Spectrum

The Great Rotation 2.0

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Federated Hermes International

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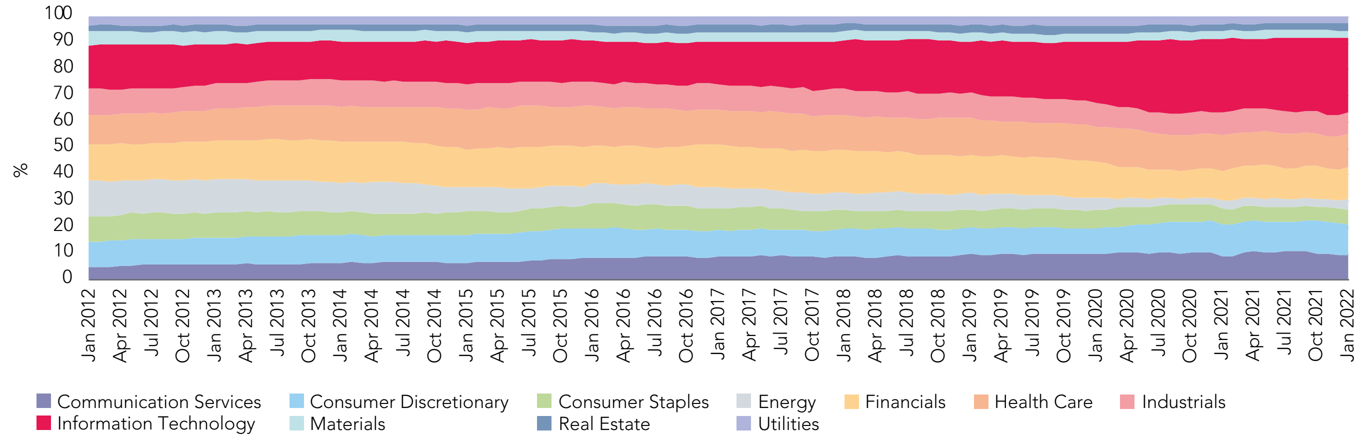
Slower growth rates, tighter labour markets, higher inflation and normalising monetary policies provides the classic backdrop to a great rotation from growth to value stocks, as well as a change in fixed income strategy. But, as we discuss in this edition of Spectrum, this cycle looks different compared to anything we have seen in decades

Stage set for sustained value rally?

Geir Lode, Head of Global Equities

Large cap tech growth stocks have dominated global equity markets over the last decade. Big tech has ballooned to more than one fifth of the market capitalisation of the North America MSCI index and many investors hold weighty positions.

Figure 1: IT stocks have ballooned in size over the last decade



Source: Bloomberg (January 2022).

Growth stocks' appeal is based on the expectation they will grow at a rate significantly above the market average, and this has held true for many large caps since the 2008-09 financial crisis as ultra-low interest rates and quantitative easing have driven record-breaking Wall Street rallies.

But this expectation has been thrown into doubt by the shifting macroeconomic backdrop as the risks related to monetary tightening loom into view, prompting investors to reconsider long over-looked value stocks in old economy sectors such as energy, mining, financials and utilities.

Behind this shift is the spectre of inflation which has risen sharply across advanced economies, driven by higher energy prices and supply-chain headwinds. The US consumer price index accelerated to 7.5% in January, while in the UK, consumer price inflation hit 5.4% in December.[1]

In response, central banks have indicated a newfound willingness to entertain a much more aggressive tightening cycle. On January 26, US Federal Reserve chair Jay Powell suggested interest rates were likely to start rising in a sustained fashion from mid-March.

