Sharp sell-off in growth stocks – a good thing?

- **2023 has seen a steep fall in our measure of corporate optimism and over-investment, a contrarian indicator which suggests a more positive market outlook.**
- **This stems from the large sell-off in growth stocks last year, which squeezed a source of cheap funds for these stocks.**
- **Our cash flow analysis still suggests that value and momentum stocks look the most attractive, but the growth de-rating may throw up opportunities if it persists.**

Sometimes our market regime indicators give us a simple, clear-cut message on the investment style we should be applying. This was the case during the early stages of the Covid pandemic, when our process was telling us loud-and-clear that we should be investing in the value space, just as investor anxiety spiked and investors were fleeing to expensive growth and quality stocks that were viewed as insulated from the impact of lockdowns.

On other occasions, the signals we get from our market indicators are more nuanced, although this doesn't mean the investment opportunity is any less compelling. This is the situation we find ourselves in today, with a largely positive investment outlook nuanced by differing prospects between Europe and the US and between different style factors within these markets.

One of the more intriguing developments in 2023 has been the drop in our measure of companies' over-optimism. This is a contrarian indicator, so a drop is a bullish development.

Our analysis shows that aggressive corporate expenditure is often a sign that executives are making overly optimistic growth forecasts which they are prepared to back with significant investment. When in due course the over-optimism is revealed and growth disappoints, the situation is exacerbated by the misplaced investment that has occurred.

When our measure of aggressive spending spiked in late 2021, we repositioned portfolios to reflect a gloomier outlook, adding some defensive exposure on long-only portfolios and increasing our short book size on long/short strategies.

This over-investment is now falling quite dramatically in the US and more steadily in Europe. As a result, we think the market outlook is much healthier than a year ago. Part of the reason for this precipitous collapse in corporate aggression must be the large sell-off in growth stocks seen during 2022 after rising interest rate expectations eroded the present value of these companies expected future profit streams. As valuations of these growth stocks fell from stratospheric levels, it closed off a lot of the opportunity for them to issue lots of highly valued equity, squeezing this source of cheap funding.

Matters also look attractive from a valuation perspective, – especially in Europe. While European markets are higher than they were a year ago when interest rate hikes were hitting sentiment, companies have delivered good growth in cash flows over this period. Cash flow-based valuations have therefore improved. From being expensive last year, Europe now looks fair value. Valuations in North America have also improved, but still looks expensive overall.

Turning to the technical picture, the last six months has seen a repairing of the technical weakness experienced in 2022. Europe is now in a firm uptrend, while North America is still presenting a mixed technical picture, although much improved on seven or eight months ago.

Stylistically, we continue to expect that both value and momentum should feature prominently in portfolios. Value continues to look cheap relative to history, should benefit from higher inflation and is due significant mean reversion in the wake of the growth dominated market 2008-2021. Our indicators are highlighting a number of trends that are usually positive for momentum strategies and, if history is any guide to the future, these suggest a momentum crash is unlikely.

One area worth keeping an eye on for now is growth stocks. For some years we've been warning of the exorbitant valuations and aggressive cash expenditures in this area of the market. As discussed above, both these factors are improving. At the start of 2022, there seemed to be a final huge surge in growth valuations, but they've since come under massive pressure as interest rate expectations have risen sharply, meaning higher discount rates applied to their expected growth.

As these stocks have got cheaper, our tilt away from this part of the market has almost disappeared. Many of these stocks still remain expensive and most of them also have very poor momentum. However, in the US particularly, where the growth sell-off was far more punishing, we are finding some selective opportunities in quality growth stocks whose ratings have sunk low enough to represent good value.

While we retain our portfolios' bias towards value, this position is now much less of a relative bet against growth-style stocks and we are now approaching a neutral stance on growth. The secondary scores we are currently focused on targeting are momentum, recovering value and cash return.

Visit the Cashflow Solution team page **for more details of their investment process.**

The investment process involves in-depth quantitative and qualitative analysis of cash flow characteristics. Initially, the team applies a simple quantitative screen using two measures of cash flow to create a composite ranking of the European universe of companies, with only the top 20% – the Cashflow Champions watchlist – qualifying for further qualitative analysis.

This core ranking is then enhanced by the application of rigorously back-tested proprietary indicators based on valuations, investor anxiety, corporate aggression and market momentum. These help the team classify the market regime which is likely to dominate in the short to medium term. They then optimise portfolio construction by emphasising particular secondary cashflow scores when selecting stocks from the Cashflow Champions watchlist. They have four secondary cashflow scores – Momentum, Cash Return, Recovering Value and Contrarian Value – which, for example, can be used to tilt a portfolio's profile towards or away from growth or value.

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