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A challenging road ahead for expensive stocks

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Snapshot

- In SEI's view, higher interest rates and inflation are likely to be a feature of the economic environment, at least in the medium-term.
- The most expensive areas of the market, stocks that have hogged the spotlight for years, appear particularly vulnerable to the reflationary currents of higher interest rates and inflation.
- We believe that our active positioning, underweighting the most expensive areas of the market, is poised to benefit. More broadly, we believe the shifting economic environment holds an advantage for active management versus top-heavy, passive indexes.

Inflation is here...

Higher inflation is here. In the U.S., the Consumer Price Index (CPI) was up 5.3% for the 12 months ending August 31, 2021. When stripping out the volatile food and energy components, the core CPI shows that prices still rose 4.0% over the same period. Needless to say, this is well above the U.S. Federal Reserve's (Fed) target of around 2% for stable inflation. Even the Fed's preferred measure of inflation—the less widely reported Personal Consumption Expenditures Price Index (PCE), which tends to run a little lower than the CPI— was up 4.3% for the 12 months to August 31, 2021.

Some of this inflation is likely transitory due to base-level effects. Year-ago prices were significantly lower, and in some cases even deflationary, due to COVID-19-related lockdowns. The fact that August's CPI report was slightly lower than July's lends some credence to the notion that a portion of this inflation may well be transitory. However, price pressures due to supply-chain disruptions could easily continue into 2022 or beyond. Unprecedented economic stimulus, both monetary and fiscal, may also contribute to inflation being stickier than initially thought. Per the U.S. Bureau of Labor Statistics, we have seen significant upward wage pressure, especially for lower-income earners, although total wages are still below pre-pandemic levels as dramatically fewer people are employed versus 18 months ago. The bottom line is that inflation—when observing either the CPI or the PCE—has been below average for over a decade. We believe that trend is part of history and investors should expect higher inflation over the near- and medium-term.

...And SEI expects higher rates to follow

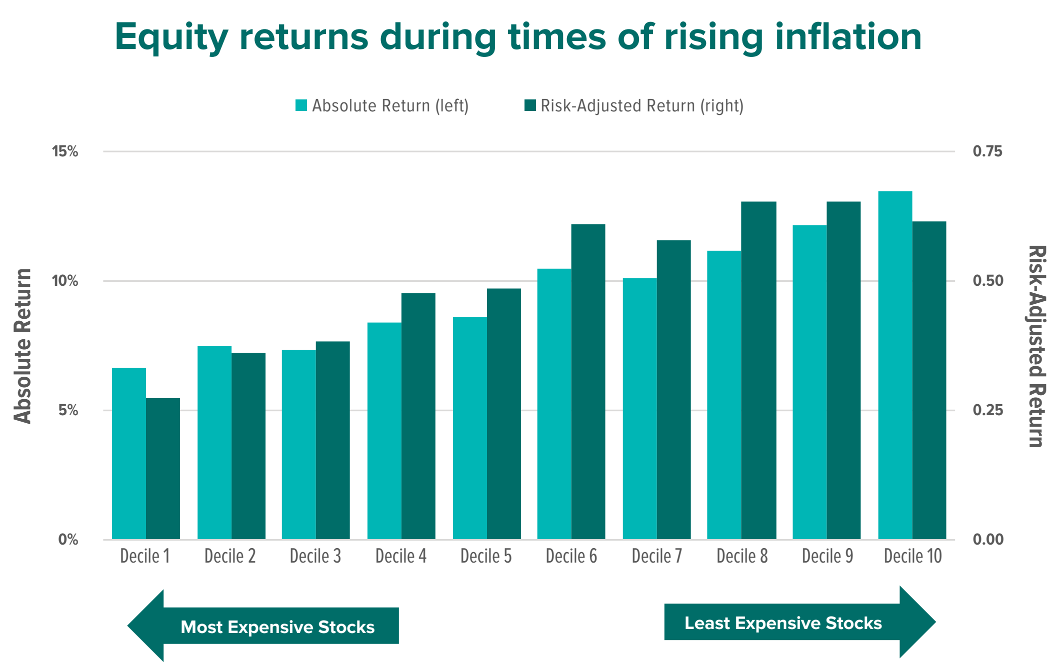
With inflation comes the expectation for higher interest rates. We've already seen this with the 10-year U.S. Treasury bond exceeding 1.7% earlier this year when an optimistic outlook for robust economic growth and inflation was more prevalent. Interest rates then settled into a lower range as optimism wavered before ticking back above 1.5% as it appears the Fed may be rethinking their 'transitory' view of inflation. While yields remain incredibly low from a historical perspective, they're generally two-to-three times the lows of 2020 when the yield dipped to around 0.5% before edging up.