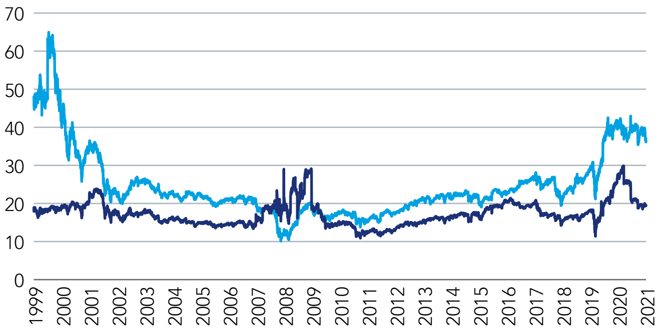
This hawkish pivot in monetary policy has led to a sell-off in large cap growth stocks as investors reappraise the outlook for the economy. The S&P 500 index fell 5.3% in January, its biggest monthly decline since the onset of the pandemic.[2] But underlying this sell-off is a shift to other assets as investors rotate their portfolios and adjust their strategies.

[1] Bloomberg as at 10 February 2022.
[2] Bloomberg as at 31 January 2022.

Rotation to value

The macro backdrop over the last decade has not been supportive of value investments and the onset of Covid-19 exacerbated existing trends; investors piled into tech and consumer staples amid lockdowns and homeworking, driving the relative valuations of growth and value to extremes. US value stocks, as measured by the Russell 1000 value index, have been trading at the biggest valuation discount to US growth stocks since 1999 and this trend is mirrored across other regions.

Figure 2: US value stocks trading at biggest discount in two decades



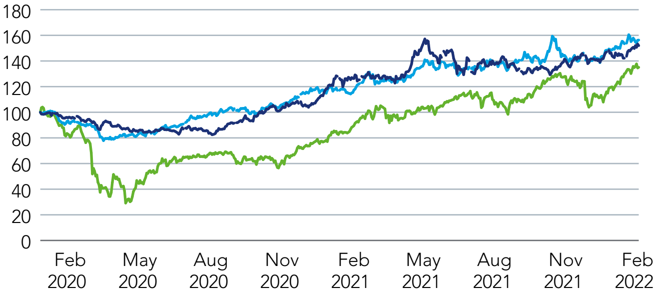
— Russell 1000 Value P/E
— Russell 1000 Growth P/E

Source: Bloomberg (January 2020).

The market began reappraising value stocks last year as the vaccine rollout bolstered confidence that the worst of the pandemic had passed. But the pivot in monetary policy at the start of this year has led to a more fundamental reappraisal and suggests that the value rally could sustain.

Value stocks have historically outperformed the wider market when inflation is rising, interest rates are moving upwards and commodity prices are booming. All three of these factors are in play.

Figure 3: Commodity prices have soared



— Bloomberg grain commodities index (corn, soybeans, wheat)
— Bloomberg industrial metal commodities index (aluminium, copper, nickel and zinc)
— Crude oil price (Brent)

Source: Bloomberg (February 2020). Commodity prices (rebased to January 2020=100).

Moreover, value stocks typically provide earnings leverage early in the cycle, when an economy is coming out of recession. This time around, any uptick in earnings will be propelled by the Covid effect, which caused countries to fall into recession at speed and, supported by stimulus, rebound equally quickly. The cycle has been compressed and the earnings outlook for value stocks over the medium term is unusually rosy.

The most recent earnings season has highlighted how precarious some valuations are, with many once-loved growth shares plummeting at the first signs of a weakening outlook. With investors apprehensive over these valuations and focusing on shorter duration assets, we see Energy and Materials names as increasingly attractive given their lower multiples. Financials – particularly banks – will benefit in this environment. Valuation is also likely to play an increased role in driving within-sector volatility.

With this macro backdrop we believe that this will be a sustained value rally lasting 12 months or longer, rather than the short-lived junk rallies we have experienced in recent years. However, given the delicate geopolitical situation, and the potential for lasting Covid effects through supply chain disruption and new variants, we anticipate increased volatility, with inflation expectations remaining a dominant equity risk factor. We therefore avoid the most speculative of value/recovery names, retaining an underpinning of quality throughout our investments. As the value rally matures this quality exposure will become increasingly important.

