Research
Macquarie Wealth Management

Investment Strategy Update #50

Invest for Reflation not Inflation - Our strategy for 2Q21 and beyond

- Reflation, not inflation should remain the dominant investment theme throughout 2021. We recommend positioning for cyclical upside and hedging against inflation. We don't think it is too late to buy into the equity rally but some protection against near term downside risks seems prudent.

- Rising bond yields will continue to drive bouts of financial market volatility but are unlikely to undermine either the economic recovery or the equity bull market in the absence of a reversal in central bank policy support, which is not imminent.

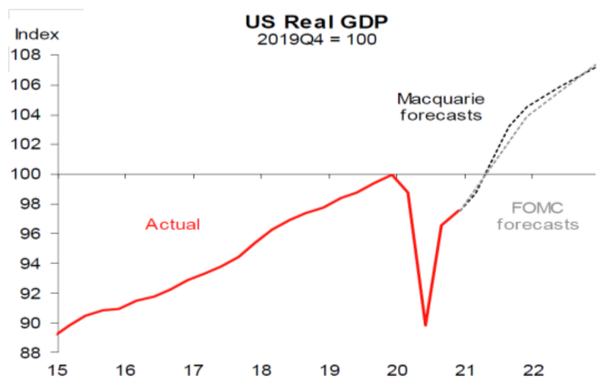
- Equity markets are within a few percent of highs despite the rapid rise in bond yields. This does make them susceptible to tactical disappointment particularly given how fast *"value"* stocks have rallied back over the past six months. However, equities still provide a substantial yield premium to either cash or fixed income and further economic improvement underpins a positive medium-term outlook.

- Investors can help protect against downside risks by allocating to both value and growth stocks / markets as well as via real assets (commodities, property, infrastructure) and alternative assets (long/short, macro and relative value).

- We see any rates- driven volatility as an opportunity to add to risk asset exposure whether in growth or value stocks and/or markets. The cycle is rolling on and while uncertainty is rising, we expect reflation and rotation to remain dominant in positioning and relative performance.

As we move into 2Q21, we reiterate our strategy and discuss how we want to be positioned as we head further into the year. We entered 2021 focused on three key investment themes: 1) Reflation and the reopening of economies; 2) A gradual rise in bond yields; and 3) Rotation into more economically sensitive stocks vis-à-vis structural growth and COVID-19 winners. Implementing these views meant we had a pro-risk asset allocation tilt via a maximum overweight in equities and being underweight both cash and fixed income in order to take advantage of the reflation/rotation trade.

The US will lead the global recovery into 2021/22

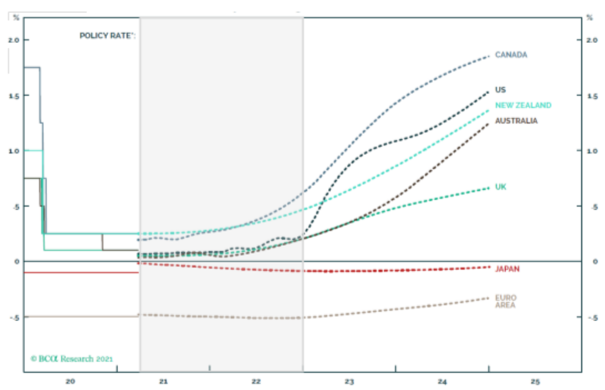


Source: Macrobond, Macquarie Macro Strategy, March 2021

We don't see strong reasons to alter our key investment themes and recommend investors remain positioned for further cyclical upside as vaccination rates improve, fiscal and monetary stimulus remains in place, excess savings are deployed and the release of pent up demand provides a strong springboard for recovery (albeit at different speeds depending on COVID-19 progress).

While inflation expectations have started to rise, they are only back in-line with average levels seen over the past 20+ years and we see this as a normalization from depressed and overly pessimistic levels. At this stage, there is no conclusive evidence that suggests we will see a sustained inflation increase and/or that structural headwinds that limited broad price increases in recent years have dissipated to an extent that we want to now position for a regime change.

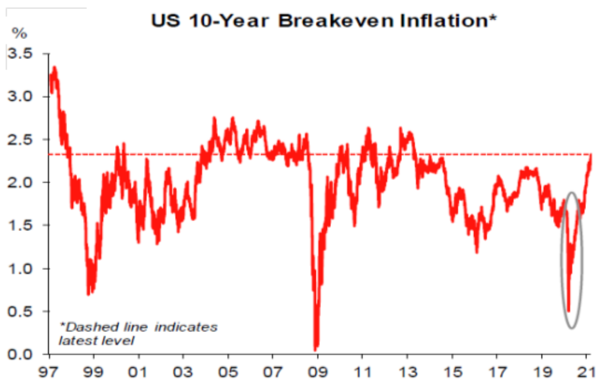
...with financial conditions "easy" for years to come



Source: BCA Research, March 2021

Consequently, if inflation remains reasonably well behaved and central banks stay committed to easy monetary conditions (via yield curve control as well as anchoring short rates), then we don't think bond yields will rise to levels that undermine the global economic recovery nor the equity bull market.

