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THE WINNING FACTORS: WILL THEY PERSIST? CLUES IN EARNINGS SEASON

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IN A NUTSHELL

_ Growth, large cap, and U.S. were the winning factors during the recovery, but Growth dominated
_ This recovery rally is unusual since it's not beta led, certainly not cyclical value
_ Super-cap leadership raised S&P concentration, especially top 3-10 stocks
_ 2Q earnings season could be an important battle in the style war
_ Tactically, a style rotation is possible, with the battle line at Tech vs. Financials

THE WINNING FACTORS: GROWTH, LARGE CAP, AND U.S.… BUT GROWTH DOMINATED

The sharp recovery rally since the pandemic-induced bear market in March featured a surge in Growth-stock outperformance after three years (2017 start to 2019 end) of sizable and consistent outperformance. Russell 1000 Growth beat Russell 1000 Value in 2017, 2018 and 2019 and in every quarter of those years but 4Q18, when equities swooned on the U.S. Federal Reserve (Fed) contemplating future rate hikes. In this year's first half, Growth beat Value by 26% after outperforming by 43% in total 2017-2019. So far, July brings more of the same, putting Growth's total outperformance at 88% vs. Value since 2017 start. This is the largest cumulative outperformance of Growth vs. Value since the style indices began in 1979 and exceeds the 73.5% Growth vs. Value burst from 1998 to Feb 2000. It's only since late 2019, and the relatively brief time in 1999-2000 that Growth cumulatively outperformed Value over the full history of these indices. This crescendo of outperformance from Growth after performing a magnum opus leaves many wondering if this is its climax, at least for now, or if more will come.

THIS IS AN UNUSUAL RECOVERY RALLY; IT'S NOT BETA LED, CERTAINLY NOT CYCLICAL VALUE

This recovery rally has not been beta led, which is very odd. It's one thing for style to overpower beta during middle- or late-cycle bull-market years, but for a style factor to dominate beta in a post-bear-market recovery rally is unusual, especially when that style isn't Value. Bear-market recovery rallies are usually dominated by High Beta, Value, Low Quality stocks. Instead, this rally's leadership is Growth, Super-cap, and Quality (strong balance sheets, high margins). This is usually the leadership toward the end of a bull market, not the beginning. This can be simply explained as leadership of all things digital amidst a pandemic's physical distancing. But for 3.5 years now, Growth has outperformed on a powerful combination of high duration & digitalization. The pandemic accelerated digital business growth and crushed real interest rates. It's doubtful this kind of rally signals investor confidence in a strong economic recovery; however, the strength of the equity market itself should help.

SUPER-CAP LEADERSHIP RAISED S&P CONCENTRATION, ESPECIALLY TOP 3-10 STOCKS

Large has outperformed small over the last few years and YTD. However, since March's bottom, large and small have been neck and neck as small-cap Growth stocks surged. But even within small, after a steep bear decline, Growth outperforms tremendously. But the most notable phenomenon by size is surging outperformance of super-cap stocks with trillion dollar plus equity capitalizations that are making the S&P 500 more concentrated and sensitive to its top-ten index weight stocks. The top 3, 5, and 10 largest S&P 500 stocks are now 15.9%, 22.8%, 30.6% of the index. All record highs. However, the top 50 largest are still a bit below their 1999 record share.

2Q EARNINGS SEASON: AN IMPORTANT BATTLE IN THE STYLE WAR

Currently, the bottom-up consensus for 2Q S&P earnings per share (EPS) is $23.26. Many expect this to be beaten as usual, but we're doubtful. First, while consensus is typically beaten the day of company reporting, there has been a pattern of last-minute cuts to estimates during the earnings season over the past two years, such that all the company "beats" on reporting day add up to the same S&P EPS figure at the start of the season. Second, while we expect most companies to beat reporting-day estimates, we also expect many big misses at the companies with losses. Most companies with likely losses in 2Q pulled guidance and often analysts don't forecast losses as big as they turn out to be in recessions. For these reasons, we expect 2Q S&P EPS to be closer to $20 than $25. This is above our $15 estimate or $10-20 range, as the reopening gross-domestic-product (GDP) bounce came sooner than we expected and there is talk of earnings immunity and even net benefits at Tech EPS year-over-year (y/y). That acknowledged, we are preparing ourselves to be amazed by earnings surprises from the digital world this earnings season given the recent share-price surges. We might raise our 2020E S&P EPS to $115-120, but unless Tech smashes it, better-than-feared 2Q EPS won't be enough to raise our 2H20 and 2021 S&P EPS estimates given the resurgent spread of the virus.

STYLE ROTATION? PERHAPS TACTICALLY, BATTLE LINE SITS AT TECH VS. FINANCIALS

Despite demanding valuations at Tech, we're inclined to stay overweight, especially given the resurgent spread of the virus. We'll see if Financials can deliver beats (with large loan-loss provisions) and consider raising it to equal-weight. But if Tech fails to impress, it could trigger an S&P correction given its index heft and that challenges elsewhere aren't quickly disappearing. We believe digital firms have bright futures, but it might be hard for them to deliver enough near-term against high expectations. We think these companies are good long-term investments, but Growth investors must be patient, especially when paying today's valuations. Equity overweights that tilted heavily to cyclical value stocks have less outperformance than usual in a recovery rally, but this extraordinary Growth vs. Value phenomenon might take a rest and the debate might miss the beta call yet becoming most important within equities into year-end. If digital doesn't deliver and the reopening bounce loses energy, sapping cyclical value's chance at putting up a better fight, we will likely take an even more defensive sector strategy with a low beta, but no style preference.

GLOSSARY

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

A bull market is a financial market where prices are rising - usually used in the context of equities markets.

A correction is a decline in stock market prices.

Cyclical is something that moves with the cycle.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Margin describes borrowed money that is used to purchase securities.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The Russell 1000 Growth Index states the performance of the companies included in the index that have higher price-to-book ratios and are forecasted with higher growth.

The Russell 1000 Value Index states the performance of the companies included in the index that have lower price-to-book ratios and are forecasted with lower growth.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

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