Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights

June 2023

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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It's simple speculation, not a preference for quality

Many stock market observers have commented regarding the market's narrow leadership. This is a fact, which by some measures has reached historic extremes.

However, few observers agree why this narrow leadership is occurring. Some, like us, believe there are similarities between the recent outperformance of technology shares and the significant appreciation in cryptocurrencies attributing both to speculation fueled by the belief the Fed will soon be returning to a regime of cheap and abundant liquidity, i.e., the Fed "pivot."

Others believe there is a fundamental justification for this narrow leadership. They claim corporate profits are under pressure, and the narrow leadership reflects investors' preference for stronger balance sheets during difficult times rather than simple speculation.

As the researchers who first came up with macroeconomic theories in the early-1990s on why there are cycles of growth and value, we disagree with the fundamental assessment. First, the dire implied economic forecast of such narrow leadership seems unrealistic. Second, year-to-date performance data seems to reflect a more speculative sector preference than a fundamental one based on quality.

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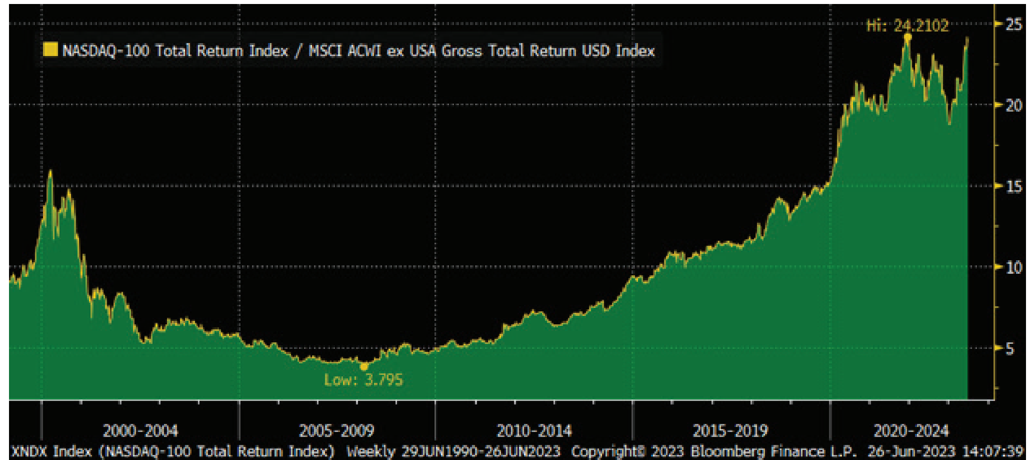
How narrow is narrow?

By some measures, the current narrow leadership within the US equity market is the narrowest in history or close to the record setting period of the late-1990s Technology Bubble. Chart 1 shows the relative total return of the NASDAQ-100 Index versus the MSCI ACWI ex USA Index.

CHART 1:
Nasdaq 100 versus MSCI ACWI ex USA
(Mar. 5, 1999 – June 26, 2023, weekly total return)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document

The NASDAQ-100 demonstrably outperformed non-US equities during the Technology Bubble, but that outperformance was followed by roughly nine years of underperformance. By 2009, the consensus was the "core" of any growth-oriented portfolio had to be focused on non-US stocks. The current periods' extreme outperformance makes the Tech Bubble seem mild.

Chart 2 compares the NASDAQ-100's total return to that of the Russell 2000. Although this comparison does not show a historic extreme as does the previous comparison, it does portray a very narrow market.

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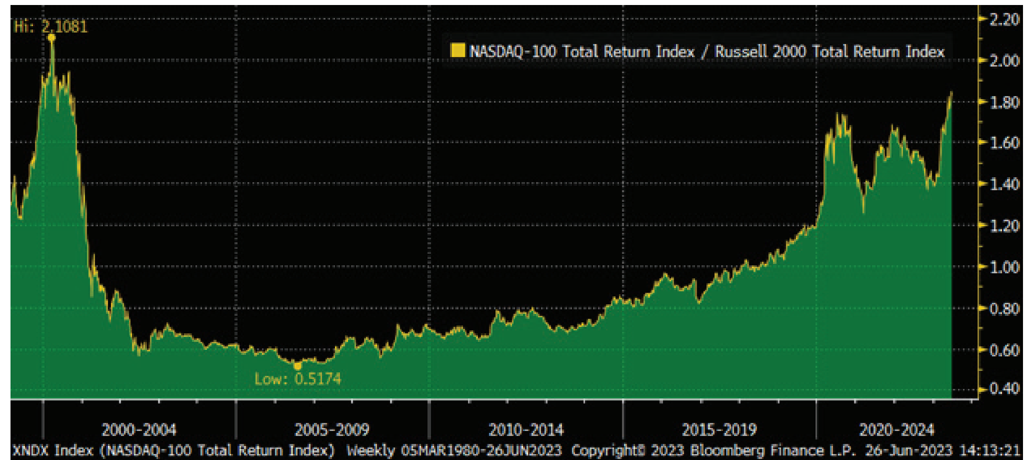
CHART 2:

