Navigating Extremes in 2022

Pandemic extremes continue, but Growth investors should look through the short-term cycle

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The last 24 months have been anything but normal. An extreme divide formed between COVID "winners" and "losers", while unimaginable levels of stimulus supported broad asset prices and fueled intense speculation.

2022 is different. A marked shift in future inflation, interest rates and liquidity expectations has resulted in an aggressive market sell-off, and an even-more-aggressive market rotation to low valuation ("Value") stocks. January 2022 was the second worst month for Growth stocks looking back over the past 20 years (Fig. 1).

The volatile start to the year in financial markets is unlikely to abate soon. Sustained inflation, a looming Federal Reserve (Fed) rate hiking cycle, tightening liquidity conditions, and the unwinding of pandemic era economic distortions — among other factors— mean that further price fluctuations can be expected. While it is too early to say that we are in a post-COVID world, the world has made significant progress and we see a pathway to living with the virus. This would be positive for normalising supply chain pressures (key to alleviating this absurd supply-driven inflation), but as we have learned through COVID, the future is anything but certain.

January 22 – New expectations catalyse a wild rotation

In January we witnessed an historic rotation to Value stocks as it became clear inflation was a bigger problem than expected. In response, expectations for US Federal Reserve rate hikes increased dramatically, while US nominal and real yields moved sharply higher, back to their highest level since early 2020. Global equity markets responded with a sharp 5% fall, with lofty valuations increasing the market's sensitivity to an adjusted rate outlook. Low quality, "deep value" stocks outperformed meaningfully and we witnessed strong divergence between sector and style returns (Fig. 2).

Our Global Growth Equity strategy focuses on quality, durable growth companies, with a 2-3 year return horizon; this was not a month for our preferred companies. While we experience adverse market conditions from time to time, the sheer speed and size of the market's rotation to lower quality companies resulted in higher underperformance than we would expect in any one single month, with positioning across the higher innovation sectors of Consumer Discretionary, Information Technology and Health Care detracting the most from returns, while no exposure to the strong-performing Energy sector also worked against the portfolio. It is important to remain humble about economic developments from here, but we see a rotation as we witnessed in January as a one-time rebasing of expectations, not a likely reoccurrence in 2022. Broad sweeping rotations such as we experienced in January tend to result in indiscriminate selling. This volatility often presents opportunity in companies whose outlook we still believe remains strong – historically this mispricing has presented us with

Growth vs Value – worst months over 20 years

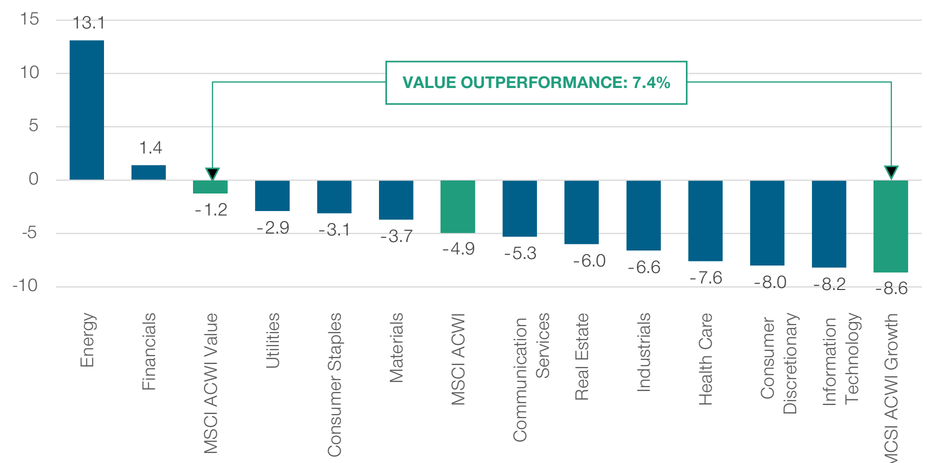
(Fig. 1) Deleveraging did stabilise credit before pandemic caused a jump in 2020

Month	Growth vs Value
Feb-2001	-7.7%
Jan-2022	**-7.4%**
Mar-2021	-4.8%
Apr-2009	-4.5%
Nov-2020	-4.5%
Dec-2021	-4.4%
Feb-2021	-4.3%
Mar-2002	-3.9%
Oct-2018	-3.8%
Sep-2008	-3.4%

Source: MSCI. MSCI ACWI Growth vs MSCI ACWI Value. Jan 01 – Jan 22. Please see additional information about this MSCI information.

Sector & Style Returns

(Fig. 2) Value Dominates, January 2022, USD



Past performance is not a reliable indicator of future performance.

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opportunities, and we see this period as no different.

