Regime Shifts: April Update

Value regime looks set to last

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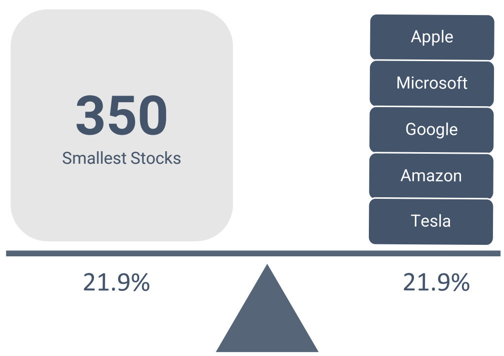
The 3.6% sell-off in the S&P 500 on Friday (4/29) capped a dismal April for the world's most traded index (-8.72%).

As we wrote in our February note **Regime Shifts: Why the S&P 500 could underperform Alternatively Weighted ETFs**, "[the S&P 500] is highly exposed to several potential headwinds in 2022, including interest rate hikes, rising vaccination rates, increased regulation, and overly optimistic valuations. A change in the prevailing market dynamic could cause one (or more) of these headwinds to reverse the long-run market trends and see cap weighted indices underperform alternatively weighted products. The Stratified LargeCap Index outperformed its cap weighted counterpart by 3.12% in April."

The environment for a sustained outperformance of alternative weighted core equity products remains in place even after the recent correction. The five largest companies in the S&P 500 make up the same weight as the smallest 350 companies (21.9%) and bias the index heavily towards the technology sector (Figure 1). Though slightly off its recent high (46.5% on September 2021), the Information and IT sectors comprise 42.2% of the index. High concentration raises the risk of crowded exits and could fuel persistent underperformance (Figure 2), especially given that the investment regime continues to favor value stocks.

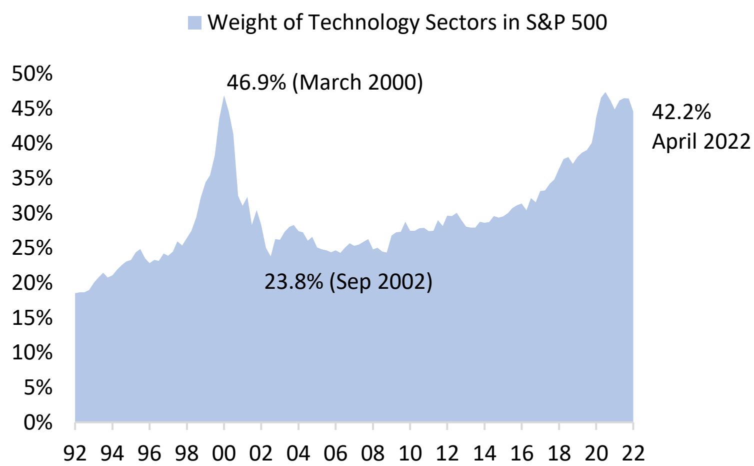
Even after a significant decline, the S&P 500 remains highly concentrated.

Figure 1: Largest 5 companies in S&P 500 (% weight)



Source: Syntax, as of 4.30.22.

Figure 2: Weight of Technology sectors in S&P 500



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April's 8.7% decline coincided with the US long bond hitting 3 percent (to 3 decimal places) for the first time in 3 years. Even if bad news doesn't necessarily come in threes, the normalization in interest rates represents a regime shift away from the liquidity fueled growth frenzy since 2019.

Big Tech disappoints on Q1 earnings, but still looks expensive

Furthermore, with 50% of the S&P 500 having reported results, the Q1 earnings season has also been problematic for Big Tech. Netflix was the biggest loser, down 45% since reporting its first decline in subscribers on April 20th. Alphabet missed on the top and bottom lines and Amazon reported its first loss in seven years falling 14% on the day (4/28). Though Facebook managed to beat its Q1 expectations, the company's pivot into the Metaverse has been met with a 38% decline since its earnings announcement on 2/2.

For those investors who are tempted to buy into the Growth sell-off we caution that the long-term charts for Value versus Growth show plenty of scope for the recent trend to persist i.e., for Value to outperform (Figures 3-4).

Even in light of the recent 17.11% outperformance of Value vs Growth this year, Growth remains 79% ahead of Value since 2016 (165% vs 86%). The P/BV multiple of the Russell 1000 Growth index is 11.1x, higher than it was at the height of the DotCom bubble. In relative terms, Value is at a 78% discount (2.46x) – significantly wider than the 67% discount seen in March 2000 (Figure 5). The shift from growth to value has strong implications for the performance of stratified vs cap weight, as shown by the significant correlation in Figure 6. Year to date, as value has outperformed growth, the Stratified LargeCap has outperformed the S&P 500 by 6.84%.

