

## Investment Commentary—January 2022

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The final three months of 2021 brought another Covid variant and more stock market highs. It's not altogether surprising that the market looked past the current Omicron wave. Relative to previous variants, Omicron leads to significantly milder illness which means that most of us are carrying on with our lives. It is more transmissible but that means that the Omicron wave will peak and then subside more quickly. The next month or two will still be very challenging as hospitalizations surge and many employers struggle with staffing shortages, but the economy should be picking up strength by the end of the quarter.

While it's understandable that the stock market shrugged off Omicron, it is harder to fathom its benign reaction to last month's Federal Reserve course correction. In mid-December, announcing the policy shift, Fed Chair Powell said, "the data we got toward the end of the fall was a really strong signal that inflation is more persistent and higher, and that the risk of it remaining higher for longer has grown." By the standards of the often cryptic "Fedspeak," Powell's comments were crystal clear; the coming rate hike cycle will start sooner and be more vigorous. The stock market responded by achieving new all-time highs. Which is odd considering that market pundits almost uniformly attributed 2021's huge gains to extremely low interest rates. This was encapsulated by the mantra TINA, which stands for "there is no alternative (to stocks)." The more rapidly interest rates rise, the more quickly we will get to the point where bond yields don't look so paltry and there will be an alternative (to stocks).

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With the stock market returning over 28% in 2021 and over 100% in three years, we wanted some long-term perspective on U.S. stock prices. With that in mind, we updated the enclosed chart of the S&P 500's inflation-adjusted total return over the past 142 years. The total real return index fluctuates significantly from year to year but tends to stay within a band of 100% above or 50% below the long-term trend. At year-end 2021 the index was 80% above trend, the biggest departure from trend since the technology bubble burst in 2001, raising the question of whether U.S. stocks are dangerously overvalued. The good news is that we see plenty of opportunities to find reasonably priced U.S. stocks, and even more opportunities outside the U.S. However, as suggested by the second chart and elaborated below, some parts of the U.S. stock market may indeed be dangerously overpriced.

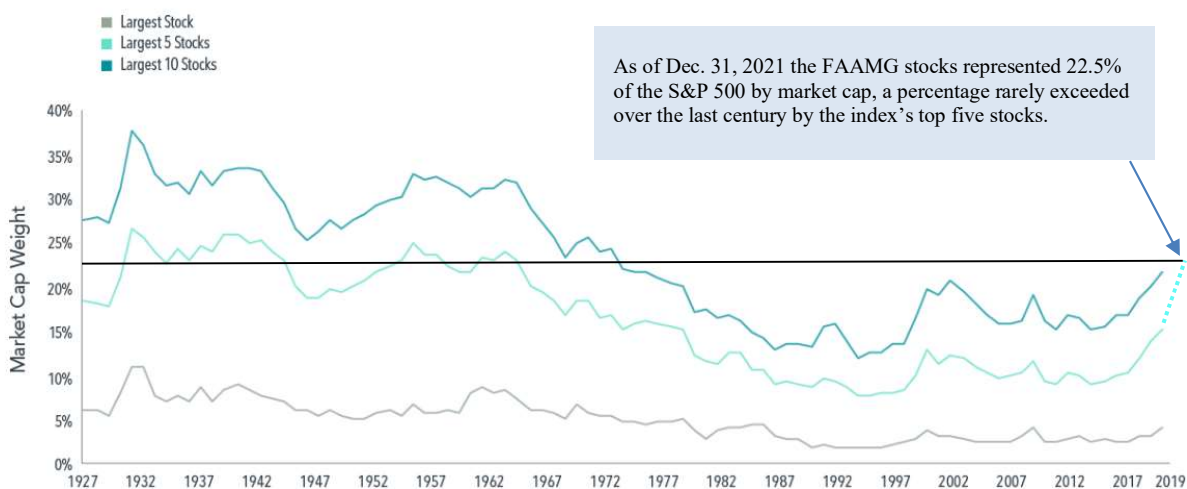
The second chart focuses on the last ten years and separates out the total return of the S&P 500 Value index and the S&P 500 Growth index. The details of how stocks are

assigned either to the value or growth “style” aren’t critical here, but the basic idea is that stocks that are reasonably priced relative to their earnings power fall on the value side, whereas stocks with rapid revenue and earnings growth fall on the growth side. Value and growth styles tend to go in cycles where one outperforms the other for many years, after which the pendulum swings and the lagging style outperforms for a long stretch of time. Over very long periods of time, the two perform similarly but with value performing a bit better. The current cycle of growth outperformance has been extreme in length and in magnitude.

