

Value Versus Growth: Are Interest Rates Turning the Wheel?

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KEY TAKEAWAYS

- We believe changes in the 10-year Treasury yield are driving recent style rotations between value and growth stocks.
- Value stocks tend to outperform when rates rise, and underperform when rates fall.
- We believe investors should have a view on the 10-year Treasury yield when allocating between value and growth stocks.

Equity market leadership has been rotating between value and growth stocks since early 2016.

Value stocks underperformed growth for the first six months of 2016 but staged a strong comeback in the second half of the year, particularly after the US elections. So far in 2017, the trend has reversed again as investors have rewarded companies with strong future earnings growth potential and shunned relatively cheap value stocks. What's behind these style rotations?

The Driving Force: Interest Rates

We examined a number of macroeconomic factors that could be driving these style shifts, especially the relationship between value stocks and interest rates. We found the trajectory of the 10-year Treasury yield is a key to understanding current style preferences.

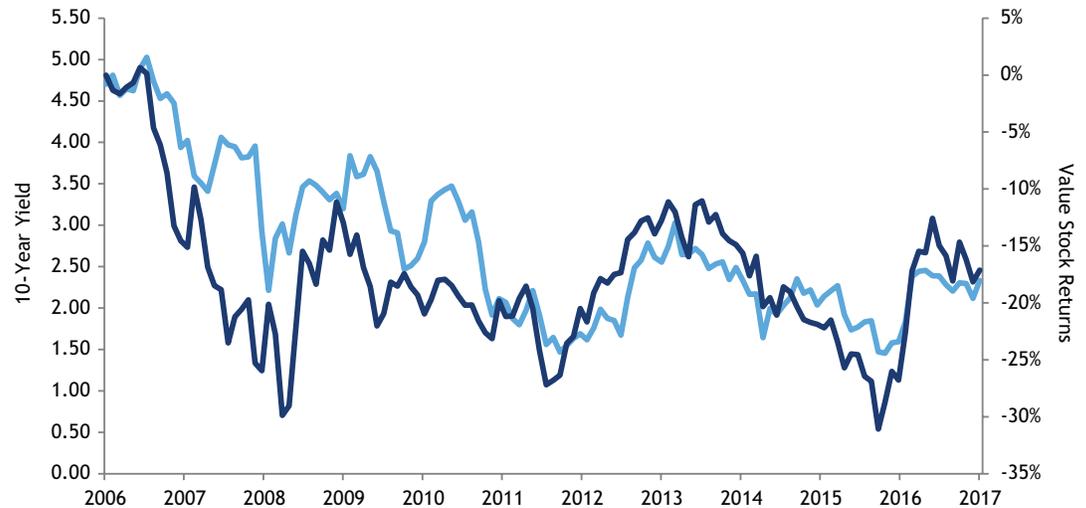
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Historically, there is a statistically significant positive relationship between the performance of value stocks and changes in the 10-year Treasury yield (see graphs below). In other words, value stocks usually outperform when long yields go up. Why? One explanation is that value stocks tend to have lower equity duration than growth stocks; therefore, value strategies typically outperform when rates rise. Another explanation is that value stocks tend to be pro-cyclical in nature and typically outperform growth stocks as the yield curve steepens.

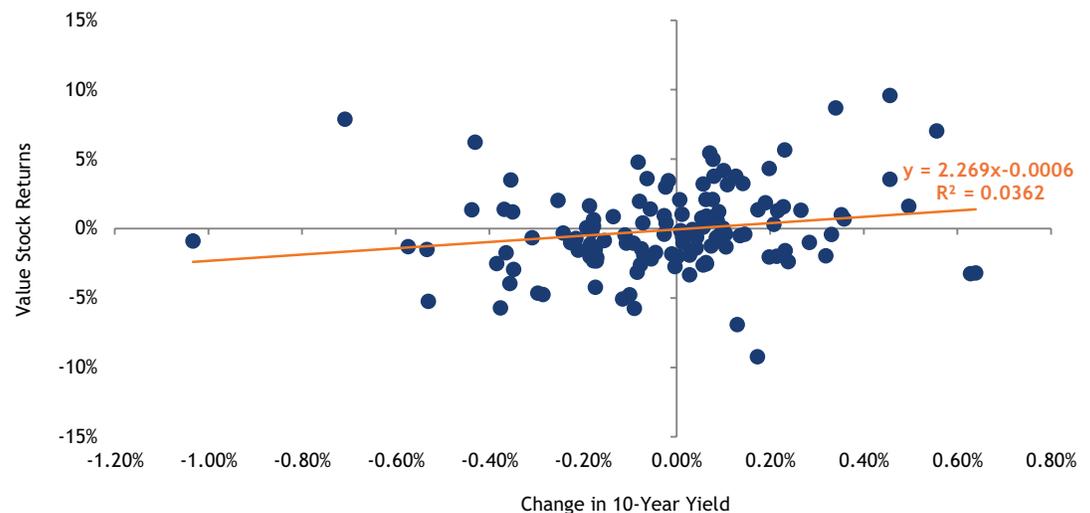
VALUE STOCK RETURNS VERSUS 10-YEAR YIELDS: LONG-TERM HISTORY
 Value stocks have tracked the 10-year Treasury yield over time.
 Source: Loomis Sayles, S&P Capital IQ and Bloomberg, data as of 9/30/2017.
 Past performance is no guarantee of future results.



