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Economic & Market Update

The Great Rotation?

After dominating for most of the last 13 years, will growth stocks finally start to lag value stocks for an extended period?

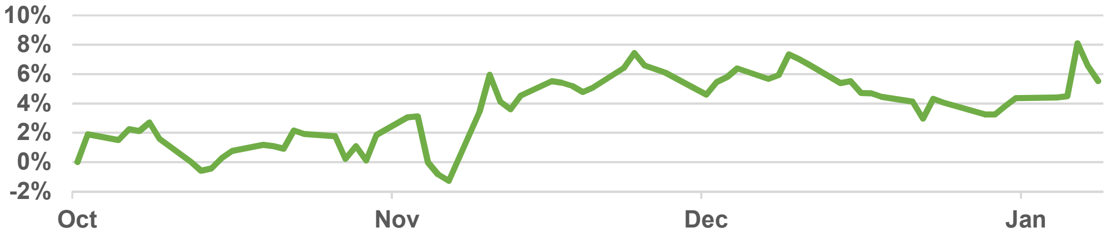
The last two and a half months of 2020 saw a potential changing of the guard in the markets. Growth stocks,[1] which captured much of the speculative fervor of 2020 and helped lead the indices higher, were outflanked by value stocks (**Chart 1**).

Reasons cited for this include some big-spending policy victories in the U.S. elections, the promise of more stimulus cheques for Americans, more Coronavirus-related bailout spending, a further telegraphing of low interest rates by the U.S. Federal Reserve (the Fed), a continuation of the Fed's substantial bond purchase program (the cash used to buy the bonds is essentially injected directly into the economy), and promising vaccines.

[1] Growth stocks compared to value stocks have a relatively high growth rate implied by their current price. With price as the numerator, growth stocks are characterized by high valuation ratios (Price/Earnings, Price/Sales, Price/Cash Flow & Price/Book Value).

Chart 1:

Relative performance of Value vs Growth Stocks in the U.S. since October 1st, 2020



Source: Bloomberg Finance L.P. as of 1/11/2021. The indices used are the S&P 500 Value Index (SVX) and the S&P 500 Growth Index (SGX). The full S&P 500 Index (SPX) is divided into value and growth using valuation metrics relative to price. In cases where a stock has both some value and growth attributes, it is proportionately divided between the two sub indeces depending on the relative strength of those attributes.

The expectation is that the economy could boom if all this cash and liquidity gets unleased once we break free of the reins of the pandemic. As a result, "cyclical" company stocks, which tend to flourish as the economy accelerates, have been getting more attention from investors. Often, cyclicals are established companies that can bide their time during slow periods because of balance sheets fortified with more cash and less debt than a typical growth company. They are ready to go at the first signs of an economic turnaround. And, if they are trading at a reasonable enough price, many investors would categorize them as value opportunities.

Value stocks might be the main beneficiaries during a quick rebound fueled by government spending and effective vaccines.

In contrast, growth companies are often in a state of greater evolution that requires them to raise proportionately more capital to fund expansion. More capital equipment, more salaries, and acquiring other companies are common features of a growth strategy and all need to be paid for. Since these kinds of companies are not at a stage where they are producing enough free cash flow to finance all these ambitions, they need to borrow from banks, raise money through bonds, find a few "white knight" investors, issue shares, or refrain from paying dividends. Tesla is a prime example, albeit a somewhat extreme one, of this of type of company.

