STYLE ANALYTICS
PART OF CONFLUENCE

Report

# Exploring the Relationship of Interest Rates to Value vs Growth Investment Strategies


Prepared by:

**Alex Lustig**
Senior Client Consultant, Investment Metrics,
a Confluence Company

**James Monroe, CFA**
Product Manager, Investment Metrics,
a Confluence Company


## Overview

After the economic turmoil caused by the COVID-19 pandemic, developed economies faced inflation rates reminiscent of the early 1980s. With the United States and the United Kingdom embarking on an unprecedented cycle of interest rate hikes to counter inflation, investors were left wondering about the potential impact on equity markets. Specifically, the question was whether this rapid rise in interest rates would favor either Value or Growth equities and to what extent. In July 2021, we analyzed historical stock returns from the 1980s to 2021 in both regions to understand how equity performance was affected when interest rates surged aggressively. Here are the key findings:

- If interest rates increased rapidly, Value stocks tended to outperform Growth stocks.
- In the US, Value stocks would outperform if long-term rates climbed by 5% in a given month, and in the UK, this threshold was over 20%.
- However, when rates didn't reach these thresholds, no clear winner emerged.

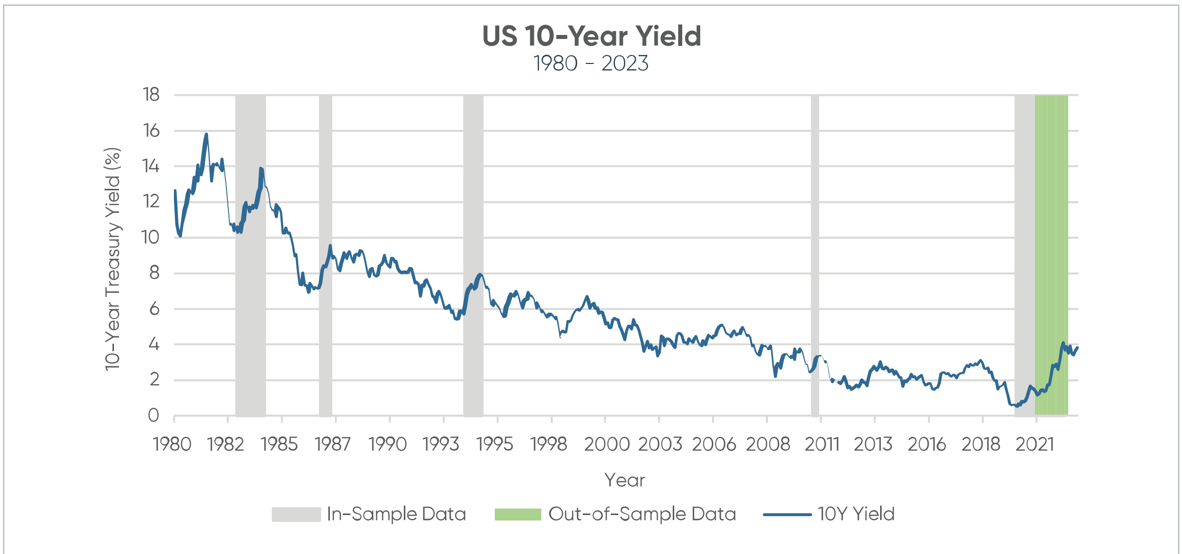


***Figure 1 – US 10-Year Treasury Yield between 1980-2023.***
*Source: Federal Reserve Economic Fata (FRED) (https://fred.stlouisfed.org/series/DGS10)*

In the United States, whenever the 10-year treasury rate increased by 10% (e.g., from 1.00% to 1.10%), we could anticipate Value stocks outperforming Growth stocks by approximately 100 basis points (bps). In the UK, a 100bps Value outperformance over Growth could only be expected if rates increased by at least 20% on a monthly basis.

Since our initial analysis, the 10-year treasury yield has continued its historic ascent. The question now is whether this relationship with long-term rates remained consistent during the Federal Reserve's aggressive rate hike cycle in 2022.

Between the trough and peak of the 10-year yield, spanning from June 2020 to October 2022, Value significantly outperformed Growth. However, this analysis only included data up to April 2021. To understand the situation in 2023, we divided the rate-rise period into in-sample (from June '21 to April '21), out-of-sample (April '21-October '22), and post-peak (October '22 to June '23) periods.

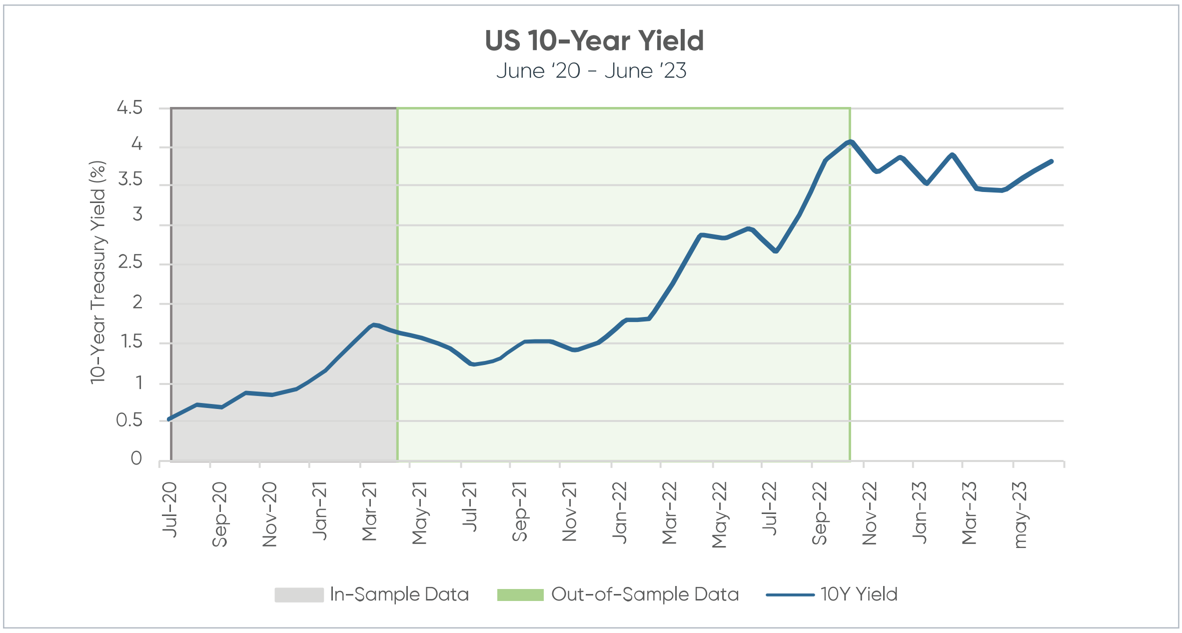


***Figure 2 – Recent rise of the US 10-Year Treasury Yield between June 2020 – June 2023.***
*Source: Federal Reserve Economic Fata (FRED) (https://fred.stlouisfed.org/series/DGS10)*

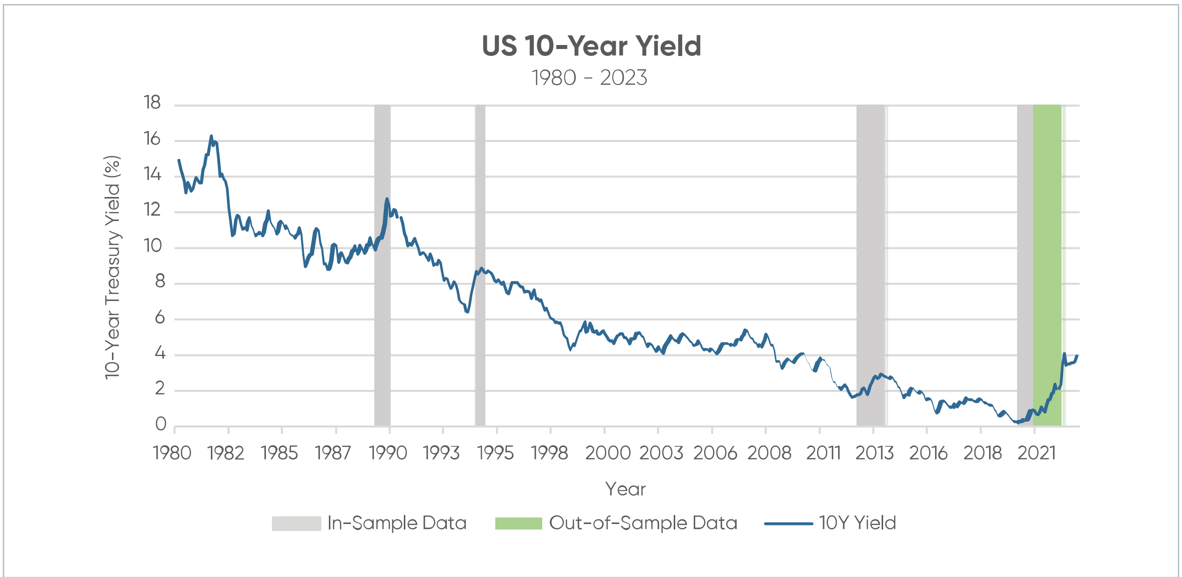


***Figure 3 – UK 10-Year Treasury Yield between 1980-2023.***
*Source: Federal Reserve Economic Fata (FRED) (https://fred.stlouisfed.org/series/IRLTLT01GBM156N)*

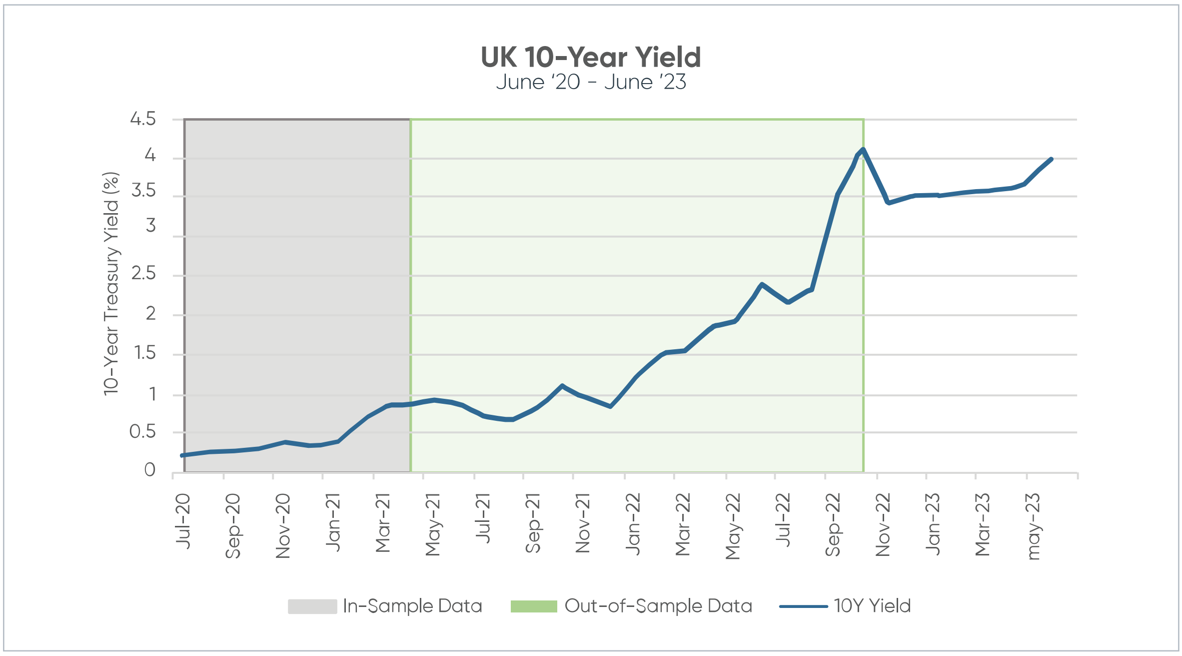


***Figure 4 – Recent rise of the UK 10-Year Treasury Yield between June 2020 – June 2023.***
*Source: Federal Reserve Economic Fata (FRED) (https://fred.stlouisfed.org/series/IRLTLT01GBM156N)*

Throughout the entire duration of the recent rate hike cycle, spanning from March'22 to October '22, the established relationship held firm: Value stocks continued to outperform growth as the 10-year treasury yield ascended to nearly 4%. Importantly, this relationship in the US exhibited roughly twice the sensitivity observed in the UK.

Specifically, our findings indicate that:

- In the US, Value stocks outperform Growth stocks by 113bps if the monthly rate increase exceeded 10%
- In the UK, Value stocks outperform Growth stocks by 134bps if the monthly rate increase exceeded 20%

Interestingly, in the UK, Value outperformed to a greater extent than initially anticipated. We expected a 100bps outperformance for every 20% increase, but the actual outcome was 34bps higher than in our initial analysis.

To assess whether the slope of this relationship remained consistent in the out-of-sample period, (excluding rate hikes prior to October '22), we conducted a separate regression analysis. The results closely resembled those observed in the total period analysis, with minor deviations due to the smaller sample size of 18 observations. A larger data set is expected to align more closely with our total period findings.

The trend is illustrated in the "US Market" chart below, where the Value-Growth spread consistently favored Value stocks throughout the total period but showed signs of weakening as the US 10-year yield fluctuated between 3.5% and 4% as of October 2022. In 2023, the decrease in the Value-Growth spread highlighted Growth stock outperformance in the US as several major technology companies recaptured valuations lost in 2022.

A similar pattern emerged in the UK market, where rates initially decreased in September 2022, only to rise to 4% by June 2023. The Value-Growth spread continued to favor Value stocks as rates climbed, though to a lesser extent as the rate increases moderated.

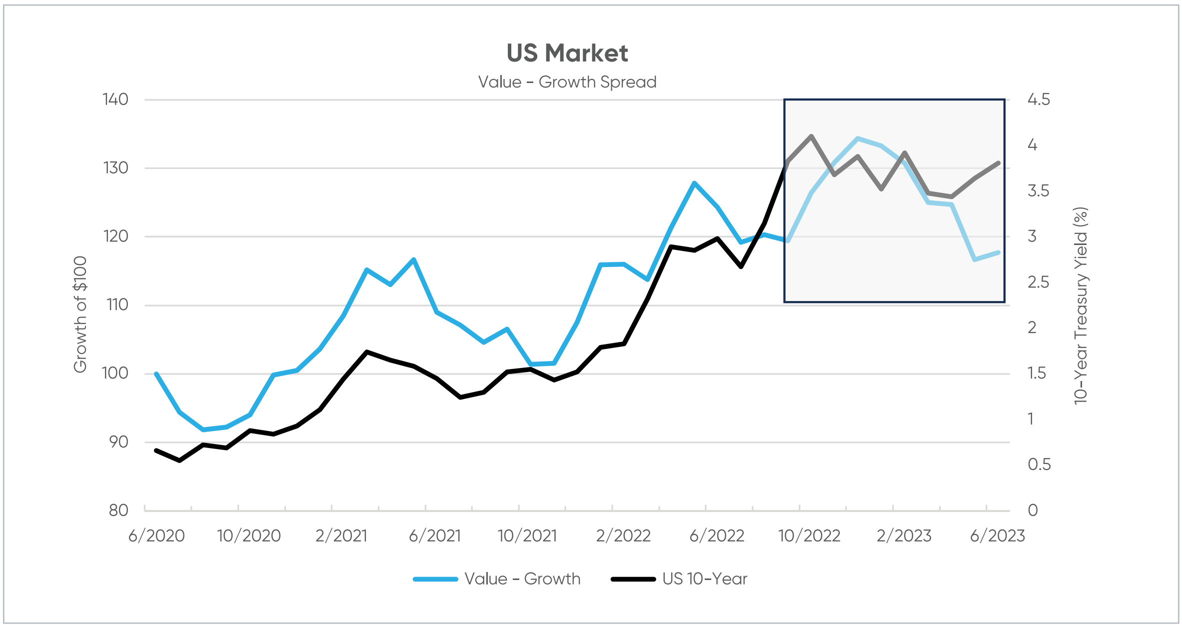


***Figure 5 – Value equity's relative performance to Growth equity compared with the US 10-Year Treasury Yield between June 2020 – June 2023.***
*Source: Federal Reserve Economic Fata (FRED) (https://fred.stlouisfed.org/series/IRLTLT01GBM156N) and Style Analytics Markets Analyzer*

