Insights
Systematic Equity-Active

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Bond Yields Climb, Equities Fall, and Value Shines

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In September, equity markets finally woke up to the higher-for-longer interest rate narrative that the Federal Reserve Board (Fed) and other developed markets' central banks had been pushing for quite some time. Bond yields soared, equity markets swooned, and the Value factor shone.

For much of this year equity markets have been relentlessly pushing upwards, seemingly in defiance of the macroeconomic environment, recession risks and warnings from central bankers about the path of interest rates. In September, finally the message seemed to get through; long-bond yields soared and global equity markets retraced quite sharply. We dig into the outperformance of the Value factor, a shining star amid this weakness.

Value and Interest Rates

Returns to the Value factor, and value equities are often linked to a bet on interest rates. We have previously written debunking this myth[1] over the long-term, particularly when using more nuanced definitions of value beyond simple book to price. We also showed that much of the increase in correlation between interest rates and value has been due to a shift in the sector composition of the value vs growth portfolio.

Over short horizons, though, the correlation between interest rates and value returns can be quite noticeable. In the post-COVID period, the fortunes of Value vs Growth stocks has seemed closely related to the direction of long-bond yields. As interest rates expectations rose over the period from late 2020 Value stocks outperformed growth. Since March of this year, however that relationship appears to have broken down; bond yields have continued to rise and Growth stocks had been outperforming their value counterparts handsomely. Since the market peaked at the end of July, there are signs that the outperformance of Growth has started to reverse.

Figure 1
MSCI Value-Growth Index Returns vs. Cumulative Changes in US 10-Year Bond Yields

Value — Growth
Benchmark

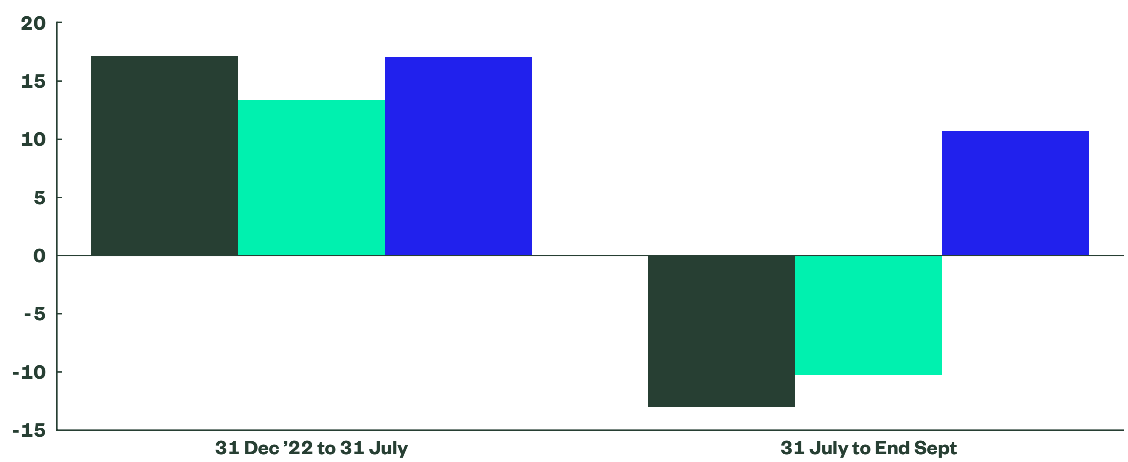
Source: MSCI, FactSet, State Street Global Advisors. Data as of September 30, 2023.

In the famous quote, attributed to Warren Buffett (with a nod to Benjamin Graham), "in the short run, the market is a voting machine but in the long run, it is a weighing machine." In times of stress, investors often vote with their feet, as equity investors did in September, selling positions and sending the market down. It seems that the Fed's warnings that interest rates would be higher for longer, were finally being heeded, along with the market digesting news of rising oil prices and slowing growth.

As is often the case, when the market started to turn negative, investors sold their more over-valued assets. Based on our more nuanced measure of Value than the simple Value/Growth index split, the most expensive quintile of securities underperformed the cheaper end of the market from the market peak at the end of July until the end of September.

Figure 2
Returns by Quintiles vs. Change in Bond Yield

Most Expensive
Cheapest
Bond Yield
(Relative % Change)



Source: Factset, State Street Global Advisors. Data as of September 30, 2023.

We note that US 10-year bond yields actually increased more in the first seven months of this year as compared to August and September; however, it was the speed of the move in September in particular that tripped up investors and led to the risk-off environment — which ultimately helped the Value rally.

The Bottom Line

We have been concerned for much of the year that equity markets, particularly in the developed world, have not been paying enough attention to the risks of slowing growth and higher interest rates, which led to the more expensive pockets in the market outperforming. In September both bond and equity markets reacted to the change in tone, sending yields up and equities down — and that risk-off tone led to a resurgence in the Value theme in September.

The macroeconomic and business environment can of course affect market returns, yet factors within markets and the timing of these factors can be difficult to predict. Which is why we believe it is important to diversify exposures across factors, sectors, and stocks to build resilient portfolios in uncertain times.

Endnote

1 Value-investing-an-interest-rate-bet.pdf (ssga.com).

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* Pensions & Investments Research Center, as of December 31, 2022.
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