BostonPartners

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Entry Points Alert | Charting the Correlation Between Inflation and Value

Transcript

Inflation, Rising Rates and the Return of the Value Cycle

Catalysts in Play: Marketwatchers for some time have been monitoring the inflationary backdrop to predict whether and when the Fed may adopt a more hawkish stance. As we near the end of the first quarter, it comes as no surprise that the Fed has indeed indicated it will be raising rates as early as March and begin selling bonds later this year. This shift in monetary policy adds a new dimension that should have widespread ramifications across the market and likely unseat many of the winners from the recent past.

Entry Points: The shift, of course, is not unprecedented. To get a sense how these new dynamics may influence equities, history can provide some color. While 10-year bond yields have largely maintained a downward trajectory for over 40 years, prior to this prolonged stretch, value equities steadily outperformed growth from 1954 to 1981. The same scenario, from approximately 2002 to 2007, again played out as a rising yield environment again coincided with value outperformance.

> **Multiple Compression:** As the cost of capital escalates, it becomes harder for investors to model growth out into the foreseeable future. A factor behind value's outperformance during inflationary periods and eras marked by rising rates is the multiple compression that occurs parallel to rising costs. Going back to 1950, price-to-earnings multiples were at their highest when inflation ranged from zero to 2%, but contracted by nearly four turns – from 18.6x to 15x earnings – whenever inflation exceeded 4%. This tendency is already evident as 10-year bond yields have increased amid growing inflation expectations.

> **Evolving Appetites:** Of course, some sectors tend to be more sensitive to rising rates and inflationary pressures. In particular, traditional growth industries such as technology and telecom have historically lagged areas of the economy associated with value, including financials, energy and industrials. As investors begin to discount future earnings, longer-duration equities tend to be more exposed as valuations are adjusted downward.

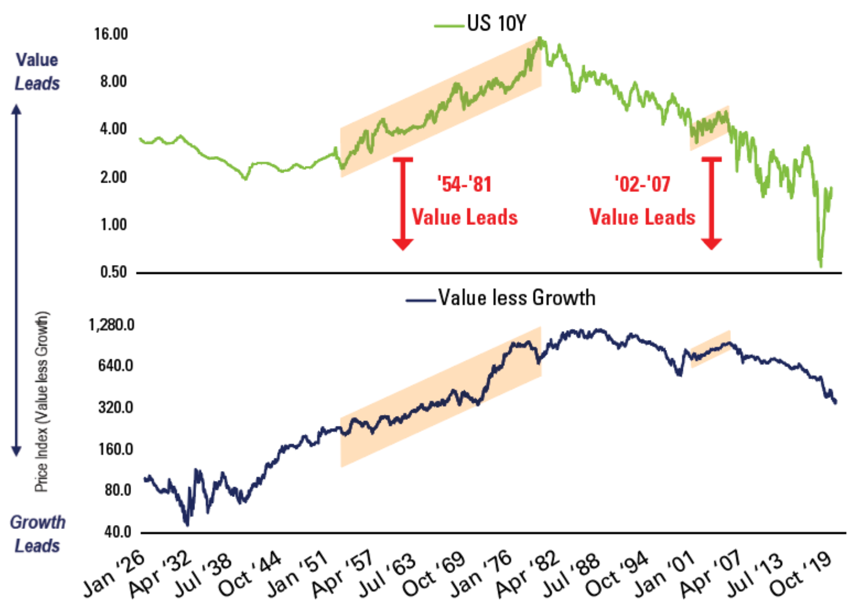
Active Strategy: As of March 2022, growth companies were trading at premiums ranging from 50% to 100% above historical median valuations dating back to 1982, based on capitalization and style. Value stocks, alternatively, were trading at a smaller 17% premium relative to history. Given that the inflationary cycle appears to be in the early innings, particularly as geopolitical tensions add new variables, Boston Partners active approach to value investing guided by an integrated investment process that can identify high-quality companies at attractive prices, while exhibiting positive business momentum – can deliver performance during periods of rising rates as well as across various economic and market environments.

