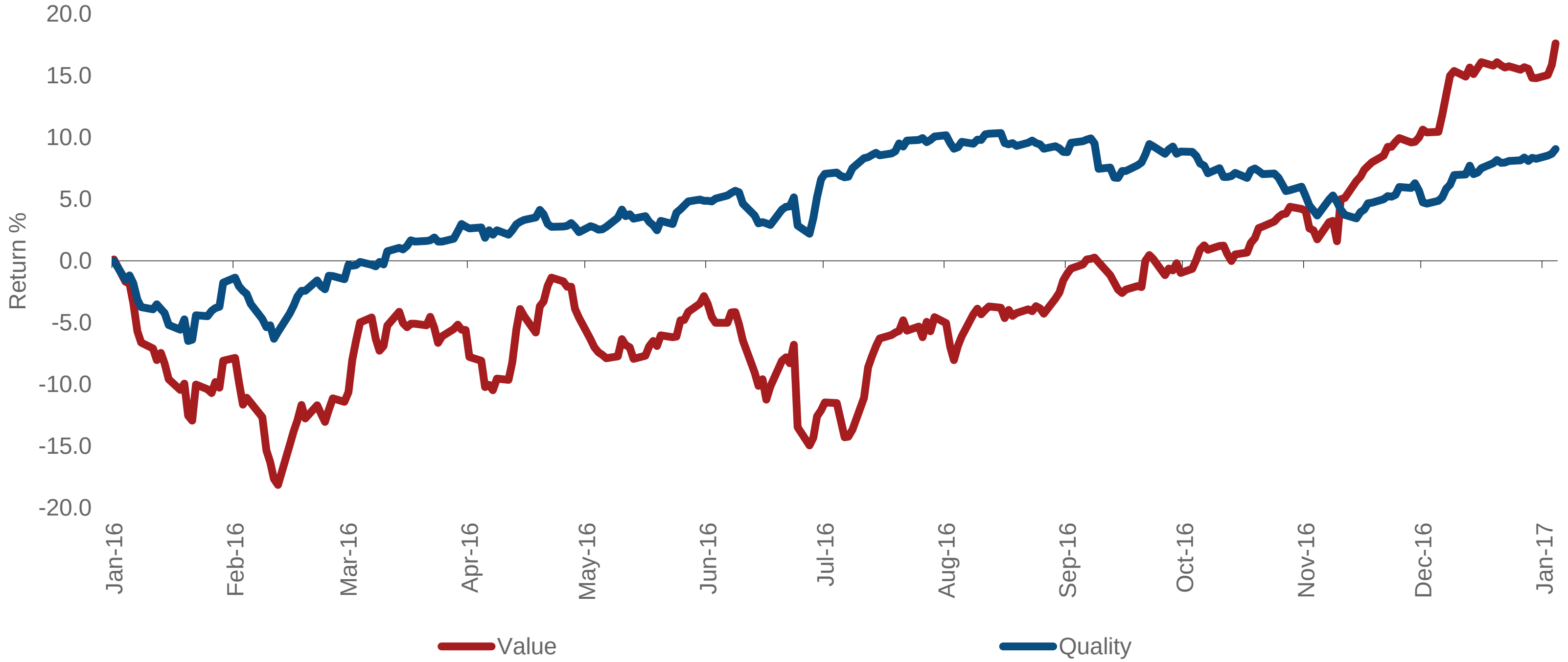
January 2017

Contents

The great value rotation

- A stand-out feature of global equity markets in the past few months has been a marked rotation away from expensive ‘quality’ stocks into cheaper ‘value’ stocks.
- As the chart shows, quality stocks strongly outperformed up to the middle of 2016. However, by November, value stocks had caught up and have since surged ahead strongly.