Inflation has risen but remains inline with 20 year levels

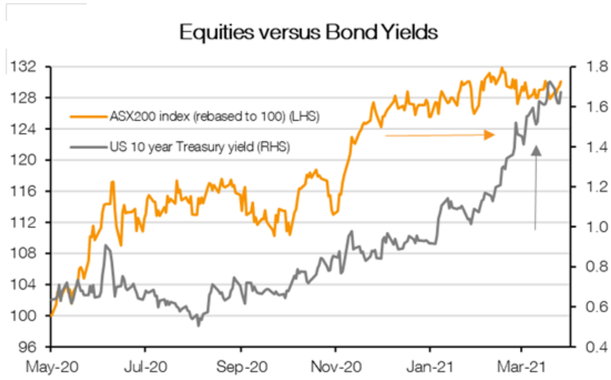


Source: Macrobond, Macquarie Macro Strategy, March 2021

Historically, equity markets have performed strongly during both the recovery and expansion phases of the economic cycle – despite the latter phase being accompanied by rising rates. Markets will not be oblivious to the threat of higher bond yields, particularly given the tailwind they have provided for valuations in recent years. Similarly, we have already seen that volatility driven by the bond market can be disruptive for parts of the equity complex - even if the overall market remains relatively insulated.

We think rising yields will continue to act as a headwind for high multiple growth stocks (particularly those which have been COVID-19 beneficiaries), but expect this to drive further rotation from growth stocks to value stocks and/or financials rather than driving a broad or sustained market correction. As outlined in "Investment Strategy Update #44 – Why it will take more than rising yields to kill the bull market", it is likely that rising bond yields will need to be accompanied by a number of other factors such as a reversal of easy monetary policy or deteriorating fundamentals if markets were to permanently reverse course.

Australian equities have absorbed rising bond yields



Source: FactSet, MWM, February 2021

It is too early to know whether the rotation in equity market leadership (from structural growth stocks to economically sensitive value stocks) will be a short-term trade or develop into something more sustainable. However, in order for a regime shift to occur, economies must break out of the secular stagnation environment they have been in since the end of the global financial crisis and it is too early to tell whether this will be the case.

To an extent, we think it is a moot point as we don't believe it determines the amount of value stock exposure in a portfolio, but rather how long you hold that allocation (ie. if the cyclical recovery is more durable then we maintain our value exposure for longer rather than increasing it in an equity allocation sense).

We don't think it is too late to buy the rally. We remind investors that it is time in the market rather than timing the market that will ultimately provide long term wealth creation. Markets might be expensive, they might have rallied hard from the lows and expectations around cyclical upside are well known. But we think policy makers are intent on pushing the recovery through to self-sustaining levels and this means further gains in corporate earnings as economies reopen and activity (spending on services) ramps higher.

If bond yields do not pressure valuations, then we expect equities remain the asset class of choice versus cash and fixed income as the reflation / rotation trade continues to dominate. This remains the case even though outperformance will likely moderate after a stunning six months where a lot of the valuation normalisation has already occurred. For the income inclined, we think equities will continue to offer a substantial yield premium to bonds for the foreseeable future.

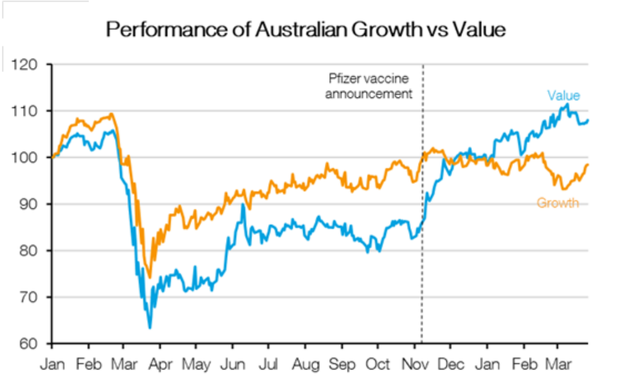
Macro fundamentals are supportive of earnings gains

Source: FactSet, Macquarie Research, March 2021

While we don't think it is too late to buy into the market, we do think it is important to have some protection against downside risks taken within and across asset classes. Within equities, we recommend investors have a mix of both value and growth stock/market exposure which allows leverage into reflation, but also a hedge against this trade reversing or running its course earlier than expected.

Ultimately, we prefer investors focus on "valuation" rather than a "value" or "growth", but tactically we do expect value to continue outperforming growth. In addition, a gradual increase in long bond yields will drive further yield curve steeping and this should provide ongoing performance support for banks and diversified financials (see "Investment Strategy Update #30 – Australian Banks the start of a new beginning").

Value will continue contributing to equity market returns



Source: FactSet, MWM, March 2021

The recent rebound in growth stocks suggest that investors are not prepared to abandon these names despite the potential for the reflation trade to strengthen. We think this is the right assessment of the backdrop where in the absence of a sustained rise in inflation, bond yield upside will be capped by any resulting equity market weakness (and tightening in financial conditions).

As a result, investors should stay overweight equities, and should use bouts of volatility to raise exposure to structural growth stocks that might be under selling pressure from higher bond yields. We recommend holding both real assets (commodities, property and infrastructure) which should both benefit from cyclical upside, rising inflation and easy liquidity conditions while also raising exposure to alternative assets (long/short equities, relative value) that have limited exposure to the direction of interest rates and/or equity markets.

Macquarie WM Investment Strategy

The report was finalised on 29 March 2021.

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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