The Fed seems content with leaving short-term rates near zero for now, but the timeline for hikes may be shortening. While previously indicating that it would not raise rates until late 2023, the Fed has more recently signaled that the first hike could now come in early 2023 or even late 2022. Continued strong growth, employment and inflation reports could potentially shorten that timeframe even more.

How does SEI expect stocks to perform in this environment?

Given the extremely elevated valuations of certain segments of the stock market, it is worthwhile to examine how expensive stocks may be expected to perform versus inexpensive stocks in times of rising inflation. Looking at Exhibit 1, we can clearly see that cheaper stocks tend to perform better than expensive stocks in times of rising inflation—especially when looking at a Sharpe Ratio to adjust for risk.

Exhibit 1: Equity Returns During Times of Rising Inflation

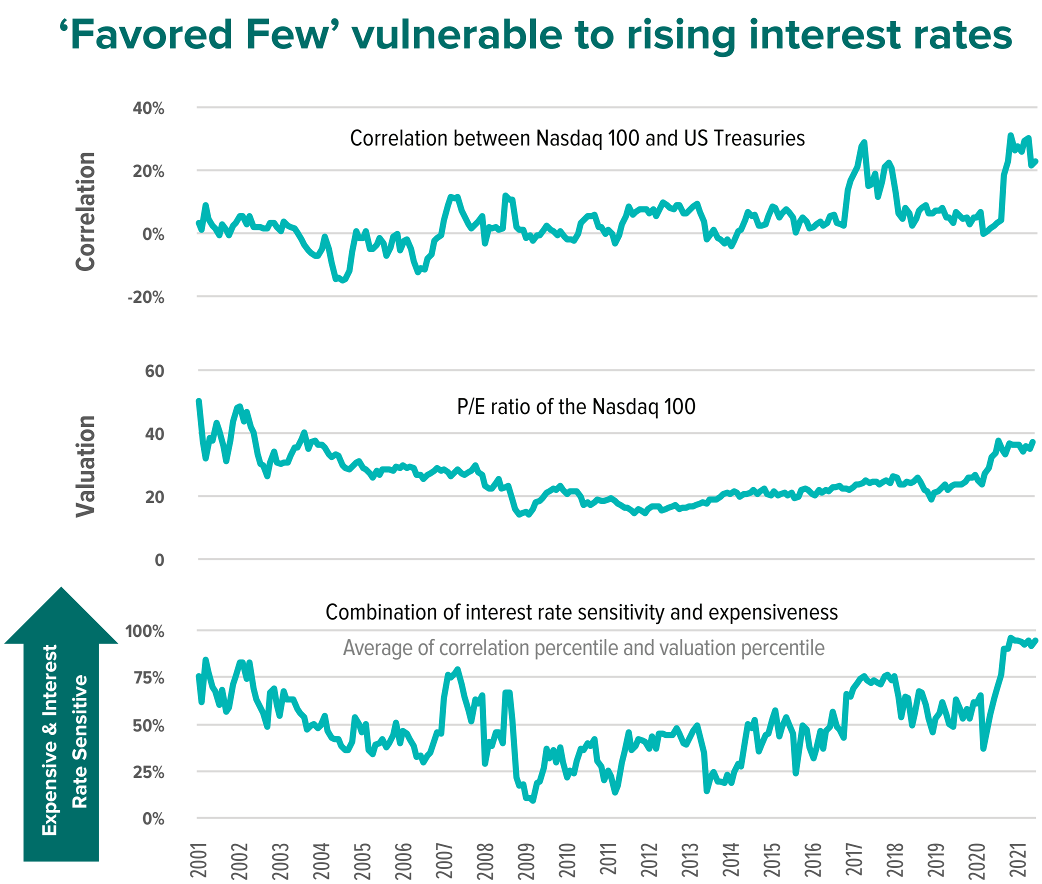


Based on returns from the Ken French data library for portfolios formed by segmenting U.S. stocks into deciles according to their price-to-earnings ratios; reconstituted annually in June. Inflation is based on the headline U.S. consumer price index; rising inflation denotes a higher rate of inflation as compared to the previous annual rate. Annual data points for returns and inflation are from June to June, to align with the reconstitution of the portfolios. Data from June 1951 to June 2020 (June 2021 data not yet available). Source: Ken French data library, Bureau of Labor Statistics, SEI. As of June 30, 2021.

At SEI, we view valuation as a significant factor in determining long-term excess returns. Therefore, while we are not exclusively value investors, our investment philosophy and process has a valuation component. Given this, and the emphasis on valuation in our current active positioning, we would expect our portfolios to perform well in an environment of rising inflation.

Perhaps more interesting is how the expensive “glamor stocks” of today may be particularly vulnerable to rising interest rates. Call them what you will—“the favored few,” “FAANGs,” or “big tech stocks”—they represent a group of exceptionally expensive stocks whose valuations can only be justified by lofty earnings expectations extending far into the future. Using the NASDAQ 100 Index as a proxy for these types of stocks, Exhibit 2 illustrates that they are currently more interest-rate sensitive compared to the broader equity market than they have been in the last 20 years. Exhibit 2 also shows that the NASDAQ 100 Index is historically expensive. Many investors are expecting higher future earnings to justify these values—making their valuations naturally more interest-rate sensitive. If rates begin to rise, the value of those future earnings will decrease since the value of future cash flows is determined by discounting them using prevailing interest rates. Higher discount rates obviously would lower the present value of the future cash flows and hence stock valuations. These types of stocks—more expensive than average, justified by above-average earnings growth—are often generically labeled “growth stocks” and tend to be more negatively impacted by higher interest rates as compared to the rest of the market. Rising interest rates could also dampen lofty expectations for earnings growth if overall economic growth moderates in response to higher rates.