Figure 3: Index performance since 1990

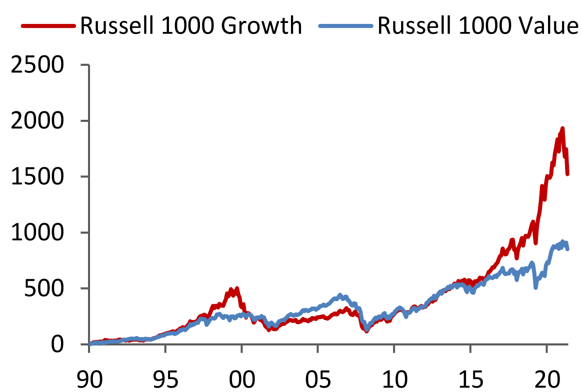
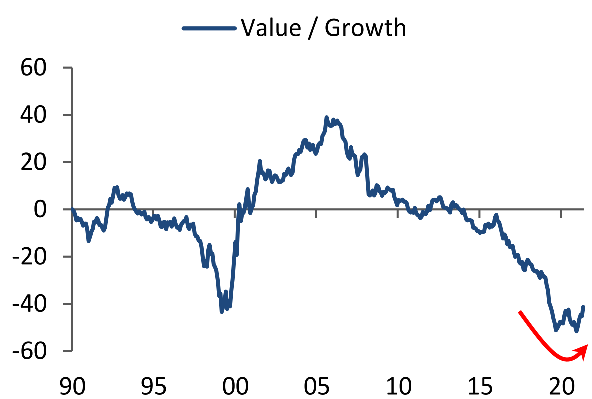


Figure 4: Relative performance (Growth remains ahead of Value)



Source: Syntax. Figure 3 shows total return indices from 12.31.1990-4.29.2022. Figure 4 shows relative total return from 12.31.1990-4.29.2022. Relative return is defined as the quotient of the Russell 1000 Value and Russell 1000 Growth Indices, normalized such that a value of 0 indicates equal cumulative performance between value and growth; decreasing values indicate growth outperformance and increasing values indicate value outperformance.

Figure 5: Growth is expensive, relative to Value

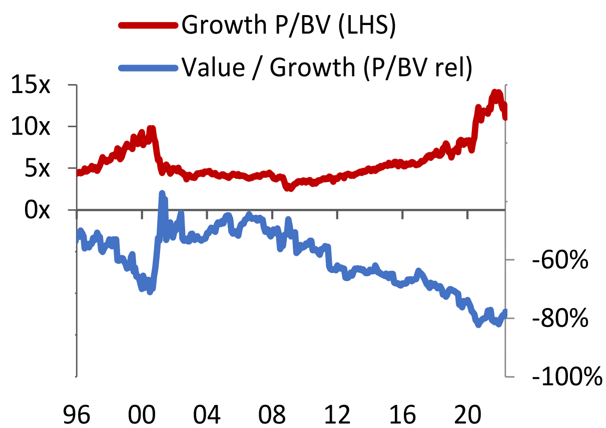
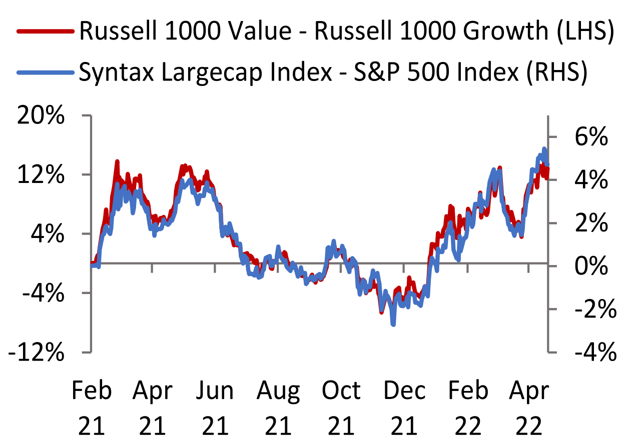


Figure 6: S&P 500 underperforms when Growth does



Source: Syntax. Figure 5 shows valuations from 12.31.1996-4.29.2022. Figure 6 shows cumulative total return from 2.11.2021-4.29.2022.

Conclusion

We therefore reiterate our sentiment from the Regime Shifts note: the S&P 500 index remains more concentrated in mega-cap technology stocks than it was at the height of the DotCom Bubble, leaving it highly exposed to changes in the long-term investment regime, namely the normalization of interest rates and a shift to value-conscious investing.

If inflation persists, it is likely that the Fed will have to raise rates faster than anticipated, amplifying the headwind for growth companies. Furthermore, with valuations at historical highs, disappointing quarterly earnings, could manifest as a crowded exit out of technology into some of the underserved sectors in the S&P 500, such as Energy, the Consumer or Food.

This shift would see the S&P 500 continue to underperform alternatively weighted products such as the Syntax Stratified LargeCap Index, which reweights the same stocks as the S&P 500, but with diversified exposures that allocate equally across all major sectors and is therefore not overweight in technology or any other business risk.

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