First Quarter 2023 Outlook and Commentary

Even with a significant fourth quarter rebound, the U.S. stock market had a very rough 2022. Typically, when the stock market experiences a sharp decline, bonds provide a meaningful cushion. Not last year. With a return[1] of -13.0% for the Bloomberg U.S. Aggregate bond index, 2022 was the worst year in nearly a century for U.S. bonds. A bit better than stocks (total return of -18.1% on the S&P 500 index), but not by much. For the classic 60/40 stock/bond mix it was the worst year since 1937.

2022 was particularly unkind to U.S. technology stocks. A year ago at this time, we noted that a very large portion of recent stock market gains had come from five stocks: Meta (formerly Facebook), Amazon, Apple, Microsoft and Alphabet (formerly Google). We pointed out that these five stocks—often referred to by the acronym FAAMG--had grown in market value from less than $1 trillion to nearly $10 trillion in the space of ten years. At year-end 2021 the FAAMG stocks represented 22.5% of the S&P 500 index, dangerously close to an all-time high for that metric and, we observed, an ominous sign for future FAAMG returns. Our warning was well timed. On average in 2022, the FAAMG stocks returned a dreadful -41.2%.

In retrospect, New Year's Day 2022 may have marked the end of a stock market era. For five years the rules of investing seemed easy and obvious: invest in U.S. stocks, not foreign developed markets or emerging markets stocks. Invest in growth stocks (companies experiencing rapid revenue and earnings growth), not value stocks (companies whose shares are priced attractively relative to some measure of fundamental value). And above all, invest in the behemoth technology stocks that seemed to (and arguably were) taking over the world. If you wanted to invest a bit more broadly than five stocks, there was always Netflix or Nvidia or Tesla (2022 returns of -51.1%, -50.3% and -65.0% respectively) or perhaps a bit of cryptocurrency. For five years it all worked, and then, early in 2022, the easy technology stock gains came to a screeching halt and went into reverse. The painful declines that ensued are even worse than they might appear. When a stock is down 50%, a 50% rebound doesn't make you whole. If you invested $1,000 in Netflix and your investment dwindled to $500, it has to **double** before you have fully recovered.

If New Year's Day 2022 was indeed the end of a stock market era, what could that mean going forward? To get an idea, we put together the accompanying chart illustrating the cumulative total return of value stocks vs. growth stocks over the last twenty-five years. Why does it start twenty-five years ago in January 1998? Because that was near the beginning of what came to be known as the "technology stock bubble" (but may eventually be known as the first technology stock bubble).

[1] All returns cited are total return, including reinvested dividends.

For the benefit of younger readers, a brief history lesson is in order. With internet usage skyrocketing in the mid-1990s, e-commerce companies like Amazon began to wreak havoc on "brick and mortar" industries. Investors were willing to pay exorbitant prices for any company that was able to gather "eyeballs." The poster child of the era, Pets.com, found half a million pet owners happy to buy pet supplies online so long as the purchases were heavily subsidized by Pets.com investors. The company launched an IPO in February of 2000 but it turned out that selling pet supplies dramatically below cost is an expensive proposition. Nine months after an IPO that coincided with the peak of the technology stock bubble, Pets.com ran out of cash and folded[2].

The devastation from the bubble's collapse was severe. The technology-oriented Nasdaq 100 stock index fell by 80% from the peak to the 2002 bottom. The index wouldn't get back to its March 2000 high for fifteen years. The point of the accompanying chart is not to hone in on the value destruction in the technology sector. Rather the point is to illustrate how dramatically the bubble and its collapse impacted the overall stock market. The technology sector represents a huge percentage of the growth stock universe and heavily influences performance. Growth stocks declined by more than fifty percent from the bubble peak to the bottom in the summer of 2002. Even while the technology stock bubble was collapsing, value stocks continued to do well until the recession of 2001 caused earnings to sag across the U.S. economy. When the stock market began to climb again in the fall of 2002, value stocks led the way and continued to outperform growth stocks for another five years. **<u>All told, value stocks outperformed growth stocks by nearly ten percentage points per year from the peak of the technology stock bubble in March 2000 until the middle of 2007.</u>**