Has there been something unique about the last decade to account for the extreme style performance gap? The relatively obvious answer is the explosive growth of a handful of technology companies that dominate our digital lives. Facebook (now Meta), Amazon, Apple, Microsoft and Google (now Alphabet)--sometimes referred to as FAAMG--have grown from a market capitalization (the market value of all shares) of less than a trillion dollars at the end of 2011 to nearly ten trillion dollars today. If you throw in a few more stocks like Tesla and chip-maker Nvidia, you have accounted for almost all of the growth style outperformance.

It’s tempting to conclude that the style performance gap is well justified. After all, companies like Amazon, Apple and Google **have** become a much bigger part of the U.S. and global economy over the last ten years. And for the most part, there are few signs that the giant tech companies are slowing down. All of that is true, but it’s wise to remember the old German proverb that “trees don’t grow to the sky,” which reminds us that rapid growth always has a limit. While above-market revenue and earnings growth at the technology giants may continue for some time, the same may not be true for their share prices, as suggested in the chart below from Dimensional Fund Advisors (to which we have added the dotted light blue line and the horizontal black line).

**Weight of largest stocks by market capitalization in US stock market, 1927–2019**



As of December 31, 2021 the FAAMG stocks accounted for 22.5% of the value of the S&P 500 index. As the chart shows, the top five stocks in the S&P 500 did account for a higher percentage

of the index several times between the late 1920s and early 1960s. Nevertheless, the chart does not bode well at all for FAAMG for several reasons. First, because the FAAMG stocks pay very little in dividends, their share prices would need to go up faster than the rest of the index just to keep pace on a total return basis. Also, even if the top five stocks in the S&P 500 index do manage to increase their 22.5% share of market capitalization there is no guarantee that those five will include all of the FAAMG stocks. Just as the top five stocks from 1960—AT&T, GM, DuPont, Exxon, and GE—were eventually replaced, so too will that fate eventually befall Meta, Amazon, Apple, Microsoft and Alphabet. The bottom line is that if history is a guide, a lot of things will have to go right for returns on FAAMG to match the rest of the stock market over the next ten years.

If it's true that returns for FAAMG and other giant tech stocks will be subpar in the coming decade, when are they likely to begin to come back to earth and what might trigger that to happen? This brings us back to the Federal Reserve and interest rates. After ignoring the Fed's policy shift over the last two weeks of 2021, financial markets began taking the Fed at its word as 2022 rolled in. In a dramatic move by bond market standards, the yield on the 10-year U.S. Treasury bond shot up from 1.51% to 1.77% in the first week of the new year. Value stocks performed fine, with the S&P 500 Value index climbing 1.0%. By contrast tech stocks declined significantly, with the FAAMG stocks ranging from down 1.4% for Meta (Facebook) to down 6.6% for Microsoft.

Why would higher interest rates be worse for growth stocks than value stocks? The details are complicated, but the key point is that future earnings and cash flows are "discounted" more heavily when interest rates are higher. Suffice it to say that investment math makes stocks that are expected to grow earnings rapidly well into the future, especially alluring when interest rates are extremely low<sup>1</sup>. The other side of the coin is that those stocks will lose a lot of their luster if and when interest rates get back to more normal levels.