— Value Stock Returns (RHS)
 — 10-Year Yield (LHS)

Note: Value stock returns are defined as the return difference between the top and bottom 20% of stocks in the S&P 500® Index, ranked using an equal-weighted composite of P/E, Forward P/E and P/B, rebalanced quarterly.

VALUE STOCK RETURNS VERSUS 10-YEAR YIELDS: LONG-TERM HISTORY
 Statistically significant positive relationship between value stock returns and change in 10-year yield.
 Source: Loomis Sayles, S&P Capital IQ and Bloomberg, data as of 9/30/2017.



T-stat: 2.18
R-squared: 4%
Correlation vs. 10-yr yield: 19%

Regression is done using monthly data from December 2006 to September 2017. See disclosures for definitions of T-stat, R-squared and correlation.



Interestingly, the relationship between value stock performance and 10-year Treasury yields has become stronger recently (see graphs below). After a sharp post-election run-up, rates have been on a downward trajectory and growth has significantly outperformed value. However, within this downward trend in rates, there were five brief mini rallies (see first graph on following page). During each of these rallies, value stocks sharply rebounded. Much of the current style rotation has been characterized as sector rotation (e.g., a technology sector meltdown, a financials rebound) but under the hood, the 10-year yield seems to be the driving factor.

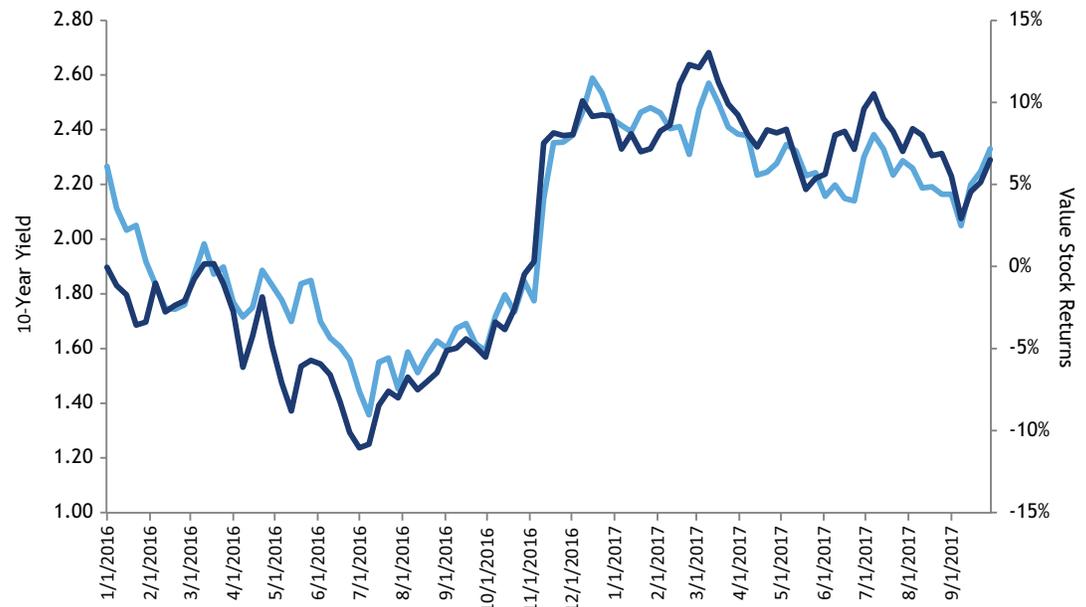
VALUE STOCK RETURNS VERSUS 10-YEAR YIELDS: RECENT HISTORY

Value stocks have been tracking the 10-year yield more closely since early 2016.

Source: Loomis Sayles, S&P Capital IQ and Bloomberg, data as of 9/30/2017.

Past performance is no guarantee of future results.

— Value Stock Returns (RHS)
— 10-Year Yield (LHS)