It is sometimes said that history doesn't repeat but it does rhyme. That seems apt when comparing the technology stock bubble of the late 1990s to the recent excesses in that sector. Valuation metrics such as price-to-earnings ratios became very stretched by the end of 2021 but fell significantly short of the extreme levels reached in early 2000. However, the last few years featured pockets of extreme speculation to rival the zaniest stories from the 1990s. The mad rush to invest in all manner of cryptocurrencies (including currencies like Dogecoin that were created as a joke) and crypto companies is the most obvious example. But there were also "meme stocks" and the proliferation of Special Purpose Acquisition Companies (SPACs). In a SPAC structure, a "sponsor" asks investors to provide capital based solely on a general description of the sort of companies the SPAC might acquire. Appropriately derided as "blank check companies," SPACs suffered bone-crushing losses in 2022.

As the chart illustrates, value stocks, which are by definition more closely tied to a company's fundamental value, held up relatively well last year. They declined but by much less than growth stocks. The interesting question is whether the outperformance of value stocks will continue for an extended period of time as it did following the collapse of the late 1990s technology stock bubble. A 2021 research piece from Vanguard Investments is useful to see what is possible. The authors looked at a variety of metrics and the correlation with the future performance of value stocks and growth stocks. Based on where these metrics stood in early 2021, the authors

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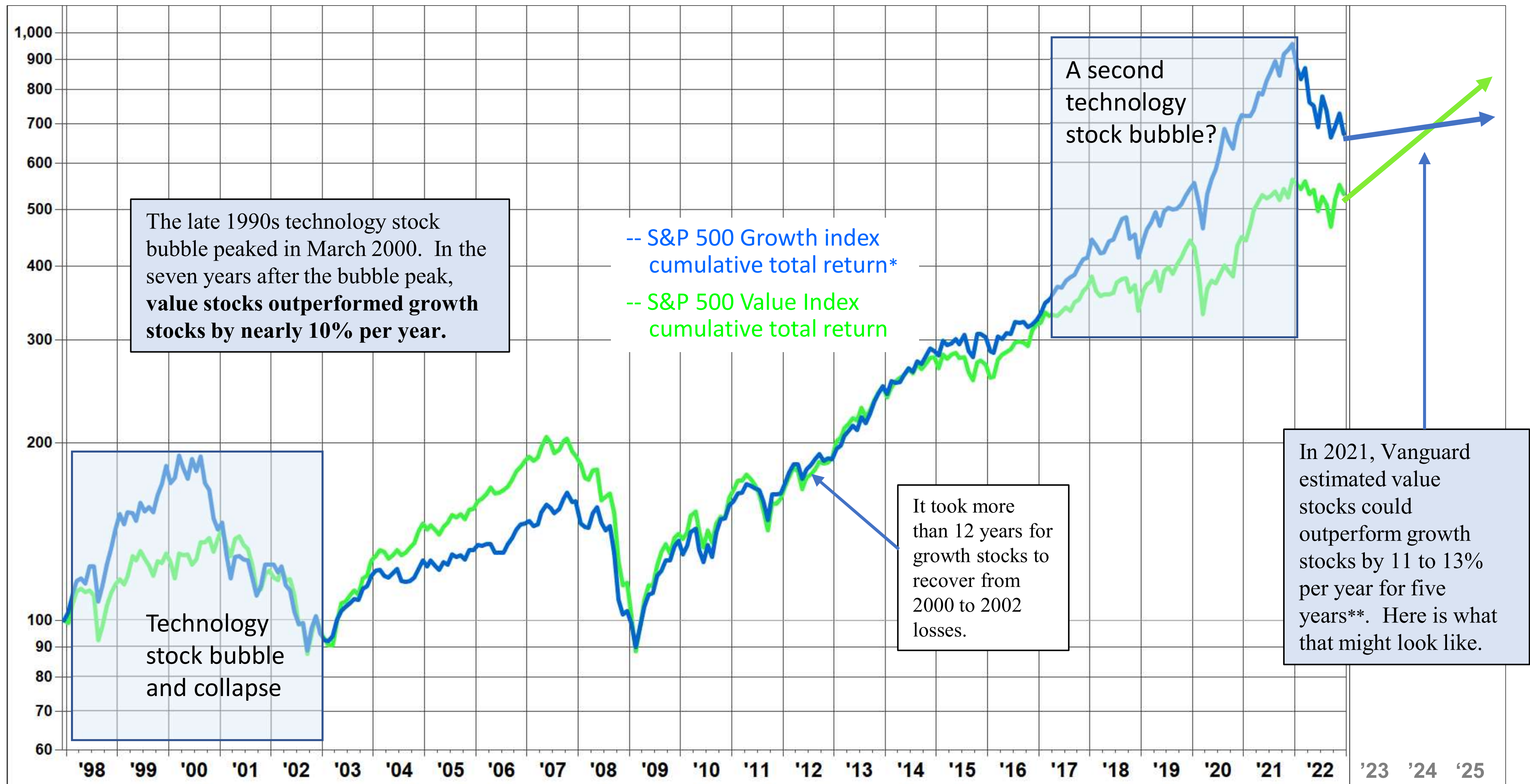
[2] To be fair, Pets.com did create something of enduring value along the way—its renowned sock puppet. At the height of its fame (and the height of the bubble), the Pets.com sock puppet contributed to Good Morning America's 2000 Oscar awards coverage. Years after the company folded, the sock puppet re-emerged selling car insurance. Vintage Pets.com sock puppets sell for around $30 on eBay.

