Research

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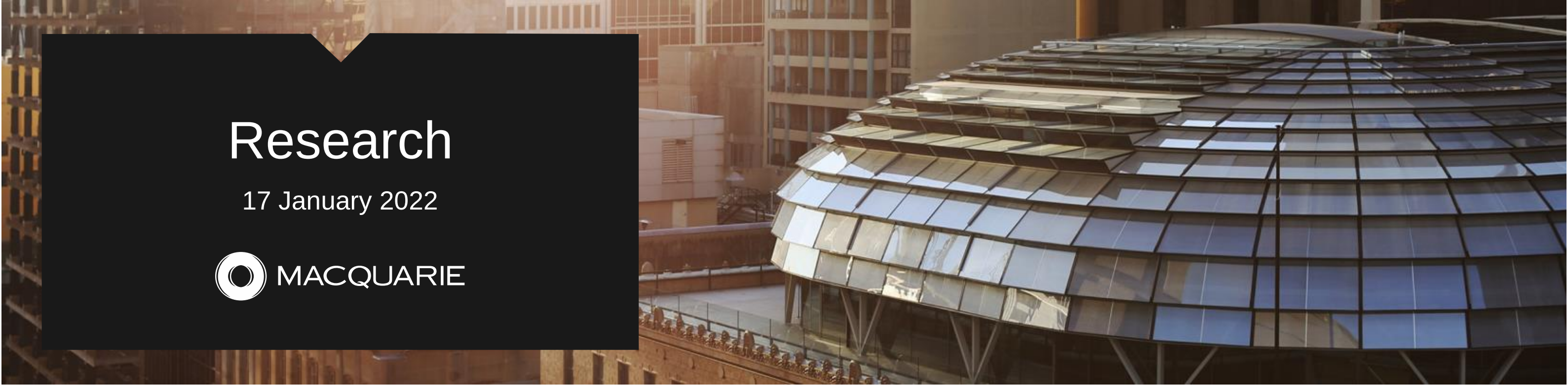


Investment Strategy Update # 82

Taking stock of a sour start to 2022

- Sentiment has soured noticeably as we have entered the new calendar year. Record high omicron case numbers and decade high inflation readings driving fears of more aggressive rate hikes have dented confidence and driven many investors to rush for the exits in 2021 high flying winners.

- At the epicentre of the sell-off has been technology stocks particularly those trading on extreme valuations, meme stocks, cryptocurrencies, SPAC's (Special Purpose Acquisition Companies) and anything else which is rate sensitive such as real estate and to a lesser extent high multiple healthcare stocks.

- The correction in parts of the equity market is concerning, but the sell-off remains isolated and we doubt it is a harbinger of weakness for the broader market for several reasons:

  1. Performance within equity markets has been bifurcated with weakness confined to areas that are sensitive to rising rates such as those on elevated valuations and/or which have received large speculative inflows through 2021

  2. Many *"cyclicals"* and *"back to work"* stocks that are leveraged to stronger economies (reopening) and demand normalization have looked through recent weakness to trade higher including energy, financials and materials

  3. Surging inflation has not driven a spike in long term inflation expectations or bond yields. Bond yields are still well below pre pandemic levels despite inflation reaching multi-decade highs. This reflects a view that inflation is a short-term problem; and

  4. We doubt the current *"spec-tech wreck"* will spill over into the broader market. The sector is dominated by industry titans that are profitable and do not trade on extreme multiples. In addition, the sector remains exposed to many structural growth themes and is now relatively diversified in its earnings base. If bond yields remain well behaved, then the froth needs to be removed, but that should remain isolated not universal.

- **We don't think the rotation that is taking place in some areas of the market is over yet,** but we think it is close. Some caution is needed for stocks exposed to higher rates, but Macquarie forecast US 10-year yields to end 2022 at just 1.9% - only 10 basis points above the current level – and this is unlikely to undermine the economic recovery. We don't see price action as a concern for our equity overweight, or for our call that recent inflation prints undermine the reopening trade. We stay invested.

A sour start to the year does not mean a sour ending to the year…

Sentiment has soured dramatically as we have entered the new calendar year. Record high omicron case numbers and decade high inflation readings have crushed confidence and driven many investors to rush for the exits in many 2021 high flying winners.

