"Multi-Cap Value Investing Is Hot Again"

Market Commentary – March 2021

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 4.1% in the fourth quarter of 2020. This is higher than the advance estimate of 4.0%. The economy continues to gain strength. According to the Federal Open Market Committee (FOMC) statement on January 27, "The path of the economy will depend significantly on the course of the virus, including progress on vaccinations. The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook." With the likelihood of herd immunity from COVID-19, whether through vaccination or previous infections, economic growth should continue to ramp up.

The Federal Reserve remains committed to its monetary policy easing to help support economic growth. The target federal funds rate should remain at 0% to 0.25% through 2023. Plus, the Fed continues to buy Treasury and mortgage backed securities to grow its balance sheet, hoping to keep interest rates low. As of February 24, the Fed had $7.64 trillion in assets on its balance sheet, which is up from $7.45 trillion one month ago (an increase of $190 billion). Investors have been conditioned to not fight the Fed, so this action is bullish for stocks. The next FOMC decision on monetary policy is scheduled for March 17.

After many investors had given up on the style, multi-cap value investing has become hot once again. In the first two months of 2021, the value indexes are leading (S&P 600 Small Cap Value +17.8%, S&P 400 Mid Cap Value +10.8%, and S&P 500 Large Cap Value +4.2%). In comparison, the growth indexes are lagging (S&P 600 Small Cap Growth +11.1%, S&P 400 Mid Cap Growth +6.0%, and S&P 500 Large Cap Growth -0.5%). Note how the trends are consistent: value is performing better than growth, small-caps are stronger than mid-caps, and mid-caps are better than large-caps. This is the exact opposite scenario observed in 2020! The mega-cap technology bubble has not yet burst, but those stocks are weighing on the same indexes they helped from 2017 to 2020. Large potential upside for multi-cap value investing remains.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) during 2021 is $170.91, which implies a price-to-earnings (P/E) ratio of 22.3 with the S&P 500 at 3,811. The earnings yield (E/P) of 4.50% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.44%. Treasury rates marched higher in February, which makes the S&P 500 index less attractive at current prices. Higher interest rates act like strong gravity in the physical world; they bring the high prices of expensive stocks back down to earth.

The S&P 500 has pulled back from its all-time closing high of 3,935 on February 12, although it remains to be seen whether a deeper correction will develop. The index is currently resting on its 50-day moving average, which is a support level that held in January. Additional support should be found near 3,550 (September and October 2020 closing highs) and 3,450 (200-day moving average). A break above 3,935 would signal a possible push to the milestone 4,000 level and beyond. It is possible that the S&P 500 could struggle while small and mid-cap indexes thrive.

Our patience with multi-cap value investing is finally being rewarded. An important lesson for investors is to stay true to your investment style and to not chase performance. Chasing performance often dooms an investor to buy at high prices, which then invites the temptation to sell at lower prices thanks to future frustration with underperformance. The psychology of "buying low" is tricky to master. Strangely, many investors feel more comfortable buying a stock after they see a stock price rise in recent months/years. Such investors look at the *left side* of a stock's price chart and note the trend. The unfortunate truth is that the *right side* of the price chart has not yet been revealed. Momentum investors who extrapolate a trend (either up or down) ultimately learn the hard lesson that valuations do matter.