MarketWatch

Opinion: Value investing isn’t back — but economic growth is

By Michael Brush

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Recent shift in stock-market leadership was to cyclical stocks from defensive sectors, not to value

Silvia Ascarelli/MarketWatch

A billboard in Lafayette, Ind.

Sorry Warren Buffett fans, your favorite guru’s investing style is not staging a comeback. So keep those dusty books by Benjamin Graham and David Dodd up on the shelf.

The good news is that your confusion about a shift in stock-market leadership back to value belies two very bullish signals for investors: Renewed signs of a pickup in the economy and persistent negativity among many investors. The latter is a positive in the contrarian sense.

I’ll explain these two bullish angles more in a minute. But first, what’s really going on, if not the return to favor of the Oracle of Omaha’s storied investing approach?

The false belief that ‘value is back’

Stocks tumbled in August because of worries that the inverted yield curve forecasted a recession. Cyclical sectors like

banks, energy and industrials were hit especially hard since they suffer the most in a recession compared to defensive names like Procter & Gamble PG, +0.24% or Duke Energy DUK, +0.53%.

At the time, I wrote that stocks were actually a buy because recession fears were overblown. I cited two reasons.

• The inverted yield curve signal was a head fake. It inverted because income investors abroad facing negative yields were scooping up U.S. long bonds. This pushed down long bond yields and inverted the curve for reasons that had nothing to do with a looming recession.

• Signs of an economic rebound were on the way. My view here was linked to some bullish insider buying patterns, and all the stimulus that was pumped into the system six to 12 months ago.

I owe thanks to Leuthold Group Chief Investment Strategist Jim Paulsen for bringing the pipeline stimulus to my attention at the time. This confirmed the bullish signal I was getting from company executives' stock-market dealings. In August, these insiders were buying the heck out of cyclical names in financials, energy and among industrials, telling me the economy was not going into recession.

By early September, as insiders and Paulsen predicted, economic indicators began to perk up. Smart-money investors noticed and piled back into cyclicals like energy stocks and industrials. The yield curve sloped upward again due to renewed signs of economic strength. So banks looked attractive and smart investors bid them up.

"The rising yield curve helped improve confidence in bank stocks in particular," says John Traynor, the chief investment officer at People's United Advisors.

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What caused the false belief that value investing was back in style? The cyclical groups rebounding in September were all cheap. So pundits mistook their rebound for the return of value investing. The problem is that while most cyclicals were cheap, not all cheap stocks came back. It was more just the cyclicals.

"It wasn't a shift from growth to value, but more a shift from defensives to cyclicals," says Paulsen. He notes that a similar shift is happening in the bond market. There, riskier high yield bonds — which do better when the economy is solid — have held up relative to safer quality bonds.

Two great signals for bulls

There are two nice signals here for investors who are bullish on stocks now, like me.

First, investors remain bearish. Pundits chose to mischaracterize the rebound in cyclicals as a style shift to value investing rather than what it really was — a reflection of the fact that a recession isn't really on the way. This misread reflects ongoing caution (investors stubbornly holding on to recession fears) which serves as a bullish contrarian indicator.

Second, economic data are improving. We get a similar bullish read from the economic data that sparked the early September move in cyclical groups. The Citigroup U.S. Economic Surprise Index and Global Economic Surprise Index

have both shot up from low levels earlier this summer, with much of the move happening since late August. The Citigroup U.S. Economic Surprise Index has moved to nearly 20 from negative 70. The global surprise index has moved to nearly zero from negative 40.

These indexes do a good job of forecasting economic trends. Layer on the fact that a lot of stimulus was put into the global economy nine to 12 month ago in the form of lower borrowing costs, faster money supply growth and more government spending — and more was just added in Europe and the U.S. — and it's easy to conclude the economy will keep improving over the next several months. (Stimulus normally takes about six months to kick in.)

As this happens, recession fears will ease and more money will come into the market pushing stocks higher. "People are still in a mindset of imminent recession, and there is a long way to go to change that," says Paulsen.

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The key takeaway here is that some very bullish signals for stocks lurk inside the misplaced conclusion that value investing is back. But classic value investing techniques like buying stocks with a margin of safety below tangible book value won't make your portfolio outshine the S&P 500 index SPX, -0.29% or the Dow Jones Industrial Average DJIA, -0.25% , any more than these tools helped do this in the recent past.

Because, no, value investing is not back. Just the economy.

Mark Hulbert: Reports of value investing's death are greatly exaggerated

What to do now: Stay long, and favor growth

"We believe the U.S. economy will continue growing into next year and avoid a recession in 2020," says Traynor at People's United Advisors. "This rally could go on for several more months, especially if we get some good news on the China trade front."

But economic growth won't pick up enough to dramatically improve earnings at classic value stocks, he says. So instead, he prefers large-cap growth companies.

"We are not at a market top yet," agrees Charles Lemonides, the chief investment officer of ValueWorks. "Growth and exciting stocks lead you into that top, not boring value stocks." Lemonides favors discounted growth-oriented companies which could see a return to favor because of looming catalysts.

He cites Qualcomm QCOM, -1.39%, where sentiment could improve as antitrust litigation resolves and the 5G rollout spurs growth; Amgen AMGN, +1.43% and Gilead GILD, +1.49%, which have transformative drugs in their pipelines; and the offshore drilling services company Transocean RIG, -1.28%, which could see a pickup in demand as oil price firm up and move higher.

Todd Lowenstein, a value manager at HighMark Capital Management likes large-cap growth stocks trading at a discount. His short list includes: Citigroup C, +0.34%, Boeing BA, -1.09%, United Parcel Service UPS, +1.16% (see my take here, Dollar Tree DLTR, +0.11%, eBay EBAY, +0.06% , Suncor Energy SU, -0.28%, Applied Materials AMAT, -0.63% and Analog Devices ADI, -0.14%.

Jefferies quant Steven DeSanctis says now is the time to favor discounted smaller companies in the Russell 2000 index RUT, -0.12% over larger Russell 1000 names which are more expensive. The relative valuation gap between the two hasn't been this wide since June 2003. His inclination makes sense, because smaller companies often do better as growth picks up. "For those of you who were around in June 2003, the next several years were quite good for small caps versus large caps," he says.

At the time of publication, Michael Brush had no positions in any stocks mentioned in this column. Brush has suggested PG, DUK, QCOM, AMGN, GILD, RIG, C, DLTR, AMAT and ADI in his stock newsletter Brush Up on Stocks. Brush is a Manhattan-based financial writer.

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