May 2022

Stability Over Cyclicals in Value's Next Inning

James Dorment, CFA

Co-Head of Large Cap Fundamental Research, Head of Value and Portfolio Manager

William Theriault, CFA

Senior Client Portfolio Manager

The prospect of rising real interest rates favors value versus growth stocks, while moderating economic growth and persistent inflation favor inexpensive stability value names over well-priced cyclicals.

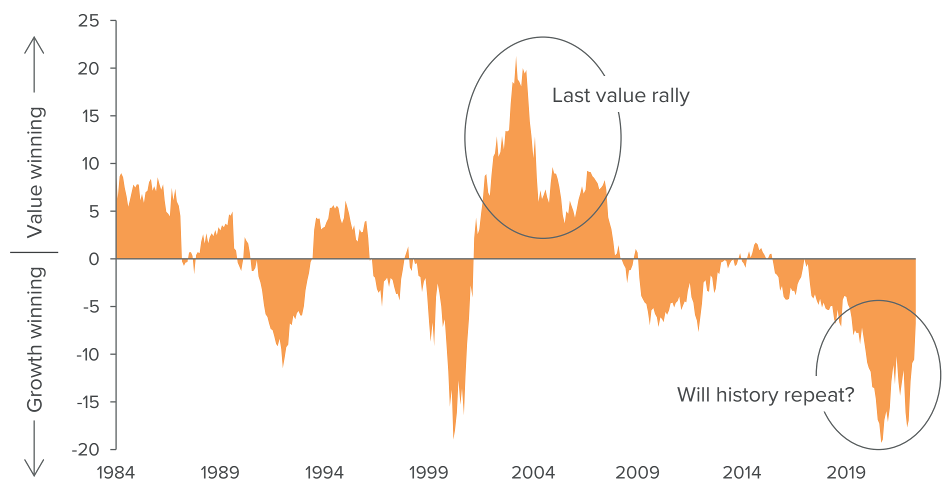
Ample runway for further value outperformance

After a long run for growth-oriented companies, value names have outperformed more recently. We polled our LinkedIn audience to find out which investing style—growth or value—they think will outperform in 2022. The majority favored value, and we tend to agree with them. From our perspective, we expect value can and likely will outperform for the foreseeable future.

Measuring the performance disparity of growth and value, growth's dominance more or less peaked in the last year. Although the initial sharp move toward mean reversion has already taken place, the disparity between growth and value is still wide compared with levels from 2017 and 2018, suggesting that markets are still solidly in the middle innings of value outperformance. Consider that the last major divergence, which occurred in the late 1990s, was followed by a sustained period of value dominance (Fig. 1).

Figure 1: The post-dot-com era saw a multi-year value rally

Relative rolling 3-year total return, Russell 1000 Value Index minus Russell 1000 Growth Index



As of April 30, 2022. Source: Morningstar, Voya Investment Management. **Past performance is no guarantee of future results.**

Rising real rates could offer fertile ground for value investing

The recent outperformance of growth over value was really turbocharged starting with the Federal Reserve's signal in December 2018 that it would stop raising rates, which drove real interest rates into negative territory. This year, the Fed is starting out on a path of multiple potential interest rate increases. Against this backdrop, markets are in the process of unwinding growth's outperformance.

From 2010 to 2018, a period marked by tepid global growth, the average of real interest rates in the U.S. was about 50 bps. We see no reason why real rates couldn't get back to or even exceed these levels given the generally stronger global economic outlook and moderating but structurally higher inflation. Should real rates reach this level, we believe it could be good for value stocks and somewhat less positive for growth stocks.

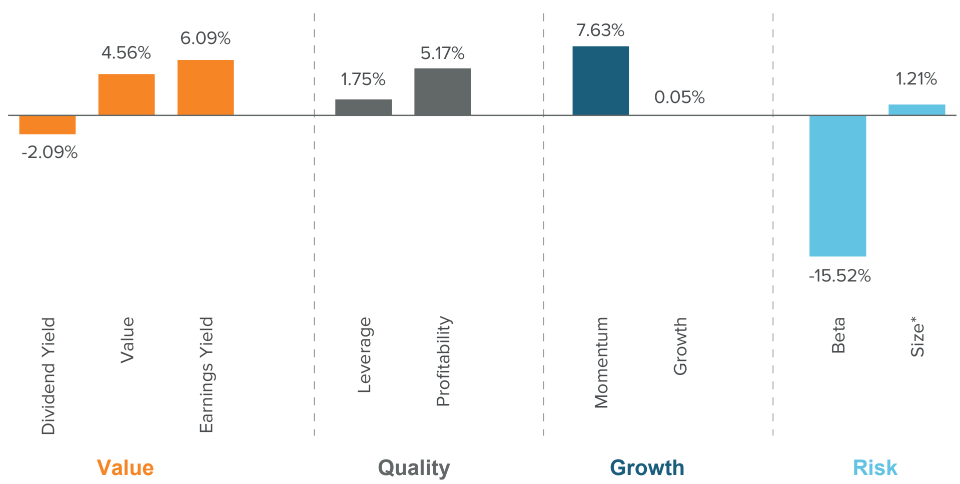
Looking to value names rooted in stability, not cyclicality

The more recent phase of value's outperformance has been led largely by cyclical forces (Fig. 2). Companies have been leveraging improved revenue growth on the heels of the pandemic recovery, driving positive revisions and multiple expansion. This has resulted in a revaluation of sorts for many cyclical names.

We think the complexion of what is undervalued has changed, becoming more rooted in stability than cyclicality. These are companies that have been somewhat ignored as investors spent the past two years wrestling with questions of "transitory versus persistent inflation" and "reopening versus lockdown."

Figure 2: Stable value leadership appears poised to continue

U.S. equity performance year to date, by factor



As of April 30, 2022. Source: Morningstar, Voya Investment Management. **Past performance is no guarantee of future results.** Performance based on the Axioma U.S. Universe. Size has been inverted to show small minus large and the effect of smaller size.

Summary

- Valuation premiums for growth versus value remain above their historical average. Rising real rates should continue to be a headwind for growth and positive for value.
- However, as economic growth likely moderates from the currently unsustainably high levels, and more persistent inflation likely pinches margins, these could prove to be headwinds for currently well-priced cyclicals.
- We believe this would really set the stage for inexpensive stability and quality to drive value outperformance going forward.

Disclaimer

IM2212647 • CMMC-VALUEVGROWTH • 217442 • 052422

voyainvestments.com