Global quality stocks versus value stocks in 2016

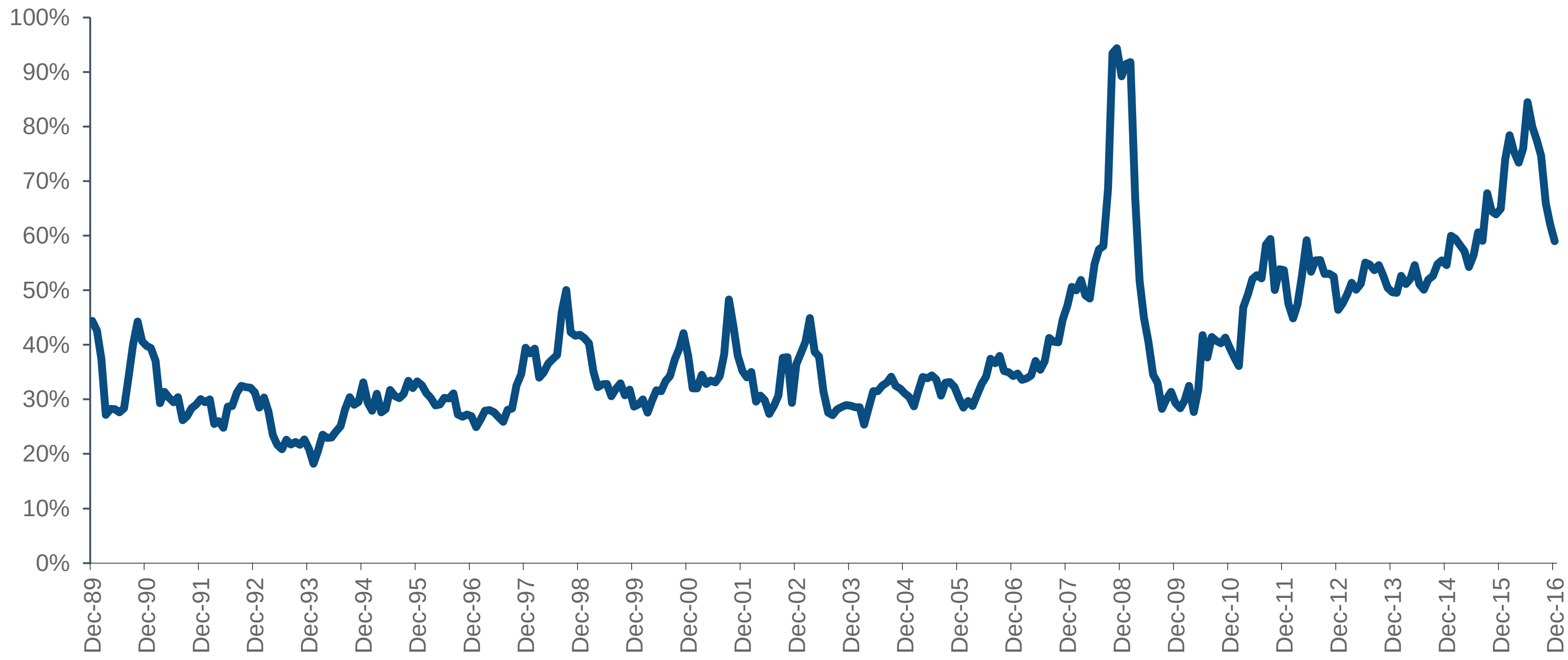


Source: Societe Generale Cross Asset Research, January 2017

Rotation drivers: valuation

- A key driver of the rotation was that quality stocks had become expensive and value stocks had become cheap by historical standards, setting the scene for mean reversion.
- The chart below illustrates how the average valuation premium of quality stocks in mid-2016 was approaching the extreme level of late 2007 before the financial crisis period – the sharp pro-value reversal since mid-2016 is also visible – and it may have further to go.

