NORTHERN TRUST
ASSET MANAGEMENT

EQUITY ROTATION
SYNTHESIZING MOVES TOWARD VALUE

February 23, 2022

Northern Trust
Global Asset Allocation

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2022 has consisted of headline-grabbing financial market volatility, higher interest rates, geopolitical uncertainty and surging energy prices. There has been a lot of intra-asset class movement, perhaps none more notable than the rotation from growth to value within equity markets. The rotation sends a key message regarding the risk appetite of equity investors and has implications for how to appropriately evaluate regional performance differentials.

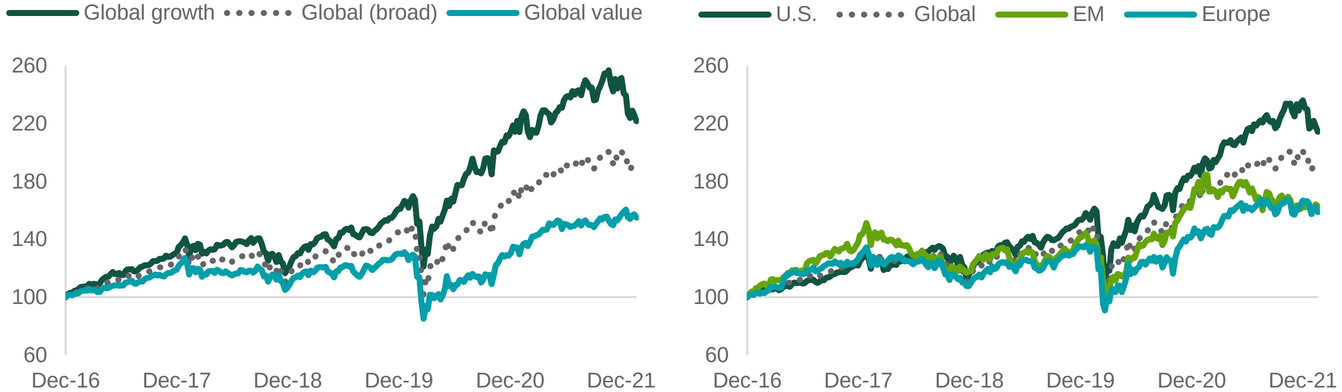
THE EQUITY MARKET ROTATION

Global growth equities outperformed global value equities by nearly 70% over the past five years (Exhibit 1). Investors were attracted to strong corporate earnings growth in a muted economic growth environment, while low interest rates helped keep a lid on the discount rate of future profitability (a hallmark of growth companies). At the same time, traditional value sectors such as Financials and Energy faced significant headwinds. Expectedly, this trend impacted relative regional equity performance through each region's differing exposure to growth versus value. The U.S. outperformed Europe and emerging markets (EM) by over 50%. However, a notable rotation took place during the recent equity market pullback. During the 7.1% decline in global equities from January 4 through February 18, growth equities declined 11.6% and value equities lost 2.6%. Regional equity performance followed a similar pattern: U.S. equities declined 9.5% and Europe equities lost a lesser 5.7% (Exhibit 1).

EXHIBIT 1: THE ROTATION(S)

After a prolonged period of growth (U.S.) outperformance, equity markets have recently rotated toward value (Europe).

EQUITY RETURNS (INDEXED TO 100)



Source: Northern Trust Asset Management, Bloomberg. Gross total returns in USD for MSCI indexes. Data from 1/2/2017-2/18/2022.

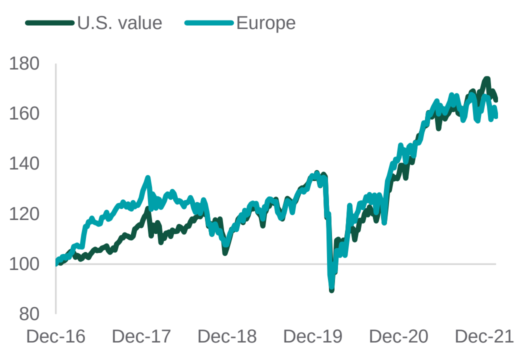
THE CONNECTION TO REGIONAL PERFORMANCE

Value tends to be far more heavily weighted toward cyclical industries such as Financials and Energy, which have benefited from higher interest rates and commodity prices, while growth indexes are heavily weighted toward Technology and adjacent industries. This same observation can be also made when comparing the U.S. and Europe. The U.S. market is heavily weighted toward Technology-oriented companies, while Europe is more old-economy cyclicals. Financials, Industrials, Energy and Materials stocks make up 26% of the U.S. market, but constitute 46% of the market in Europe. Meanwhile, those sectors account for 40% of the U.S. value market (Exhibit 2). Consequently, U.S. value performance has closely resembled that of the broader Europe market over the past several years (Exhibit 2). Regionally, comparing the U.S. to Europe is much like comparing growth to value, with support coming from both valuations and relative performance.

EXHIBIT 2: MAN IN THE MIRROR

Europe has resembled U.S. value in many ways, including performance and sector composition.

EQUITY RETURNS (INDEXED TO 100)



Weights (%)	U.S.	Europe	U.S. value
Healthcare	13	14	17
Cons. Stpls.	6	13	10
Utilities	2	4	5
Real Estate	3	1	4
Technology	29	7	12
Cons. Disc.	12	11	8
Comm. Services	10	4	4
Financials	12	17	19
Industrials	8	15	11
Materials	3	8	4
Energy	3	6	6

Source: Northern Trust Asset Management, Bloomberg. Weights and returns for MSCI indexes as of 2/18/2022.

CONCLUSION: ROTATION REFLECTS INCREASED UNCERTAINTY

Inflation is elevated, interest rates have moved up and the number of expected Fed rate hikes in 2022 has increased to 6 from 3 year-to-date. The investor response to favor less interest-rate sensitive value stocks, to some degree, reflects a drop in risk appetite when faced with risks to corporate profitability, higher interest rates and elevated uncertainty regarding the future path of monetary policy.

The significance of the rotation should not be overstated at this stage of the cycle. We believe the global economy has a decent runway for growth and we expect corporate profits to be resilient in the face of higher interest rates and input costs. While it is understandable that investors would lower their risk appetite toward interest-rate sensitive growth stocks in the face of a more hawkish Fed, we think monetary policy will remain accommodative by historical standards. Knowing that equity investors are sending a consistent message across sectors and regions gives us comfort that our current preference for developed market equities over EM, combined with a natural resources overweight for protection against inflation and Russia-Ukraine risks, is the best combination for the time being. Moreover, we appreciate that a global portfolio provides not only geographic diversification, but also exposure to cyclical industries currently offering greater protection from inflation and monetary policy uncertainty.