Nasdaq 100 versus Russell 2000

(Mar. 5, 1999 – June 26, 2023, weekly total return)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document

Why growth outperforms when profits wane

Our seminal research 30 years ago was the first to explain the catalysts behind cycles of growth and value. The research highlighted that such cycles are tied to the abundance or scarcity of earnings growth within a sector, an overall economy, a region, or the entire global economy.

Profits growth becomes increasingly scarce when profits cycles decelerate. Investors accordingly bid up the price of that scarce resource (i.e., earnings growth) and value investors typically won't pay a high price for growth. Thus, growth tends to outperform value when profits cycles decelerate.

When profits cycles decelerate, markets become increasingly "Darwinistic," i.e., performance is determined by survival of the fittest. Fewer and fewer companies can maintain their earnings growth rates as the overall economy and profits environment get worse, and investors gravitate to the fewer and fewer growth opportunities.

However, profits growth becomes abundant when profits cycles accelerate, and investors become comparison shoppers for an abundant resource, i.e., why pay a high price for profits growth when it's everywhere? Accordingly, value tends to outperform growth when profits cycles accelerate.

Charts 3 and 4 show the historical performance of growth and value by size when profits cycles accelerate or decelerate.

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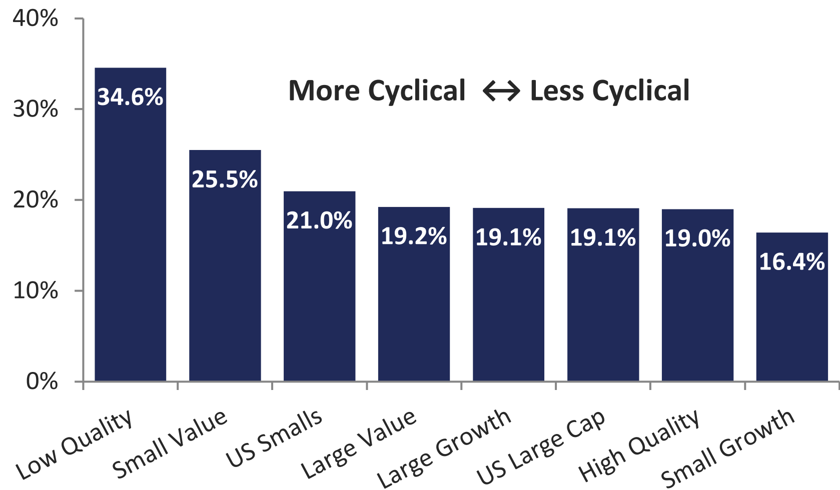
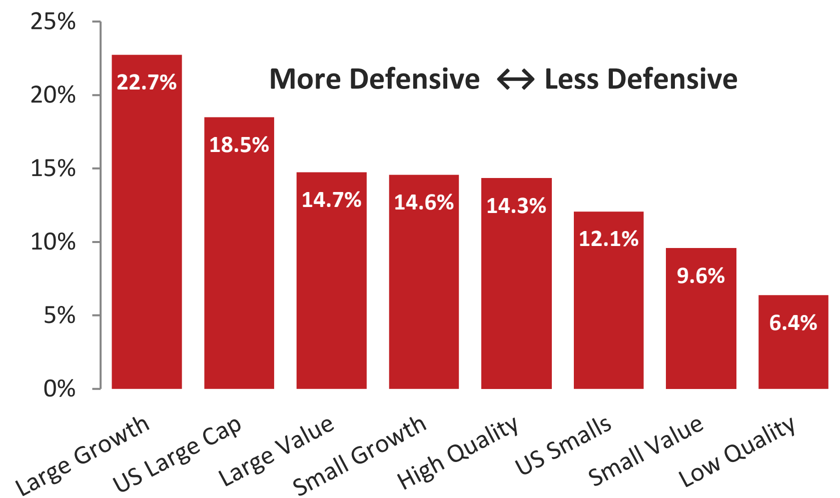
CHART 3:
Average Performance when Profits Accelerate ex the Tech Bubble*
(Sep. 1989 – Dec. 2021 Total Returns)



*excludes the tech bubble profits acceleration of 12/98-3/00
Dec. 2021 last profits cycle peak
Source: Richard Bernstein Advisors LLC., Bloomberg Finance L.P.

