2024 Outlook: Value Equity

By: Aaron Dunn, CFA | & Bradley Galko, CFA | December 11, 2023

Normalization of Supply Chains May Create Opportunity for Value Investors

KEY POINTS
1. While inventory destocking has been deep and painful, we believe the slate is now clean for companies in sectors that have been beaten down due to this phenomenon. We also continue to closely watch what we term the GLP-1 (or weight-loss drug) reversion trade — our assumption being that consumer goods companies will still have a place when the dust settles.
2. We're focusing on company-specific opportunities within the industrials, basic materials, semiconductors, consumer and utilities sectors.
3. We believe rates will be higher for longer, and a balanced approach among equity allocations will be key in this regime where risk has a price.

What We Are Seeing

Many who foresaw continued outperformance by value over growth stocks at the end of 2022 have been disappointed by this year's growth surge. However, when you look at the Russell 1000 Growth Index, excluding the seven heavyweights, the story becomes more surprising and murkier. Without the so-called Magnificent Seven — a group that includes Alphabet, Apple, Amazon, Meta Platforms, Microsoft, Nvidia and Tesla — the growth index's returns are far closer to those of the Russell 1000 Value Index in 2023. We believe we will see a broadening in performance, particularly if the Federal Reserve (the Fed) maintains or cuts rates.

It may surprise many that, on a three-year annualized basis, value is outperforming growth by over 3% (comparing Russell 1000 Value Index to Russell 1000 Growth Index returns over three years, as of 9/30/2023). The Fed now faces a challenging balance — how to control inflation and simultaneously support economic growth. This creates a change in the policy dynamic that has predominated since the Global Financial Crisis — a change which we believe makes a balanced equity exposure essential for investors.

What We Are Doing

We continue to invest in companies that have strong balance sheets, excellent management, and quality businesses. We are long-term investors, seeking out companies that are mispriced and trading at a discount to their intrinsic value.

Looking ahead, we believe opportunities may be found in the industrials, basic materials, semiconductors, utilities and consumer sectors. As supply chains are finally reaching the end of destocking, we expect this normalization to benefit certain sectors. Within industrials, we think deglobalization will continue to play a meaningful role, which we believe will benefit U.S. industrials. Within basic materials, we are focused selectively on those companies poised to take advantage of the end of inventory destocking and now execute offensively.

Utilities were significantly impacted in 2023 from the steep rise in interest rates. Although we believe rates are likely to stay higher for longer, we think they are appropriately captured in valuations today — both from the perspective of income investors and when considering costlier project financing.

Within consumer staples, we are focused on food companies and retailers perceived to be impacted with the major uptake in GLP-1 (glucagon-like peptide-1) weight-loss drugs. We believe these new drugs will have a meaningful impact on the market, but the numbers suggest that consumption reduction is overcapitalized in the shares of many leading companies. Still, we believe being a leader within food or a retailer who can quickly change and anticipate upcoming trends is essential.

What We Are Watching

The U.S. consumer. With savings rates at a low, credit card debt at a peak, fewer child tax credit payments, student loan relief ending, and the supplemental nutrition assistance program (SNAP) payments declining — the consumer now faces several headwinds.

Market concentration. We are observing concentration levels for market capitalization in the major indexes, and the amount of return driven by those indexes. We believe where there is less concentration, there is more opportunity to add value as an active manager.

Global economies. While we are primarily U.S. focused, global economies have a major impact on our companies. In this vein, we are tracking Germany's planning around energy consumption — their contracting (or not) for liquified gas terminals (LNG) will likely have potentially serious consequences.

Heading into 2022, based on correlations between broad indexes, we warned investors holding a typical 60/40 portfolio that they lacked a diverse asset mix. While the numbers have shifted over the last two years, we believe it is important to be aware of the correlation between fixed income and various leading equity indexes, as simply indexing for U.S. exposure by solely holding a core U.S. equity position has not offered a great deal of diversification over the last few years.

Index definitions:

Russell 1000 Growth Index is an unmanaged index of U.S. large-cap growth stocks. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance of the fund.

Russell 1000 Value Index is an unmanaged index of U.S. large-cap value stocks. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance of the fund.

Risk Considerations: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Diversification does not eliminate the risk of loss. Active management attempts to outperform a passive benchmark through proactive security selection and assumes considerable risk should managers incorrectly anticipate changing conditions.*

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