A Tale of Two Bubbles:

Growth Stocks vs. Value Stocks over the last 25 years



* Data source: FactSet. Cumulative total return illustrates how $100 invested Jan. 1, 1998 would have grown if invested according to the respective index with dividends reinvested.

** "Value versus growth stocks: The coming reversal of fortunes" by Vanguard Investments, published April 2021. Projected 11% to 13% annualized value outperfomance is for the period March 1, 2021 to February 28, 2026. Illustration above assumes midpoint of the projection and style-neutral annual returns of 7%.

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concluded that value stocks would outperform growth stocks by 11% to 13% in the subsequent five years. The right side of the chart illustrates what that might look like.

Up to this point, we have been discussing growth stocks vs. value stocks. But it's important to also consider growth **strategies** vs. value **strategies**. An investment manager using a value approach generally seeks to invest in value stocks, while a growth investor generally seeks to invest in growth stocks. The word "generally" is important, however. There are a large number of growth stocks that declined so much in price during 2022 that they are attractively valued right now—Alphabet, Amazon, PayPal and Salesforce to name a few. Standard and Poor's may still map them into its S&P 500 Growth index, but value investors are likely buying them nonetheless.

This sort of opportunity, where stocks that were previously overpriced suddenly become attractive by traditional value metrics, could explain why, according to one recent study, active management outperformed indexing for six straight years after the collapse of the late 1990s technology stock bubble[3]. Indexes are rigid. Portfolio managers on the other hand have the ability to be flexible and pivot as the investment opportunity set changes. When certain sectors of the market are climbing mindlessly, the rigidity of indexes can pay off. When the momentum reverses, prompting investors to pay closer attention to what companies are really worth, the hard work of fundamental analysis is likely to be well rewarded.

Long-term outperformance by value strategies relative to growth strategies would be a major tailwind for your portfolio. Another likely tailwind is foreign stock allocations, which will benefit from lower starting valuations and probable foreign currency gains. We noted three months ago that the U.S. dollar was stronger relative to other currencies than any time in the last twenty years. Dollar strength was driven by rapidly increasing U.S. interest rates. With the prospect that the Federal Reserve may soon wind down its current rate hike cycle, the dollar has weakened significantly in the last few months. Once again, history suggests that this could be the beginning of a powerful trend. The collapse of the U.S. technology stock bubble in 2000 coincided with the beginning of a steep dollar decline. For example, over seven years the Euro nearly doubled in value relative to the U.S. dollar. Anything resembling that going forward would be a huge benefit to U.S. holders of foreign stock strategies.

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[3] "The Cyclical Nature of Active & Passive Investing," by Hartford Funds, March 2022.

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