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GROWTH STOCKS DOMINATED VALUE STOCKS FOR THE PAST SIX MONTHS

Despite some voices of distrust, the major stock indexes continued their long-term advances during the past quarter, making this the third-longest bull market of the past century. In addition to its abnormal length, this upcycle has shown another quirk … the atypical behavior between "growth" stocks and "value" stocks. There may be no hard and fast definitions of what makes a value or a growth stock, but most investors have a general idea of what the terms imply. Value investors look for out-of-favor companies that are statistically cheap, but where the underlying fundamentals are likely to improve. Growth investors, on the other hand, prefer to buy stocks in companies with proven histories of above-average sales and earnings progress, even if it means paying up for the privilege.

There will probably always be a tug-of-war between growth and value strategies within the stock market, with each side adamantly claiming their own method as the "right" way to invest. Throughout history however, there have been many successful managers from both sides of the divide. Due to the inherent volatility within the stock market, even the best adherents of each style must endure long stretches of underperformance when their strategy is out of favor. Since 1940, value stocks have produced much better long-term results than growth stocks, especially during periods of economic expansion and, therefore, value investors didn't have long to wait to be back in charge. Not this time.

Since 2006, growth stocks have posted their longest relative winning streak against value stocks since World War II. Even though value stocks had a good year in 2016, growth came roaring back in 2017. The Russell 1000 Growth Index's handsome 14.0% total return through June 30 trounced the Russell 1000 Value Index's humbler 4.7% return. Investors haven't seen such a marked six-month difference between the two indexes since 2009. The results are even more unusual, however, because the Growth Index has been largely propelled by a subset of the fastest growing companies, while companies with slightly slower, but still above-average, earnings growth rates have lagged. Many of the best performing stocks have been those with the highest Price/Earnings ratios, the opposite of what most value investors would have expected. Given this backdrop, the first six months of 2017 have been a dream for many growth investors, but far more difficult for most value investors.

OUR CORE STRATEGY TAKES A BLENDED APPROACH

Hallmark's Core strategy doesn't strictly fall into either a growth or value style, since it has some aspects of each approach. Within our Valuation Screen, the Business History component incorporates several growth and profitability ratios that most growth investors would appreciate. The screen also incorporates each stock's Price/Earnings ratio however, so there is a definite value slant to the final value score. High growth companies can screen well, if they are not too expensive, and lower quality companies also can show up if the expected earnings growth is sufficiently high. In using our screen to help find new purchases, the resulting Hallmark Core portfolio generally has some representatives from both the growth and value domain. The so-called glamour growth stocks, with extraordinarily high Price/Earnings ratios, generally don't pass our screening process, so there is a value tilt overall. Our Dividend Driven strategy, on the other hand, is almost exclusively drawn from the universe of value stocks and is much more strongly correlated to what most investors would view as a value approach.

The historical performance of Core strategy demonstrates the relative influence of the growth/value cycle on our results. In the past fifteen years, there were eight years when the Russell 1000 Value Index beat the Russell Growth Index and seven years when the Growth Index won. Hallmark's Core equity approach finished ahead of the S&P 500 Index on a gross-of-fee basis in seven out of the eight years when value was in favor (87.5% of the time), but it led the S&P 500 in only four out of seven years when growth was in fashion (57.1% of the time). The Dividend Driven strategy has not been in existence for that entire period, but its results against the S&P 500 were also skewed to periods when value prevailed.

In years such as this one, when growth has overwhelmed value, the Dividend Driven strategy has struggled against the S&P 500 far more than the Core approach. Given the differences in their construction, this shouldn't be too surprising.

WHY WE THINK GROWTH HAS DONE SO WELL

The extended outperformance of Growth stocks has created an alien environment for value investors. Since 1940 value investors were ultimately rewarded for sticking with their strategies through down cycles because the long-term trend consistently favored value. The recent extended period of growth outperformance has left some questioning whether value's long performance reign has come to an end. Why has growth done so well for so long?

Most people intuitively understand that, all else being equal, faster growing companies are more valuable than firms with less dynamic prospects. The longer a company can show above-average growth, the more it will ultimately be prized. Similarly, the greater the differential between a fast grower and an average company, the more valuable it ultimately will become to investors. Over the past eighty years, corporate profits in America have grown at a compounded rate of about 9%, but with a great deal of variability. During strong economic conditions, earnings growth not only tends to be faster, but it also is apt to be more broadly based. Companies that might have been struggling during a recession can display impressive turnarounds when a recovery starts. Often, investors project that these high rates of growth will continue longer than they actually last, and these projections narrow the valuation spread between average companies and the truly exceptional ones.

Since the end of the Financial Crisis however, economic growth has been abnormally low and investors have come to believe that future "real" (after inflation) profit growth is likely to stay below normal for an unprecedented period. This outlook is often referred to as the "New Normal." Accordingly, any expectations for a typical company posting high rates of future earnings growth for extended periods tend to be relatively rare. Therefore, investors have placed an increasing premium valuation on the stocks of companies that have been able to demonstrate above-average growth in the current slow environment. Something similar happened during the stagflation era of the 1970's when the so-called "Nifty Fifty" stocks reached valuation levels that were unheard of at the time. The Nifty Fifty saw its end, and we are experienced enough to understand that it's not likely "different this time."

