CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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Inflation Fears Fuel Rotation Out of Growth Stocks

- Equity markets are selling off, led by high-growth technology stocks.
- Inflation concerns are rising, putting pressure on stock valuations and bond prices.
- Inflation and valuation adjustments impact companies differently. Diversification is key.

Stocks opened lower again today after selling off Monday. The S&P 500 kicked off the week with a 1.04% decline with the three worst performing sectors (Technology, Consumer Discretionary and Communication Services) each falling by more than 1.9% yesterday. Optimism and economic metrics are improving, but risks are also starting to mount. The tech-heavy Nasdaq Composite has underperformed the S&P 500 nine out of the last 10 trading days as of yesterday's close.

Investors increasingly fear inflation and its impact to both stocks and bonds. Bond investors are demanding higher yields to compensate them for inflation's effect on purchasing power. This impacts stocks, because higher borrowing costs from rising yields make corporate debt more expensive. Stock valuations, which are currently at levels not seen since the dot-com bubble, also must be adjusted for the rising costs and this is especially bad for technology companies.

Bond yields fell to record lows after the pandemic started and this was a key driver in driving up technology stocks, which also benefited from stay-at-home measures that pushed consumers to online streaming and shopping. Generally, technology stocks are impacted by bond yields because they tend to have higher stock price valuations that are calculated based on projected future earnings or dividends. Higher yields create higher discount rates (cost of equity) for valuing those future earnings streams and thus the stocks become less valuable. Below is a simple formula for valuing stocks. Many technology stocks do not pay dividends, so their dividends are projected well into the future and even more vulnerable to changes in assumptions around the cost of equity.

So much is spoken about valuations, so going through a simple example is helpful. If we assume a dividend of $1 and a dividend growth rate of 3%, with a cost of equity of 8%, the stock price is $20. With all else equal, changing the cost of equity to 10% will drop the stock price to $14.29, a nearly 30% drop in stock price.

$$\text{Stock Price} = \frac{\text{Expected Dividend Next Year}}{\text{Cost of Equity Capital} - \text{Dividend Growth Rate}}$$

This example illustrates the importance of low yields and borrowing costs. Now, inflation pressures are pushing these yields higher. With technology stocks making up over 25% of the S&P 500, the impact to the broader market is even greater. In our recent market outlooks and commentaries, we wrote about a rotation out of technology and into value-oriented companies. We expect this rotation to continue. Also, rising input costs don't impact all companies equally. Some companies can pass on these costs, while others have a more difficult time. Company fundamentals become increasingly important in this environment as there will be winners and losers.

The Fed is watching all this closely and will need to combat inflation by raising short-term interest rates eventually. Right now, the expectation is that this won't happen for another year or two but if inflation persists, the Fed may be forced to act sooner. Currently, the expectation is that inflation will rise but be temporary, which is less concerning. However, the Fed has less control over longer-term bond yields which have been rising and tend to influence borrowing costs such as mortgage rates. The good news is that if these longer-term yields rise too much, the Fed could enter the market and begin buying longer maturity bonds to lower the yields again. This process is known as quantitative easing.

Inflation may end up being transitory, but with the risk of inflation being more persistent, we anticipate more volatility in the near-term. Coupled with proposals in Washington for increases in corporate taxes and capital gains taxes, risks to markets are mounting. Stock market valuations are perhaps priced to perfection which can amplify this volatility. We may see a stock market correction at some point this year, but we don't expect a big correction like last spring.

We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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Glossary
The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index is a broad based index.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries