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Why growth will trump value in the long grind of recovery

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The swift and intense economic volatility caused by the Covid-19 crisis has left investors with something of a blind spot. Traditional business cycle analyses have no inputs for a global pandemic, making it hard to judge how to position portfolios for a market rebound.

But one opportunity stands out: the world's high-quality growth companies, many of which were trading on valuations a third below their early 2020 highs. The MSCI ACWI Quality Index, for example, finished March about 20% below its previous high on 12 March this year.

The path of economic recovery once the virus is vanquished is open to debate. Will it be W-shaped as a lockdown is intermittently reapplied or V-shaped as pent-up demand is unleashed? Whichever it is, the initial recovery seems likely to be followed by a long grind of slow growth.

This post-recovery environment could be a case of déjà vu, similar to the 12 years that followed the global financial crisis (GFC). As economic growth remained subdued, interest rates stayed low and capital was inexpensive. The result? The number of companies able to generate reasonably high earnings growth year after year shrunk. Broadly speaking, only high-quality growth companies could do so and their stocks outperformed.

Growth stocks at discounts

In a post-Covid-19 low-growth world, these same companies are likely to continue to prosper. With formidable economic moats, or competitive advantages, they are the beneficiaries of secular trends such as the rise of cloud computing, the expansion of capital-light knowledge-driven businesses, and ageing populations. The virus might have brought economic activity to a halt for now, but these powerful trends will continue almost regardless.

That is not to say these companies' share prices will always outperform. Since the GFC there have been at least five short periods when value stocks have outperformed significantly. And when equity markets initially rebound from the current crisis, it's likely they will once again rise further and faster. Governments and central banks have injected a huge amount of fiscal and monetary stimulus, and there will be pent-up demand, so the first burst of economic recovery may be strong. As is often the case at such times, value stocks – many of them low-quality with financial and operating leverage – will likely perform best for a short while.

But as sharp economic recovery turns to long grind of slow GDP expansion, so high-quality growth companies look best placed to prosper over the long term. Mastercard is a good example. Since the crisis struck, analysts have reduced their estimates of future earnings by more than 10%. Towards the end of March its stock price had fallen by almost a third from its mid-February peak. It is rare to have a chance to buy such a winning company at 25%-30% below its previous valuation.

Lessons from Japan

Japan's economy and equity market show what might be in store. Its economy has been battling with deflation since the 1990s with the result that banks, which struggle in deflation with lower interest margins, trade at a low valuation of 0.4 times book value. By contrast, the US has just entered a period of zero interest rates that will probably last for a long time, accompanied by quantitative easing. So, how will US banks justify trading at pre-Covid-19 valuations of more than one times book value?

It might be tempting to buy a bank or some other cheap business if there is a very strong GDP recovery for a short time – after all, they will look inexpensive. But if an immediate V-shaped recovery is followed by a long, slow economic grind then stocks such as these will not perform well and you'll find yourself in a "value trap".

One thematic change likely to result from the Covid-19 crisis is the restructuring of supply chains. Typically, Western industrial and consumer companies have outsourced production to other parts of the globe and elongated their supply chains over the past 20 years. That has allowed them to expand profit margins, reduce capital expenditure and have huge free cashflows, which they have used to buy back shares.

Yet the crisis has revealed the vulnerability of global supply chains. Companies will likely react by diversifying them, if not bringing them back onshore. The upshot? Higher capital expenditure and lower cash flow. These companies will not be as profitable after the crisis.

In today's fast-moving environment it is worth recalling that the virus will not dominate headlines for ever, and equity markets will rebound once they foresee evidence of the global economy recovering. The initial winners may well be value stocks. But in the longer term, buying high-quality companies at around two-thirds their pre-crisis prices cannot be the wrong thing to do.