Comparison of Two Market Regimes: Is 2019 more like 1999 or 2000?

Parallels with the Stock Market 20 Years Ago

- The relevant question at mid-year is whether 2019 is more like 1999 or 2000? Will we see reversions back towards a broader market, led by value-oriented stocks, and with active managers having an easier time adding value in the latter half of 2019? Or will we need to wait for 2020? If the post-financial crisis era relationship between Less Volatile and Value stocks continues, it looks like the turnaround to Value may be coming sooner rather than later.

- Following May, its only negative month so far this year, the S&P 500® Index roared back in June and established new all-time highs. The 18.5% return during the first six months of 2019 for the S&P 500® Index is the highest return through June since 1997 (when the S&P 500® Index was up 20.6%). The strength of the domestic equity market during the first six months of the calendar year is not the only similarity between the current market environment and the stock market that began in the mid-1990's and lasted until early 2000.

- There are several parallel themes between the current stock market experience beginning in March 2016 and the stock market from 1995 through the late 1990's:
  - ✓ Direction - the S&P 500® Index goes up more often than average on a monthly basis, led by mega-cap stocks.
  - ✓ Volatility - both periods commence with the S&P 500® Index going up on very low volatility (in 1995 and following election in 2016 and throughout 2017).
  - ✓ Style - the Growth side of the market demolishes the Value side of the market.
  - ✓ Factor Performance - simultaneous failure of diversifying quantitative (valuation, growth/momentum and quality) factors that traditionally tend to offset each other.

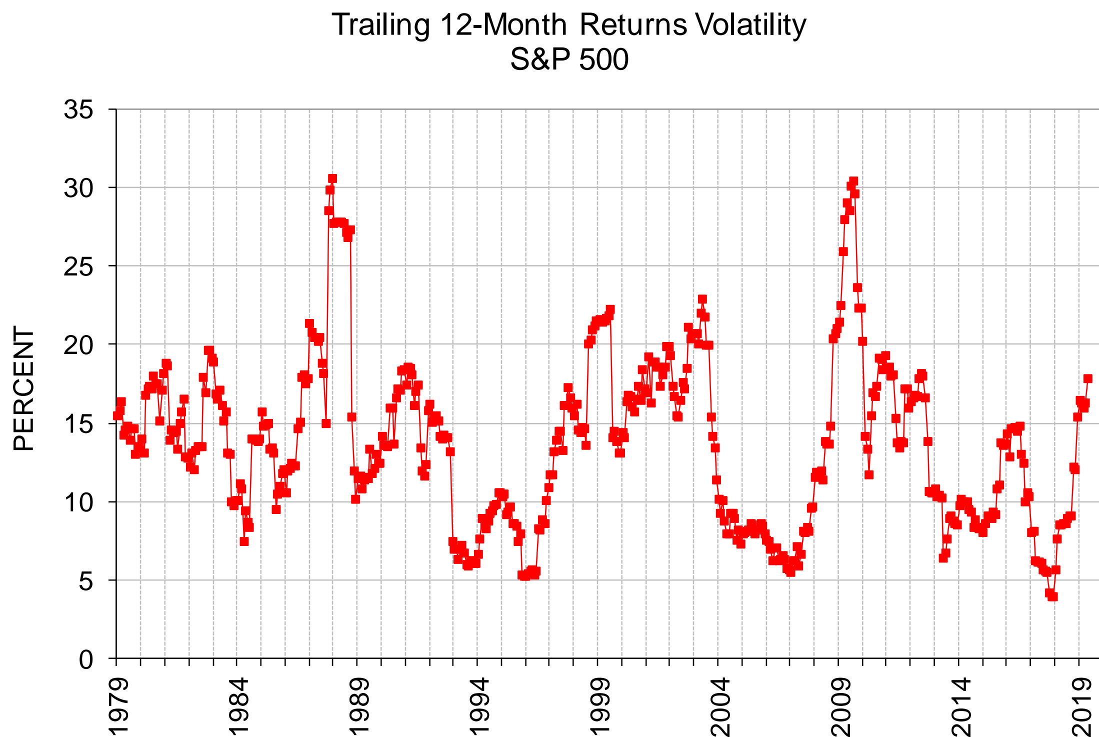
Direction

- Over the past few years, TWIN's update has noted the streak of positive S&P 500® months that began in March 2016. In the most recent 40-month period (March 2016 through June 2019), the S&P 500® has been positive 34 times or 85% of the months. Historically, the S&P 500® is up 63% of all months. Dating back to February 1962, there have only been 2 other instances out of 650 rolling 40-month periods with an S&P 500® positive hit rate of 34 months - the periods ending in March and April 1998.