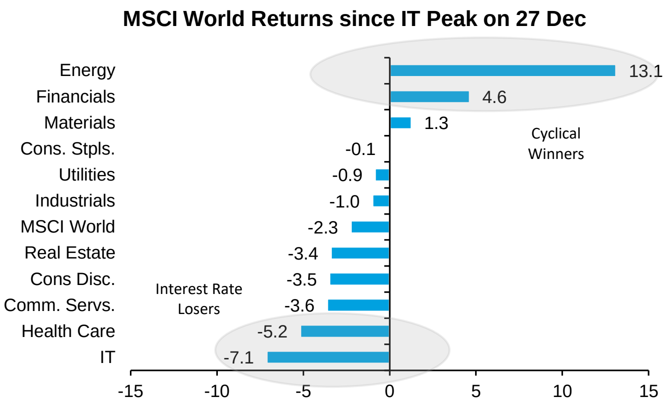
It would be easy to get caught up in the hyperbole of runaway inflation and central bank tightening given both pose significant threats to the outlook of improving economic growth and further gains for equity markets. But, while conditions are set to change as the tsunami of free money that has been a constant tailwind for markets begins to ebb, it doesn't spell doom.

We think markets are doing a good job at compartmentalizing risks and differentiating between areas that are/may come under threat versus those that won't. While the sell offs in many areas such as technology and meme stocks, SPAC's and crypto currencies have been savage, weakness has largely been confined to interest rate sensitive areas and has not spread to areas more leveraged into the broader economic outlook such as cyclicals and "*back to work"* stocks.

We make the following observations that provide us with some comfort that markets are differentiating correctly and that there is not yet sign of systemic risk across and within markets:

1. **Weakness remains isolated:** Equity markets have started 2022 on a weak note, but the pain has been confined to areas that are at most risk from rising interest rates and/or which have had a high speculative element to their 2021 performance. This includes high multiple technology and meme stocks (which in many cases are already down ~40-50% from recent highs), as well as SPAC's (Special Purpose Acquisition Companies) and cryptocurrencies (BTC). In the US, an index of non-profitable tech stocks has now fallen 33% from its peak yet remains 3x as expensive as the broader NASDAQ which suggests further de-rating pain is possible. While we have not seen such large declines for Australian tech stocks, they have also been at the epicentre of the sell-off with buy now pay later (BNPL) stocks Afterpay (APT), Zip Co (Z1P) and Sezzle (SZL) the biggest causalities.

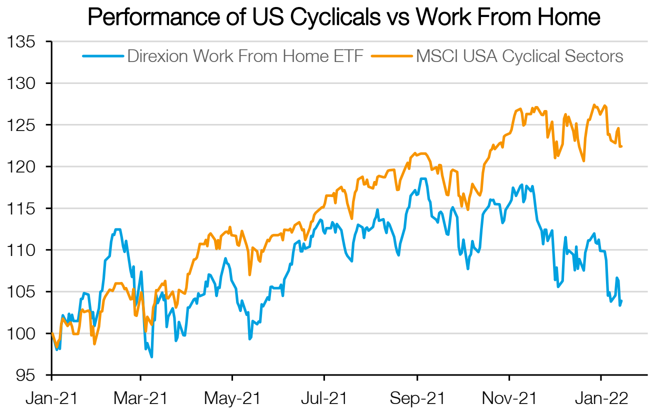
The market is differentiating between rate risk and cyclical risk



Source: MSCI, Factset, MWM Research, January 2022

2. **The *"return to work"* and *"cyclical"* trades remain intact:** The cyclical and *"return to work"* trades remain largely intact suggesting that markets are discounting areas of interest rate risk but not economic growth risks. In other words, the fear factor is not universal and performance suggests it remains concentrated in areas directly exposed to rising rates/speculative valuations and has not spread into the broader economic outlook.

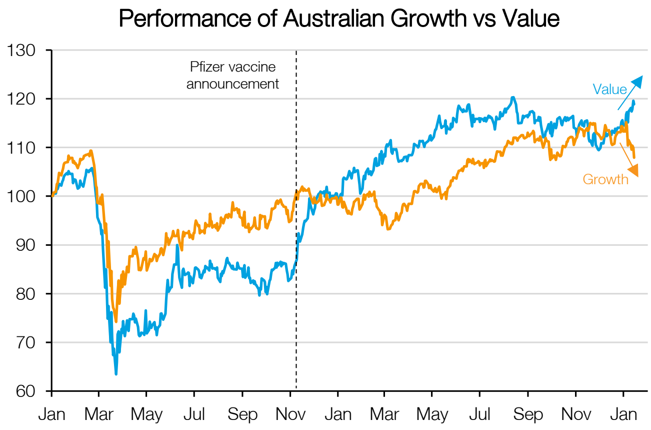
Equity weakness has been isolated to areas exposed to higher rates



Source: MSCI, Factset, MWM Research, January 2022

This performance bifurcation is most easily seen in the "growth vs value" split with Energy and Financials up strongly YTD while technology (primarily software and services), healthcare and real estate have been aggressively sold down. In Australia, the technology sector is down a massive 11% YTD courtesy of a near 60% sell-off in Block (Afterpay). We think the willingness of the market to rotate out of interest rate 'losers' while at the same time betting on economic 'winners' remains a key sign that the threat of policy tightening has not yet spread into driving a meaningful contraction in economic activity.