CHART 4:
Average Performance when Profits Decelerate ex the Tech Bubble*
(Sep. 1989 – Dec. 2020 Total Returns)



*excludes the post tech bubble profits recession of 3/00-12/01
Dec. 2020 last profits cycle trough
Source: Richard Bernstein Advisors LLC., Bloomberg Finance L.P.

Growth and value relative performance, therefore, depends on an implied economic and profits forecast. If profits are expected to rebound, then value will tend to outperform growth. When profits growth is expected to wane, then growth will tend to outperform value.

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Although often portrayed as optimistic and opportunistic, growth investing implies a negative view of future economy-wide earnings growth, and extremely narrow leadership implies only a handful of companies will be able to grow. Today's historically narrow markets suggest not only a deep profits recession, but even questions corporate survival for the broader global equity market. We have trouble envisioning such a morose global economy.

The original Nifty 50 of the 1970s subsequently underperformed because the implied dire economic forecast was incorrect and many companies ultimately had earnings growth. Similarly, we expect today's Nifty 20 (?) to underperform. It is hard for us to imagine that there are no other growth opportunities anywhere else in the world.

Tech isn't defensive

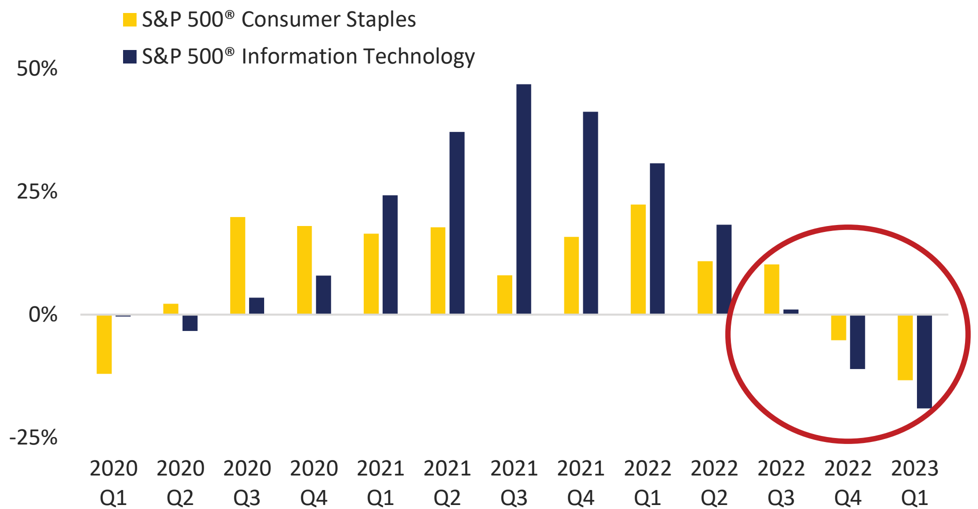
Some have tried to justify the current narrow leadership by asserting that Technology companies are defensive. Unfortunately, that is not true.

Consumer Staples (industries such as Foods, Beverages, and Household Products) have historically been quite defensive because the products are considered necessities, and that has been true in this cycle as well. Technology has historically been a cyclical sector influenced by the profits cycle. The earnings for both sectors seems to be following that historical precedent.

Chart 5 shows the two sectors' profits growth during the past cycle. Consumer Staples' profits growth has actually been superior to Technology's in each of the last three quarters. It would appear that this time is not different, and defensive sectors like Consumer Staples remain defensive, whereas cyclical sectors like Technology remain cyclical.

CHART 5:

S&P 500® Index: Information Technology vs. Consumer Staples Sectors %YoY Growth in Trailing 12m Reported EPS



Source: Richard Bernstein Advisors LLC, S&P Global

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Performance isn't attributable to quality either

Some have suggested the current narrow leadership is attributable to a rush to quality or the Darwinstic market we described earlier. Unfortunately, the data do not support that contention either.