- In both of the prior strong 40-month periods for the S&P 500®, market breadth narrowed as mega-cap stocks led the market. The 50 largest S&P 500® stocks were up 36.9% annualized while the S&P 500® was up 33.2% annualized in the 40-month period ending April 1998. In the most recent 40-month period ending June 2019, the largest 50 S&P 500® stocks produced an annualized return of 16.6% compared to the 15.7% annualized return to the broader market index.

Volatility

- Early on in both periods, the S&P 500® took off in a low volatile environment. There were only 13 days in 1995 and even fewer days (8) in 2017 where the S&P 500® Index moved by more than 1% +/-; compared to the historical annual average of 52 days where the S&P 500® moves by more than 1% up or down. Similarly, the S&P 500® annual standard deviation (using monthly returns) in 1995 was 5.2%, which was the previous lowest value prior to the 3.9% measure in 2017. Following both periods of extremely low volatility in 1995 and 2017, market volatility jumped up and continued to move higher for the next 18 months. In the former instance, market volatility kept rising and remained high for the next few years.



Style

- Another similarity between the recent market regime and the one roughly 20 years ago is the dominance of Growth over Value. For the 10-years ending 1999, the Russell 1000® Growth Index beat the Russell 1000® Value index by 4.8% annualized whereas for the 10-years ending 2018, the Russell 1000® Growth Index outpaced the Value Index by 4.1% annualized.

- In addition to the longer-term (10-year) differential favoring Growth, the streak of quarterly Growth wins over Value is currently as extreme as it was in the late 1990's. From the first quarter of 1998 through the second quarter of 2000, the Russell 1000® Growth Index beat the Russell 1000® Value Index 9 of 10 consecutive quarters. From the first quarter of 2017 through the second quarter of 2019, the Russell 1000® Growth Index beat the Russell 1000® Value Index 9 of 10 consecutive quarters. Only twice since 1979 has the Growth side beaten Value so consistently for 10 consecutive quarters.

Factor Performance

- Longer-tenured investors may remember the difficult market environment in the late 1990's when few active managers outperformed their market benchmarks. That is another similarity between the late 1990's and the past few years in which active managers have had a harder time adding value. Some may also recall the wonderful market environment for many active managers that started in mid-2000 and continued through 2006 when many factors (such as Value and Momentum) worked quite well.

- TWIN has calculated historical returns for several types of stock-level characteristics for S&P 500® constituents back to 1980. These returns are based on univariate simulations (pure-play factor exposures), unlike factor performance featured in our multi-variate model quarterly reports. Specifically every month for each of five "Smart-Beta" factors (Value, Momentum, Quality, Reversal and Volatility) we form 4 portfolios at the end of the prior month by ranking stocks on exposure to the relevant factors. Realized returns to these 125-stock portfolios are computed for the subsequent month. The equal weight return to the portfolio of S&P 500® stocks is also calculated. Monthly hedge returns (the difference between the returns to portfolios with the highest/lowest exposures to a factor) and target portfolio excess returns (the difference between the returns to a single portfolio with the desired exposure to a factor and the S&P 500® portfolio) are evaluated to get a sense of the relationship between the factor and stock returns during the month.