A sustainable approach

A value rally driven by oil companies, mining groups and utilities does, however, present something of a conundrum for sustainable investors.

As an organisation, Federated Hermes believes the consequences of a company's actions have far-reaching implications. Those companies and industries with unsustainable business practices – contributing to environmental harm, for example – face being left behind unless they adapt. While this is undoubtedly true in the long term, in the short-medium term many investors are not prepared to forgo the financial benefits of investment in energy, mining and utilities.

Many sustainable themes align naturally with growth investments, however their fundamentals have not necessarily kept pace with their valuations, and their performance has been challenging during the recent market transition. Crucially however, companies with strong and improving ESG credentials have tended to outperform their peers even during this period – ESG is an indicator of a company's quality rather than its growth potential.

We continue to favour sustainable themes as a long-term indicator of excess growth potential for a company, but remain cognisant that the price of these investments is becoming increasingly important in the current market environment, and we will not overpay simply because of the green credentials of a business. As growth stocks underperform we are likely to see attractive entry points for long term sustainable investments. ESG characteristics, however, are a universal strength regardless of the market backdrop, and while we remain selective over our exposure to high growth areas of the market we are instead favouring well-managed, responsible businesses across the broad market, including the more traditional value sectors.

Geir Lode is the lead portfolio manager on the Federated Hermes Global Equity strategy

This time looks different

Silvia Dall'Angelo, Senior Economist

We expect the economic recovery from the pandemic will continue this year, although at a slower pace than last year, as fiscal and monetary stimulus wanes.

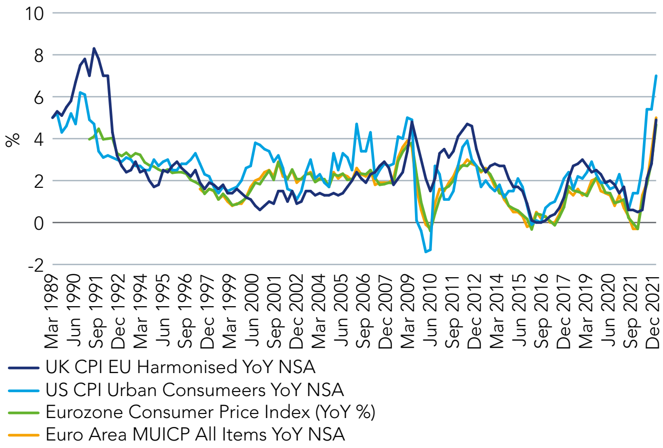
The move to a more mature phase of the cycle – with slower growth rates, tighter labour markets, higher inflation and normalising fiscal and monetary policies – provides a classic macro backdrop to a great rotation narrative.

However, as clichéd as it may sound, this cycle looks different compared to anything we have seen for many decades. The supply-side shock caused by Covid-19, plunged much of the world into recession in the first half of 2020 and the aggressive policy response has ensured the subsequent recovery has been steep and fast.

As a consequence, the current cycle looks extremely compressed by historical standards – the magnitude of the GDP swing in the UK over the last two years, for example, has been the widest in 300 years – which has contributed to pronounced supply-demand imbalances and dislocations. A number of late-cycle features have emerged early in the recovery, such as the sharp rise in inflation. We expect inflation will start to moderate in the second quarter of this year as demand cools off somewhat – while also shifting back to services from goods – and supply constraints begin to ease.

However, less benign scenarios are also possible. High realised inflation might become embedded via expectations and wage dynamics, which would necessitate a much more aggressive tightening of monetary policy. In addition, some of the Covid-related changes that have contributed to elevated inflation – a shift in consumption patterns away from services towards goods, lower participation rates in labour markets and supply chain upheaval – could prove longer-lasting and more structural.

Figure 4: Developed market inflation highest in decades



US, UK and Euro Area CPI.
Source: Bloomberg (January 2022).