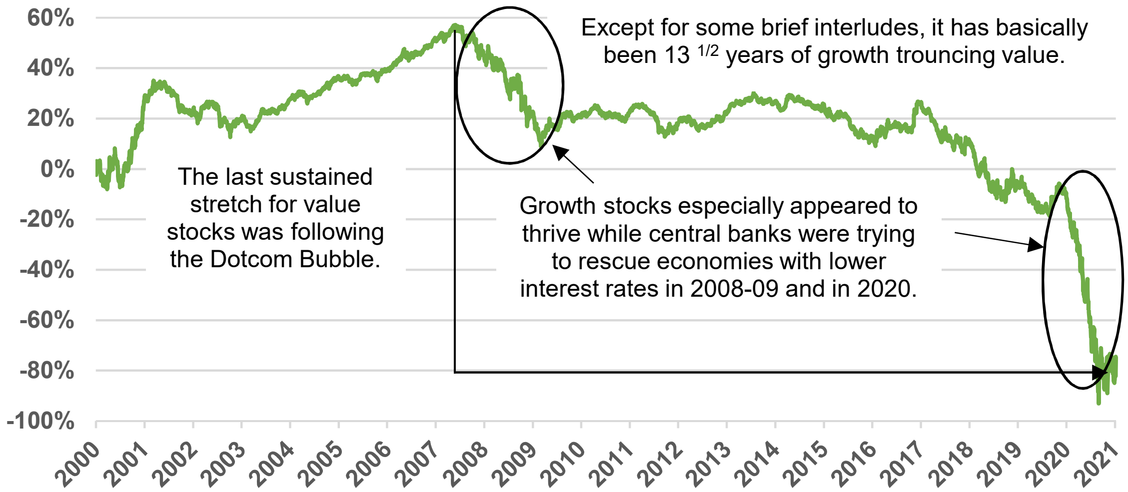
Value stocks tend to be more in tune with economic cycles and often have excess capacity that can be put to work in a recovery.

Growth stocks tend not to have excess capacity as such a characteristic would risk slower growth.

Also, to clarify, growth companies will also do better as the economy accelerates. But they have less "operating leverage" than cyclical companies do on average.[2] A cyclical value stock might have excess manufacturing capacity which provides the dry powder to take advantage of recovery's early stage, enabling their revenue to spike at a faster rate compared to a growth company.

[2] Operating leverage refers to the ability to utilize machinery and people that are already in place to magnify potential profits if revenues rise. Financial leverage refers to the ability to utilize debt to magnify the longer-term net earnings growth profile of a company that has yet to mature.

Chart 2:
Relative performance of U.S. Value Stocks vs U.S. Growth Stocks Since January 1st, 2000



Source: Bloomberg Finance L.P. as of 1/11/2021. The indices used are the S&P 500 Value Index (SVX) and the S&P 500 Growth Index (SGX). The full S&P 500 Index (SPX) is divided into value and growth using valuation metrics relative to price. In cases where a stock has both some value and growth attributes, it is proportionately divided between the two sub indeces depending on the relative strength of those attributes.

As a result, the recent rotation from growth to value may be the result of investors looking for companies that will experience the fastest jump in net earnings when the impact of the vaccine combines with continued significant government stimulus, continued low interest rates, and a continued expanding money supply.

One other aspect that could bolster a sustained rotation is the spectre of inflation. As we have discussed in recent issues of *The Charter Group Monthly Letter*, the massive increase in government largess might lead to a few unattractive outcomes. If the least painful option is to print money, the risk is that the spending power of that money will decline. Will companies be able to increase prices without losing customers? Does a company produce a good or service that consumers "need" and will pay a higher price? Or, does a company produce something that is a "want" and which can be foregone or delayed without causing immediate problems for the consumer? Growth companies are often in newer sectors where their goods and services offer an improvement of life, not the basic needs of life. Therefore, they can be more vulnerable in a rising price environment.

