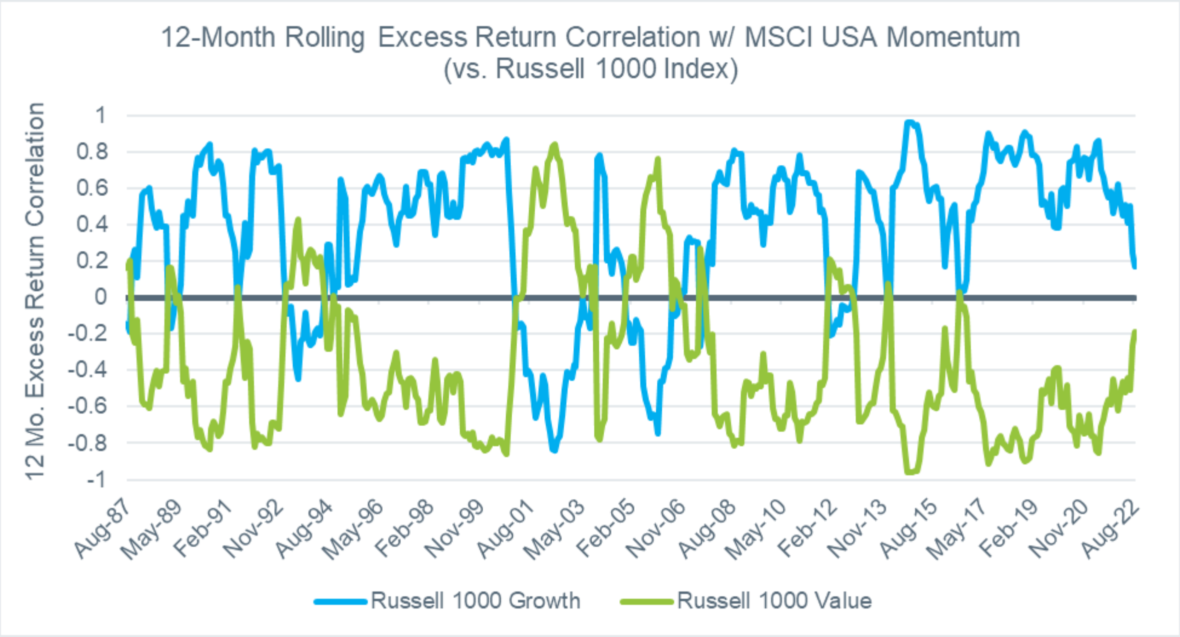
US Equity Trends - Momentum Shift

The correction among growth stocks in the US equity market has been swift. Investor sentiment has rapidly moved away from stocks with prices tied to above average long-term growth forecasts. This change has occurred in an environment characterized by rising interest rates, commodity price shocks, and an increasing probability of a global recession. At market inflection points, it is important to put current behavior into context. To provide this necessary context, three primary trends will be explored in this piece:

1. The historical correlation between momentum, growth, and value stocks.
2. The shifting holdings composition of stocks with higher momentum.
3. Current EPS growth and valuation estimates for growth and value stocks.

Definitions of momentum vary, but generally the momentum factor is used to identify stocks with above average trailing returns, normally measured over shorter-term periods, such as 3 months, 6 months, or 1 year. The momentum factor does not explicitly target a certain style, instead it will track better performing stocks whether they are growth or value oriented. However, the long-term data has shown that momentum is more heavily correlated with growth stocks. This association is normally explained by the tendency of investors to follow stocks with earnings growth trending higher. In addition, value stocks are commonly viewed as “anti-momentum” since they’re associated with recent price declines leading to a company being undervalued.