Rising rates environment

As it stands, central banks have begun the process of withdrawing the stimulus that they provided to tackle the Covid-19 downturn and have embarked on a path towards the normalisation of monetary policy, although the nature of the Covid-related shocks hitting the economies has resulted in uncomfortable trade-offs and pronounced uncertainty about the outlook. As inflation has proved both more persistent and higher than initially expected, inflationary concerns have gained prominence and have imparted an acceleration to normalisation processes, with differences across jurisdictions. In general, major central banks have signalled they would bring some tightening forward in coming months, suggesting they are serious about preventing high inflation from becoming ingrained via second-round effects.

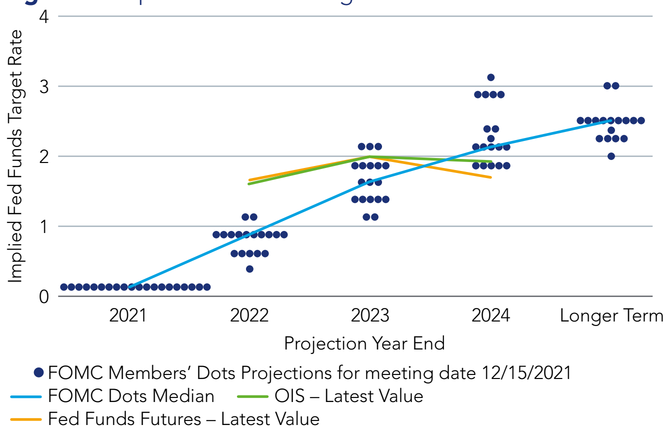
As inflation has proved both more persistent and higher than initially expected, inflationary concerns have gained prominence and have imparted an acceleration to normalisation processes, with differences across jurisdictions.

The US Federal Reserve performed a hawkish pivot at the tail end of last year, speeding up the pace of tapering and paving the way to raise rates in sustained fashion from mid-March.

At the Fed's January meeting, chair Jay Powell suggested that all options – including back-to-back rate increases and larger 50bp hikes – are on the table should the inflation outlook deteriorate further.[3]

In the eurozone, inflation hit a record 5.1% in January from a year earlier, increasing the pressure on the European Central Bank to respond with tighter monetary policy.

Figure 5: Implied Fed funds target rate



The Fed offers forward guidance with its dot plot every quarter. Each dot represents a member of the Federal Open Market Committee (FOMC) and their view on where interest rates should be.

Source: Bloomberg (January 2022).

The Bank of England, meanwhile, began its hiking cycle in December, amid concerns the tight labour market is adding to inflationary pressures, followed by another rate rise to 0.5% in February. In addition, the Bank has confirmed it would stop the reinvestment of its maturing holdings of government bonds, starting quantitative tightening.

In the eurozone, inflation hit a record 5.1% in January from a year earlier, increasing the pressure on the European Central Bank to respond with tighter monetary policy. In its February meeting, ECB president Christine Lagarde adopted a more hawkish tone and did not rule out raising rates this year.[4]

Going forward, the central banks' baseline scenario is that they won't have to do too much and too fast, on the assumption that inflation will start to decline at around mid-year as exogenous inflationary forces start to subside. Yet, they know that soft landings are rare occurrences and they face two-sided risks. While inflationary concerns are now in the driving seat, there is also the risk of a policy error whereby monetary and fiscal tightening coupled with an inflation squeeze to real incomes might lead to a sharp demand slowdown, potentially chocking the expansion. Hence central banks are likely to follow a mantra of flexibility and optionality, which can be adapted in either direction, depending on the evolution of data.

[3] Financial Times as at 16 January 2022.
[4] Bloomberg as at 2 February 2022.

Wider fixed income universe may be required

Fraser Lundie, Head of Fixed Income – Public Markets

The last two decades have seen a predictable negative correlation between rates and risky assets. Everything has been pretty straightforward from a risk management perspective and, as a result, investors have become accustomed to bonds providing close-to high single-digit returns every year.

But central banks' hawkish pivot at the end of last year in the face of rising inflation has provided something of a reality check and investors' long-term return expectations may need to be reset.