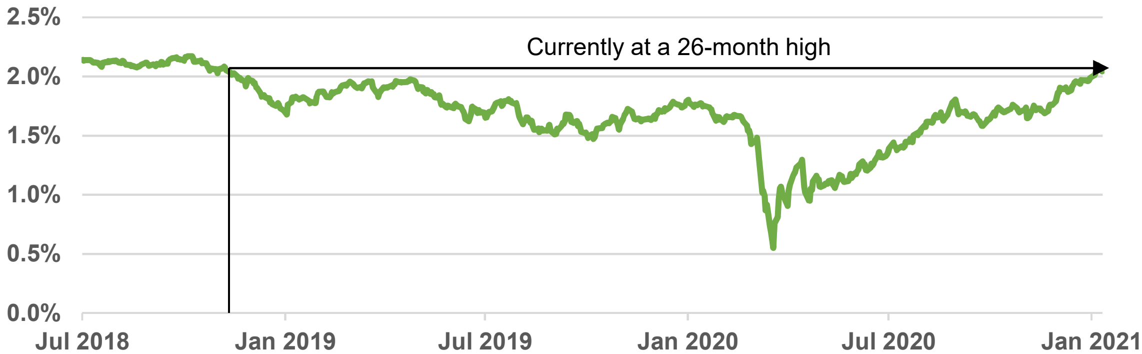
If the recovery is robust enough, it could lead to more inflation and higher interest rates. Historically, this raises the cost of capital, something that is more vital to a growth company than a value company.

The more serious impact of inflation however is that it raises the cost of capital. Lenders will demand higher interest rates. Investors participating in a new issue might demand a lower initial price in order to protect their potential return on investment. Some weaker growth companies that cannot afford this higher cost of capital won't survive a sustained inflationary period. Stronger ones may not have to worry about survival, but a higher cost of capital will challenge their forecasts and their promises of substantial earnings growth, which could put a damper on their current share prices.

Although inflation is relatively tame overall, its implied expected potential has reached a 26-month high (**Chart 3**).

Chart 3:

Breakeven Inflation Rate - US 10-Year Treasury Bond



Source: Bloomberg Finance L.P. and the Federal Reserve Bank of St. Louis as of 1/11/2021. The breakeven inflation rate represents a measure of expected inflation derived from 10-Year Treasury Constant Maturity Securities and 10-Year Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 10 years, on average.

So, are we in the early innings of a rotation out of growth stocks and into value stocks? Signs are pointing in that direction. However, there are a few scenarios that could delay the onset of the rotation. First, if we see an exceptionally stable recovery without much anxiety-inducing volatility in the investment markets, investors might be comfortable with further price-earnings multiple expansion and with minimal inflation-protection in portfolios. That could give growth stocks a further lift upward.

Positive investor psychology or negative interest rates might halt the rotation from growth to value.

However, the probability of those scenarios may not be great.

Second, if the U.S. Federal Reserve and the Bank of Canada push for a policy of negative interest rates, that could be enough catnip for investors to ride the growth stock train a little further. Although a negative interest rate policy invites a whole bunch of adverse consequences, one thing that it is good for is lowering the cost of capital for companies.

However, the probabilities for the scenarios required to extend the winning streak for growth stocks are dwindling. It is hard to gauge how confident investors are regarding the rotation, but we might be seeing the signs of some early repositioning just in case.

Model Portfolio Update[3]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	(1.0)
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	(2.5)
U.S. Bonds	6.0	2.5
Alternative Investments:		
Gold	8.0	None
Silver	1.0	1.0
Commodities & Agriculture	3.0	None
Cash	2.0	None

Changes were made to both the individual securities and the overall asset allocations in the model portfolios during December.

The asset allocations were tilted a little more towards the U.S. dollar on concern that the rally in the Canadian dollar has gone a little too far to justify.

The Canadian dollar might have difficult sustaining its lofty valuation versus the U.S. dollar because of the challenge of funding all the Coronavirus spending, and because the Canadian dollar has essentially surfed the negative sentiment among global traders with respect to the U.S. dollar. As a result, we trimmed the Canadian dollar exposure in the Balanced Portfolio by 3%, shifting 1% of the allocation in Canadian stocks into a silver bullion position as a hedge, and 2% of the allocation in Canadian bonds into U.S. bonds.

Hong Kong's politics have created too much economic cloudiness, so the position has been sold.