John C. Forelli, CFA, Director of Portfolio Research:

00:00:01	Inflation is currently running north of seven percent. Current Fed funds rate is at zero and the Fed is still buying bonds in the open market. My name is John Forelli, director of portfolio research at Boston Partners. And today we'll talk about rising rates, inflation, and value investing.
00:00:16	It comes as no surprise that the Fed has indicated it will be raising rates beginning in March and selling bonds later this year, putting pressure on the longer end of the [yield] curve, with inflation expectations rising and real interest rates in negative territory, we believe it is reasonable to expect interest rates to rise in 2022. Many investors are asking, "what will happen to equities in a rising rate accelerating inflation environment?" Looking back at history, 10 year bond yields have been on a downward trajectory for over 40 years. During the 1954 to 1981 period, 10 year yields were moving up and value steadily outperformed. Also from 2002 to 2007, 10 year yields climbed and value consistently outperformed growth. Value's outperformance in a rising yield environment coincided with periods of price to earnings multiple compression in the market. Looking back to 1950, PE multiples have been highest during periods when inflation has been zero to two percent.

Value has Outperformed Growth in Rising Yield Environments

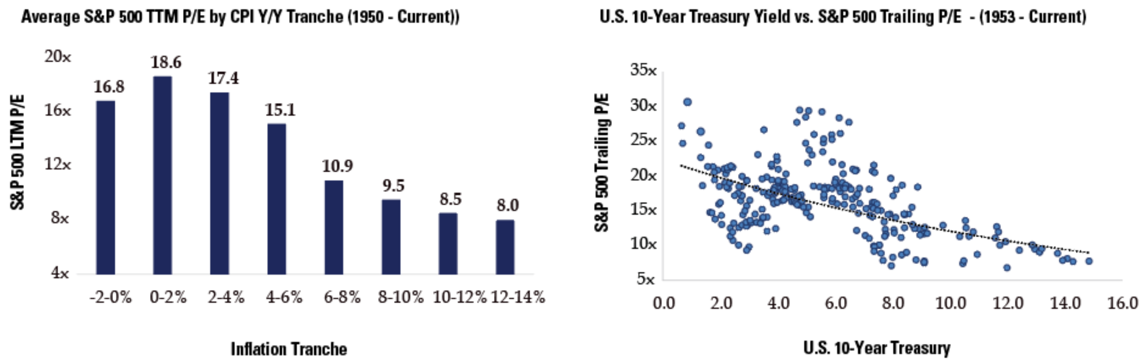
Comparison of U.S. 10-year yields and value vs. growth relative returns



Data as of January 6, 2022.
Source: Fundstrat, Bloomberg, FAMA until 1975.
Growth and value universes are defined by FAMA database prior to 1975 and Russell Indices thereafter.
Price index for Value vs. Growth is based on daily net return (value less growth)
since 1926. Past performance is not an indication of future results. Please refer to the end of the video for other important disclosures.

00:01:18	However, as inflation has exceeded four percent, PE multiples have contracted from eighteen point six times to about 15 times earnings. Similarly, we noticed a negative relationship with the 10 year bond yields and PE multiples. As yields have gone up, PE ratios have gone down, on average. We believe we are witnessing this phenomenon today, with PE multiples compressing as inflation expectations and 10 year bond yields have increased. During past periods of rising inflation, we have noticed that more economically sensitive value industries have outperformed at the expense of traditional growth industries. Financials, energy and industrials have assumed market leadership, while technology and telecommunications services have lagged.