Last year, in the wake of the election, there was a burst of hope that the economy might get a shot in the arm from lower taxes and infrastructure spending. However, these hopes were soon dashed as first quarter real GDP rose at only a 1.2% annual rate. Rosy earnings forecasts suddenly seemed overly optimistic and fewer companies were expected to post the high earnings growth rates that analysts had been forecasting. Thanks to the Federal Reserve, there was still plenty of liquidity in the financial system to keep the overall stock market afloat, so investors simply rotated away from slower-growing value companies to firms that had a proven ability to grow under almost any economic environment. Although economic data for the second quarter has improved, there remains plenty of skepticism about a return to the days of 3%-or-4% real GDP growth any time soon.

THE YIELD CURVE FLATTENS – THIS YEAR'S FINANCIAL SURPRISE

Interestingly, growth stocks also tend to outperform value stocks when long-term interest rates are falling. This is consistent with the behavior in the bond market this year, where intermediate and longer-term rates surprisingly have moved lower, despite the actions of the Federal Reserve. This has echoes of the bond market of a decade ago.

Back in 2004 to 2006, the Federal Reserve under then Chairman Alan Greenspan (remember him?) raised short-term interest rates from a low of 1% to 5.25%. Most economists at the time expected that intermediate-term interest rates would increase as well, but it didn't happen. Through the entire period, 10-year U.S. Treasury Notes traded in a fairly narrow range, seemingly unaffected by the Fed's rate hikes. Famously, Mr. Greenspan testified to a Congressional committee that the bond market's moves were a "conundrum" to him. Our guess is that he would be just as befuddled by the recent action in the bond market. The Fed has raised rates four times since December 2015, yet, on June 29, the interest rate on the 10-year Treasury is virtually at the same 2.27% level as it was the day before the Fed made its first move.

Since intermediate and longer-term rates have remained stable while short rates have moved up, the yield differential between the two has narrowed to a 10-year low. As the spread between yields moved closer, it caught the attention of many economists. In past cycles, this kind of behavior from bond investors has proven to be a good indicator of an upcoming recession.

Given the interventions from the world's central banks, however, it is difficult to put very much faith in any signal coming from the bond market. Over the last ten years, the world's central banks have expanded their balance sheets by an astounding amount, as much as $17 trillion. Massive bond purchasing from both the European Central Bank and the Bank of Japan have kept their government bonds trading with very low or negative yields. Additionally, China's store of U.S. Treasuries started to rise again this year, as their government was able to slow the tide of capital leaving their country.

Trading in the final days of the quarter seemed to bolster the idea that the actions of central banks have been the major factors sending longer bond yields to such low levels. A speech by ECB President Mario Draghi intimated that the European economy was finally nearing sufficient strength to allow a reduction in European Central Bank's bond-purchasing program. Slightly more hawkish speeches from the leaders at the Bank of England and the Bank of Canada led investors to believe that a coordinated effort was underway to begin scaling back global monetary stimulus. The price of German 10-year bonds dropped by 2% almost immediately and interest rates in many other countries rose in sympathy around the globe. When and by how much central banks ultimately choose to diminish their monetary support will be the key issue driving global bond markets.

THE FED'S POLICY DILEMMA

Central bankers realize that the longer this period of extraordinary monetary easing continues, the greater the potential for unintended negative consequences down the road. Now that monthly Labor Department reports of unemployment are at levels normally associated with higher inflationary pressures, there is greater pressure on the Federal Reserve Board members to raise rates. Thanks to tepid real GDP growth however, inflation remains stubbornly beneath the Fed's 2% target, with few signs of acceleration. Oil prices, which have a significant impact on topline inflation numbers, have been sinking lately on concerns about oversupply. Prices of food consumed at home, which are excluded from core inflation, but not from household budgets, declined on an annual basis for the first time in half a century.

Despite the Fed's desire to normalize interest rates, tightening monetary conditions now risks unnecessarily slowing the economy and further dampening inflation expectations. Many are questioning why the Fed members seem so anxious to continue to raise short-term interest rates.

ARE STOCKS THE REAL TARGET?

Having been burned by the real estate bubble and subsequent financial crisis, central bankers may see a need to lean against any perceived asset bubbles because of the risk they pose to the economy. Could this recent hawkishness be a reaction to the latest surge in the stock market? Both Chair Janet Yellen and Vice Chair Stanley Fischer have made references to high stock-market valuations in recent speeches. After all, since the interim low in February 2016, the S&P 500 Index is up over 34% on a total return basis. Valuations, especially for the favored glamour growth stocks, may seem overextended to policy makers.

Despite the heightened rhetoric on additional rate increases, the futures markets still put very low odds of a Fed rate hike in September and only a 50-50 chance in the December meeting. Traders remain skeptical that GDP growth or inflation rates will snap back as strongly as the Fed's economists now forecast. As long as economic growth remains anemic, it seems likely that policy makers will have to move very cautiously in any decisions to tighten.

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