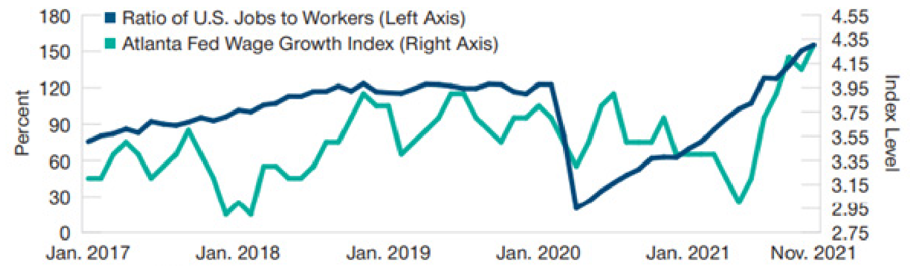
Inflation – a sticky problem?

The persistence of inflation has been a surprise. Wages, for example, look set to remain high—there are more jobs than workers in the U.S. (Fig. 3). 26 U.S. states will raise their minimum wage in 2022, and many firms are raising their pay floors even higher. Rents are going up, and house prices are skyrocketing. Food bills are surging on the back of higher transportation and material costs, while the price of oil remains close to its highest since 2014 amid limited supply and tensions in Europe and the Middle East. While we expect pricing pressures to ease for goods such as used cars, it is likely areas such as wages and rents will persist. A combination of structural and transitory inflation is the likely path forward, requiring balance in portfolio construction and a broader investment universe across all sectors (while retaining our durable growth preference).

As we step forward in 2022, we believe inflation will decline from its unsustainably high and distorted

The U.S Labour Market Is Tight

(Fig. 3) There are more jobs than workers, and wages are rising



As of November 30, 2021.
Sources: Federal Reserve Bank of Atlanta, Bloomberg Financial L.P. Analysis by T. Rowe Price.

current levels. Used cars and oil are unlikely repeat their step-change support to inflation, while persisting supply chain pressures will continue to add pressure. The combination of persistent and transitory inflation inputs will see inflation fall to lower-than-current levels but settle higher than the pre-COVID environment in our view. Our base case is that this is an environment which will prevent interest rates moving too high and support continued economic growth. As a bottom-up stock picker, we are avoiding trying to be too precise (while acknowledging the importance for markets) and focusing more on the individual impacts these inflationary pressures are having on company margins.

Growth vs Value – separating the short and long term

Outperformance of growth stocks has been persistent post GFC. Declining interest rates and secular tailwinds such as globalization, ageing demographics, innovation (the list goes on), have been part of the story, but pure outperformance of fundamentals has driven this divergence.

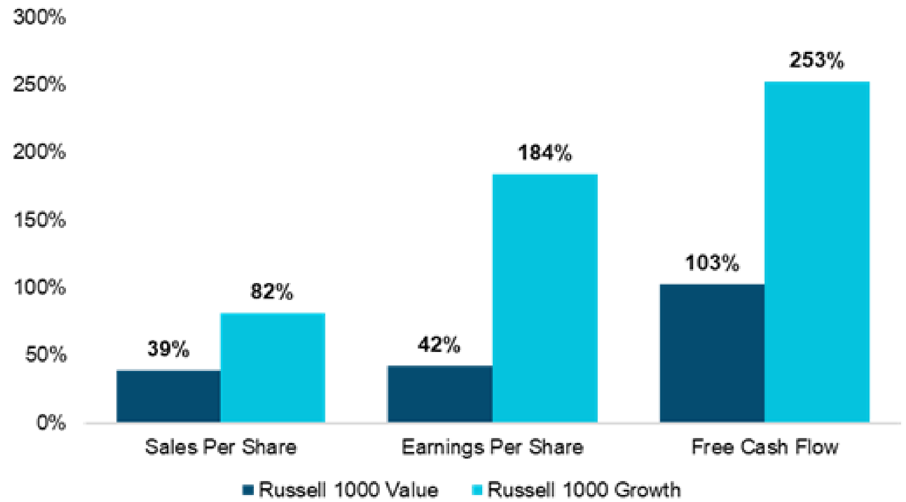
This changed following Pfizer's initial vaccine data release in Nov 2020 – expectations of a Pandemic "cure" coupled with inflation's persistence have driven Value to outperform by more than 20% since 9 Nov 2020. Attempting to call the direction of Growth or Value in the near term is incredibly difficult – this requires informed and high conviction views on COVID cases/variants, pandemic normalization, supply chain pressures, inflation, central bank reactions, real economy strength (plus more)- these are all unprecedented and incredibly uncertain.

We find ourselves remaining humble about what we can't know. While the recent outperformance of Value has been deserved (recovering from deep underperformance earlier in the pandemic), the length of such a rally, taking into account Value's extreme comeback, may be as swift on the way out as the way in. In dealing with uncertainty such as this, we lean into diversification and idiosyncratic stock picking. We are picking companies across the full market where we believe their 2-3 year outlook is sound, not filtering the portfolio for a "factor". The market is likely to oscillate between Growth and Value as the year continues, but historically this volatility has provided a strong stock picking environment.