Political developments in Hong Kong have limited the ability to confidently assess the city's economic and corporate earnings growth going forward. As a result, we eliminated our exposure. That was replaced with small positions in a number of other international

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 1/11/2021. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

jurisdictions. U.K. exposure was added for the first time in three years as the post-Brexit era should provide more policy clarity. Also, it will be an incentive to focus more on the deficiencies of the U.K. economy rather having the luxury of relying on E.U. trade to lift the economy along. Sometimes operating unilaterally is a good form of disciple and may be enough to offset the trade losses as a result of separating from Europe.

U.K. exposure was re-added as there might be more policy clarity and more discipline when not being able to rely on trade with the E.U.

Exposure to New Zealand was initiated as "real" goods exporting countries look attractive at this stage of the cycle (increasing demand and potentially increasing prices). A similar rationale was behind initiating exposure to Qatar with its focus on national gas and Asia's willingness to pay a premium for it. Also, a cooling of diplomatic tensions between Qatar and other Arab Gulf states looks promising. (Qatar is the wealthiest country in the world measured in terms of per capita wealth, so does not fall into the category of "emerging markets", a category that I have ranted about over the years.)

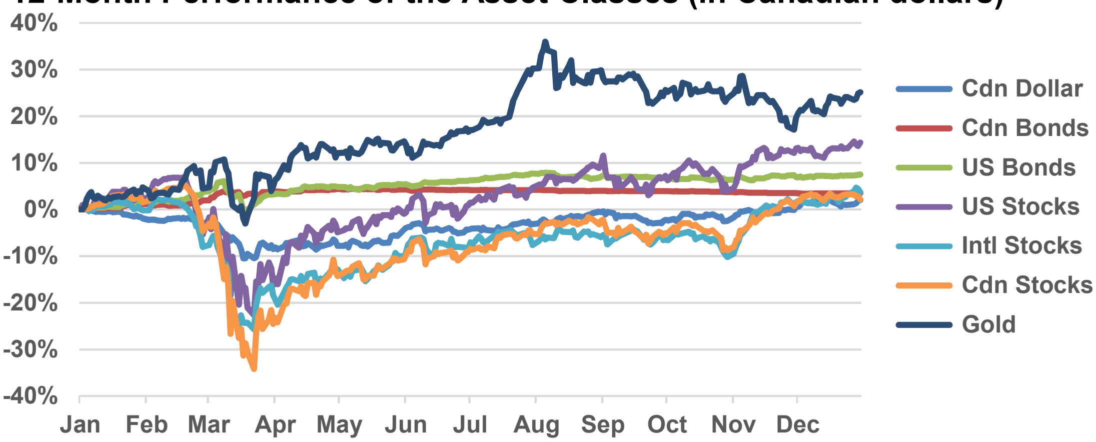
New Zealand and Qatar were added to the portfolio as commodity exports may be aided by increasing demand and prices.

Finally, a small position exposed to Taiwan was initiated because of where we are in the semiconductor cycle. Plus, although Taiwan is located in a geopolitical hotspot, that might be enough to garner greater international attention and focus because of the global importance of semiconductor manufacturing in our high-tech world.

Taiwan was added because of the importance of semiconductors and were we are in the semiconductor cycle.

Below is the 2020 performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 4**).[4]

Chart 4:
12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. from 1/1/2020 to 12/31/2020

[4] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[5]

Issue	Importance	Potential Impact
1. U.S. Fiscal & Monetary Stimulus	Significant	Positive
2. Coronavirus Geopolitics	Significant	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. Canadian Federal Economic Policy	Moderate	Negative
5. China's Economic Growth	Moderate	Negative
6. Short-term U.S. Interest Rates	Moderate	Positive
7. Canada's Economic Growth (Oil)	Moderate	Negative
8. Deglobalization	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Long-term U.S. Interest Rates	Light	Negative

[5] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of January 11, 2021.

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