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Value Stocks Have Contrarian Appeal

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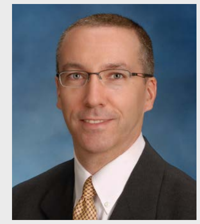

U.S. large-cap stocks have been strong performers so far in 2017. Through Tuesday, the Standard & Poor's 500 index was up nearly 9% on a total-return basis. But that number might have a casual market-watcher wondering, "Really? Only 9%?"

Such a perception gap could exist because news out of the equity market seems to be concentrated on a handful of the biggest and best-known names in technology that are posting year-to-date returns close to four times the S&P average.

A couple of these stocks are generating increasingly bold headlines as their price approaches $1,000 a share, with mind-boggling references to how much richer you would be now if only you were lucky enough to invest even a modest sum on their first day of trading (and smart enough not to sell during the many rough patches along the way). As a group, these high-fliers now include the four largest companies in the world by market cap.

Of course, the ride is exhilarating when a stock shoots up so high and so fast, but the higher and faster the trip, the more potential dangers of ownership.

We're by no means suggesting these stocks or the tech sector overall (+20% YTD through May 26) are in imminent peril. We do think, however, that some caution could be in order for those tempted to chase the hot trend — some of the loftiest tech names are now priced around 200 times earnings. By comparison, the S&P 500's P/E ratio is roughly 24x, itself a fair bit higher than the index's long-term average.

Demand for growth-oriented stocks is being driven largely by sagging expectations for the U.S. economy. First-quarter real GDP growth has been revised up from an annualized rate of 0.7% to 1.2%, but equity investors have been searching for signs that the economy could exceed 3% real growth for a sustained period.

KEY TAKEAWAYS

- Growth stocks have been on a tear in 2017, driven in large measure by sagging expectations for the U.S. economy. The run-up has us thinking some caution could be in order for those tempted to chase the hot trend.
- Although they've underperformed, a case can be made for value stocks. First, they are cheap relative to the S&P 500 as a whole. This means they could provide more upside over time, and also offer a measure of downside protection.
- We see more value opportunities in international developed markets, most notably Europe. Among the reasons: Fundamental valuations are considerably lower than in the U.S., and the region is also seeing a pick-up in GDP growth.

When those signs fail to emerge, they seek out the stocks with the best growth prospects. And when the same names end up on everyone's list, their prices are bid up into nosebleed territory.

Current conditions have been tough on value stocks, which tend to perform better when the economic outlook is brighter. With consumer spending in decline, the Federal Reserve in tightening mode and the White House's pro-growth plans in doubt, it's hard to see where any GDP tailwind would come from.

All this said, it might seem a stretch to suggest that now might be a good time to consider investing in value, but a case can be made for this contrarian approach.

First, because value stocks are so unloved these days, they are cheap relative to the S&P 500 as a whole. This means investors are paying less for every dollar of earnings being generated by these companies, and those dollars are increasing. Forecasts call for decent-to-good earnings growth at least through 2017. Cheapness may also help on the risk side by providing a measure of downside protection compared to higher-priced growth stocks.

Selectivity is also important. While value overall is underperforming growth, some value-oriented sectors have turned in above-average returns so far this year. These include utilities and consumer staples, which have benefited from investors seeking dividend income and from those taking a defensive stance as the stock market continues to hit new all-time highs in a weak macro environment.

In fact, most of value's troubles can be traced to just two struggling sectors: energy (-13% YTD) and telecom (-10%). Financials are flat for the year, but stand to see improving fortunes as the Fed boosts interest rates and if tax cuts and/or reduced regulation pass muster in Washington.

We search for value globally, and now we see more opportunities in international developed markets, most notably Europe. Among other reasons, fundamental valuations are considerably lower in Europe than in the U.S., which could increase the upside potential. The region is also seeing a pick-up in GDP growth, albeit slowly and from a very low base. This momentum, if sustained, could create ripe conditions for value investors.

As always, we encourage investors to speak with one of our financial advisors, who can help determine which investment vehicles are suited for you based upon your individual goals, objectives, risk tolerance and time horizon.

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