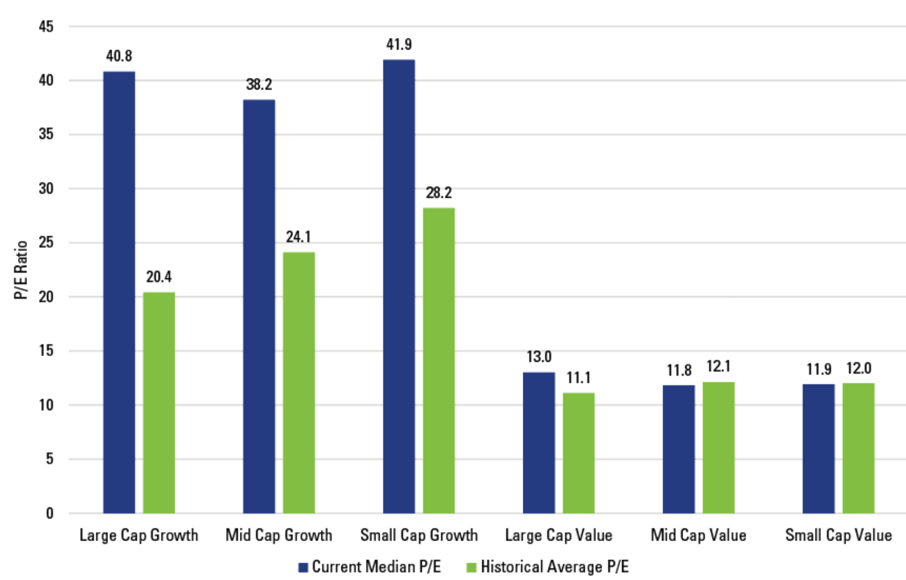
Rising Inflation and 10-Year Yields Historically Have Led to P/E Multiple Compression



Data as of December 31, 2021.
Source: Strategas.
TTM = trailing 12 months. Past performance is not an indication of future results. Please refer to the end of the video for other important disclosures.

00:02:02	As investors discount future earnings at higher rates, longer duration growth equities have had their valuations adjusted downward more than shorter duration value equities. Looking at the equity market today by capitalization and style, growth companies are trading at 50 to 100 percent premiums relative to historical median valuations dating back to 1982. Value companies are trading at modest discount to a 17 percent premium relative to history.

Value Looks Attractive Relative to Growth



Data as of December 31, 2021.
Source: The Leuthold Group.
Market caps and universes are defined by Leuthold.
Median Valuations: Largest 3,000 companies Large Cap > $39.1B; Mid Cap $5.8B - $39.1B; Small Cap $1.4B - $5.8B.
Historical average median P/E period is from January 1982 to December 2021. Past performance is not an indication of future results. Please refer to the end of the video for other important disclosures.

We believe it is reasonable to expect interest rates and inflation to rise during 2022, pressuring PE multiples. The extended valuations of growth stocks make them appear much more vulnerable to significant PE multiple compression compared to more reasonably priced value counterparts. We believe a genuine value based approach to investing should reward investors in 2022 and beyond.

John C. Forelli, CFA
Director of Portfolio Research

Mr. Forelli is the Director of Portfolio Research for Boston Partners. In this position, he directs our team of investment professionals in formulating, developing, and communicating the investment narrative for Boston Partners. Prior to this role, he was a senior portfolio analyst and has extensive experience with all of the firm's strategies. Mr. Forelli has 12 years of experience as a portfolio manager focused on large cap equities. He joined the firm from Independence Investments where he was large cap core portfolio manager, senior partner and member of the investment committee. Mr. Forelli was also a research analyst specializing in health care, chemical, capital goods and industrial companies. He began his career as an investment banker with Prudential Securities focusing on raising capital for emerging growth companies and merger and acquisition transactions. Mr. Forelli holds a B.A. degree in economics from Dartmouth College and an M.B.A. degree from the Tuck School of Business at Dartmouth College. He holds the Chartered Financial Analyst® designation and FINRA licenses 7 and 66. He has thirty-seven years of industry experience.

Disclosure

Definitions

Inflation: A decrease in the purchasing power of money, reflected in a general increase in the prices of goods and services in an economy.

Fed Funds Rate: The term federal funds rate refers to the target interest rate set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight. The FOMC, which is the policymaking body of the Federal Reserve System, meets eight times a year to set the target federal funds rate, which is part of its monetary policy. This is used to help promote economic growth.

Real Interest Rates: A real interest rate is an interest rate that has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender or to an investor. The real interest rate reflects the rate of time-preference for current goods over future goods.

Yield Curve: A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

Price to Earnings Multiple: The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

S&P 500® Index: The S&P 500® Index is a registered trademark of the McGraw-Hill Companies, Inc. and is an unmanaged Index of the common stocks of 500 widely held U.S. companies.

Consumer Price Index (CPI): The CPI is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

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