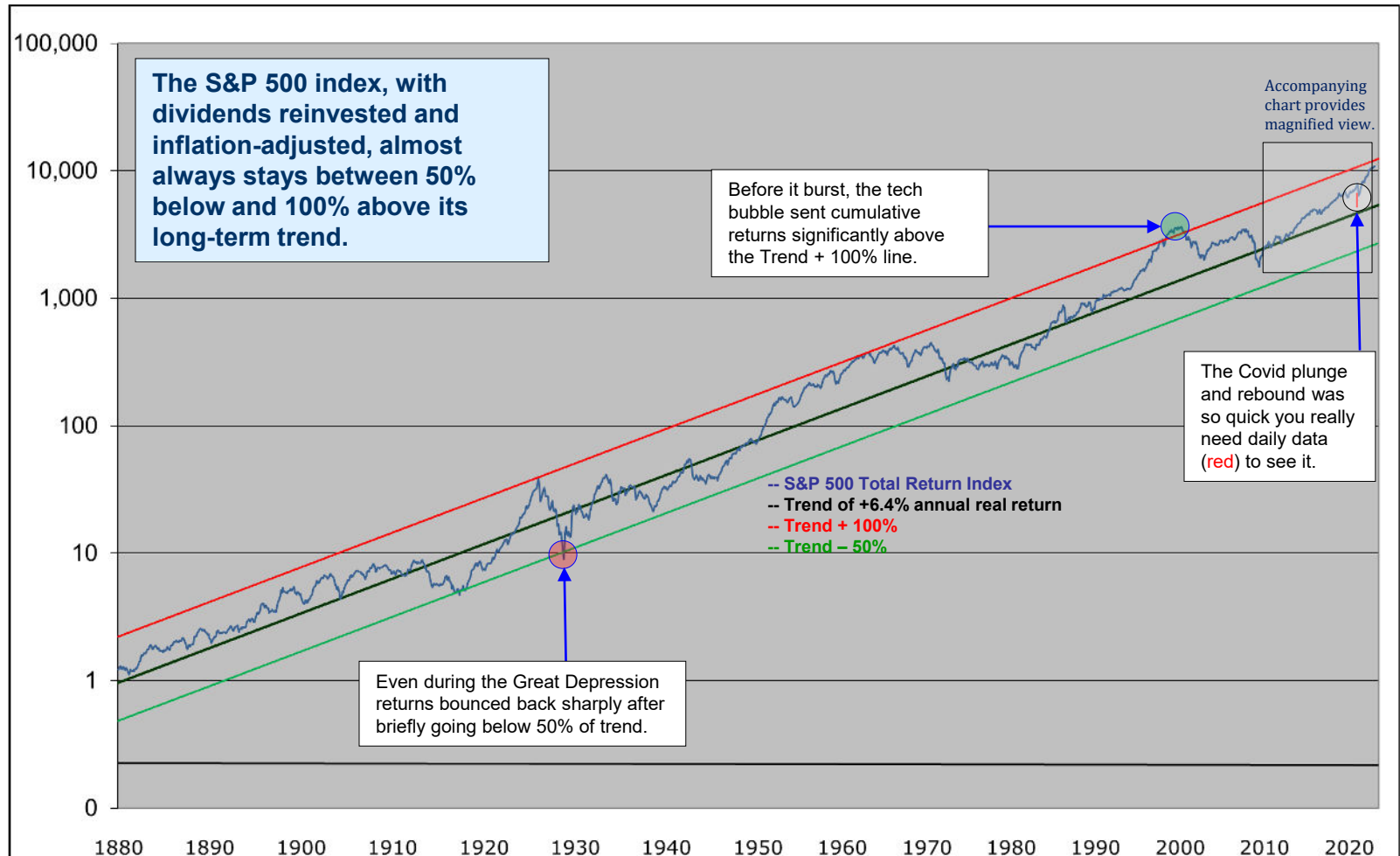
Between 1965 and 2008, the yield on the benchmark 10-year U.S. Treasury bond almost never fell below 3.50%. Since June of 2011, the yield has almost never exceeded 3.00%. The coming rate hike cycle may finally push that yield back to historically normal levels. That possibility creates some risks for stocks in general, but the risks are particularly acute for growth stocks which have enjoyed an interest rate tailwind for the last ten years. Fortunately, there are a wide range of options outside of U.S. growth stocks that should hold up much better as rates begin to normalize. Investors whose portfolios have become overweighted toward U.S. growth stocks would be wise to consider other parts of the investment universe sooner rather than later.