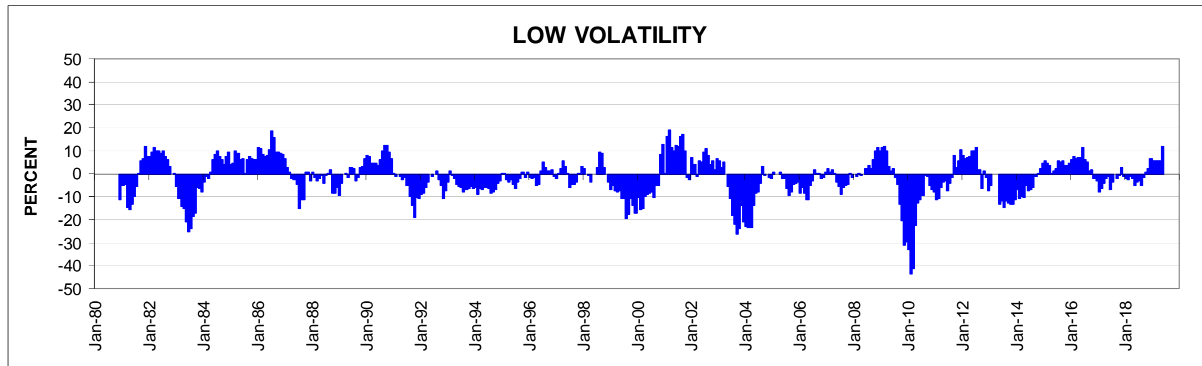
- Specifically, TWIN's analysis indicates there are very few months of simultaneous failure in which all 5 factor portfolios generate a negative hedge return, but there have been more of them lately. Over the period from January 1980 through May 2019, broad failure occurred in only 12 months. Three episodes of simultaneous failure occurred between March 1996 and March 1999. All 5 factor portfolios have generated a simultaneous negative monthly return three times since April 2016.

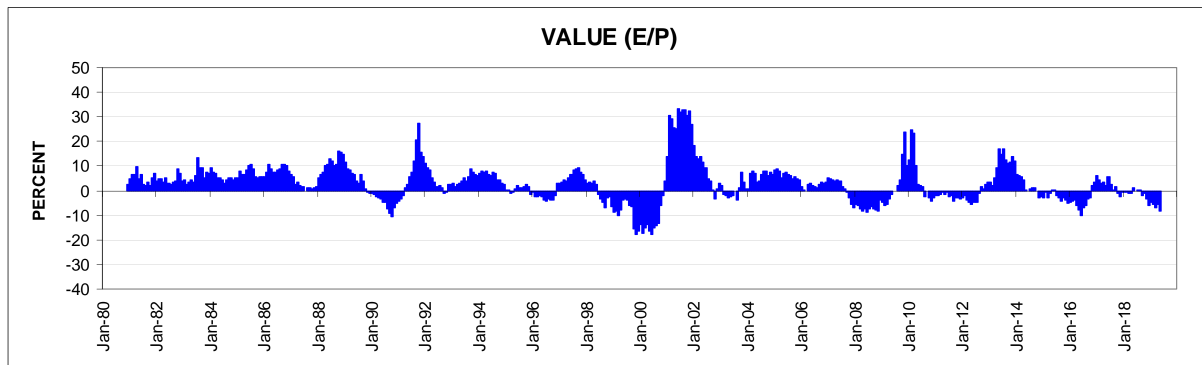
- While it is rare for all 5 factor portfolios to simultaneously generate negative excess monthly returns, it's about three times as likely that all 5 factor portfolios generate a positive monthly hedge return – there have been 35 instances since 1980. If you're following the theme of this piece it's no surprise that seven of those months with all 5 factor portfolios working as expected occurred between February 2001 and December 2006.

- The following charts provide the trailing 12-month target portfolio excess returns of two of the five "Smart-Beta" factors – (cheapness) Value and (less) Volatility. Prior to the financial crisis, the trailing 12-month excess returns to these two factors relative to the S&P 500® were in sync (meaning that when cheaper stocks were outperforming the market so were less volatile stocks). Starting in 2008, less Volatile stocks seem to lead Value stocks. In other words, for the past 10-plus years, following periods in which less volatile stocks beat the market, value stocks become in favor later on.

- Specifically, the least-volatile stocks started performing well and peaking in 2008/ 2009 whereas the Value factor peaked in 2010 when Volatility was already on the skids. Similarly, Volatility peaked again in 2011 and early 2012 while Value's peak came later in 2013. After Volatility peaked again in 2015, Value had a very strong 2016. The Volatility factor clearly began rising sharply in September, taking only 10 months to hit a 12-month rolling return level not seen since 2009. Reaching similarly-sized peaks for

less-volatile stocks post financial crisis, these less-volatile stocks began underperforming the market while Value stocks started winning and we would expect the same for the remainder of 2019 and 2020.





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