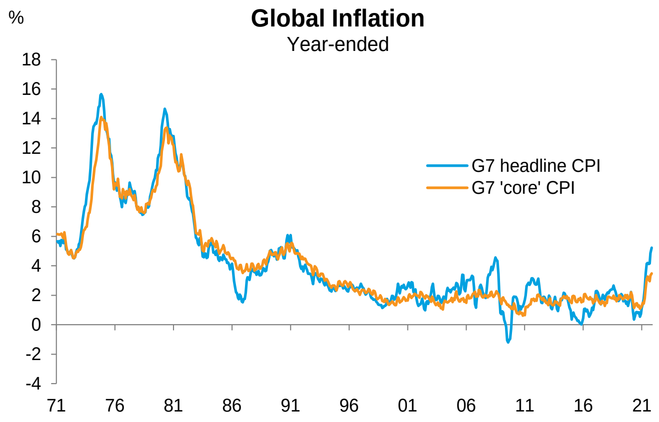
Value has outperformed growth by +8.6% YTD



Source: Factset, MWM Research, January 2022

3. **Surging inflation has not driven a surge in bond yields:** Global inflation prints have surged to four-decade highs over the past month But, inflation expectations (both medium and long term) have remained reasonably well contained with bond yields barely taking out their 2021 highs. In addition, while the increase in bond yields has been significant, at 1.79%, US 10-year yields remain substantially below the 3.23% level reached in 2019 before the pandemic took hold despite the surge in inflation.

Inflation has surged but bond yields have not



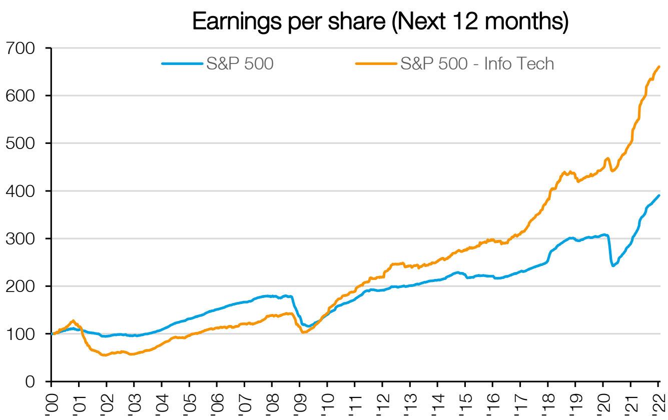
Source: Factset, MWM Research, January 2022

We think a large portion of the rise in long bond yields has already taken place even though they still remain below 2.0%. Macquarie expect the 10-year bond yield to only rise a further 10 basis points through year-end 2022 before moving slightly higher by mid-2023. This is despite ongoing supply side disruptions that may cause inflation prints to remain stickier than expected. We maintain our view that inflation will peak in 1H22 and we have already seen key inflation drivers begin to fall back including energy prices and transportation costs as well as for some key goods including cars. We think fears that central bank policy tightening is going to cause a more widespread valuation de-rating is not consistent with where inflation expectations sit, what is implied in bond yields or our own expectations.

4. **Spec-Tech Wreck not likely to infect the broader market:** We do not view recent tech weakness as a repeat of the dotcom bust or an event that is likely to infect the broader market. While many tech stocks delivered massive outperformance through 2020/21 there are some important differences to the bursting of the dotcom bubble when there was widespread speculation and excessive valuations.

Clearly there have been certain pockets that have been overextended through 2020/21, but our view has always been these were isolated pockets of excess (rather than the entire market) and that unless every tech stock was an Apple or Google or Amazon, then many of these had to ultimately deflate / de-rate either because valuations get pricked (from higher rates), or the earnings expectations are brought back to reality.

Tech benefits from multiple structural tailwinds



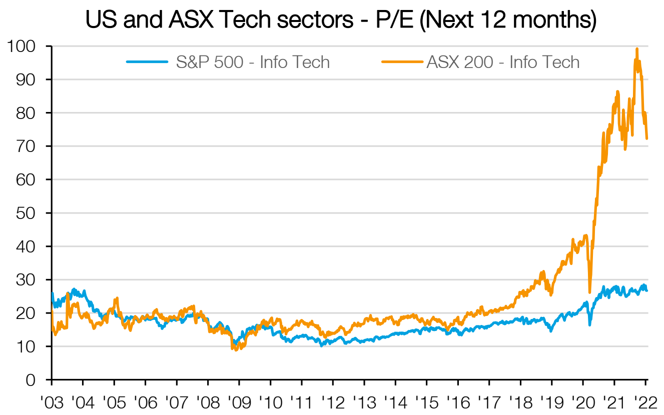
Source: Factset, MWM Research, January 2022

But, a number of key differences exist between the make-up of the tech sector and what we saw seep into the broader equity market when the dotcom bubble burst.