Table 1 shows year-to-date quality performance by sector. Quality rankings are from Standard & Poor's and are based on ten years of a company's growth and stability in earnings and dividends. Highlighted green cells are those that outperformed the S&P 500®. Importantly, the analysis incorporates roughly 1,700 companies and is equal-weighted so we remove company size, a proxy for a narrow market, from the analysis.

First, the table reflects the narrow leadership within the equity market because relatively few cells are shaded green and the average stock is up only 5.2% year-to-date, which compares poorly to the NASDAQ-100's 35%.

More important though, the table clearly demonstrates that 2023's narrow market is NOT attributable to a rush to quality. Technology companies' performance has been extremely strong regardless of quality and the best performing quality ranks across sectors were B's, B-'s, and C's.

TABLE 1:

Year-to-Date Total Return % of US Stocks by Quality Ranking

(through 6/23/2023)

	A+	A	A-	B+	B	B-	C	Sector Avg
Communication Services	17.12	4.35	1.06	26.14	6.87	-3.25	10.58	**6.72**
Consumer Discretionary	11.21	12.40	6.34	12.89	10.49	18.12	18.25	**13.45**
Consumer Staples	0.96	1.50	8.16	-2.61	5.08	-3.31	7.39	**1.52**
Energy				-20.90	-4.17	-7.58	-3.83	**-6.07**
Financials	-28.14	-12.81	-16.92	-12.40	1.44	5.35	2.82	**-8.78**
Health Care	-7.57	4.23	-0.24	7.49	1.57	2.66	6.19	**4.47**
Industrials	13.85	11.05	12.09	13.67	12.15	20.26	23.07	**14.91**
Information Technology	6.25	26.04	23.48	21.96	24.40	12.80	21.13	**20.05**
Materials	5.99	15.57	9.07	3.71	-1.12	-2.38	0.74	**1.97**
Real Estate	2.64	-5.88	0.56	-4.76	-0.20	-1.86	4.48	**-1.31**
Utilities		-3.08	-6.60	-3.70	0.86	-13.83	4.18	**-3.81**
Quality Rank Avg	**3.76**	**-0.38**	**-2.80**	**4.02**	**7.76**	**7.26**	**9.77**	**5.17**

Source: Richard Bernstein Advisors LLC, BofA Global Quantitative Strategy, Bloomberg Finance L.P.

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Narrow speculation leads to a lengthy and tasty menu of investment opportunities.

The current market environment seems highly speculative. The narrow advance can't be justified by a rush to quality or that Technology stocks are defensive. In addition, we can't envision the dire economic forecast and lack of general corporate survival that is implied by such narrow leadership.

The extremely narrow market leadership suggests investors are ignoring what might be a huge set of investment opportunities around the world. We don't believe the enthusiasm for the Nifty 20 will be justified, and our portfolios are lagging year-to-date as a result.

However, as was borne out subsequent to virtually every speculative burst, the menu of ignored investment opportunities right now appears lengthy and tasty.

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500®: S&P 500® Index: The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

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Nasdaq®-100: The NASDAQ-100 Index is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international issues listed on the NASDAQ. No security can have more than a 24% weighting. The index was developed with a base value of 125 as of February 1, 1985. Prior to December 21,1998 the Nasdaq 100 was a cap-weighted index.

Russell 2000: Russell 2000 Index. The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

MSCI ACWI ex USA®: MSCI All Country World Index (ACWI®) excluding the USA. The MSCI ACWI® ex US is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of global developed and emerging markets excluding the United States.

Large Cap: S&P 500® Index: The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Small Cap: Russell 2000 Index. The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

Large Growth: Russell 1000 Growth Index. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Large Value: Russell 1000 Value Index. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

Small Growth: Russell 2000 Growth Index. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

Small Value: Russell 2000 Value Index. The Russell 2000 Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

High Quality: The BofA A+ Quality Index: BofA Quality indices: each month BofA groups all of the stocks in the BofA US research coverage universe based on their Standard and Poor's quality ranking. The returns are calculated based on the subsequent months' average price return of each group assuming monthly rebalancing.

Low Quality: The BofA C&D Quality Index: BofA Quality indices: each month BofA groups all of the stocks in the BofA US research coverage universe based on their Standard and Poor's quality ranking. The returns are calculated based on the subsequent months' average price return of each group assuming monthly rebalancing.

Sector/Industries: Sector/industry references in this report are in accordance with the Global Industry Classification Standard (GICS®) developed by MSCI Barra and S&P Global

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About Richard Bernstein Advisors

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