*January 12, 2022  
Boston, MA*

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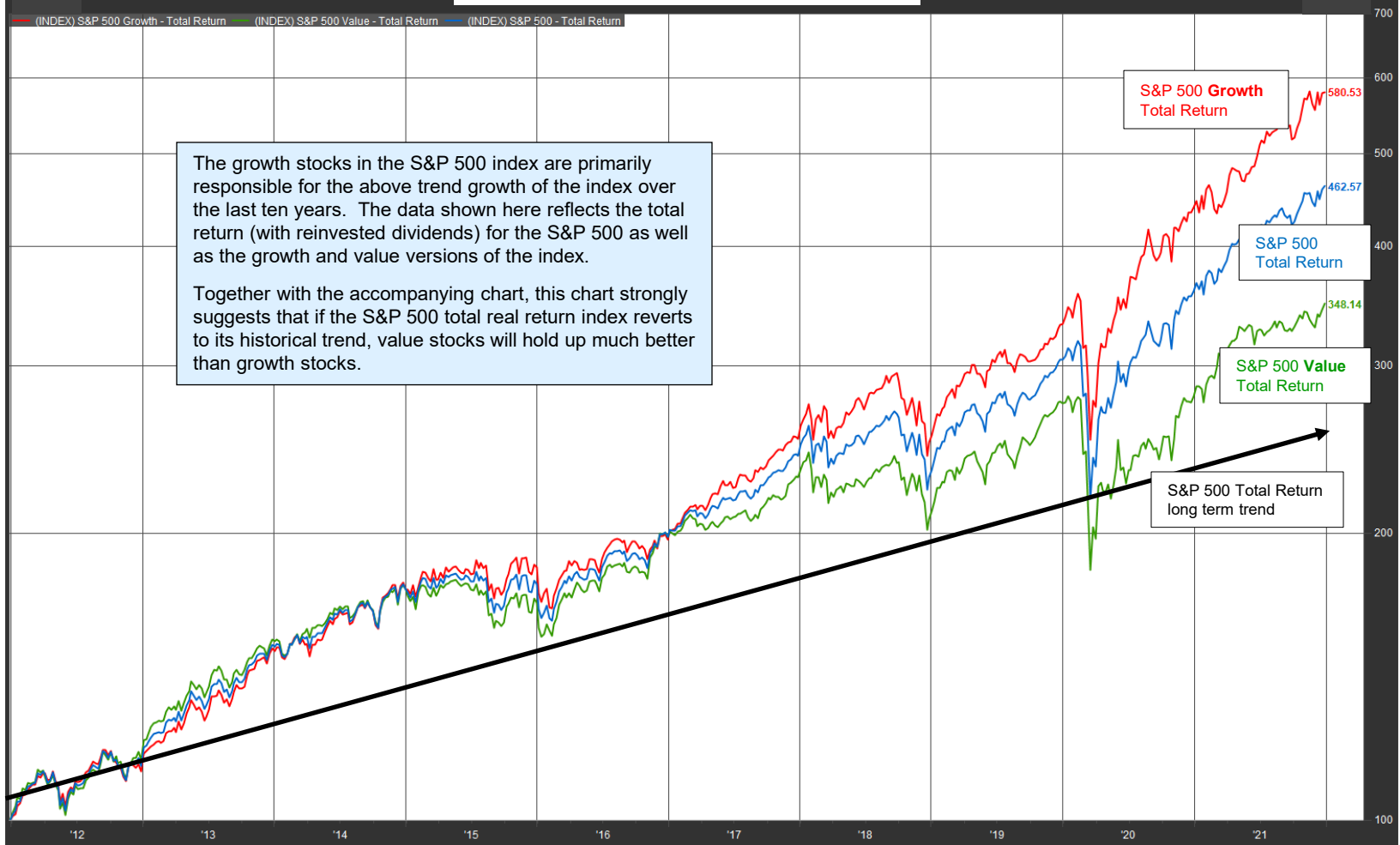
<sup>1</sup> A bit more detail by way of example: if Amazon grows earnings at 15% a year for the next ten years, earnings will go up fourfold. How much investors are willing to pay for those earnings depends on how heavily they discount them. Part of the discount is based on the risk that Amazon will fall short. But interest rates also factor in. Higher interest rates will lead to higher discount rates, which will make distant earnings less valuable. The premium investors pay for sustained levels of high earnings growth will decline, hurting Amazon's share price.

# S&P 500 Total Real Return Index 1880 - 2021



- Raw data is from [www.irrationalexuberance.com](http://www.irrationalexuberance.com), the website for Robert Shiller's *Irrational Exuberance*.
- The total real return index is presented on a logarithmic scale. It is based on the monthly average price of the S&P 500 Index (including its backward extension by Alfred Cowles) and assumes dividend reinvestment at that price.
- Because the total real return index includes reinvested dividends and adjusts for inflation, its values do not correspond directly to the widely quoted price index.
- The trendline uses the average of the total real return index from 1876 to 1885 as a starting point and assumes a 6.4% annual real return from that point forward.
- Past performance is not necessarily indicative of future results.

## S&P 500 Growth vs. Value 2012-2021



\* The total returns shown above are not inflation-adjusted. For clarity of presentation, the total return trend line (black arrow) is based on average inflation (US CPI) over the entire period.