Investment Strategy Update #124

What will it take for growth stocks/style to recover?

- Traditionally growth stocks are driven by interest rates while value stocks are driven by earnings. When interest rates fall, growth stocks tend to rise (re-rate) and when rates rise, growth stocks tend to fall (de-rate). This has been the story through 2022.

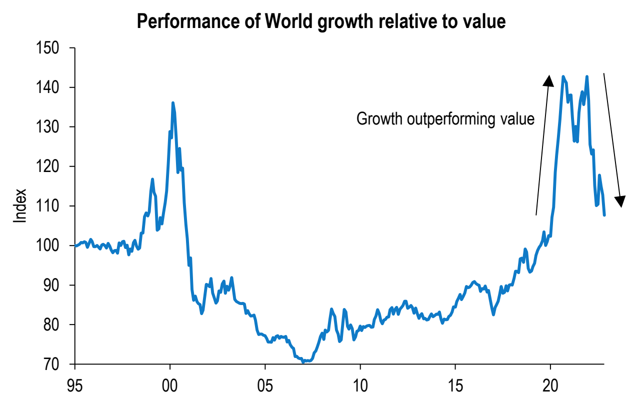
- With inflation measures beginning to soften, there is now considerable debate as to whether a stabilisation in rates and/or the potential for a policy pivot is enough to support a sustainable turn in growth stocks.

- We think the outlook for growth stocks is improving simply as a consequence of rates approaching peak levels. But we believe it will take a sustained decline in rates in order to drive a period of consistent growth stock outperformance and it is probably too early to expect this given central banks have not yet finished their tightening cycle and valuations are not outright cheap.

- For now, we think the market will continue to oscillate between value and growth stocks/styles. There is not yet enough evidence to suggest rates are set to decline but at the same time rising economic risks suggest the tailwinds for value are also weakening. In other words, ongoing macroeconomic uncertainty will make it difficult for one style to show consistent outperformance.

- Against a backdrop that is not particularly friendly to either growth or value, we think investors should aim to remain close to "core" within equity allocations. This means any tilts to growth should be offset by a similar tilt to value to bring overall exposures back to centre (and vice-versa).

Growth stocks posted historic outperformance in 2020



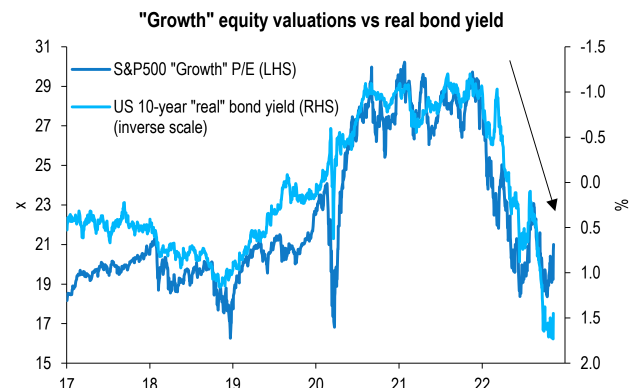
Source: Factset, MWM Research, November 2022

Why has growth underperformed in CY22?

Growth stocks have had a torrid 2022 as gains through 2020/21 have sharply reversed due to several factors:

1. A sharp rise in inflation drove one of the most rapid increases in interest rates for decades. As a result, high flying growth stocks saw valuations come under significant pressure as expectations of ongoing zero rates was quickly reversed out.

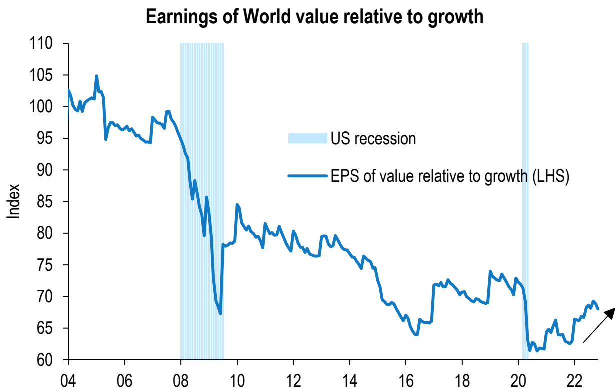
Growth stock valuations hostage to interest rates



Source: Factset, MWM Research, November 2022

2. As lockdowns ended and economies reopened, many growth stock ‘lockdown beneficiaries’ saw a reversal of their fortunes as earnings began to normalise. Likewise, economically sensitive value stocks saw their earnings rise as economies reopened. Value stocks also received an extra boost from a sharp rise in commodity prices, given the prevalence of resource/energy among value stocks.

Earnings of value stocks rose as economies re-opened

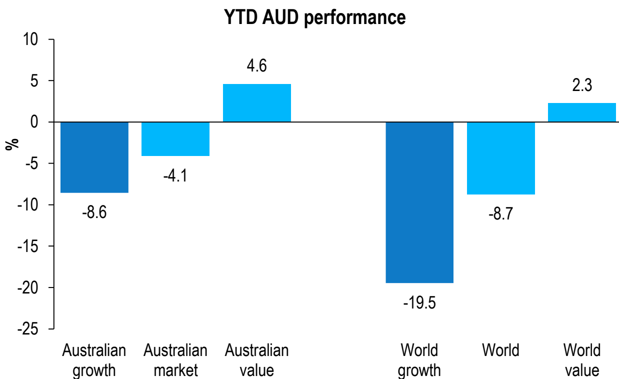


Source: Factset, MWM Research, November 2022

Why have Australian growth stocks outperformed global peers?