Global quality-to-value stock valuation premium

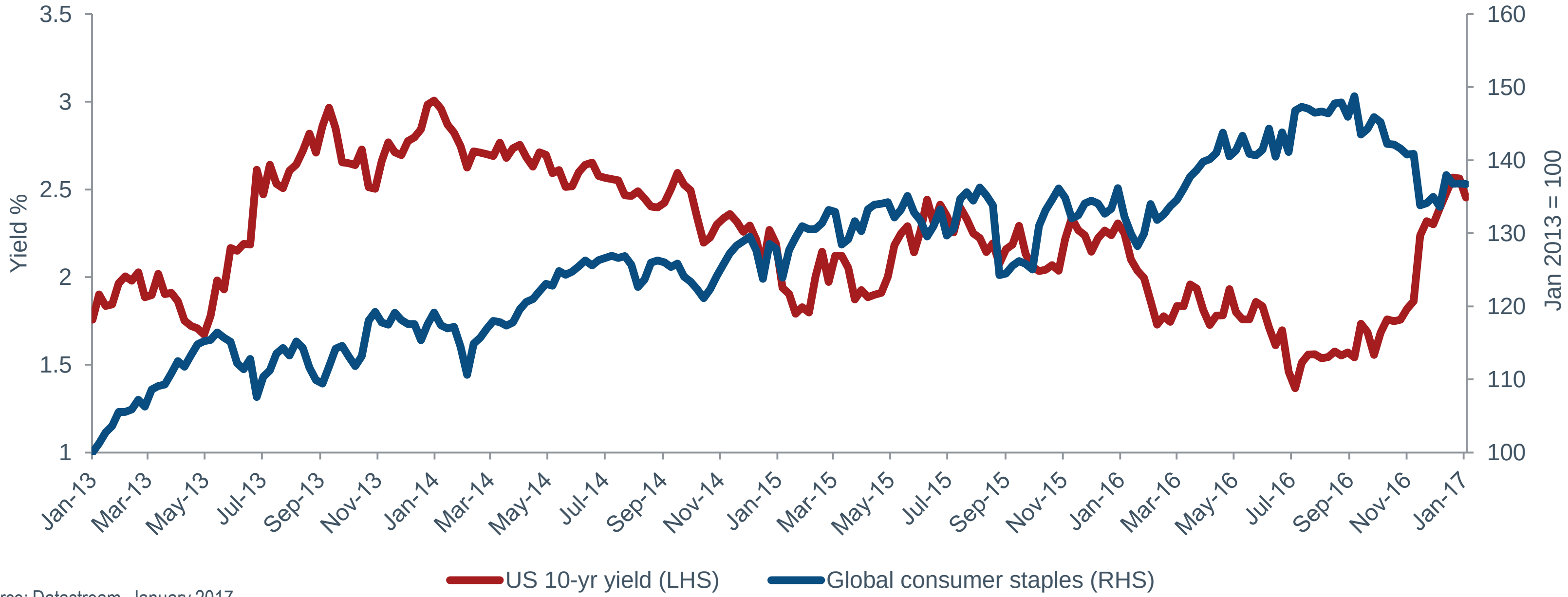


Source: Societe Generale Cross Asset Research, January 2017

Rotation drivers: bond yields and bond proxies

- In a low interest rate environment, the attraction of reliable income streams is magnified. This has meant heightened interest in 'bond proxies' – high-quality equities with low earnings volatility and solid dividend pay-out track records.
- The chart shows that the more bond yields fell, the more bond proxies (here approximated by global consumer staples) performed well.
- Crucially, the chart also shows that this trend began to reverse from mid-2016 as US bond yields rose.

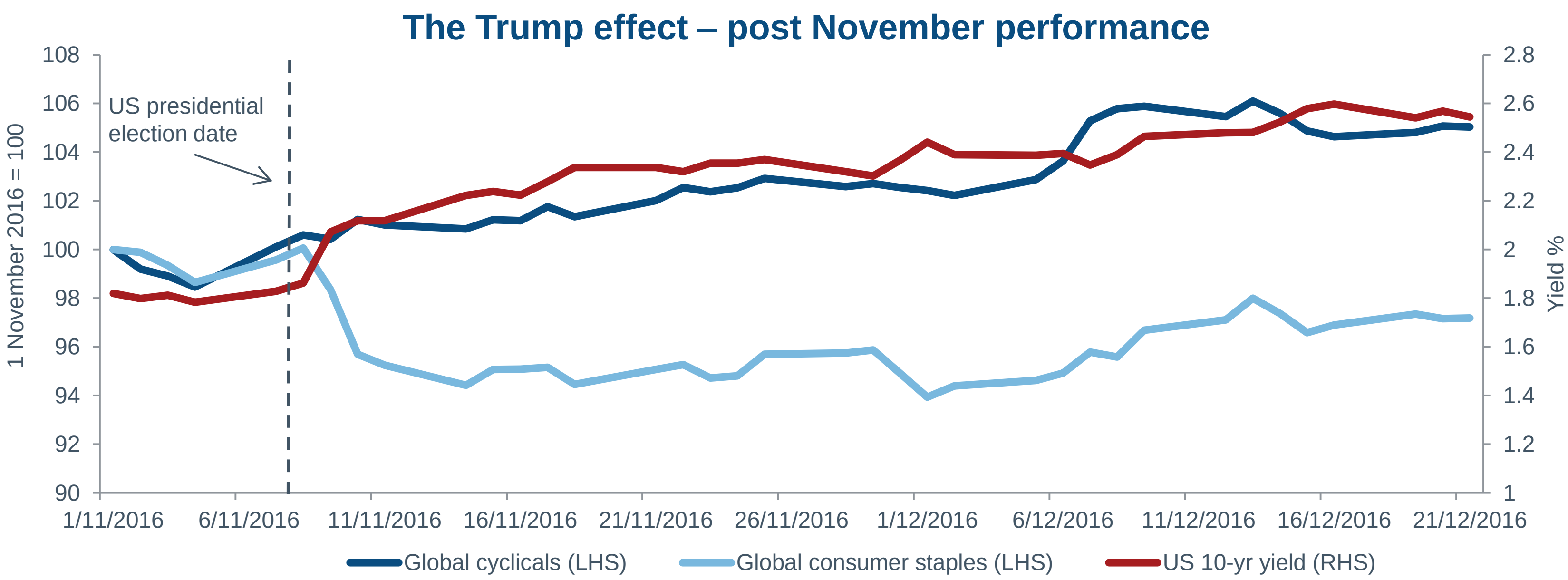
The bond proxy effect: US 10-yr yield versus global staples



