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Fundamentals Re-emerging

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Monetary policy has hampered the ability of fundamentals to influence market prices, but we're beginning to see them re-emerge, which should create opportunities for fundamental investors like us.

The past three major waves of monetary policy have played out in similar ways, and the fourth and current wave now looks like a repeat.

As a result of the world's central banks having been extraordinarily accommodative, asset prices have appreciated, volatility has been low, and the current market environment appears primed for a significant disruption.

Investors have ridden the tide with passive and semi-passive strategies, which benefit from positive momentum and low volatility.

That's normal in periods of monetary policy easing, when systematic developments become more important, and fundamentals become less important. Systematic strategies tend to perform well; fundamental strategies tend to struggle.

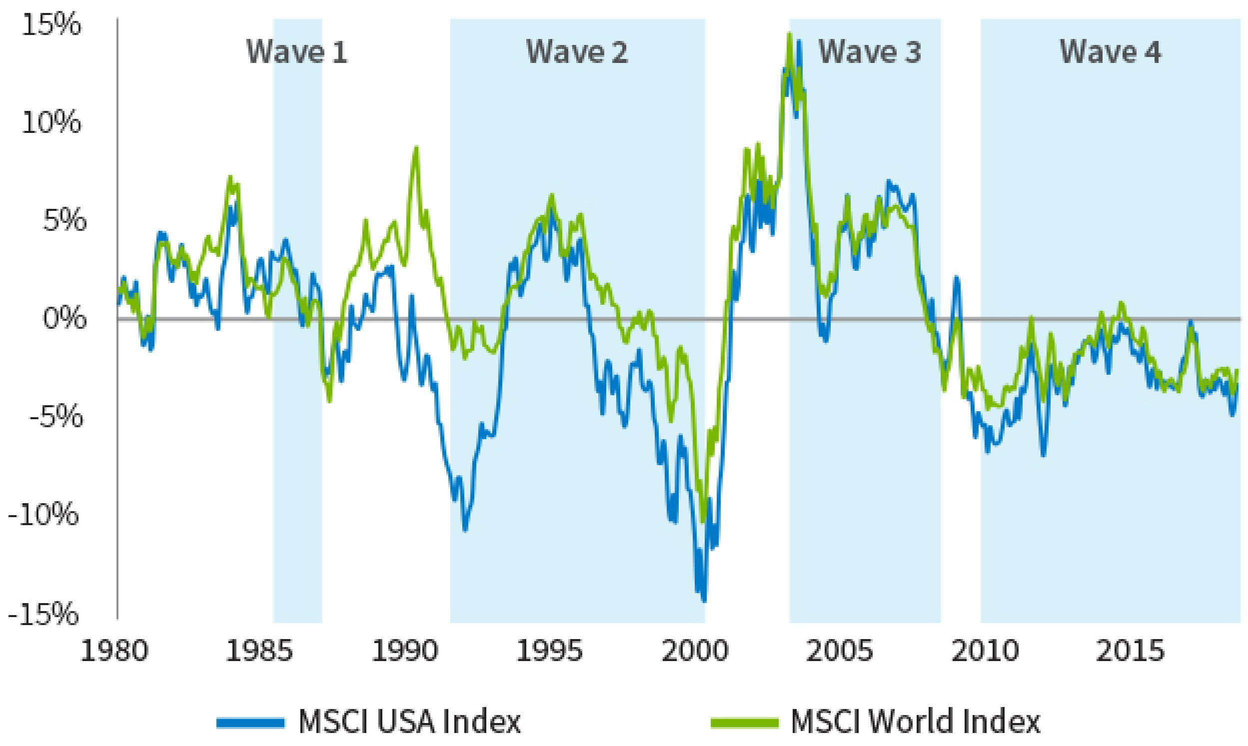
Value Versus Growth

A crude proxy of this dynamic is the relationship between value and growth equities. During times of easy monetary policy when fundamentals are not able to exert themselves, value equities tend to underperform growth equities.

When fundamentals are able to exert themselves, value equities tend to outperform.