The takeaway is that the fixed income assets that many investors have relied on over the last 20 years may not necessarily be sufficient to make the same risk-adjusted returns going forward.

The risks have increased and assets may not behave quite as predictably as they used to. As a result, funds are going have to work harder and scope out a broader selection of the fixed income universe, and investors may been to consider assets they have previously overlooked.

A lot of the uncertainty surrounds long-end interest rate risk, which many investors will not want to rely on too heavily at the present time. But if they can rotate that investment towards a mix of shorter duration assets such as emerging market debt, high yield, leveraged loans and collateralized loan obligations, diversifying sources of risk premia away from interest rate term premia, then they are potentially left with a portfolio that is better adapted to the changing macro environment.

To achieve such a rotation of assets effectively, investors may need to hand over allocation decisions to flexible multi-asset credit specialists such as ourselves.

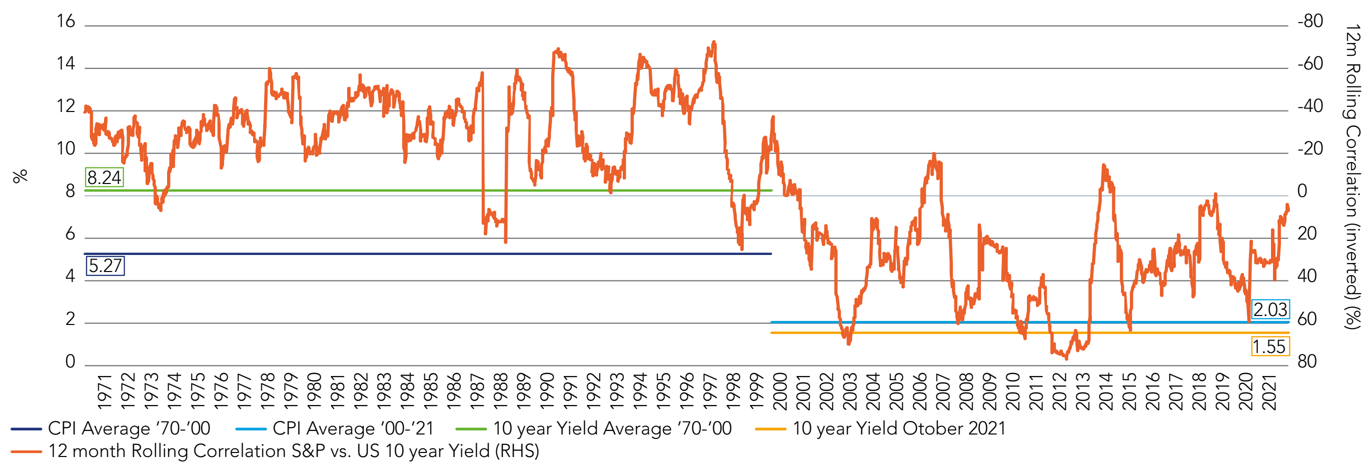
While the Fed is serious about raising rates, the US economy may not be able to withstand a sustained period of tightening. A standoff is developing between the market and the Fed, particularly as China is slowing.

The Fed's hardline position towards inflation mirrors the approach of former ECB head Mario Draghi's to the European debt crisis a decade ago. Mr Draghi famously stated the ECB would do 'whatever it takes' to prop up the euro in 2012. In many respects, he did not have to do anything else afterwards because a shocked market had priced in all possible scenarios.

The market now expects the Fed to hike rates five times over the next 12 months because all options are on the table. But it's not a simple trade to follow consensus: The conflict in Ukraine could escalate, leading to an abrupt drop in the number of expected hikes; the consensus also assumes the Covid pandemic will not throw up more surprises. It's a big assumption.