Source: Datastream, January 2017

Rotation drivers: the Trump factor

- A key factor that has boosted and extended the value rotation was the surprise election victory of Donald Trump.
- Trump's strongly pro-growth and 'reflationary' policy agenda - which is focussed on increased fiscal spending - has led to a surge in global inflation expectations which in turn has pushed up global bond yields, led by US Treasuries.
- This has accelerated the underperformance of 'bond proxies' and supported the performance of global cyclicals, where an abundance of 'value' stocks can be found, particularly in the unloved financials and commodities sectors.

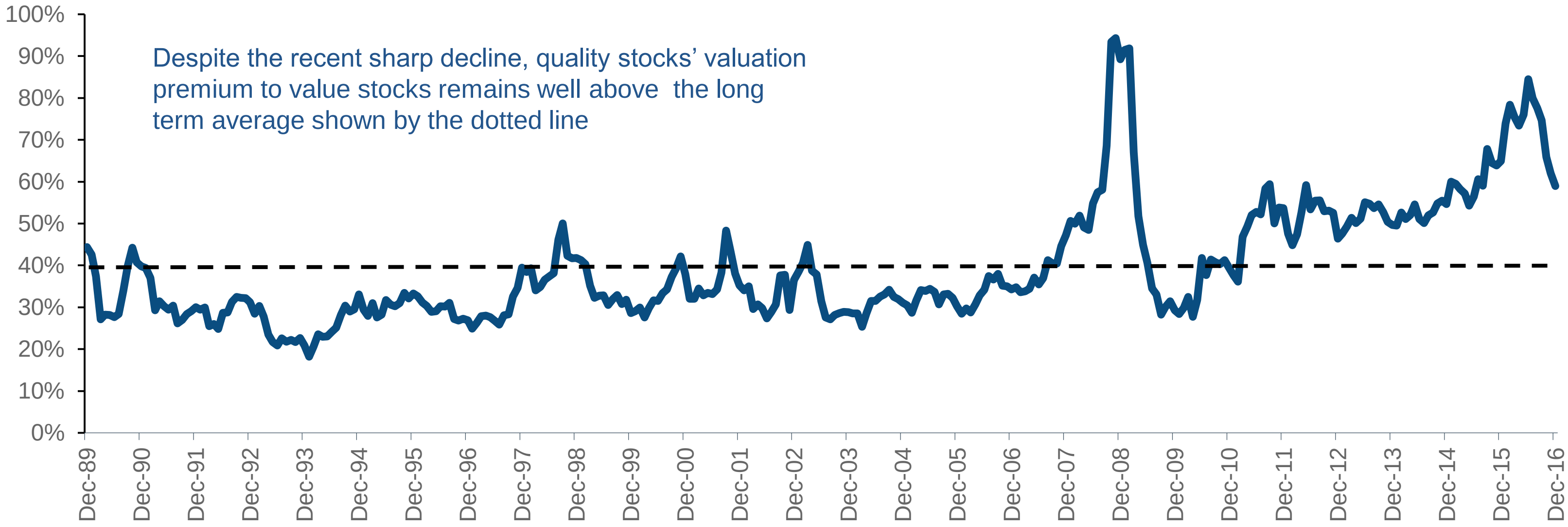


Source: Datastream, January 2017

Can the value rotation continue? The case for…

- The current global quality-to-value stock premium of 59% remains well above the long term average level of 39%*- this might suggest the reversal has further to go.
- The global reflation story, led by the policies of Donald Trump in the US, is still at an early stage and markets may be underestimating upside inflationary risks given that core inflation in many developed markets is already around the 2% level.
- A number of factors suggest that commodity prices (oil in particular) may have bottomed in 2016 and if they continue rising in 2017 this would fuel inflation further and lend more support to the value recovery in industrial cyclicals and financials.

