Growth Stock Relative Performance

“Value relative to growth has never been cheaper, globally.”
- Rob Arnott, chairman and co-founder of Research Affiliates with $170 billion under management and the creator of fundamental indexing.

Last week’s *EVA* pointed out the considerable damage that has occurred below the placid surface of the US stock market. It also urged taking advantage of the stealth sell-off, particularly with regard to those market segments of a more cyclical nature. These had been especially punished by the Omicron-driven panic selling that began on Black Friday (the day after Thanksgiving) and largely continued through most of last week. At one point, the S&P 500 briefly retreated by 5.2% before the usual buy-the-dip response kicked in.

That *EVA* also conveyed a fair amount of expert opinion and up-beat news on Omicron. Fortunately, as this week has unfolded, that viewpoint has been mostly validated…for now. When it comes to the ever-mysterious Covid, and its various variants, one can never assume its nasty impacts are totally in the rear view mirror. Yet, thus far, there has been a healthy rebound in virus victim sectors such as energy, restaurants, hotels, airlines, as well as chemical and industrial metals producers, among other economically sensitive areas.

The overarching theme of last week’s *EVA*, though, was the shocking price declines of a long list of formerly hyper-performing growth stocks. To add another factoid to the story, a few days ago there were 615 issues with a market value of $1 billion or more that had tumbled at least 30% from their 52-week peaks. Most of these reside in the small- and mid-cap categories and many have tanked by 50% and even 70%. This is decidedly odd behavior in what must still be considered to be a full-blown bull market (heavily inflated, of course, by the Fed’s many fabricated trillions.)

This month’s Gavekal *EVA*, from our prestigious partner firm, is authored by its founder himself, Louis Gave. Because we’ve added quite a few new readers in recent months (thank you for subscribing!), I should provide a brief background on Louis. He co-founded Gavekal Research in the late 1990s in the wake of the Asian Crisis. That event created tremendous damage in asset prices throughout Asia, including a 70% plunge in Hong Kong home prices, the city in which he chose to base his new firm. Thus, it took considerable guts to start a firm focused on emerging investing opportunities in that region during a bear market of epic proportions. Of course, in hindsight, his timing was impeccable.

Starting from a tiny office with two other partners and his dog, Oshkosh, Louis has built an organization of truly global proportions. (The other two founding partners were his father, Charles Gave, and Anatole Kaletsky.) There are now   branches around the world, staffed by individuals, and most major investment firms are clients of Gavekal. Louis has been extensively quoted in *Barron’s* and the *Wall Street Journal*, as well as numerous other leading financial publications. Further, he is one of the most in-demand speakers at investment conferences around the world. He is also one of my closest personal friends.

As you will soon see, Louis is highlighting the significant chasm that has opened up between the famous FAANGM type names and the formerly white-hot, now ice-cold, small cap growth stocks. Moreover, as senior Gavekal team member Will Denyer pointed out in a related note, the same is true with mid-cap growth stocks versus the mega-cap names such as Apple and Microsoft. This is further evidence of the extreme narrowing of leadership that is occurring in the US equity markets. As I discussed last week, this is a scarlet red flag about the overall market’s health…or lack thereof.

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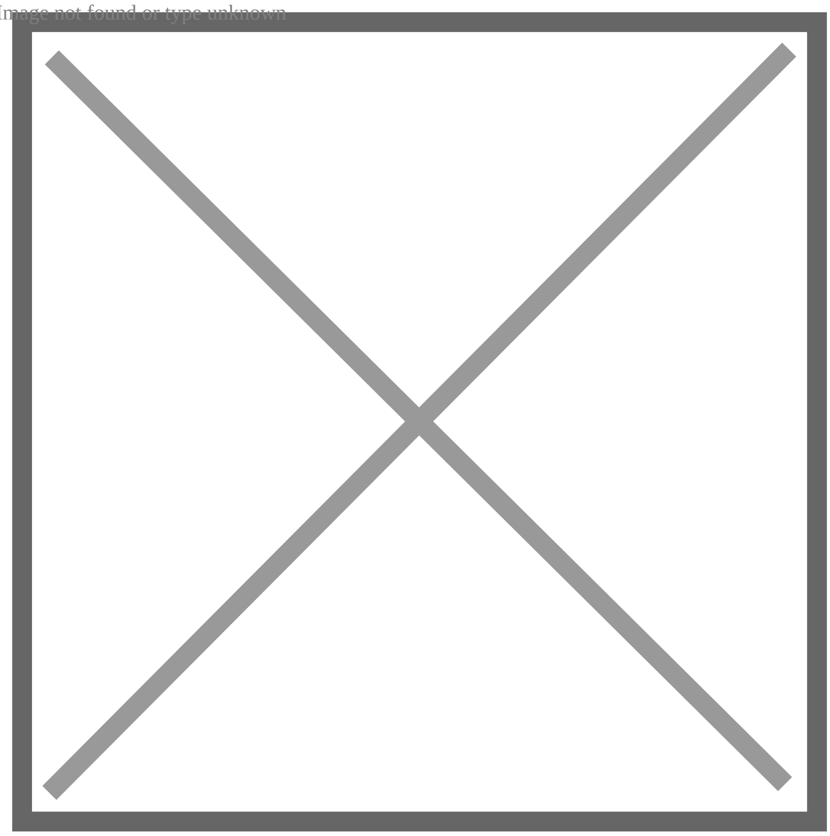
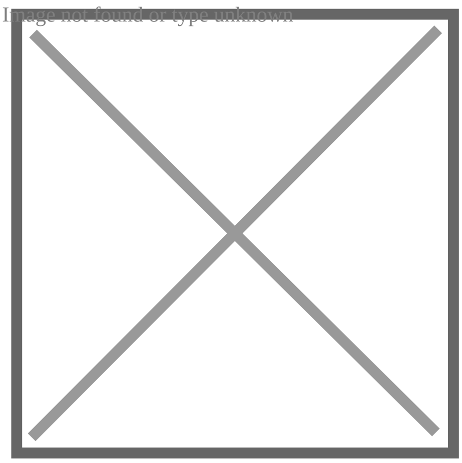