Australian growth stocks have held up substantially better than their global peers through 2022. This reflects the compositional difference of the Australian market versus the global “growth” universe and because they lagged the upswing versus global peers throughout the COVID period. From a compositional perspective, Australia has a much lower weighting in technology versus the rest of the world, at only 4% versus 35% for MSCI World Growth.

Australian growth has substantially outperformed global growth



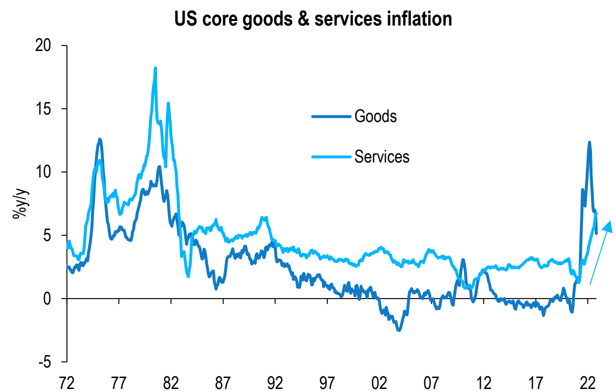
Source: Factset, MWM Research, November 2022

What will it take for growth to sustainably outperform again?

We think it will take a number of drivers to see a sustained upside in growth stocks:

1. A stabilisation or decline in interest rates or policy pivot. Growth stock valuation multiples (and therefore performance) will ultimately be hostage to movements in bond yields, which are in turn hostage to inflation and the future path of central bank rate hikes. Therefore, ultimately, for growth stocks to start outperforming value in a meaningful way, we’ll need to see evidence of inflation, specifically ‘stickier’ services inflation, cooling.

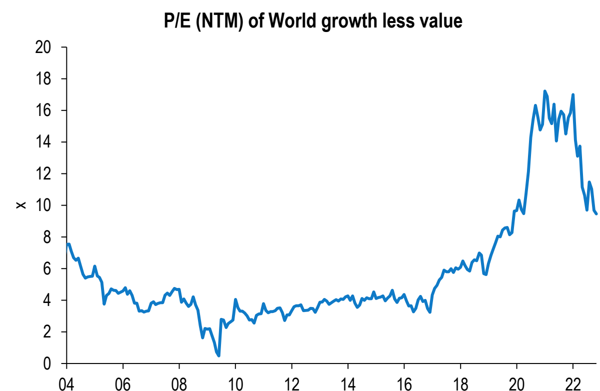
‘Stickier’ services inflation still rising



Source: Factset, MWM Research, November 2022

2. Valuations reaching ‘cheap’ levels, which will provide a cushion against disappointment and a springboard for upside if sentiment improves. While the valuation multiple premium of growth stocks, both in absolute and relative terms, has contracted substantially this year, it is still elevated relative to history, suggesting growth stocks are not an ‘absolute’ or ‘relative’ bargain yet on valuation grounds.

P/E premium of growth stocks still elevated



Source: Factset, MWM Research, November 2022

3. A deeper economic downturn. Under this scenario, value stocks will underperform given their greater leverage to the economic cycle. Additionally, this would send rates lower, driving a P/E re-rating of stocks with strong structural earnings growth.

No clear pathway for growth vs value while macro uncertainty persists

We see few signs that macroeconomic uncertainty driven by inflation, rates and economic growth, is about to materially improve.

The US Federal Reserve, who is key to global policy conditions, indicated that it is still not seeing the types of inflation readings or easing in labour market conditions that would cause a pause in rate hikes. At the same time, global yield curves are flattening, suggesting that further tightening is now translating into rising economic (recession) risk. In addition, it is too early to bet on a policy pivot while central banks are still raising rates. Historically the lag between the last Fed rate hike and first Fed rate cut is around 4-5 months. This would suggest a sustained policy easing backdrop remains some time off.

Our preferred positioning when style is inconsistent

We do not have a style preference across either value or growth, but we have a bias towards quality which applies across style. This means “core” is our preferred exposure within the equities space or, alternatively, we would have any “growth” exposure offset by “value” exposure in order to bring a style tilt back to centre. While the decline in bond yields has driven a broad rebound in markets with global growth stocks recovering more than broader market indices, we have not seen the same trends play out domestically. This is because the style shift has not been as dramatic for the Australian market given a much lower weighting towards technology and because healthcare (the other high multiple area within Australian equities) tends to be quality.

Macquarie WM Investment Strategy Team

Investment Strategy Update #124 finalised on 16 November 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at https://www.macquarie.com.au/advisers/financial-services-guide.html.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e -mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research.

Important disclosure information regarding the subject companies covered in this report is available at macquarie.com/disclosures.

© 2022 Macquarie Group. All rights reserved