Value Is Alive—But Far From Kicking

By Ken Fisher, October 15, 2020

Many pundits claim value stocks are long overdue for a comeback—and that this nascent bull market provides the long-awaited spark. Others disagree, contending Big Tech's dominance, the rise of private equity and indexing's popularity permanently killed value. Who is right? Neither. Value's time will come, but not soon. Here's why it isn't ready to shine—and how to recognize when the tide finally turns.

You know 2020's downturn struck lightning-quick—highly unusual. Most bear markets start stealthily, with gradual early declines masquerading as buying opportunities. Most investors fall prey, anticipating a quick rebound. "Buy the dips!" pundits crow. Later and lower, sharp drops whack everyone as panicky plunges implode prices. This bear market went off-script, hitting the panic button fast and hard—even with the economy on prior solid footing and corporate profits climbing. While stocks were at record highs, the euphoria that typically dooms bull markets never appeared.

Instead, government lockdowns aimed at slowing the coronavirus's spread forced stocks to price in economic implosion ultra-fast. World stocks plummeted to bear market territory in 20 trading days—record time.[i] Less than six weeks from its start, the -34% decline was over.[ii] By definition, the downturn was a bear market—a decline of at least -20% with a fundamental cause. But the sudden, panicky plunge acted more like a hugely oversized bull market correction.

The distinction may seem academic. It isn't. The bear market's correction-like features distorted the credit cycle that fuels value's usual early bull market strength. Consider: Typically, as expansions mature, central banks shift focus from fostering growth to corralling inflation. They raise short-term interest rates but inevitably overshoot. Short rates surpass long rates, inverting the yield curve. Banks profit by borrowing money at lower short-term rates and lending it at higher long-term rates, so an inverted yield curve saps their incentive to lend. Stocks know tightening credit squeezes growth, so they begin pre-pricing recession. A bear market starts drifting lower.

As the downturn wears on, small value firms suffer most. Their higher leverage and greater default risk make lenders leery—too much risk for too little reward. The drawn-out struggle is grueling. Prior to 2020, post-World War II US recessions averaged nearly a year—an eternity for cash-strapped businesses trying to survive.[iii] Shares plummet. Some firms fail. But eventually and inevitably, panic causes stocks to overshoot to the downside. Central banks reverse course, cutting short rates and steepening the yield curve. Markets anticipate wider credit spreads spurring lenders to warm to riskier firms. Relieved, battered small value stocks finally soar.

This time? While the US yield curve flirted with inversion in 2019, it wasn't because the Fed raised rates to quell inflation. Instead, long rates sank. But the tiny inversions didn't materially impact loan profitability much. Banks' huge cash stockpiles meant they didn't need to compete for customers, letting them keep deposit rates well below short rates. They could also borrow abroad more cheaply, if need be, and lend where long rates are higher. No big lending contraction came.

Instead, this time economic shutdowns triggered the bear market and economic implosion. Instead of a sustained beating, small value took a sharp but brief hit, falling -43.6% in less than two months.[iv] No long, brutal slog setting them up to zoom early in the bull market. From this year's March 23 low through October 7, global small value's 53.5% return lags global large-cap growth's 62.3%.[v] Central banks' massive quantitative easing programs don't help—they choke long rates, compressing the yield curve and preventing the credit boost value firms need.

Other factors conspire against value stocks today. Tight credit spreads also weigh on profits of banks and many other Financials—classic value plays. Moreover, the overhanging oil supply glut limits upside for the value-heavy Energy sector. Tight credit makes small oil and gas drillers particularly vulnerable —no shock that bankruptcies there are on the rise.[vi]

Rock-bottom short rates mean a credit boost won't come without strong inflation juicing long rates. That isn't likely—not anytime soon. Headlines shrieked about record-high money supply growth after the Fed's moves this winter, but for inflation to spike, that money needs to move. It isn't. Velocity—the rate at which money actually changes hands—has plummeted.

No big boost in velocity, no material inflation uptick. No inflation uptick, no boost to long rates—and no credit kick-start.

Pundits ignore these realities, instead saying value is "due" for a comeback. But leadership never changes because one style is "due"—just as one style doesn't "die" when out of favor. Leadership shifts when fundamental drivers impacting companies' outlooks change. Understanding that value stocks won't soar without a big credit boost gives you an advantage over those who see an imminent rebound—and those who think one will never come.

i Source: FactSet, as of 10/8/2020. MSCI World Index return with net dividends in USD breached -20% on 3/12/2020.

ii Source: FactSet, as of 10/8/2020. MSCI World Index return with net dividends in USD, 2/12/2020 – 3/23/2020.

iii Source: The National Bureau of Economic Research, as of 10/8/2020. Statement based on 11 recessions from 1946 – 2019.

iv Source: FactSet, as of 10/9/2020. MSCI World Small Cap Value Index return with net dividends in USD, 2/12/2020 – 3/23/2020.

v Source: FactSet, as of 10/8/2020. MSCI World Small Cap Value Index and MSCI World Large Cap Growth Index returns with net dividends in USD, 3/23/2020 – 10/7/2020.

vi "Bankruptcies Pile Up in North America Energy Sector in Third Quarter: Haynes and Boone," Staff, Reuters, 10/13/2020.

About the Author

Ken Fisher is the Founder, Executive Chairman and Co-Chief Investment Officer of Fisher Investments. His prestigious *Forbes* "Portfolio Strategy" column ran from 1984 through 2016, making Ken the longest continuously running columnist in the magazine's history. He has authored 11 books, including 4 *New York Times* bestsellers. Ken writes regular columns for more than a dozen countries worldwide.