With that as an introduction, let’s see what Louis has to say about this very odd divergence of fortunes…

In a recent daily, we pondered the odd outperformance of US growth stocks at a time of upside inflationary surprises. A sharp-eyed client highlighted that the outperformance of growth was highly dependent on which parts of the market one was investing in. After all, our reader pointed out, the Russell 2000 growth index is roughly flat for the year… not much 2021 outperformance there, especially when one considers the +25% gain in the Russell 2000 value index:



Digging deeper, it is clear that while US large-cap growth stocks have done very well, thus grabbing headlines and the popular imagination, the US small cap growth space has had a tough time. In fact, the relative performance divergence between US large-cap growth stocks and US small-cap growth stocks is unprecedented (see middle pane in the chart below).

Zooming in further, it can be seen that after their recent pull-back, US small cap growth stocks have given back about a decade's worth of outperformance (see lower pane in the chart). The conditions of the last decade—a strong US dollar, low energy prices, low inflation, low interest rates, record retail participation, record foreign inflows and record private equity activity—all favored small-cap US growth stocks. Yet they ended up delivering a similar result to the broader US equity market. These were still very good returns but in an almost "perfect" environment, one might have hoped that the usually high-beta small-cap growth stocks would have outperformed. Worse still, they now seem to be markedly underperforming.

In short, in the past 10 months, it seems that small-cap growth stocks have adapted to a US economy that was growing strongly with accelerating inflation by underperforming both US small-cap value stocks and the broader market. At the same time, US large-cap growth stocks have continued to surge. So what should we make of this parting of ways?

- **Option #1. It is March-April 2000 all over again.** Back then, as flimsy dot-com stocks began to implode, investors exited cash-burning business models in favor of established tech behemoths like Cisco, Intel and Nokia. The telecom names held their own as the market figured "in a gold rush, shovel-makers should be held". Yet by the summer of 2000, even the large-cap technology and telecom companies were rolling over. Today, perhaps we are starting to see a repeat of this pattern unfold
- **Option #2. US large-cap growth stocks are anti-fragile assets of choice.** In a number of papers I have argued that large-cap tech behemoths have achieved the investment nirvana of anti-fragile status. They thus join a fairly exclusive group like Japanese banks in the late 1980s, telecom stocks in the late 1990s and energy stocks in the late 2000s. And once one reaches such status, global macro conditions barely matter. This is especially so as negative real interest rates mean that OECD government bonds, especially US treasuries, do not pose the competition for anti-fragile status that they once did.
- **Option #3. US large-cap growth stocks are the new asset of choice to recycle US current account deficits.** In recent papers, Charles reviewed how excessive US current account deficits used to be recycled into treasuries to fund the US government. He argued this is no longer happening. Instead, the wonders of indexation mean that ever more

money is accruing to a small number of giant US firms, with the top five accounting for more than 20% of the S&P 500's value. And this will last until either the US current account deficit disappears, or the actors on the other side of the US current account deficit need the dollars for other purposes like funding growing energy bills, paying for inventories or boosting capital spending to meet strong final demand.

- **Option #4. The new "nifty-50".** As inflation started to accelerate in the early 1970s, investors became convinced that a few global multinationals would always be able to pass on cost increases. Hence, valuations for the likes of Xerox, IBM and Avon Products soared. Yet when oil prices spiked in 1973, the valuation of nifty-50 stocks collapsed. In time, some would make new highs (Coca-Cola, Disney and Pfizer) while others disappeared (Polaroid and Eastman Kodak). Fast forward to today and in these nascent inflationary times, the new immortals seem to be a nifty-10 (Alphabet, Meta, Microsoft, Apple, Nvidia, Amazon, Salesforce, Tesla, TSMC, Visa), which, directly or indirectly, seem to be technology plays.

Figuring out which of these options is the right one will offer insights to risks faced by US growth stock investors. Back in 2000, rising short and long rates broke the back of the boom. Today, this does not look like an immediate threat and a bigger concern may be rising energy prices. After all, once they develop a certain momentum, equity bull markets tend to brush off most bad news until they are killed either by higher interest rates, rising energy prices, or a combination of both.

This brings me to a key divergence of opinion within Gavekal. Those, like Anatole, who think that energy prices will not exceed their recent highs conclude that inflation will prove temporary and the bull market will roll on. Those, like me, who think that years of underinvestment in energy has set the world up for a period of rapidly rising energy prices are, for the reasons listed above, more concerned about the viability of the bull market in US large-cap growth stocks. In short, energy bears should probably load up on small-cap US growth stocks, as those will bounce back and catch up with their large-cap brethren; and energy bulls should lighten up on large-cap growth plays.