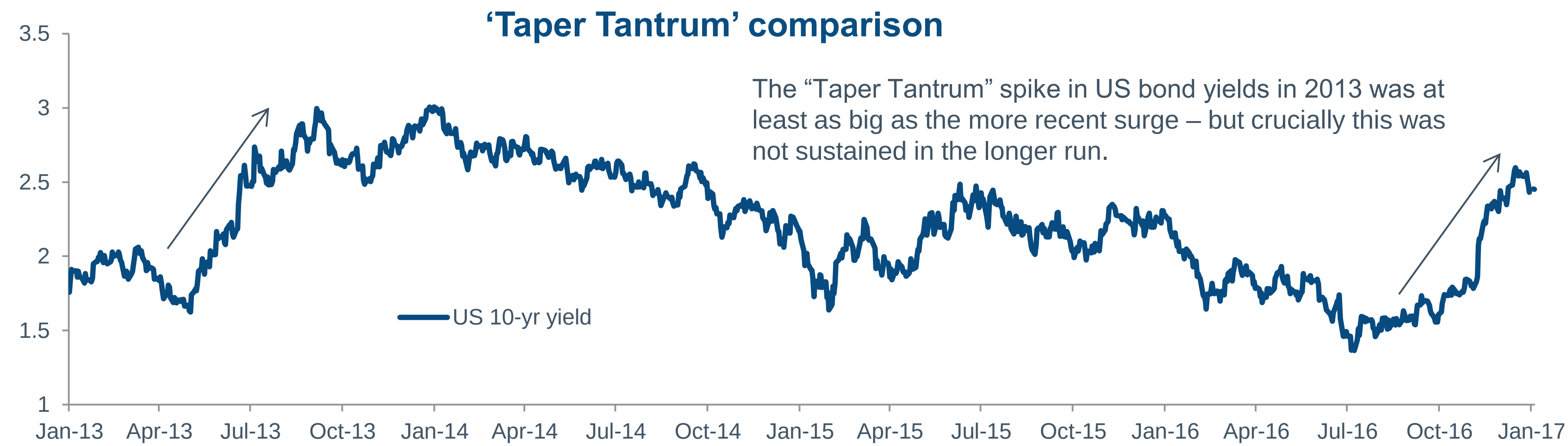
Global quality stock valuation premiums remain well above the long-term average



Source: Societe Generale Cross Asset Research, January 2017 * Long term average here refers to the average from 1990-2016

Can the value rotation continue? The case against…

- We need only look at how long the low-growth, low-rates landscape has lasted to make the case against. There is **no guarantee** that the value discount should correct to the average level if future economic conditions do not continue to justify such a move.
- The forces of **secular stagnation** – excess capital savings, high debt levels, and unfavourable demographics – are still significant, so there is a possibility we could revert back to the moribund low-growth stagnancy of the post-financial crisis period.
- In terms of global reflation, Trump, perhaps hampered by Congress, may not succeed in boosting US economic growth. It's possible that the pick-up in inflation expectations and US bond yields may prove to be a false dawn akin to the 'Taper Tantrum' of May 2013, as shown below, when yields spiked by a similar amount but only for a limited time.



Source: Datastream, January 2017

Investment implications

- It is an open question whether the sharp rally in the value investing style that we have seen in recent months might have further to run.
- We believe investors should take a diversified long-term approach that ensures they are adequately exposed to different style factors over time.
- Selectively buying formerly unloved but recovering value sectors, such as commodities and financials, may be one way of rectifying any under-exposure to value stocks in portfolios.

Alex Wright, Portfolio Manager, UK Equities

“Given the extreme starting point, it is certainly possible that the value rally we have seen in recent months could have further to go, particularly if inflation and growth expectations continue to find a new base. In this environment, investors would be wise to take a diversified approach that includes some ‘value’ sectors of the market.”

Dominic Rossi, CIO Equities

“The positive market reaction to the US election result reflects an improved view on economic and earnings growth. In fact, activity levels were already picking up and this was confirmed in the rotation from richly-priced ‘bond proxies’ into more attractively valued cyclicals – a trend that we expect to continue.”

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