LPL RESEARCH

WEEKLY MARKET COMMENTARY

IBG FINANCIAL ADVISORS

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TIME FOR VALUE TO SHINE?

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KEY TAKEAWAYS

After the longest run of outperformance of growth stocks ever, we think value may be poised for a comeback.

Value stocks may be supported by accelerating economic growth, attractive relative valuations, and the potential for improved financials sector performance.

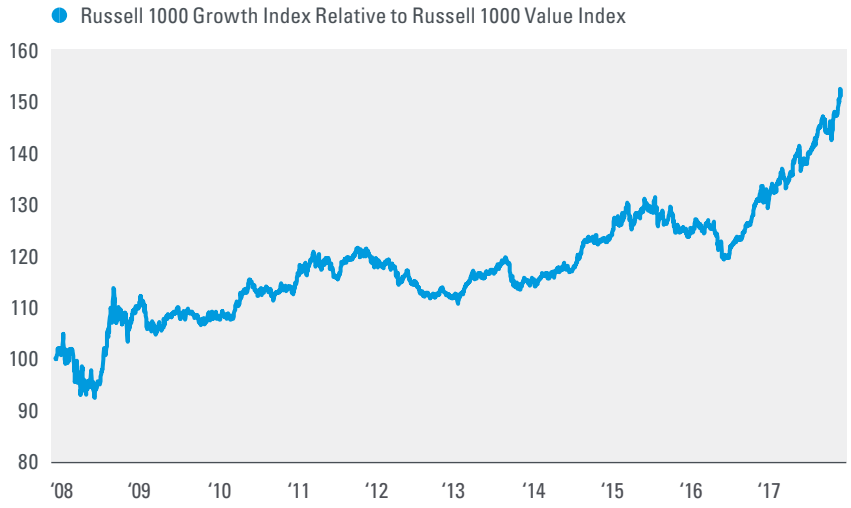
We expect modest value outperformance over the balance of the year.

When will value have its day in the sun? The growth style's historic run of outperformance has continued this year, despite the emergence of several drivers that have traditionally served as catalysts for value stock outperformance. Generally, value stocks benefit from an economic growth tailwind, whereas growth stocks tend to be more in favor when the growth potential they offer is scarce. Year to date, the Russell 1000 Growth Index has returned 9.5%, compared with just 0.5% for the Russell 1000 Value Index. Over the past 10 years, including the 2008–09 financial crisis, large cap growth stocks have outperformed value stocks by about 80 percentage points [Figure 1]. Based on the longest available data series*, the current growth stock rally is actually the longest ever. So as summer approaches, we ask: When will value finally have its day in the sun and start to shine?

WHAT'S WRONG WITH VALUE?

Accelerating economic growth has historically helped the value style, a condition that is in place today. Consensus forecasts for U.S. gross domestic product (GDP)

1 HOW MUCH LONGER CAN GROWTH DOMINANCE CONTINUE?



Source: LPL Research, FactSet 06/07/18

Data indexed to 100.

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reflect a solid rebound from 2.2% growth in the first quarter to over 3% in the second and third quarters. We forecast GDP growth for this year at near 3%, above last year's 2.2% and consistent with consensus. Yet, the growth style of investing has continued to lead the equity market higher.

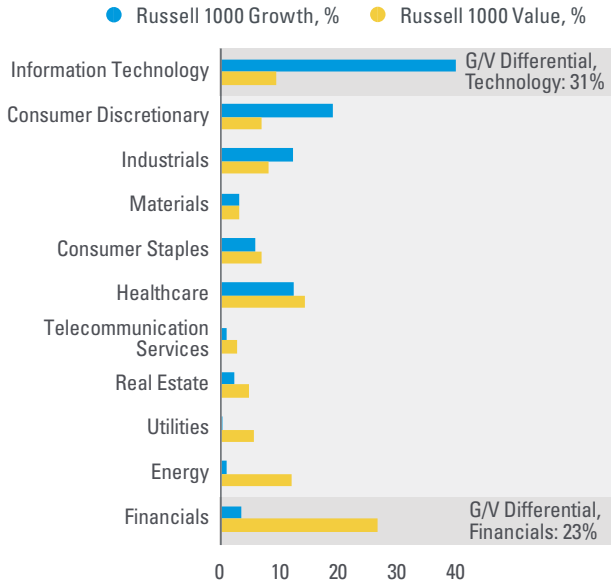
Accelerating earnings have also historically provided a tailwind for value that has not worked recently. Earnings growth accelerated over the past two quarters even when the benefit of the tax cut is excluded from the profit calculation. Though second-quarter earnings growth may slow from the previous quarter's pace, we do not expect much deceleration. Consensus estimates reflect strong double-digit increases for the next three quarters, at or near 20%.

Accelerating economic and profit growth does not always lead to value outperformance. The late 1990s were a glaring exception when growth stocks significantly outperformed on technology's strength.

So what's wrong with value? A few things:

- **Interest rate sensitivity.** Higher interest rates have been a drag on the high dividend paying areas within the value style, including real estate, telecom, and utilities. Consumer staples, which have had a very difficult year, also tilt toward value. We are not big fans of these defensive income-oriented sectors. However, in a more volatile market environment, we would have expected a smaller performance gap relative to growth stocks.
- **Flattening yield curve.** Those higher interest rates would typically be expected to help the financials sector (the largest sector of value [Figure 2]), since it leads to higher returns on financial institutions' assets and more profitable loans. Although higher short-term interest rates have helped some financial companies, long-term interest rates (think 10-year Treasury) have not moved higher by nearly as much, flattening the yield curve. The shrinking gap between short-term rates (cost of funds) and longer-term rates (return on funds via loans) has been a drag on the financials sector, which has underperformed the overall market this year. Year to date, the S&P 500 Financials Index has returned just 1%, behind the 4.8% return for the S&P 500 Index. We continue to favor the sector based on our expectation that the yield curve will steepen, as longer-term interest rates rise, deregulation efforts persist, and profitability improves.
- **Technology strength.** The technology sector, which is the biggest growth sector by far, has had a tremendous year. Year to date, the S&P 500 Information Technology Index has returned over 14%, well ahead of the S&P 500. Market-beating gains in technology this year, and in recent years, have been supported by underlying earnings strength.

2 TECHNOLOGY AND FINANCIALS ARE KEYS TO GROWTH/VALUE (G/V) DECISION



Source: LPL Research, FactSet 06/08/18

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