Fraser Lundie is the lead portfolio manager on a range of credit strategies

Figure 6: Inflation and correlation



Source: Bloomberg as at 31 October 2021. The chart shows two period different periods, 1970-2000 and post-2000 to date. The US and much of the world experienced high inflation through the 1970s and 80s and during this period, correlations between S&P 500 returns and 10-year treasury yields were generally negatively correlated. After the US entered a period of low and stable inflation in the late 1990 onwards this relationship went into reverse.

Financial institutions set to prosper?

Filippo Alloatti, Head of Financials (Credit)

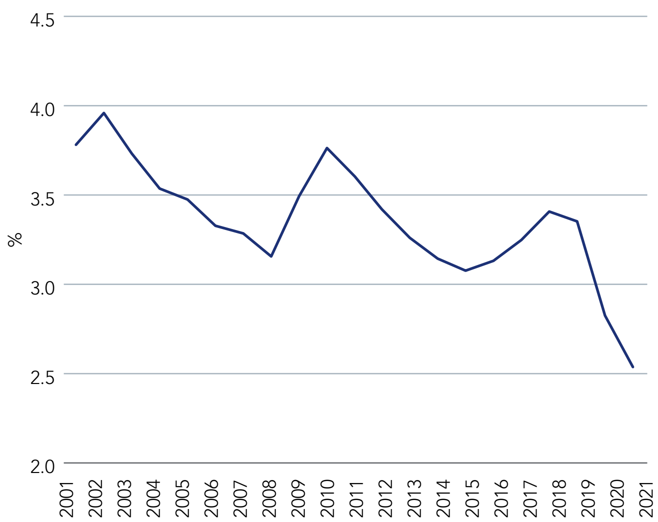
The low interest rate environment has squeezed banks' net interest margins (NIM) – the difference in income between interest charged and paid out, and a core measure of bank profitability – and rising rates promise a higher return on equity at over the short to medium term.

On the basis that the US Federal Reserve raises rates three to five times over the next 12 months, US banks' NIM should leave the low point of Q4 2021 behind. European banks, in particular, have struggled with ultra-low or even negative rates. The ECB is now expected to only tentatively hike rates, but later in the year, after the summer. This amounts to a difficult balancing act since higher rates, while positive for earnings, could penalise banks in southern Europe where non-performing loans are typically higher than Germany or France.

European banks, in particular, have struggled with ultra-low or even negative rates.

A steepening of the US interest rate curve has historically been a positive to the insurance sector. Life insurance groups, in particular, will benefit from having less reinvestment risk and more capital to deploy into higher yielding assets.

Figure 7: US bank net interest margins



Source: FDIC (as of 31 September 2021).

Opportunity in EM financials?

Kunjal Gala, Lead Portfolio Manager, Emerging Markets

A rotation into emerging market financial institutions now presents an attractive opportunity with long term drivers. Historically, rising US real rates have weighed on the performance of emerging market equities. However, emerging market banks are positively aligned to higher rates in the US.

Emerging market banks' net interest margins have been pushed down over the last decade by low rates. But as interest rates rise, these margins should increase, without detriment to loan growth or asset quality. Besides upside to margins, emerging market banks look well placed to absorb any new asset quality weakness arising from the latest Covid variant.

During the pandemic, the sector has built up capital as banking regulators have restricted dividend pay-outs due to Covid-related asset quality uncertainty.

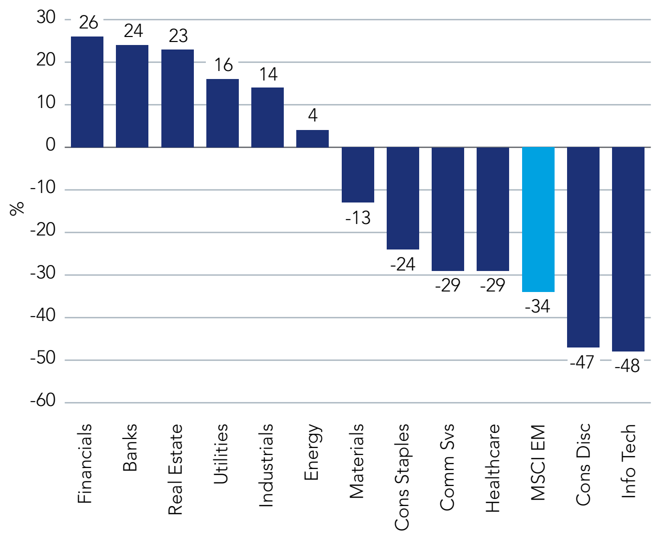
Structurally, there is under-penetration of financial services and insurance across many developing markets. The insurance sector, in particular, offers a structural growth opportunity and the pandemic has reset the consumer perception regarding the need for health protection.

