Markets

Left-for-Dead Stock Trade Gets Lifeline in Treasury Yield Chaos

By Vidana Hajic
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► Value stocks add 19% on average in three years after inversion
► JPMorgan, SEI Investments see reason for value to revitalize

Newsflash, the yield curve inverted, which everyone knows is bad for the economy and risk assets in general. But it may be good for an area of the stock market that could use a little help.

Turns out that equities in one of the least-loved investment factors, value, often find their legs right after short-term bond yields rose above long ones. In fact, amid mostly down markets, stocks trading cheapest to metrics like earnings generate cumulative returns of nearly 10% the year after an inversion.

While sounding a little random, value fans will take anything that eases the pain at this point. Their stocks have struggled for years, trailing growth companies, low-volatility shares, defensive sectors and just about everything else. Slower growth, falling yields, and a Federal Reserve seemingly bent on cutting rates pushed investors into other groups. One measure of value's returns versus growth sits at the lowest level since the dot-com bubble.
Whereas the stock market’s risk-adjusted return is around negative 9% in the year following a curve inversion, value tends to benefit, according to an analysis by Cam Harvey, a finance professor at Duke University. A long-short value portfolio paid 12.4% two years out and 19% after three, he said.

“Value has low correlation, or even negative correlation, with the market as a whole. Essentially what it’s doing is providing a hedge-like return,” said Harvey in a phone interview. “Just because the market goes down doesn’t necessarily mean that value goes down.”

Hedge funds, for one, continue to shun value stocks in favor of companies whose profits are rising — they’re now more exposed to growth stocks versus value than at any point in at least nine years, according to Evercore ISI, which analyzed 13F filings.

Investors have withdrawn more than $4 billion from exchange-traded funds tracking value this year, but have added about $2.2 billion to growth strategies, Bloomberg data looking at stocks with momentum characteristics show.

But given that valuations for quality stocks are already high, some investors are starting to bet cheap stocks could rebound. Analysts appear to believe policy makers could “save the day for stocks, especially value shares, as price targets continue to move up while earnings estimates drop,” Gina Martin Adams, a Bloomberg Intelligence analyst, wrote in a recent note. Firms with the lowest valuations could see the highest price gains over the next year, she said, with the
median stock expected to gain 14.6%. But little upside remains for recent winners, including defensive names.

Strategists at Oaks, Pennsylvania-based SEI Investments Co., too, are wagering value stocks may have found a floor. And those at JPMorgan Chase & Co. say progress in trade negotiations between the U.S. and China, along with stabilizing economic data, could revive value.

“It kind of makes sense that some of the value, and other factor portfolios, if there is a draw-down in the equity market that’s associated with a recession, then you need to look at other investment styles and value is one of them,” said Harvey. “If a draw-down comes, it might be that the growth stocks are the ones that are hammered.”

— With assistance by Rachel Evans, and Brandon Kochkodin

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