Figure 1: Momentum Correlations Shifting Toward Value Stocks

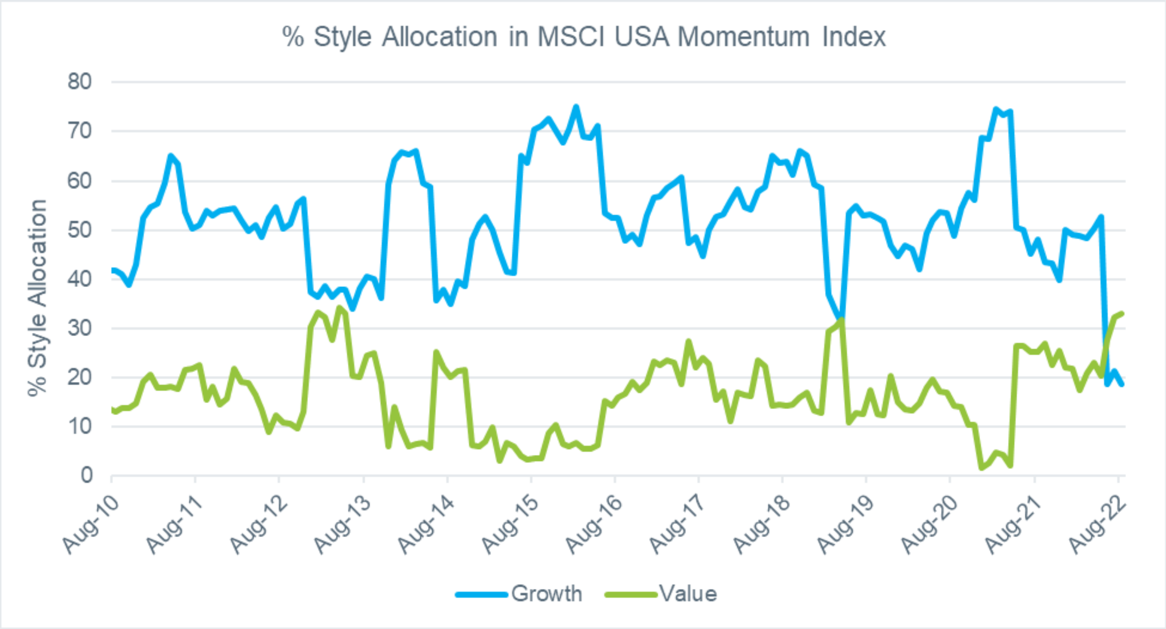


Source: FTSE Russell, MSCI. The MSCI USA Momentum Index used in this analysis emphasizes stocks with positive 6-month and/or 12-month momentum, excluding the most recent month of performance, adjusted for volatility and subject to liquidity and diversification guidelines. The index is rebalanced on a semi-annual basis.

As **Figure 1** displays, while momentum and growth are typically positively correlated more often, there are multiple instances where momentum and value have been positively correlated, normally around market corrections where investors revisit their expectations for the long-term growth prospects of their holdings. Over the most recent 12-month period, momentum and value stocks have become less negatively correlated, but are not yet positively correlated. It is important to note that there is a good deal of variation in the length of time during past periods of positive correlations between growth and value stocks.

Style allocations, based on the holdings of each index and Morningstar style definitions, paint a similar picture as the correlations data. **Figure 2** shows that for much of the past decade, growth stocks have populated the MSCI USA Momentum Index to a greater degree than value stocks. In recent months, value stocks have become more heavily weighted in the index. In contrast, the weight of growth stocks within the momentum index has plummeted from recent levels.

Figure 2: Momentum Index Holdings Increasingly Value Oriented

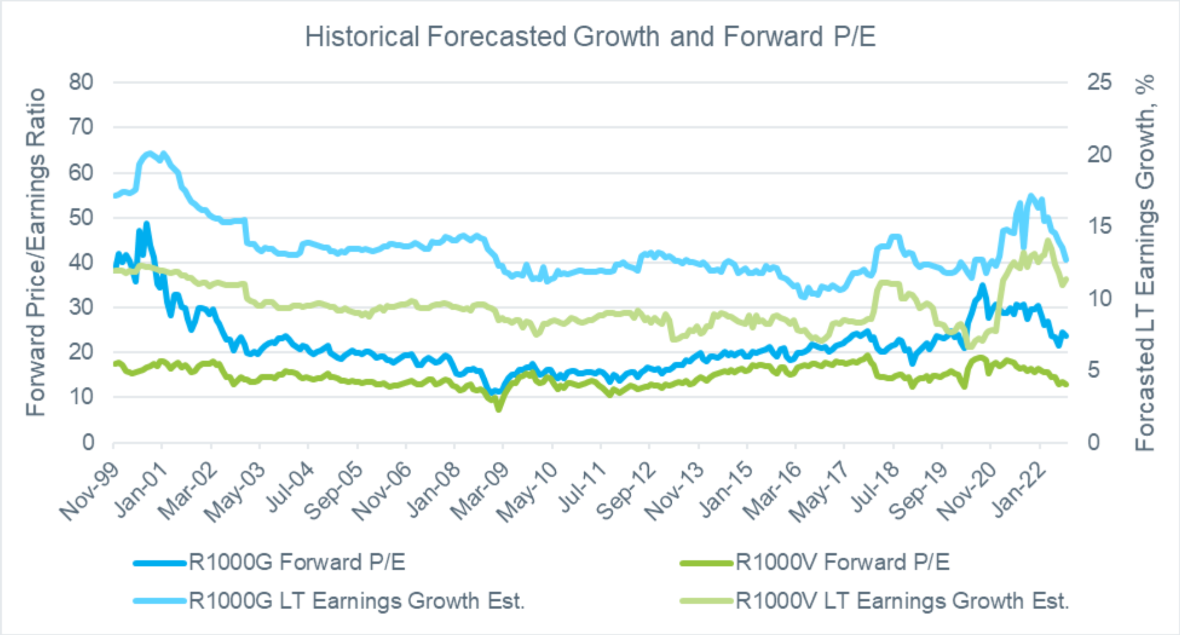


Source: : Morningstar Direct, MSCI, Standard & Poor's. Style allocations shown do not include the core style and will not round to 100%.

