Intelligent Investing

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The Great Rotation

Over the past few months there has been speculation and writing about what many are calling the Great Rotation in stocks from Growth to Value. So, what is this Great Rotation all about and what implications are there for a well-constructed selection of business in an investment portfolio?

The stock market is made up of thousands of public companies that for the sake of analysis are usually grouped into different sectors – think Financials, Technology, Healthcare, Consumer Staples, Industrials etc. These different sectors have their own investment characteristics which can affect how they perform in different investment environments. The key influences on which sectors are favoured are general economic conditions, inflation expectations and the level of interest rates all of which are intertwined. In a low growth, low inflation and low interest rate world any company that can grow earnings is worth much more than those that need healthy economic growth to prosper – think big Technology stocks like **Microsoft**, **Amazon**, **Apple**. Sectors of the economy like Construction, Tourism, and Energy need sustained economic growth to prosper as do Financials (banks like **Westpac** or **Wells Fargo**) which benefit from higher interest rates and generally sound economic activity which makes it easier to make good margins on lending and to have limited provisions for bad loans.

Since October the key driver in the change in performance of different sectors of the market has been the sharp rise in longer term interest rates. NZ, Australian, and US yields have jumped from around 0.5% to a 1.5-1.8% range driven by the rebound in economic growth post-pandemic as the vaccine rollout gathers pace in western countries. Inflation has jumped from the depressed levels of a year ago when the economy was being shuttered by Governments. How great this rotation from high growth Technology & safe haven Healthcare to cyclical value like Financials and Industrials becomes depends on the outcome of the current debate on how persistent inflation starting to be felt becomes. The central banks tell us they think it is a transitory effect of the global economic restart post-Covid, but many market participants think inflation may be more persistent and eventually force the central banks to play catch-up and raise short-term interest rates earlier than the signalled 2024 timeline of the US Fed and Reserve Bank of Australia. Who is right is not clear despite many strongly held opinions. So, what does all this mean for a reasonably diversified investment portfolio?

Trying to second-guess which sectors will outperform depends largely on being right about the economic environment month-to-month and year-to-year. That is exceptionally difficult and should not be the investors' objective. A well-constructed investment portfolio should hold stocks across a range of sectors where the overall sector performance will ebb and flow over the years. You can tilt in favour of Financials or Technology etc at different times but the longer-term focus should be on maintaining exposure to a broad range of sectors and owning high quality businesses within those sectors. A portfolio with some Financials, Technology, Healthcare, Consumer Staples, Energy, Utilities, Property etc will ensure that over time no matter which sectors might be going in and out of favour your portfolio does well. Selling out of Technology because Financials are outperforming in 2021 is likely to be something a longer-term investor will regret just as selling Financials, **Wells Fargo** was US$22 in late 2020, to buy high priced Technology in 2020 when it appeared that was the only option for earnings growth at the time would not have served you well (**Wells Fargo** is now US$46). Closer to home Australian banks and construction stocks like **Fletcher Building** have outperformed in 2021 but the heavily utility weighted NZX50 has struggled as higher long term interest rates undermine slow growing utilities.

What is going on within and across sectors of the market in the short-term is interesting, but it should not dictate your longer-term investment strategy. Avoiding a sector in long-term decline though is another matter for another newsletter.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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