First Quarter 2021

The Great Rotation

Investors Trim High Flying Growth Stocks and Load Up On Value Stocks as Rising Inflation Expectations Push Long-Term Interest Rates Higher

The Team:

Brian Steele, CA, CPA, CFA®
Laura Prust, CIM®, CPCA
Jeannine Campbell
Kelly Edmonds
Elizabeth Kernohan
Nudrat Ahsan
Sam Ryder, CFA®
Matthew Bell, CFA®

Quarterly Summary and How We're Positioning for Q2

It has been a long time since the S&P 500 index and the often sleepy TSX composite index outperformed the high-flying Nasdaq composite but that is what Q1 2021 gave us. The outperformance was not insignificant either with the Dow, S&P 500 and TSX returning 7.8%, 5.8% and 7.3% respectively during the quarter and the Nasdaq returning only 2.8%. The investor flows out of high valued stocks represented by the Nasdaq and into stocks that are/were historically reasonable from a valuation perspective was relieving to see after years of seemingly consistent growth stock outperformance. This rotation from growth to value benefitted Canadian investors in general as the Canadian market consists almost entirely of value stocks.

The rotation from growth stocks to value stocks was driven by growing investor optimism about COVID re-opening throughout 2021 and robust government fiscal support globally which in turn has resulted in rising inflation expectations and rising long-term interest rates. Higher inflation and interest rates hurts high growth stocks as it means investors begin to apply a higher "discount rate" to the earnings expected in the distant future. Inversely, value stocks can benefit from higher inflation and interest rates as they tend to be the sellers of physical goods and most benefit from the rising price of said goods. The profit margins often remain the same but the top-line price rises resulting in a greater expected profit. Further, higher inflation means that the larger debt obligations of value stocks is likely to be eroded faster than before, kind of like if you lock in a mortgage today at 2% and mortgage rates soon rise to 4%, the value of your 2% mortgage just went up a ton!

It seems one can see inflation everywhere these days – ***residential real estate***, ***food prices***, ***oil/gasoline prices***, ***vehicle prices***. It is clear that we are experiencing broad based inflation, likely due to the economic distortions caused by COVID and governments' COVID relief programs. The $64,000 question is how durable this inflation will be. After all, while many Canadians can make adjustments to their spending to accommodate this inflation, food and oil price inflation will have a huge impact on household budgets for those Canadians who may be facing an uncertain return to full employment after COVID as well as ***those in more impoverished countries with much less household budget flexibility***.

The durability of the 'rotation to value' rally will entirely depend on when inflation goes too far and consumers around the world can no longer afford the things necessary to initiate and maintain a new household – housing/rent, transportation, food, utilities, etc. There is likely still some room for prices to rise further, and governments can intervene to make certain goods more affordable to their populaces, but there will be a breaking point. As emerging market are the most vulnerable to rapidly rising inflation, it is likely problems will begin there. This is especially true given the extraordinary financial stress that emerging market governments are under following the COVID pandemic. ***Brazil and Turkey have already begun to raise interest rates*** to entice foreign investors to keep their money invested there.

Despite the new stock market feel wherein the market leaders are in the financials, energy, materials, industrials and consumer discretionary sectors, it is important to note that market valuations remains near all-time highs. Further, the market mantra over the past five years was that equity markets can be highly valued because interest rates are low. Well if interest rates are rising, shouldn't that mean the near all-time high valuations may be difficult to maintain? Again, we are not market timers, and many market sectors offer historically attractive valuations, but there is an inconsistency in the market's mantra.

The "Reddit raids" of Q1 may end up being emblematic of the end of growth stock outperformance as well as a peak of investor enthusiasm for this market cycle. The Reddit raids involved investors congregating on Reddit to target well-known, over-the-hill stocks with high short interest like GameStop (GME), BlackBerry (BB) and AMC Entertainment (AMC) and push their stocks beyond anyone's imagination. The tactic was highly sophisticated for a group of investors that many derided just days before and their actions resulted in a US congressional hearing wherein hedge fund investors (many of which were betting against the stock and suffered significant losses as a result) and retail investors (i.e. Redditors, etc.) alike testified about their role in the raids.

How To Position Portfolios Going Forward?

Given the still elevated growth stock valuations and somewhat reasonable value stock valuations that exist at the end of Q1, long-term return expectations still greatly favour value stocks and we believe that value stock outperformance may continue for quite some time. That said, there is still good reason to own small pockets of growth stocks which have durable long-term, or generational, growth outlooks in truly disruptive subsectors.

In Q4 2020 and Q1 2021, in anticipation of the rotation to value and specifically cyclical value, we added names like Intel (INTC) and Cisco Systems (CSCO) which trade at historically attractive valuations and have indirect exposure to hot technology trends like the expansion of cloud infrastructure and increasing data volume and collection. We also added to names like Constellation Brands (STZ), Pfizer (PFE) and Berkshire Hathaway (BRK.B), all of which trade at discounts to peers and are reasonably valued on a historical basis. More recently, we started to add Sonova Holding (SONVY), a global leader in hearing aid production and sales that is trading at a reasonable valuation relative to the long-term growth outlook, and a company that is likely to benefit from the end of COVID. These are just a few of the companies that we think are well equipped for the near and distant future. We continue to believe it pays to stick with companies that trade in line with or at a discount to historical average valuations, with a consideration for future expected growth.

We have continued to bolster our position in long-term US Treasury bonds as bond yields have continued to rise. Falling long-term interest rates mean rising long-term bond yields. US 30-year Treasury bond yields hit a high of 2.5% in mid-March after hitting a low of 0.99% in March 2020. Long-term bond values (or valuations) traditionally rise during periods of equity market stress so adding these bonds can help offset the risk associated with the equity positions held and reduce overall portfolio volatility during times of equity market stress.

We have continued to add to alternative investments which have returns that are generally uncorrelated to equity markets and can therefore help preserve portfolio value during potential equity market downturns. We have incorporated mortgage pools and credit/merger arbitrage funds across most portfolios and are beginning to evaluate the usefulness of adding private credit funds and private equity as a way to further diversify portfolios and provide a smoother return experience over time.

We are working constantly to position your portfolio appropriately to maximize return, while managing your overall portfolio risk exposure.

Sincerely,

Steele Wealth Management

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