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Growth versus Value: The Flip Flop

By Robert Zuccaro, CFA

Value stocks jumped to the fore in the stock market during the first two months of this year as the Russell 1000 Value ETF had outdistanced the Russell 1000 Growth ETF. Numerous observers, along with several brokerages, jumped on the value bandwagon and argued that value stocks would enjoy a long run after substantially underperforming growth stocks over the past 10 years. During 2010 to 2020, the Russell Growth ETF handily beat the Russell Value ETF with a cumulative return of 380%, compared to 166%.

Our commentary on April 20 of this year concluded, "Golden Eagle Strategies believes that the party is not over for growth stocks and that growth stocks would retake the lead in the market before the year is out." Since April 20th, growth stocks have seized the market lead, once again as the Russell Growth ETF has risen 6.6% vs 2.1%% for the Russell value ETF.

Why? First, the initial earnings estimate for the S&P 500 for the 3rd quarter was a gain of 63%, which now has been chopped to a gain of 37% according to Yardeni Research. Second, the spread of the Delta variant is slowing businesses around the world, which is negative for manufacturing, hotel, restaurant and lodging stocks, many of which reside in the value category. Third, the Bureau of Labor Statistics just released its price index for intermediate goods, showing a 23% year over year advance. Its finished goods index gained 10.5% year over year, which means that the cost of materials is rising faster than selling prices. Hence, profit margins are being squeezed, which is the reason for the dramatic downward revision in third quarter earnings.

FedEx (FDX) recently reported its latest fiscal quarter and badly missed estimates. The culprit was an unanticipated rise in labor costs of $450 million in the quarter, due to labor shortages which forced wages up. In turn, FedEx announced a price increase of 5.9% to be implemented on January 1st. DHL followed Fed Ex by announcing its plan to raise prices which matches the plan set forth earlier by FedEx. Undoubtedly, the upward thrust in operating costs will push many more companies to raise prices, in both the manufacturing and service sectors of the economy, for at least several more quarters.

Pressures in the way of rising labor costs combined with very high materials costs seem certain to limit the earnings progress of many value companies, whereas many growth companies in industries such as software and biotech are largely insulated from such pressures. Thus, the gap in profits growth between the two investment styles should widen in going forward. As mentioned, earnings for the S&P are estimated to rise 37% and then decline to 29% in the 4th quarter, again according to Yardeni Research. For the full year of 2022, earnings are expected to rise by 6%.

There is a new myth being bandied about in the media by Wall Street that rising interest rates are bad for growth stocks. This argument had been levied against the stock market for the past century before it recently morphed into an argument directed at the growth style. History tells us that this argument is without merit. During the 1970s, the rate of inflation reared its' head with the CPI jumping from 3.3% in 1972 to 12.5% in 1980 before turning down. According to the Wiesberger Fund Indexes, growth stocks increased in line with the general market whereas aggressive growth stocks outdistanced the S&P 500 return by 130% vs 64% over this eight-year period year.

The ongoing debate about which style will be more rewarding in coming years is like the rivalry between the Yankees and Red Sox. Since the turn of the century,

**net of all fees and expenses*

there is no question that the growth style has won out against the value style as evidenced by the Russell indices. The Russell 1000 Growth ETF has returned a cumulative 438% vs 320% for the Russell 1000 Value ETF from the end of 2000 through September 30, 2021. With the US economy heading into a normalized environment of single digit profits gains over the next few years, we expect growth stocks to hold on to their recently won dominance over value stocks.

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