The challenge investors have today, is separating long term expected returns from short term narratives. As we consider the future from where we sit today, we believe the world will be more similar to its pre-pandemic self than not. While some forces which have supported Growth appear to have shifted, such as peaking globalisation, our base case is that supply chains will normalize as we learn to live with COVID, inflation will revert back to a lower, manageable range, interest rates will rise but are likely to level out at levels we were used to pre-

Growth's outperformance of fundamentals

(Fig. 4) Cumulative Change (1 June 2007 to 31 December 2021)



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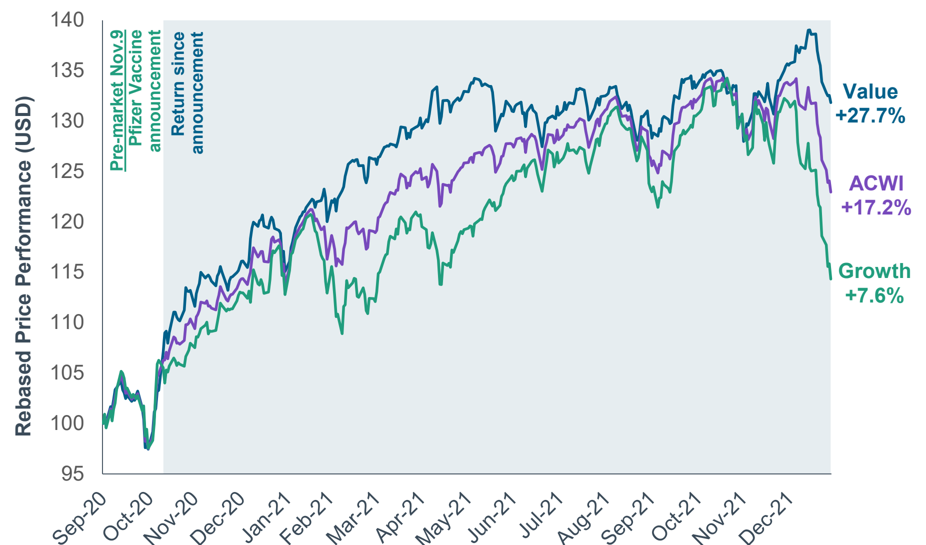
Source for Russell Index Data: London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group"). Please see Additional Disclosures for information about this FTSE Russell information.

More of the same, or regime change?

(Fig. 5) MSCI ACWI Returns



Past performance is not a reliable indicator of future performance.
As of 27 January 2022.
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pandemic, and that overall economic growth will remain positive, but slow. In a new world which has adopted a shift to technology like no other period in history, we believe this environment will support the fundamental outperformance of Growth stocks, but this a longer-term view that won't be the narrative of 2022. The challenge is, are you a long-term or short-term investor? Mistiming these short-term shifts can be challenging, hence our framework which focuses on fundamentals over 2-3 year horizons.

Navigating the uncertainty

As pandemic extremes continue to find a path of normalization, we retain our 2021 approach of positioning the portfolio in the "middle of the fairway" and focusing on idiosyncratic stock picking. Heightened uncertainty remains and this is not the time, in our view, to make portfolio-defining shifts in either direction.

Investors are navigating the negative "change" of key market drivers such as GDP, corporate earnings, interest rates, liquidity etc. It is important, in our view, to acknowledge that despite this deceleration, absolute "levels" will likely remain strong which can support markets. GDP and earnings growth are likely to remain positive, interest rates (despite rising) are likely to remain low in a historical context, liquidity (despite receding from unprecedented levels) remains very strong. While investors need to consider both the "change" and "levels" dynamics, we remain optimistic that markets can continue to move higher should the levels remain positive.

At the stock level, we are observing a broader opportunity set than we have for some time – innovative, high growth companies trading at more reasonable valuations, reopening opportunities in travel and recreation, companies whose supply-chain-induced margin pressures are reversing, and idiosyncratic opportunities not tied to broader market forces. After the recent sell-off, we are at a point where risk-reward looks strong in our view.

With inflation pressures remaining and appearing more persistent in the near-term, we retain our exposure to Financials and Real Estate but are carefully managing our weights in light of recent outperformance. We will however not compromise our hurdles for companies and may underperform should low quality, leveraged cyclicals outperform.

We retain our preference for special, innovative companies in growing end markets and are focused on individual company fundamentals. We are observing companies becoming oversold as the market's short-term focus, in our view, undervalues the value creation over coming years. As the market debates the future growth prospects for sectors such as IT Software or Internet Retail, we believe a meaningful portion of the world's shift to online is structural – there are numerous businesses whose revenues or customer base have materially expanded versus pre-COVID but due to short term margin headwinds and the aggressive rotation, are trading at levels we believe are disconnected from the structural expansion of their business models. Not all companies in this category will be equal however, and we are selectively defending companies as we retain our 2-3 year investment horizon.

Acknowledging extremes and the unknowable requires humility and patience but combining this with experience and deep insights across sectors and regions positions us well to pursue the opportunities we expect to emerge. Our portfolio continues to represent the highest conviction ideas from our global research platform, diversified across companies, sectors and regions. This has served us well, for delivering investors strong and consistent outperformance since inception.

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