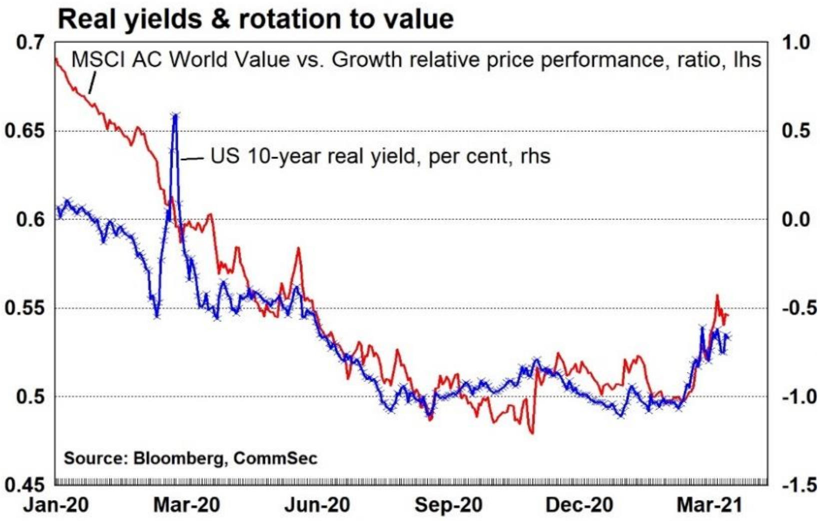
| 14 April 2021

Trading places: Growth, value and 2021's Great Rotation

As the global economy transitions from recession to expansion in the aftermath of the pandemic, professional investors have begun rebalancing their portfolios, driving one of the biggest market rotations in history. It's a mood shift of huge significance for sharemarkets, your portfolio and the economy. In fact, in the March quarter, US value shares outperformed their growth peers by the widest margin since 2001. The same applies to Aussie shares, where leadership has also pivoted away from previously high-flying technology shares in favour of value and cyclical stocks.



Growth stocks—shares of fast growing companies expected to outperform the market as they develop and realise potential—have largely driven the global sharemarket's recovery since it collapsed in March 2020. As Covid-19 fear swept across the world, these mega-cap technology-dominated stocks benefitted from the work from home trend with a surge in consumer demand for gadgets like iPads and MacBooks driving up Apple's earnings. Netflix has also been a beneficiary of stay-at-home lockdowns with subscription numbers surging, while online sales have boosted e-commerce behemoth Amazon.com. With central banks cutting interest rates to record lows, the search-for-yield has intensified, pushing investors up the risk spectrum into growth-orientated stock holdings.

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What's happened?

From March 2020 to October 2020, Nasdaq-listed video conferencing company Zoom's share price shot up over 200 per cent, while Aussie buy-now-pay-later (BNPL) firm Afterpay increased over 400 per cent, a beneficiary of people shopping from home. Other tech names have generally fared well thanks to the pandemic forcing people to stay home and connect with each other online.

But, change has been in the air since October, when the rebound in wider equity markets gathered steam. Covid-19 vaccines begun rolling out and the US Presidential election ushered in a raft of new stimulus measures, adding to the enhanced outlook for 2021. The improvement in the health situation, easing of government restrictions and boost to economic activity has prompted stronger economic growth, as measured by GDP, and may cause consumer and commodity prices to lift, implying higher bond yields.

The recent rally in longer-term bond yields has also injected greater volatility into the shares of growth-orientated companies, such as tech stocks whose earnings could potentially be pressured by higher interest rates, the re-opening of the economy and expensive valuations.

The recent upturn in economic activity and the business cycle has encouraged investors to steadily rotate from growth to value or cyclical shares, given more attractive relative valuations. Value are stocks viewed as trading below their true worth—typically older established blue chip names listed on the Dow Jones index (i.e. Boeing)—while cyclical shares are those that tend to fare better in more prosperous conditions, such as retail, energy or financials.

The rotation of market leadership—in response to growth sensitivity, valuations and higher market interest rates—has seen the ASX 200 Financials sector lift 13.9 per cent as at April 8 year-to-date, but the ASX 200 Information Technology (IT) sector is down 3 per cent over the period. It is still a modest reversal so far from the depths of the pandemic—where the IT sector surged 159.4 per cent between March 23, 2020 and December 31, 2020.

The risks

If the rotation picks up pace, the effect on growth stocks could accelerate. Equity markets, particularly in the US and its tech-focused names, are already trading at rich price-to-earnings (PE) ratios—in other words, valuations are lofty. While an allocation to tech stocks remains a sensible portfolio strategy from a diversification perspective, frothy valuations and rising bond yields will only encourage investors to seek value and cyclical stocks leveraged to a solid economic recovery.

Your portfolio

Portfolio or sectoral rotation—along with position sizing—are important investment strategies, particularly if over the last 12 months your portfolio holdings have overweighted towards tech heavy growth stocks. It might be time to take stock and review your portfolio and make sure it's still balanced and well diversified. The rotation is tipped to continue throughout 2021 as the economy recovers and stimulus measures wash through the business community, so now is a good time to re-evaluate your positions by consulting your Financial Advisor.

For a refresher on how to analyse, measure and manage your risk, click here.