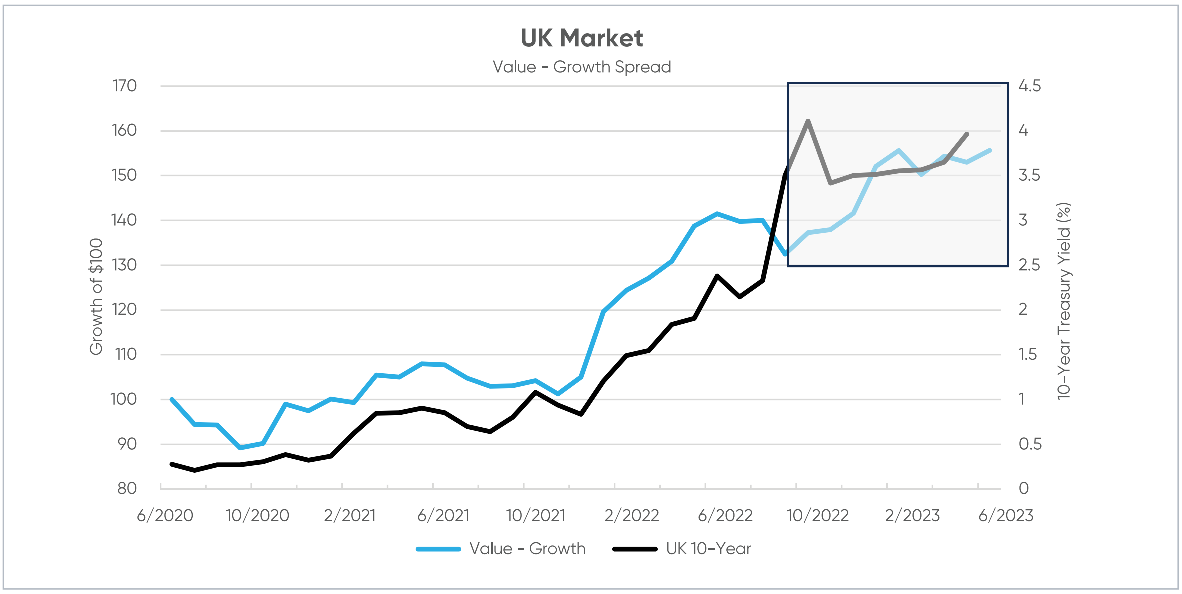


***Figure 6 – Value equity's relative performance to Growth equity compared with the UK 10-Year Treasury Yield between June 2020 – June 2023.***
*Source: Source: Federal Reserve Economic Fata (FRED) (https://fred.stlouisfed.org/series/IRLTLT01GBM156N) and Style Analytics Markets Analyzer*

As of September 2023, the US 10-year yield surpassed 4.3%, while the UK Gilt increased to 4.2%. Consequently, if the ongoing upward trajectory of the US and UK's 10-year yields remains consistent, we can reasonably expect Value stocks to maintain their outperformance over Growth stocks in both countries.

However, it's crucial to note that once yields peak and fail to increase by at least 10% each month, the model's predictive power diminishes, and the expectation of Value stocks outperforming Growth stocks no longer holds.

Portfolio Analyzer, part of the Style Analytics solution, provides powerful analytics on your portfolio's factor exposures, performance attribution and risk. Its intuitive visualizations bring your factor analysis to life through our industry-leading Style Skyline™. Additional modules unpack the "how" and "why" of exposure shifts and simulate rebalancing choices. Uncover your differentiating factor profiles for effective investor communications.

Request a demo by **clicking here**.

## About Investment Metrics, a Confluence company

Confluence is a leading global technology solutions provider committed to helping the investment management industry solve complex data challenges across the front, middle and back offices. From data-driven portfolio analytics to compliance and regulatory solutions, including investment insights and research, Confluence invests in the latest technology to meet the evolving needs of asset managers, asset owners, asset services, and asset allocators to provide best-of-breed solutions that deliver maximum scalability, speed, and flexibility, while reducing risk and increasing efficiency. Headquartered in Pittsburgh, PA, with 900+ employees in 15 offices across the United Kingdom, Europe, North America, South Africa, and Australia, Confluence services over 1000 clients in more than 40 countries. For more information, visit **www.confluence.com**.

**www.confluence.com**
**info@confluence.com**
**+44 (0)20 8410 9876**
**@Confluence_News**
**@confluence**