Exhibit 2: “Favored Few” Vulnerable to Rising Interest Rates



Correlation between total returns of the NASDAQ 100 Index and U.S. Treasurys in excess of broader U.S. stock-market correlation with U.S. Treasurys (broader U.S. stock market represented by Russell 3000 Index; U.S. Treasurys represented by Bloomberg U.S. Treasury Index). Correlations calculated on a rolling 125-day basis. P/E ratio is the index positive price-to-earnings ratio as reported by Bloomberg. Percentile within the historical range istaken for the correlation data and the P/E ratio data, and the average of the two is shown in order to convey the combination of interest-rate sensitivity and expensiveness. All data from January 2001 to June 2021. Source: Bloomberg, SEI. As of June 30, 2021.

While the expensiveness of the NASDAQ 100 Index may not be completely unique even at historically elevated levels, the combination of how expensive it is, and its current, high degree of interest-rate sensitivity is unique to today's environment. As such, we believe this segment of the market is particularly vulnerable to rising rates going forward.

SEI's positioning

As previously noted, SEI is not exclusively a value investor; rather we diversify across multiple strategies and drivers of excess return—with value being one of those drivers. We generally have a meaningful exposure to value, and currently that exposure is overweight in most of our equity funds. Expensive stocks appear particularly vulnerable to the changing inflation and interest-rate environment. We believe that our active positioning, underweighting the most expensive areas of the market and emphasizing value—is poised to benefit.

In our view, it is always prudent to remain well diversified across an investment portfolio; the current environment also provides the opportunity to take advantage of our expectation that value should see a significant period of outperformance versus growth. More broadly, active management may also benefit from the shifting inflation and interest-rate environments. Passive investing is historically expensive as it generally seeks to imitate a chosen index—most of which are market-capitalization weighted and therefore have increased exposure to the overpriced "favored few." We believe that as bull markets age, passive strategies inherently suffer from high valuation and inefficient concentration of holdings. Active strategies can still invest using valuation metrics and potentially better allocate their capital than passive strategies.

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