Fundamentally, there have been changes in the forecasted growth and valuation levels for growth and value stocks, as shown in **Figure 3** on the following page. Due to a higher representation of energy companies compared to the growth bucket, earnings growth forecasts for value stocks have benefited from rising commodity prices. Additionally, sectors that generally deliver lower, more stable earnings levels, such as REITs and Utilities, are more heavily represented in value indexes. These composition differences have contributed to value stocks closing the earnings gap with growth stocks to a considerable degree. However, the forecasted earnings growth of the Russell 1000 Growth Index continues to be higher than the Russell 1000 Value Index despite the contraction of valuation multiples in many key growth-related industries.

Relatedly, the forward P/E ratio of the Russell 1000 Growth Index has declined from recent peaks but remains elevated compared to the forward P/E of the Russell 1000 Value Index. At current levels, there have been arguments made by growth and value investors that their style should benefit from future market conditions. However, the sustainability of these forecasted earnings and valuation levels will only become more clear following further earnings seasons.

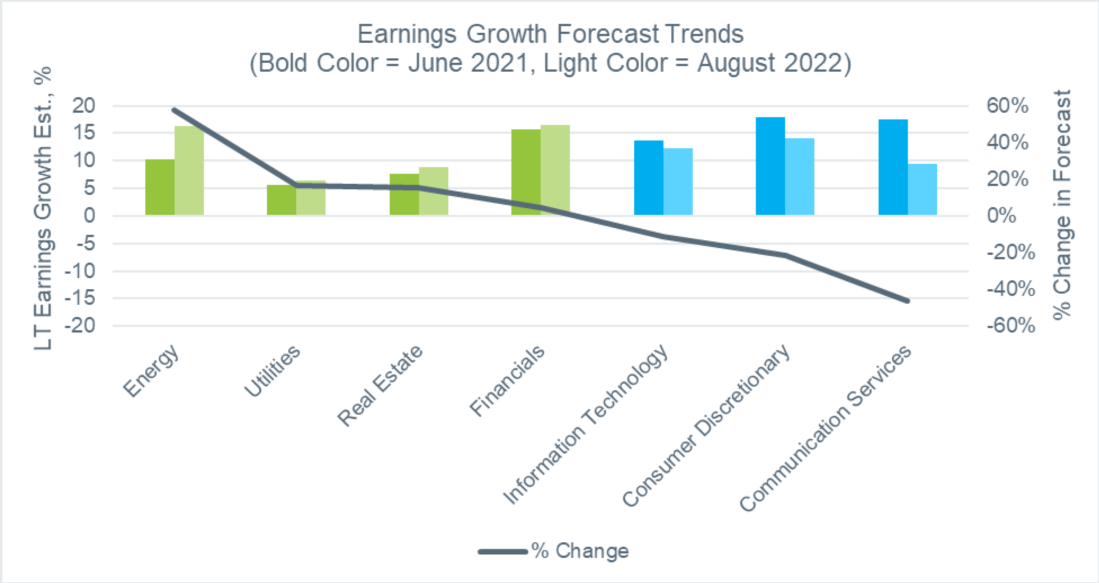
Figure 3: Current Earnings Growth Expectations and Valuations



Source: Morningstar Direct, FTSE Russell.

More specifically, the changes in earnings growth estimates for the broader style indexes have been driven by sector composition differences. **Figure 4** on the following page showcases the recent disparity in earnings growth forecast changes for sectors considered more growth leaning (in **blue**) versus those more value leaning (in **green**). The earnings growth forecasts from August 2022 have significantly changed compared to levels recorded in June 2021.

Figure 4: Earnings Growth Forecasts for Key Sectors



Source: : Morningstar Direct.

The timing of these momentum shifts is difficult to predict and can happen quickly. The recent inflection point has been significantly negative for most growth investors following an extended period of favorable conditions for the style. The information reviewed in this piece does not point to a straightforward decision for investors attempting to determine an optimal time to rebalance between growth and value stocks. However, these trends do point to relationships that tend to be cyclical, which can create opportunities for disciplined investors willing to make uncomfortable rebalancing decisions to align their portfolios with long-term strategic allocations.

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[1]Between July and October 2021, Coalition Greenwich conducted phone interviews with 811 individuals from 661 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, and endowments/foundations with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients that chose to participate in the survey. The results are not indicative of RVK's future performance. To read the Greenwich press release, please refer to the following URL: https://www.greenwich.com/institutional-investing/investment-consultants-strengthen-role-top-advisors-us-asset-owners.