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Shift to value stocks isn't over, says Sage Capital boss Sean Fenton

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The rotation from growth to value has taken a swift U-turn as investors consider the impact of a more hawkish US Federal Reserve, but value and cyclical stocks will soon come back into favour, according to Sage Capital managing director Sean Fenton.

After being snubbed for a decade, value stocks captivated the market for the first half of this year as investors shifted away from their long love affair with growth. This movement was stopped in its tracks last week when the Fed prepared the market for two rate hikes in 2023 — and potentially sooner, based on comments by St Louis Fed president James Bullard.

The market reaction was swift and brutal for so-called value stocks, which are often in cyclical industries and linked to the strength of the economy. The pain looks set to continue in the very near term, with the cyclical-heavy Australian sharemarket eyeing a 1.5 per cent drop at the open on Monday.

"This shift (from the Fed) has triggered some wild rotations across the market in the last few days, but in the absence of much weaker economic data we've likely seen the end of the recent rally back down in bond yields and will likely see value and cyclical stocks start to perform better again," Mr Fenton said.

When the Fed set its policy stance over a year ago the world was a very different place. There were expectations of a severe recession and, with already low rates, the Fed was running out of policy tools, according to the Sydney-based portfolio manager.

"Setting forward guidance of rates being maintained at very low levels for years to come was appropriate (at the time). Since then, the success of vaccines and the economic recovery have been far stronger than expected, so it's pretty normal for the Fed to back away from its forward guidance," Mr Fenton said of Wednesday's policy update.

"This will eventually lead into tapering of the QE program and then actual rate rises. The same can be said for the RBA and its policy positioning," he predicted.

Rising inflation has been the big focus in recent months, as investors and central bankers try to work out whether it will be transitory or longer lasting.



Sean Fenton says value stocks will start to perform better despite concerns over US rate rises. Picture: Hollie Adams

While the US central bank is sticking with its transitory line, Mr Fenton thinks higher inflation could linger for longer than many expect.

"I think it could prove to be quite a bit more persistent than the central bank thesis at the moment," he said.

"We see some of the supply chain disruptions persisting for longer. If you look at semiconductor availability, we're talking about well over a year before that's normalised.

"Then there's shipping container volumes, among others, and you've still got a lot of the reopening dynamic and extra savings to support demand and stimulus out there."

The psychology around price was shifting as well, with companies far more willing to pass through price rises and consumers accepting them, he said.

Mr Fenton sees inflation hanging around for longer than central banks estimate, but ultimately he doesn't see it as a long-term phenomenon, simply because of all the debt and leverage in the world.

Still, it is the key driver for markets right now and will be a focal point for this year and next. The coming volatility will be an opportunity for patient investors, according to Mr Fenton.

"There will be a challenge to markets down the track with higher bond yields and potentially from tapering," he said as he warned of the risk of moving on a trade too early.

The US 10-year bond yield rose last Wednesday after the US Fed's update, before dropping on Thursday and falling below 1.5 per cent on Friday, sparking the rush to tech stocks and a shift away from value.

In unpredictable, volatile markets, Mr Fenton sees the best move as de-risking and taking a more neutral stance rather than risk being committed in the wrong direction.

His long/short fund Sage Capital, currently has "a broad mix" of different exposures, including inflation hedges such as energy and steel stocks. But not wanting to miss out on growth, it is also holding positions in Resmed, CSL and Afterpay.

The key is to "get a good mix and focus on what companies can deliver — so bottom-up earnings to build out some of those broad macro shocks like inflation and bond yields moving around," Mr Fenton said.

While he likes diversified financials, Mr Fenton is less convinced on the major banks and is even short CBA, stepping in to sell the stock earlier this month as its share price breezed past \$100. The fund is also short Woolworths and Wesfarmers due to their "stretched valuations".

His stock pick right now? QBE.

"The global insurance cycle is very powerful at the moment. And ultimately they do benefit from rising bond yields in their investment portfolio."