Northern Trust | Value Stocks Poised to Outperform

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March is shaping up to be one of the more interesting months on record. In recent weeks, we've witnessed three major market milestones. The valuation spread between growth and value stocks is at a historical high, while equity correlations and the macroeconomic influence on market volatility are the lowest in a decade. These three events are all related and all suggest one thing-- value stocks may be poised to outperform.

Since 2009, the valuations spread, or, simply put, the price gap between growth and value stocks, has been steadily growing. Value stocks have become successively cheaper, while growth stocks have become even pricier. In March, this spread silently slipped into uncharted territory when it surpassed previous highs set in the dot-com era. In other words, on a relative basis, growth stocks have never been so expensive and value stocks never so attractive.

Historically, in those rare situations where valuation spreads set new records, the value factor has consistently delivered positive returns over the subsequent 12 months. But this is only a piece of the story.

Equity markets trade on two information flows-- macroeconomic sentiment and stock fundamentals. In recent months, we've witnessed a sharp decline in the influence of macrosentiment on market returns as evidenced by the market's severe reaction to the slowing earnings in late 2018.

Currently, economic malaise is hovering at levels not seen in more than 15 years. This is important because as the influence of macrosentiment wanes, the impact of stock fundamentals waxes. The value factor tends to win when investors are concerned more with the behavior of individual stocks than the market as a whole.

Finally, stock correlations have plummeted since December to levels, again, not seen since the end of the dot-com era. This means stock prices are less correlated to each other, corroborating a renewed emphasis on fundamentals over sentiment. Should this continue, we would expect wider equity price dispersion. Dispersion coupled with downward earnings revisions is the optimal environment for the value factor.

Investors who have struggled to find opportunities in 2019 should look no further than equity value strategies. Record spreads means the value factor should have the wind at its back, and market mechanics suggest the growth-to-value turn is underway. While we don't possess a crystal ball, it seems the values' stars are finally aligning.

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