Emerging market banks' net interest margins have been pushed down over the last decade by low rates.

Moreover, the growth of the middle class across Asia, particularly in China, provides huge growth opportunities in wealth management for Asian banks. In addition, banks are accelerating their digital transformation journeys. The shift towards digital banking should enable cost savings via branch rationalisation and smaller workforces while potentially raising fee revenues from new online products and services, such as cross-selling third parties' products and services to their existing customer base.

Kunjal Gala is the lead portfolio manager on the Federated Hermes Global Emerging Markets strategy

Figure 8: Financials have the most significant correlation with the bond yield



Source: IBES, MSCI, Datastream, UBS as at 6 December 2021.

Value rotation could prove short lived

Martin Todd, Portfolio Manager, Sustainable Global Equities

We haven't really seen a proper rate tightening cycle for a very long time. Markets have changed so much since that last cycle that trying to draw parallels from previous periods can be misleading.

The inflationary pressures in many sectors are a consequence of the pandemic; supply chain bottlenecks and shortages have led to higher prices as opposed to demand-pull inflation.

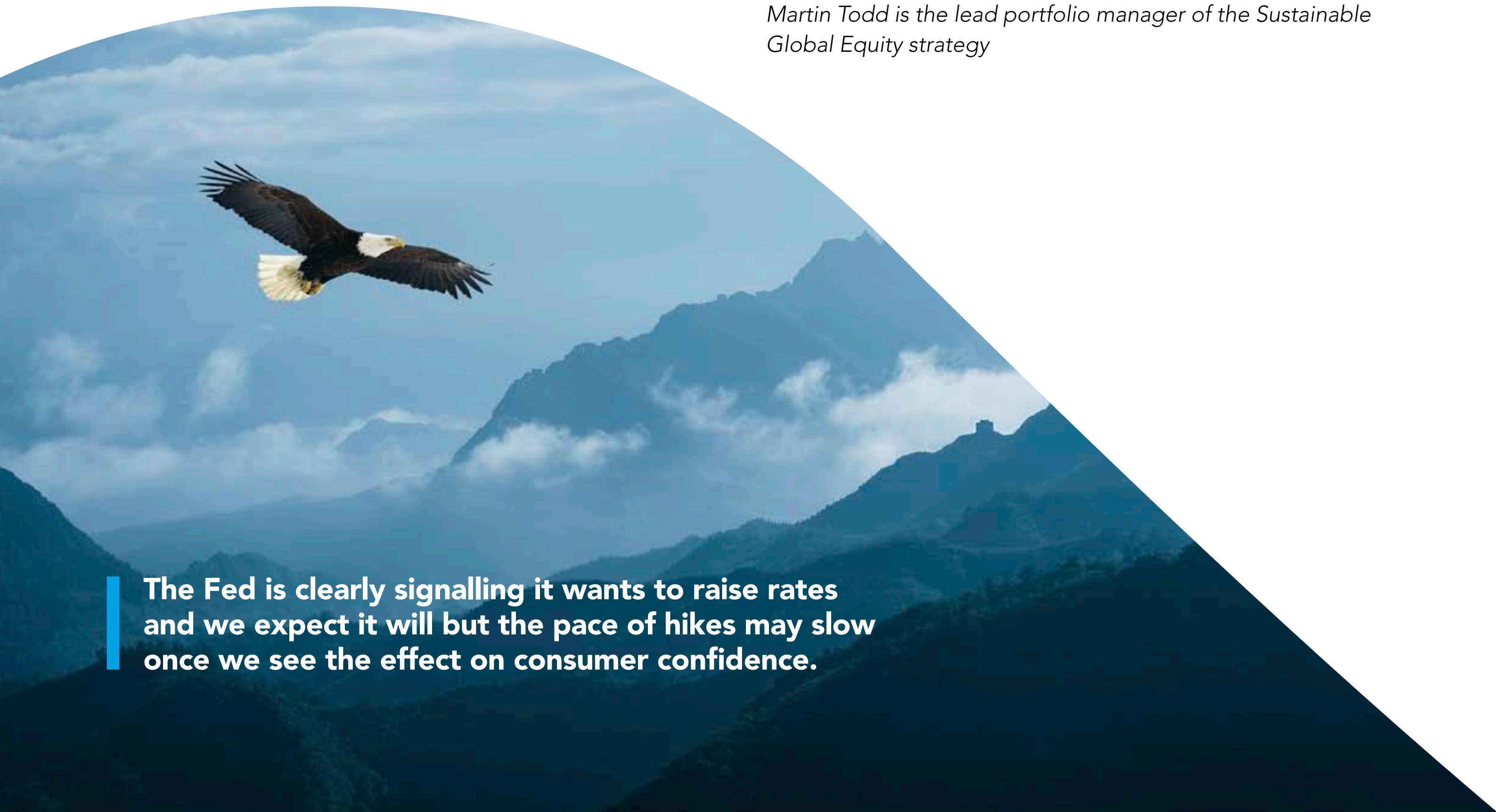
The Fed is clearly signalling it wants to raise rates and we expect it will but the pace of hikes may slow once we see the effect on consumer confidence.