The chart below illustrates this dynamic. The shaded area show waves of monetary policy. The dark blue line shows the relative performance of value equities relative to growth equities in the United States; the light blue line shows this relationship for global stocks. When the line is below zero, value is underperforming growth; when it's above zero, value is outperforming growth.

Rolling 36-Month Relative Returns, Value Versus Growth



Source: William Blair, as of July 2018. **Past performance is not indicative of future returns.** Value and growth style characteristics are as defined by MSCI.

In the first three waves, you see value performance relative to growth coming down, both in the United States and globally. We see this persistent underperformance of value whenever central banks are taking control.

By manipulating interest rates, central banks become the price-setting investors, precluding fundamentals from exerting enough influence to bring asset prices back toward value. This makes markets more systematic, rewarding persistent exploitation of factors like momentum and low volatility.

Now we're in the midst of the fourth wave, and we aren't seeing the *extreme* underperformance of value we saw in the second wave (the technology bubble). But we have seen a *lengthy* underperformance of value.

Since 2008, fundamental investors have been beating their heads against the wall because value has underperformed growth both in the United States and abroad.

What's different this time? In the three waves, the underperformance of value occurred more in the United States because there was one 800-pound gorilla: the U.S. Federal Reserve (Fed). In the current wave, the underperformance of value is more global because there's a troop of gorillas: the European Central Bank (ECB), the Bank of England (BoE), the Bank of Japan (BoJ), and even the People's Bank of China (PBoC).

Reason for Caution

While this environment can encourage just about anyone to jump on the bandwagon in fear of missing out, we see reason for caution.

The Fed is now starting to tighten, depending on how you define "tighten." The policymakers are still stimulating, but they are doing so at a slower rate than they had before (which was significant). But the balance sheet is certainly tightening, and interest rates are rising. (Although the latter started years ago, we are just now beginning to feel the effects.)

The ECB, BoE, and BoJ, are all beginning to follow suit. The ECB's giant bond-buying program, for example, ends at the end of 2018. Capital markets are not sure how the situation will evolve thereafter, but balance-sheet growth will certainly stop and begin to shrink.

Although world central banks are just beginning the tightening process, and it lags that of the Fed, the effects should emerge within a few years. This will augment the reversal in monetary policy we're seeing in the United States.

There is no telling what event will trigger the switch in the market mood: a U.S.-initiated trade war, slowing Chinese growth, emerging market currency crises, Russia's disputes with the European Union and the United States, a sudden jump in inflation in the United States or Euro area, a quarter or two of disappointing earnings in the United States, a Tweet. The list goes on but, as we frequently stress, it is not the trigger that matters, but the environment that allows any of a multitude of triggers to begin the asset-price adjustment process.

The change won't occur overnight; it will likely be protracted in nature. But we worry that policymakers and markets will be ineffective in stemming the next market crash, for reasons we noted in other posts in this series: the proliferation of rules-based strategies, the Volcker Rule, and circuit breakers. Once the crisis is imminent, the Fed "put" has few teeth left to stop it.

Moreover, current U.S. Federal Reserve Chair Jerome Powell will likely be more tolerant of market volatility than his predecessors, and although this may be painful, it will be a healthy development and markets will become more fundamentally efficient.

Opportunities Arise

Rather than fearing the day of reckoning, however, we should consider it an opportunity to step in and take advantage of the fundamental influences that are re-emerging. When fundamentals fully re-emerge, we will no longer be swimming upstream; we will be swimming with the current.

After 10 years of headwinds, we are looking forward to a long period of tailwinds for fundamental-value-based investors. There will be opportunities. In anticipation, we have positioned our portfolio cautiously so we are able to, for example, buy into equity markets when there are punctuations of downside.

Navigating a Troop of Gorillas Blog Series

Part 1: Navigating a Troop of Gorillas
Part 2: New Movie, Same Plot: 4 Waves of Monetary Policies
Part 3: The Bigger the Easing, the Bigger the Fall
Part 4: Why This Disruption is Different—Rules-Based Strategies
Part 5: Why This Disruption Is Different—the Volcker Rule
Part 6: Why This Disruption Is Different—Circuit Breakers
Part 8: Where We See Fundamental Opportunities

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