MACQUARIE

Investment Strategy Update #132

Growth Stocks - still stuck on a red light

- Style investing isn't about to get easier. Growth was beaten up due to the increase in rates driving a sharp valuation de-rating. Now value is under pressure due to the prospect of recession which is pressuring earnings. We recommend staying style-neutral with a strong quality overlay.

- In the past month growth stocks have rallied because central banks are signalling that rates are approaching their peak. However, signs of a peak in rates doesn't mean they soon fall off a cliff. If central banks were seriously contemplating cutting rates, growth would be attractive, but it's too early for this. Growth is still stuck on a red light.

- The other factor that would make growth stocks attractive is valuation. If growth was cheap, it would probably outperform even if rates moved a little higher. However, despite the beat-up last year, growth isn't cheap with MSCI World Growth trading on a PE of 23.1 (versus the long-term average of 18.5). MSCI Australia Growth is trading at 18.8 (versus its long-term average of 17.0.

- Value performed relatively well last year (return versus growth), despite slowing earnings growth. This is unusual, but it mostly reflected the market's fear of rising rates on valuation of growth stocks and a relatively good safe haven of positive earnings, even though margins are peaking and earnings growth slowing.

The market's focus is shifting from rates to earnings growth

Equity markets remain challenging, despite last year's valuation adjustment. Macquarie think the US, Europe and the UK are all heading into a recession that is neither deep, nor protracted. But history shows equities always fall during recessions regardless of the recession's depth or length.

Performance during US recessions

Recession start	S&P500 Price fall	All Ordinaries Price fall
Nov-73	-48%	-54%
Jan-80	-17%	-20%
Jul-81	-27%	-37%
Jul-90	-20%	-18%
Mar-01	-49%	-12%
Dec-07	-57%	-53%
Feb-20	-34%	-34%
Average	-36%	-33%
Current	-15%	-6%

Source: Factset, MWM Research, February 2023

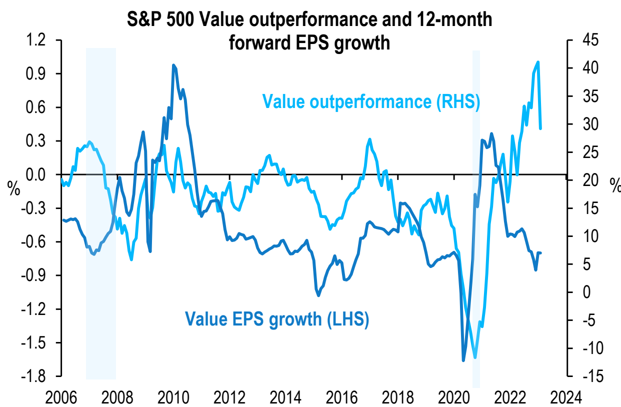
Some investors may be prepared to look through the coming economic downturn, given last year's correction has lowered valuations and lifted the prospect for longer-term returns. However, short-term risks are still large, volatility is likely to remain high and the reward could be some time coming.

Cyclically (near term), we err on the side of caution and think it's too early to position for a rally, but it's a good time to revisit some of the fundamentals driving style performance and think about how to be positioned when investing by style offers up opportunities.

- G**rowth stocks are driven by interest rates,** with the market confident about earnings growth of these stocks in both the short and longer-term. When interest rates fall, growth stocks tend to rise (re-rate) and when rates rise, growth stocks tend to fall (de-rate). This was the story in 2022.

- **Value stocks are driven by earnings** and tend to be cyclical. When earnings are rising, value stocks tend to outperform and when earnings growth is slowing, or declining value stocks underperform. Last year was a little unusual in that value outperformed, despite slowing earnings growth. We think this reflected the market's fear of rising rates on the valuation of growth stocks and a relatively good safe haven of stocks with positive earnings growth even if it was slowing.

Value is giving back last year's outperformance



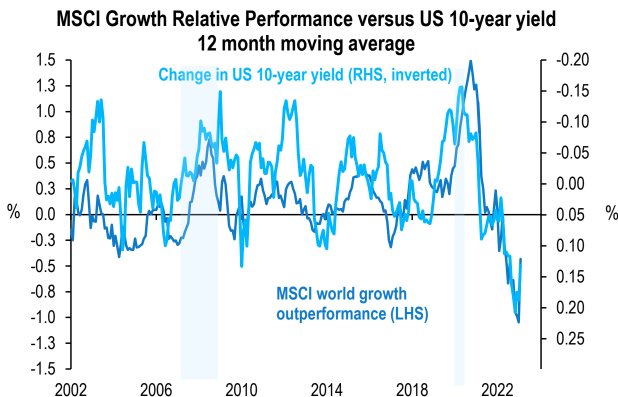
Source: Factset, MWM Research, February 2023. Shaded area indicates recession

This year we expect earnings to decline, and this is the key risk for value stocks (which tend to have higher cyclical exposure) as the global economy heads towards recession. On the other hand, we think the outlook for growth is improving simply because rates and inflation are approaching a peak. As this stage, we think there is too much uncertainty around the economic and earnings outlook in coming months to drive sustained value outperformance even if they have more valuation cushion than growth stocks.

For us to be more comfortable that growth can sustainably outperform we need to be confident in the following:

- An interest rate easing cycle is about to occur. Unfortunately, central banks remain consistent in their message – rates need to rise a little further and may potentially remain at peak a little longer than the market is currently expecting.

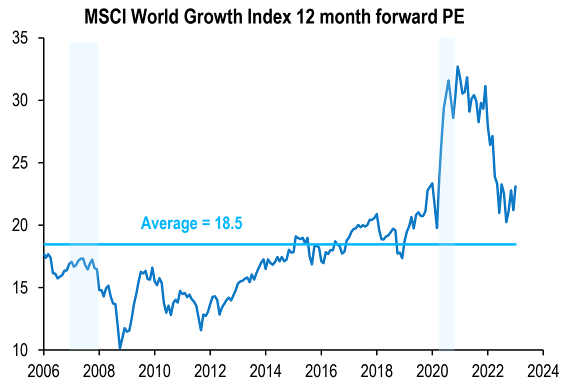
Growth outperformance needs lower rates



Source: Factset, MWM Research, February 2023

Valuations of growth stocks are not cheap. The 12-month forward PE MSCI world growth is trading at 23.1 versus its long-term average of 18.5. Last year's correction merely bought the valuation of growth back to towards average - they are not cheap and vulnerable to further increases in interest rates. In Australia, growth trades on a 12-month forward PE of 18.8 versus its long-term average of 17.0.

Growth not yet attractive enough



Source: Factset, MWM Research, February 2023

For now, we think the market will continue to oscillate between short periods of value and growth outperformance and timing these tactical shifts is difficult. There is not yet enough evidence to suggest rates are set to decline but at the same time rising economic risks suggest the headwinds for value are increasing.

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 and avoid moving too far out the risk spectrum.

Portfolio construction should then be done by offsetting any tilts to growth with a similar tilt to value in order to bring overall exposures back to centre (and vice-versa). However, it is important to balance out style exposure with a quality overlay. Quality tends to become scarce before and during recessions. Quality stocks have good return on equity, low gearing and earnings variability.

Quality is king during recessions

Source: Factset, MWM Research, February 2023

Longer term, we continue to like the structural appeal of high-quality growth style exposure and we think balanced portfolios should maintain a tilt to this style.

Please see our "2023 Outlook: Better Days Ahead" for more detail on our investment views, asset allocation and key recommendations.

Macquarie WM Investment Strategy Team

The report was finalised on 17 February 2023.

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

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