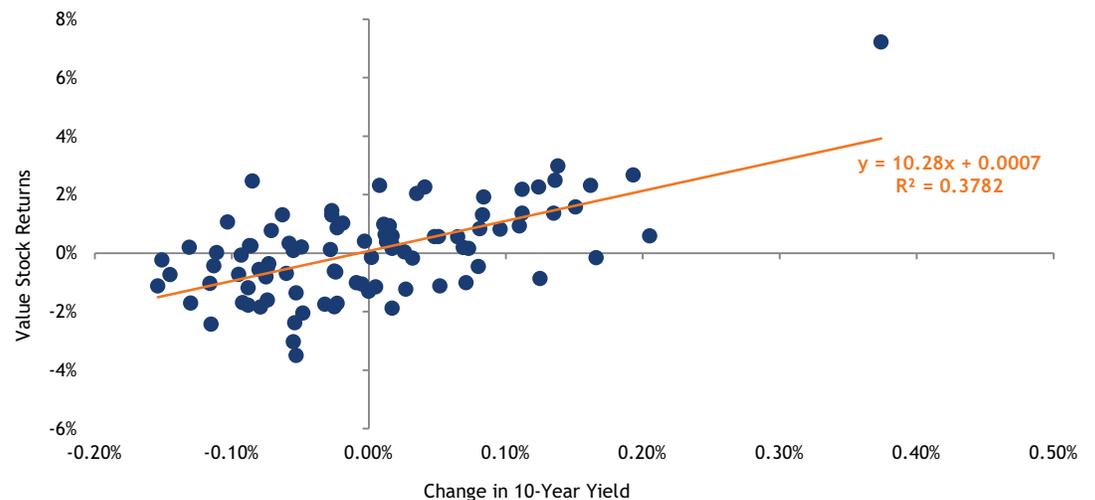
Note: Value stock returns are defined as the return difference between the top and bottom 20% of stocks in the S&P 500, ranked using an equal-weighted composite of P/E, Forward P/E and P/B, rebalanced quarterly.

VALUE STOCK RETURNS VERSUS 10-YEAR YIELDS: RECENT HISTORY

Relationship between value stock returns and change in 10-year yield has become stronger recently.

Source: Loomis Sayles, S&P Capital IQ and Bloomberg, data as of 9/30/2017.

T-stat: 7.36
R-squared: 38%
Correlation vs. 10-yr yield: 62%



Regression is done using weekly data from December 2015 to September 2017. See disclosures for definitions of T-stat, R-squared and correlation.



US 10-YEAR YIELD

The US 10-year yield has had five mini rallies this year, and during each of those rallies, value strategies outperformed.

Source: Loomis Sayles and Bloomberg, data as of 9/30/2017.

Past performance is no guarantee of future results.

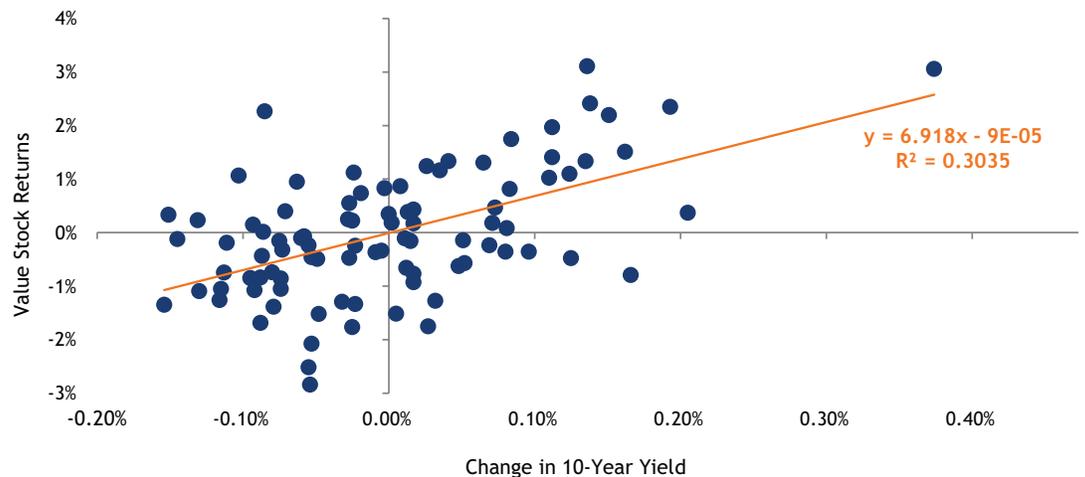


Could the rise in correlation between value and the 10-year yield be related to the overweighting of financials in the value segment and the strong link between financials and interest rates? The financial sector effect is important, but we do not think it explains the whole story since we still see a strong relationship between value and the 10-year yield even on a sector-neutral basis (see graph below).

SECTOR-NEUTRAL VALUE STOCK RETURNS VERSUS CHANGE IN 10-YEAR YIELD

Strong relationship between value stock returns and change in 10-year yield, even on a sector-neutral basis.

Source: Loomis Sayles, S&P Capital IQ and Bloomberg, data as of 9/30/2017.



T-stat: 6.23
R-squared: 30%
Correlation vs. 10-yr yield: 55%

Regression is done using weekly data from December 2015 to September 2017. See disclosures for definitions of T-stat, R-squared and correlation.

When Should Investors Consider Value Stocks?

Based on our analysis, we believe investors should have a view on the 10-year Treasury yield when making top-down allocation decisions between value and growth stocks. We believe value stocks need support from macroeconomic factors such as reflation, a rise in 10-year rates or an increase in risk appetite to drive a sustained rally. Without these supports, we would expect growth stocks to outperform value.

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Disclosure

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T-stat: Measures the significance of a statistical estimate. Usually a T-stat greater than two indicates statistical significance.

R-squared: A statistical measure of how closely the data fits the regression line. In the context of this paper, it represents the proportion of value stock returns that can be explained by movements in the 10-year Treasury yield.

Correlation: A statistical measure that shows how strongly two variables are related.