

U.S. Equity

Growth vs Value Stocks

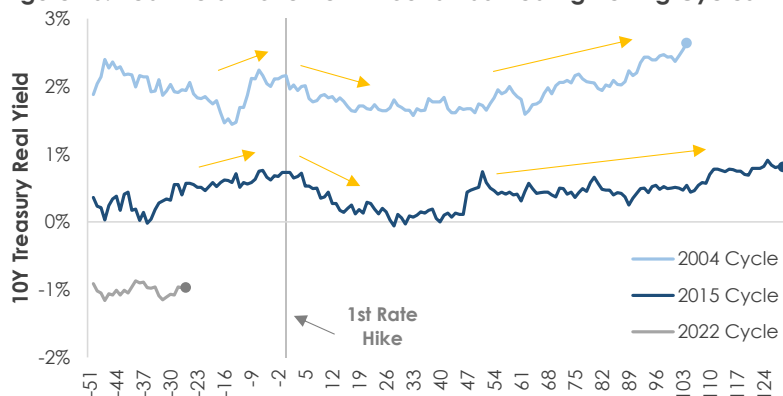
► **Double Downgrade Growth to UW; Upgrade Value to OW:** Growth vs Value positioning is extremely complicated right now. The answer lies with real yields. The big picture — lower real yields drive Growth outperformance, and vice versa. Why? In a world of negative real yields and low rates, investors are relying on Growth to generate positive inflation-adjusted returns. Figure 7 shows Growth's P/E multiple is well-above the average since 2016. Heading into 2022, the pressure on real yields is to the upside. Our ratings change is not a statement on Growth businesses, which are tied to secular trends and generate high returns on capital. Rather, the ratings change is a tactical, defensive move to position for rising real yields. The risk to this positioning change is real yields stay low due to low interest rates and/or high inflation. As of now, we would expect to switch back to Growth around mid-2022 once real yields normalize.

Figure 15: Value/Growth Performance Gap vs 10Y Treasury Real Yield



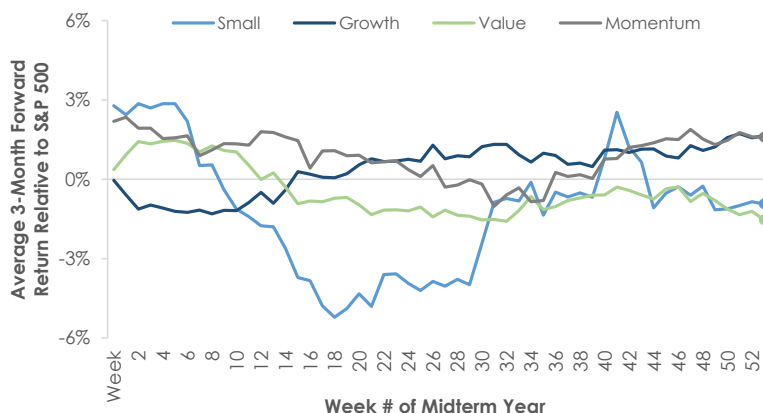
Source: MarketDesk, Federal Reserve. Note: Russell 1000 Growth and Value.

Figure 16: Real Yield Movement Around Past Fed Tightening Cycles



Source: MarketDesk. Note: 2022 line assumes the first rate hike occurs on 6/30/22.

Figure 17: Rolling 3-Month Forward Factor Returns During Midterm Years



Source: MarketDesk. Note: Returns represent average rolling 3-month forward price returns vs S&P 500. Data covers midterm election years since 1994.

Value/Growth Relative Performance Gap Tracks 10Y Treasury Real Yield ...

- Growth outperformed Value by +16.5% since June this year. The outperformance was noteworthy as inflation rose at the fastest pace since 1982. Historically rising inflation benefits Value and hurts Growth's high P/E multiple.
- How did Growth outperform? The answer: real yields. Since 2018, the 10Y Treasury real yield and Value/Growth performance gap have moved together. Value outperformed as real yields rose, and vice versa. The relationship was statistically strong with a 0.93 r-squared and 0.96 correlation between the two variables.

Real Yields Increased Ahead of the First 2004 & 2015 Rate Hikes; Upgrade Value to OW ...

- We upgraded Growth to OW in the 3Q21 AA Guide at the start of July and have remained OW during the past 6 months. Looking at Fig 15, our concern moving forward is real yields rise and Growth underperforms Value.
- Figure 16 charts the 10Y real yield during the 12 months before and 24 months after the first rate increase. The real yield rose heading into the first 2004 and 2015 rate increases, declined in the six months after, and ultimately ended near its highest level. If the Figure 15 relationship holds, history indicates Value will outperform during 1H22 and underperform during 2H22.

Mapping Factor Performance During Midterm Election Years ...

- Figure 17 expands on the Figure 5 in the 12/10/21 Strategy Snapshot. It graphs the rolling forward 3-month returns of various factors against the S&P 500 during midterm election years.
- Three key takeaways: (1) Value outperforms Growth midway into 2Q before underperforming the rest of the year, which further supports our Value upgrade headed into 2022. (2) Small Caps are seasonally strong 1Q, underperform during 2Q significantly, and slightly underperform into year-end. (3) Momentum outperforms in 1Q and 2Q, stumbles in 3Q as the elections approach, and outperforms into year-end.

Asset Allocation Views