1. The global tech sector has come a long way since the promises of the late 1990s, with technology companies leveraged to highly attractive structural growth themes including cloud computing, artificial intelligence, e-commerce and automation consistently providing investors with above average earnings growth.

2. US tech now provides access to a range of high-quality companies which are global leaders in their fields – the tech sector is much more diversified and established vis-à-vis the late 1990's even while valuations are on the expensive side and are at some risk from rising rates.

US tech stocks are expensive, but the sector is dominated by high quality earnings growers



Source: Factset, MWM Research, January 2022

3. The NASDAQ is now relatively well diversified even if it remains dominated by the global titans – MSFT, AMZN, GOOG and FB. While many US tech stocks have corrected from frothy valuations, particularly those viewed as Covid beneficiaries (i.e., Zoom and Peloton have already retraced 70-80% from their late 2020 peaks), much of the tech sector remains in good health.

4. The bursting of the TMT sector helped drive an economic recession that took down the broader equity market. We don't see the same type of excesses that must be unwound and nor do we see the need for rates to be tightened to an extent that would drive a reassessment of the economic outlook.

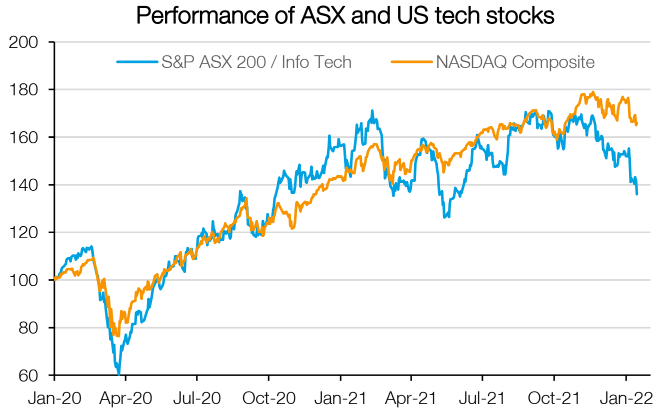
Finally, Australian tech stocks have underperformed US tech stocks in recent weeks. This might come as a surprise to many but can be easily explained by a much more concentrated tech sector as well as far more extreme valuations.

S&P/ASX 200 Info Tech - Constituents

Stock Code	Company Name	Index Weights (%)	Market Cap (US$b)	P/E (NTM)
APT	Afterpay Limited	21.1	15	258
XRO	Xero Limited	18.6	13	445
CPU	Computershare Limited	14.1	9	25
WTC	Wisetech Global Ltd.	10.3	12	93
NXT	Nextdc Limited	6.2	4	375
ALU	Altium	5.9	4	65
NVX	NOVONIX Ltd	3.8	3	-
TNE	Technology One Limited	3.7	3	42
LNK	Link Administration Holdings L	3.4	2	24
MP1	Megaport Ltd.	3.3	2	-

Source: FactSet, MWM Research, January 2022

Australian tech stocks underperformed through 4Q2021



Source: Factset, MWM Research, January 2022

Australia's technology sector is far more concentrated than in the US, less global in nature, less liquid and is biased towards the richly-valued BNPL (Buy Now Pay Later) sector. Unlike the US, Australian investors can also only access a handful of good quality liquid tech stocks, placing upwards pressure on valuations. As a result, Australia's tech sector is trading at extreme valuation levels, even versus US tech. For instance, the average forward PE multiple for Australia's top 10 leaders is 166x versus 40x for the US. At a sector level, the S&P/ASX 200 tech sector recently peaked at a 100x P/E, well ahead of historical averages and versus the US on ~27x. In addition, Australia's top 10 tech stocks comprise over 90% of the tech sector. This compares with the top 10 US stocks which account for a little over 50% of the Nasdaq and hence makes the Australian sector much more sensitive to stock specific moves.

We think the lack of investment options in Australia will see the tech sector remain at a healthy premium to the US. Where this premium settles will depend on how high bond yields go, when sentiment towards global technology stocks settles down and the earnings outlook for individual stocks. Ultimately, we want to buy good quality companies at appropriate valuations but the speculative element that has been priced into the sector may still require some normalizing. While fears of another dotcom boom are understandable, we think a repeat is unlikely due to the highly attractive earnings growth on offer, far more developed business models and large valuation correction that has already played out.

Macquarie WM Investment Strategy Team

The report was finalised on 17 January 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

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