

What's in Style for U.S. Equities?

Fashion styles can often be described as an expression of one's true personality and creativity. And with the evolution of time, fashion has also evolved typically over the span of decades to keep up with changes in the environment. However, given the rapid pace of change in the environment that we have all observed over the past year, it feels as though we have transitioned from the simpler times of the 1920s to the fast fashion days of the early 1990s in a matter of only nine months.

Soaring inflation, rapid increases in interest rates/yields, a war brewing in Europe, and lockdowns in China have resulted in a material increase in market volatility globally and the deceleration in global economic growth prospects. At the onset of the year, we were expecting a change from the simpler days of 2021 – most asset classes including stocks, commodities, crypto, etc., ended the year in the green – the current backdrop has been anything but that. **That said, one consistent theme we have been reiterating since the beginning of year was for investors to focus on quality stocks. So what does this specifically mean?**

The definition of quality is quite subjective and will vary quite extensively from one person to the next. However, given the growth in factor investing over the past +10 years, which to put it simply is an investment approach that involves targeting specific drivers of returns for various asset classes, there has been a lot more consistency in how factors such as quality are defined.

In the world of factor investing, there are six major style factors: growth, value, quality, low volatility, high dividend, and momentum. For each of these factors, there are common metrics used to group stocks into each of these style factor buckets. For example, for the quality style factor, this would include companies that have durable business models, a sustainable competitive advantage, and high profitability. Given the uncertainty of the economic backdrop and our expectation that a recession is on the horizon, companies that meet this definition represent our preference since these companies have historically outperformed during periods of economic contraction.

Style Factor Definitions

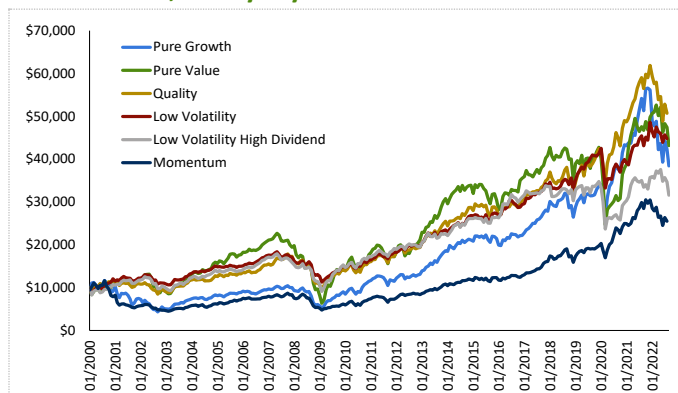
Style Factor	What it is?	Commonly Used Metrics to Identify Stocks	Index
Growth	Capture excess returns to stocks that are expected to grow at an above average rate compared to their peers	Sales growth, the ratio of earnings change to price, momentum	The S&P 500® Pure Growth index
Value	Captures excess returns to stocks that have low prices relative to their fundamental value	Book to price, earnings to price, book value, sales, earnings, cash earnings, net profit, dividends, cash flow	The S&P 500® Pure Value index
Quality	Captures excess returns to stocks that are characterized by companies which have durable business models, a sustainable competitive advantage, and high profitability	ROE, earnings stability, dividend growth stability, total assets, free cash flows, accruals, financial leverage, gross margin	The S&P 500® Quality Index
Low Volatility	Captures excess returns to stocks with lower than average volatility, beta, and/or idiosyncratic risk	Standard deviation (1-yr, 2-yrs, 3-yrs), downside standard deviation, standard deviation of idiosyncratic returns, beta	The S&P 500® Low Volatility Index
High Dividend	Captures excess returns to stocks that have higher-than-average dividend yields	Dividend yield	The S&P 500 Low Volatility High Dividend index
Momentum	Reflects excess returns to stocks with stronger past performance	Relative returns (3-mth, 6-mth, 12-mth, sometimes with last 1 mth excluded), historical alpha	The S&P 500® Momentum

Source: MSCI Inc.; S&P Global; Raymond James Ltd.

Fast Fashion or Sticking with the Classic Look?

Over the long term, including over the past 20 years, quality as a style has outperformed all other factors. That said, there have been many periods and even extended periods when quality as a factor has not outperformed. The worst-performing factor has been the fast fashion style or in this case momentum.

Growth of 10,000 by Style Factor



Source: FactSet; Raymond James Ltd.; Data range from January 1, 2000 to September 26, 2022. Each style factor is represented by its corresponding S&P Dow Jones Index.

Quality Definitely in Vogue Today

Our expectations for the remainder of this year and heading into 2023 remains consistent with a disinflationary theme – best defined as an environment in which the rate of change of inflation slows down. Recent developments suggest to us that we are now past the peak in inflation, with year-over-year change in CPI moderating from +9.1 per cent in June to +8.3 per cent in August. Moreover, given our expectation for a further weakening in the economic backdrop including our forecast of a recession in 2023, quality appears best positioned to outperform in this environment followed by momentum.

Style Factor Performance: Four Inflation Regimes

	Inflation	Flat	Disinflation	Deflation
Definition	Goods and services prices rising at a increasing pace	Goods and services prices rising at a relatively steady pace	Goods and services prices rising at a decreasing pace	Goods and services prices falling (CPI YoY % Chg. < 0)
# of months since 1997	136	94	67	15
Growth	15.4%	0.6%	13.0%	27.4%
Value	7.5%	14.2%	8.6%	26.4%
Quality	11.9%	3.4%	17.1%	14.4%
Low Volatility	10.6%	11.0%	11.4%	4.1%
High Dividend	13.7%	11.7%	12.4%	16.8%
Momentum	14.3%	-5.6%	16.9%	4.1%

Source: FactSet; Raymond James Ltd.; Data as of August 31, 2022.

What Styles Are Pricey vs. Cheap?

The low volatility style is trading closest to its long-term average, which makes sense given the elevated level of uncertainty observed this year. In our view, that will likely continue, while momentum is trading at the largest discount/spread relative to its historical trading range.

Style Factor P/E NTM Current vs. Historical

Median PE NTM	Current	Historical	(+) Premium/ (-) Discount
Growth	15.7	20.3	-4.6
Value	9.3	11.7	-2.4
Quality	14.9	18.2	-3.3
Low Volatility	17.8	18.9	-1.1
High Dividend	11.6	13.3	-1.7
Momentum	14.0	21.1	-7.1

Source: FactSet; Raymond James Ltd.; P/E NTM data range from January 1, 2016 to August 31, 2022. Each style factor is represented by its corresponding Invesco S&P 500 style factor ETF.

Style Factor Performance: Recessions/Non-Recessions

Performance	Avg. Annualized Return During Recessions	Avg. Annualized Return Not in A Recession	3-Month Return	YTD Return
Growth	-21.6%	13.4%	-2.8%	-30.7%
Value	-34.7%	16.0%	-7.9%	-11.7%
Quality	-12.6%	13.5%	-5.1%	-23.5%
Low Volatility	-22.5%	11.5%	-3.8%	-12.4%
High Dividend	-24.1%	13.2%	-9.5%	-9.6%
Momentum	-20.4%	12.9%	-4.6%	-21.4%

Source: FactSet; Raymond James Ltd.; Performance data range from December 31, 1996 to September 26, 2022. Each style factor is represented by its corresponding S&P Dow Jones Index.

Final Thoughts

As the market/economy moves closer to the end of this cycle and into an eventual recession, we believe the quality style is where equity investors should be focused on allocating capital to. As history shows, the quality style factor – and in particular companies that have durable business models, a sustainable competitive advantage, and high profitability have performed the best during recessionary periods.

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