Myth busters

Adrian Clayton, CIO

We test some of the dangerous hard-coded market narratives against the data and find them wanting – specifically the influence of interest rates and the usefulness of value vs growth investing styles at different points in the interest rate cycle. Along the way, we confirm the single factor that is actually effective in predicting outperformance or underperformance.

The market has a communal mind. Frequently a narrative, an idea or concept is latched onto by investors, hard coded and accepted as gospel. Presently, examples include:

1. The idea that higher interest rates will catalyse equity weakness;
2. Growth/quality has been a fad and it is time to pivot into value, which is a better long-term performance metric.
3. Then there is the thesis that value outperforms growth/quality when interest rates rise.

Being natural sceptics, we used a data-focused approach to test these potential "myths".

Stock markets rise as rates fall and fall as rates rise – myth or fact?

We analysed 10 hiking and 10 declining USD rate cycles dating back to the 1950's and our findings are as follows:

- There is an unexpectedly long lag and during the initial stages of a rising cycle generally, markets continue to head higher for at least a year, before performing poorly.
- The same lag, up to two years, exists when rates are cut.

Economies and markets have natural momentum, be it positive or negative, and this lasts longer than expected when interest rates are changed. Although broadly similar each cycle differs uniquely based on the relative levels of equity valuations.

So interest rates are negative for equity prices, BUT we emphasize that this is not always immediate and in the short-term (up to two years) equity prices often move in the opposite direction to what is expected.

Growth/Quality is a fad – pivot to Value – myth or fact?

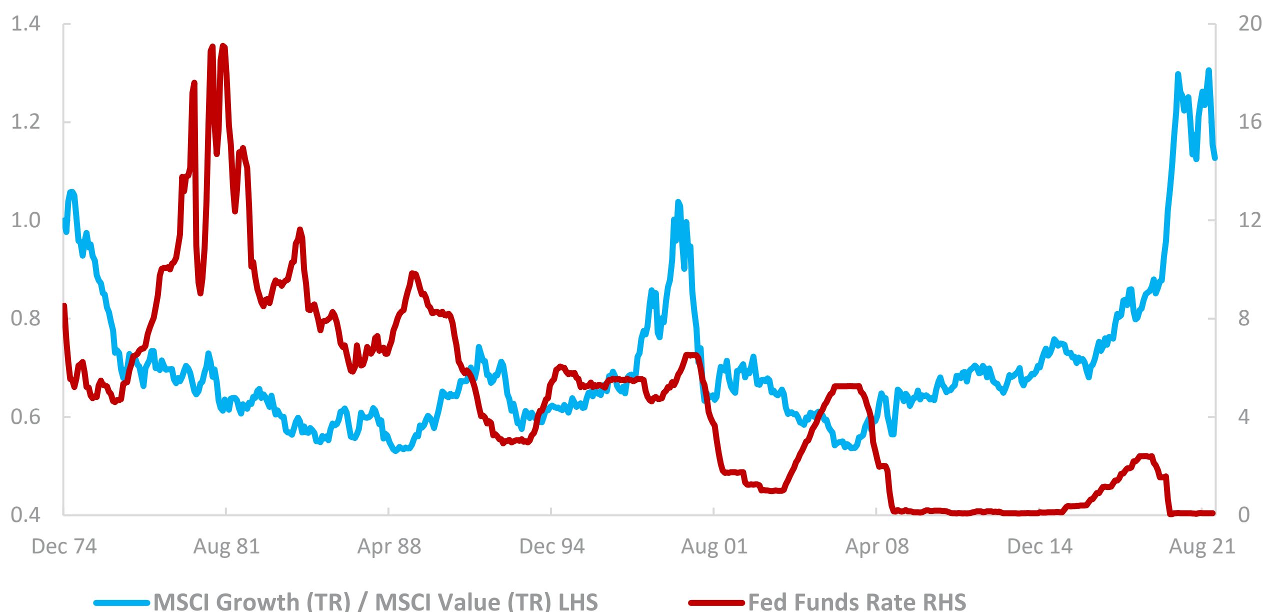
Chart 6 compares growth against value over the past 45 years. Growth outperforms when the blue line on the chart rises. We note four distinct periods, showing which style outperformed.

Period	Style outperformance
1974 to mid 1988	Value
Mid-1988 to early 2000	Growth
Early 2000 to mid-2007	Value
Mid-2007 to 2020	Growth

Out of interest, both styles pretty much returned the same quantum from December 1974 to February 2020. Both styles win when they start off cheap. Growth's well known outperformance from 2007 to 2020 created a buying opportunity for value. It is impossible to forecast the duration of the current value cycle, suffice to say that

historically once a style gains momentum it tends to last for a long time. Our point is that there is no quantitative evidence to point to one style being superior to the other.

Chart 6: Growth/Value vs Fed Funds Rate



Source: Source: Inet and Northstar

Value outperforms growth during rising interest rates cycles – myth or fact?
The theory behind front loaded cash flow being worth more to investors in a rising interest rate environment makes sense. We intuitively buy the concept that more mature companies that we view as value stocks should offer this.

In practice though, there is no conclusive evidence that value outperforms growth/quality companies during interest rate rising cycles. The definition of a rate cycle is key and we have focused our attention on the longer, more established US cycles stretching back to the early 1970's. With reference to our chart, we note four significant interest rising periods and indicate which style outperformed:

Interest Rising Period	Style outperformance
1977 to 1981	Massive increasing cycle Value
1986 to 1988	Growth
1993 to 2000	Growth
2004 to 2017	Value
2015 to 2019	Value outperformed for the first 15 months and then Growth accelerated and outperformend

It is evident that there appears no direct correlation between rising interest rate cycles and value outperforming.

In summary, our analysis leads us to the view that hard coded narratives are dangerous.
Although rising rates in the long-term are not great for markets and declining rates are market friendly, lags exist in the short term once interest rate cycles start to change.

One style is not necessarily better than the other. It is our contention that their relative pricing or valuation is key to initiating an outperforming or underperforming cycle. On this point, growth/quality became expensive in late 2020 and value was relatively cheap.

Finally, the view that higher rates always favour value stocks appears unfounded and we struggle to see proof of this in the numbers.

NORTHSTAR

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NORTHSTAR ASSET MANAGEMENT

Northstar Asset Management (Pty) Ltd
Registration No. 1996/001423/07 | FSP number 601
Suite 1A, Madison Place, Alphen Office Park, Constantia Road,
Constantia PostNet Suite #784, Private Bag X16, Constantia 7848
Tel +27 (0)21 810 8400 | Fax +27 (0)21 794 2885
info@northstar.co.za | www.northstar.co.za

SANLAM COLLECTIVE INVESTMENTS

Sanlam Collective Investments (RF) (Pty) Ltd
Registration No. 1967/002865/07
2 Strand Street Bellville, 7530 PO Box 30, Sanlamhof, Bellville, 7532
Tel +27 (0)21 916 1800 Fax +27 (0)21 947 8224
service@sci.sanlam.com, www.sanlaminvestments.com
Please refer to our website for directors & company secretary details

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