The Chinese economy has been slowing and the People's Bank of China cut its benchmark mortgage lending rate for the first time in nearly two years in January. There is also a lot of geopolitical tension around the world.

The Fed faces a potential scenario where it begins tightening into an already slowing US economy. You can see the market is already anticipating this given how the yield curve has been flattening – suggesting investors have lost confidence in the economy's growth outlook.

We think that another shift in the direction of monetary policy is likely at some point this year and, as a result, our view is that the value rotation may prove relatively short.

Martin Todd is the lead portfolio manager of the Sustainable Global Equity strategy



The Fed is clearly signalling it wants to raise rates and we expect it will but the pace of hikes may slow once we see the effect on consumer confidence.

Value opportunity in China

Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan

For over a decade, being contrarian has been synonymous with investing in value. Nowadays, things are less clear cut. It's no longer value stocks alone that suffer investor disdain. Suddenly a swathe of Chinese technology growth stocks has fallen out of favour as investors, aware of mounting risks, sell them down, presenting us with opportunities to buy higher quality stocks at bargain prices.

The concerns surrounding China have hit stock valuations. The Hang Seng China Enterprise Index fell 22% in 2021 in absolute terms, and 17% relative to our Asia ex-Japan benchmark, and now trades on a price-to-earnings multiple of a mere 7 times. The valuation discount to the rest of the world is now at a more than two-decade high.[5]

As contrarian investors, our main response to a more aggressive Chinese policy agenda – which has been targeting areas such as online gaming, worker conditions and monopolies – is to seek stocks that spooked investors have sold down but are not in fact in the crosshairs of government policy.

We have added to our holdings of some of the high-quality Chinese names on our portfolio because they are now priced as if they were value stocks.

Figure 9: The China valuation discount

The Hang Seng trades at cheapest relative to the world since 1998

Source. Bloomberg, as at 23 December 2021. Calculated as Hang Seng Index/ MSCI ACWI Index.

Jonathan Pines is the lead portfolio manager on Federated Hermes Asia ex-Japan strategy

[5] Source: MSCI, Bloomberg as at 31 December 2021.

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International

Federated Hermes

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