Value Stocks: A (Potentially) Attractively Priced "Insurance" Against Rising Inflation?

Within the investment world, it appears that the topic of inflation has been discussed more often in the past one year than during the few decades prior. Early this month, the Federal Reserve approved plans to taper its stimulus, further supporting the notion that inflation is here to stay—at least for longer than initially expected.[1]

While we never attempt to make any calls on economic projections, we are always mindful of the factors that can affect company valuations, including inflation and interest rates. We believe the current environment, combined with the continued discounts at which value stocks trade compared to growth stocks, may provide a favorable catalyst for value stocks.

FACTORS CONTRIBUTING TO INFLATION

Likely Shorter Term

- Increased demand
- Supply chain bottlenecks
- Labor shortages

RISING INFLATION[2]

6.2%

Increase in consumer prices in the last 12 months

30 YEARS

Largest annual increase in three decades

Likely Longer Term

- Reshoring
- Monetary stimulus
- Regulatory tightening

BRANDES' VIEW

- Our investments are not dependent on an assumption of materially higher interest rates or inflation.
- ***We believe interest rates should normalize upwards over the longer term, although we do not expect any kind of excessive inflation.***

RISING INFLATION AND INTEREST RATES MAY BODE WELL FOR VALUE

Financials

- Largest component of many value indices
- May benefit from net interest margin expansions during periods of steepening yield curve
- Higher interest rates may also boost the returns of their short-term investments

Discount Rate

- The present value of a growth stock is largely driven by cash flows from a distant future (long duration)
- Rising inflation/interest rates drive up the discount rate used in company valuations, making long-duration growth stocks worth incrementally less compared to value stocks with more immediate expected cash flows (short duration)

Cyclical Stocks

- A big component of value stocks (including financials, industrials, energy, etc.) tends to be economically sensitive
- Rising inflation and interest rates have tended to occur during periods of economic strengthening, which had boded well for value stocks

Investor Sentiment

- During uncertain times (e.g., trade war, pandemic) investors are likely willing to pay a premium for the prospect visibility provided by growth stocks
- As the economy strengthens—and inflation rises—investors typically become more comfortable investing in economically sensitive value stocks

[1] Source: The Wall Street Journal, "Fed Dials Back Bond Purchases, Plot Ends to Stimulus by June," published 11/3/21.

[2] Source: Bloomberg, "Inflation in U.S. Builds with Biggest Gain in Prices Since 1990," published 11/10/21. CPI-U for the 12 months ending October 31, 2021.

Net Interest Margin: Interest income generated by a financial institution minus the amount of interest paid to its lenders, divided by average earning assets.

Yield Curve: A yield curve shows the relation between the yield on debt instruments (i.e., annual income from the investment, divided by the current market price of the investment) and their times to maturity. A typical yield curve slopes upward to reflect higher interest rates for longer maturities.

Reshoring: Bringing manufacturing of goods and services to the country of the company's domicile.