Bitterroot
CAPITAL ADVISORS

Memorandum

To: BCA Clients and Friends
From: Sid Nadkarni, BCA CIO
Date: May 12, 2022
Subject: Market declines YTD and perspectives on high-quality growth stocks

UPDATE ON MARKET DEVELOPMENTS AND OUR PERSPECTIVES

Dear BCA Clients and Friends,

Although we recently provided a quarterly update, the equity markets have continued to decline since then. Additionally, this year, growth stocks have materially underperformed value stocks (a sharp reversal vs. the large outperformance of growth stocks over the prior six years and more broadly since the GFC). We wish to share some of our current and evolving thoughts regarding a) reasons behind the equity market decline YTD, b) potential scenarios over the next 12 months for the S&P 500, and c) further discussion behind the growth and technology stock selloffs and potential opportunities going forward.

Equity Market Performance YTD and Potential Scenarios over the next 12-18 months

The US economy continues to exhibit strength in terms of an extremely healthy consumer (sitting on over $2 trillion of pandemic-era excess savings) and a very tight labor market. Businesses are generally in strong shape with record profits in 2021, corporate earnings that are still growing in 2022, and companies that have strong balance sheets and liquidity. Yet, the S&P 500 is down 17.1% YTD and the NASDAQ is down 27.2% (as of May 11, 2022 closing prices). The declines have been especially pronounced since the end of Q1 with the S&P down 13.0% and the NASDAQ down 19.5%. The question is why is this the case?

The answer lies in that equity markets are forward-looking. There are presently several headwinds that are simultaneously creating high uncertainty as to the health of the global economy and the outlook for corporate earnings entering into 2023 and beyond. These factors include a) much higher and longer-lasting inflation vs. expectations, b) sharply increased central bank hawkishness regarding monetary policy in response to the inflationary conditions which has resulted in a corresponding swift increase in short-and-mid-term bond yields, c) supply chains that have been slow to return to normal, d) resurgent

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COVID in China and the Chinese government's strict Zero-COVID policy which is leading to slowing economic growth in China coupled with continued supply chain delays, and e) the Russia / Ukraine conflict which in addition to creating geopolitical concerns is also leading to key shortages of certain commodities and adding to inflationary pressures. In a nutshell, while things are still fine today, the uncertainty regarding the next couple of years is far greater and the forward-looking market hates uncertainty.

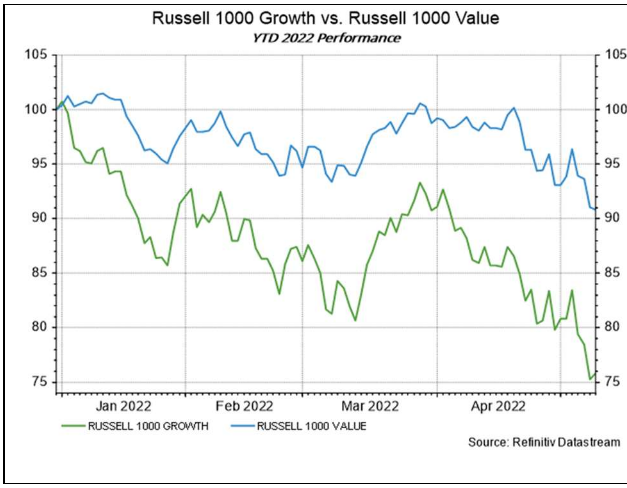
We see three primary scenarios for the S&P 500 over the next 12-15 months:

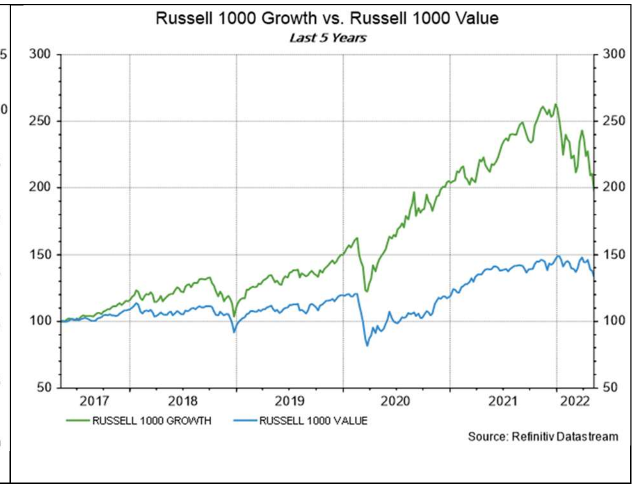
- <u>Scenario 1</u>: Range bound with no-real clarity emerging till well into 2023. In this scenario, we assume inflation begins to moderate over the next few months but still remains significantly above central bank comfort levels. Central banks continue to hike at the presently indicated pace. We also assume that the Russia / Ukraine war status quo remains and the conflict neither resolves nor escalates. Under this scenario, we assume the S&P 500 will trade in a range of +/- 5% to 8% from present levels. While the S&P is down 18% from prior peaks, it is important to note that valuations were high coming into 2022. Even after this pullback, the S&P 500 is still trading at 17x next 12-month consensus earnings (just above historical averages).
- <u>Scenario 2</u>: Sharp upside beginning in H2 2022. In this scenario, we assume inflation peaks soon and begins a steady decline over the back half of 2022 due to tightening financial conditions coupled with unsnarling supply chains. The Fed may not hike as much as expected and economic growth will slow to pre-pandemic levels without tipping into recession. We assume some clarity with regards to a path towards Ukraine / Russia resolution. In this scenario, the S&P 500 could rally by 15%-20% from the present levels.
- <u>Scenario 3</u>: Sharp downside as investors increasingly price in a recession. In this scenario, we assume that inflation continues to increase, the Fed tightens faster than investors anticipate and exogenous pressures (i.e. COVID lockdowns in China or an escalation in Ukraine / Russia) intensify. During these periods, investors tend to anticipate sharp declines in corporate earnings and sell before these occur. As such, the S&P 500 could have 15%+ downside. In most prior recessions, equity markets have declined 30%-50% from peak levels which would put an ultimate S&P 500 floor value of 2,400 to 3,400 vs. 3,935 at May 11, 2022 closing prices.

Given the many variables at play and the large degree of exogenous circumstances impacting these variables, it is impossible to predict any of these scenarios with great confidence. However, since consumer balance sheets are so strong, we believe that Scenario 1 has the highest probability (perhaps 50%), with Scenario 2 and Scenario 3 at roughly 25% each.

Interest Rates and Equities (Growth vs. Value)

While the S&P 500 has declined 17.1% YTD, there has been significant dispersion between growth (technology, e-commerce, certain consumer discretionary stocks) and value stocks (energy, interest-rate sensitive financials, consumer staples, and certain healthcare stocks). The Russell 1000 Growth Index is down 26.2% YTD while the Russell 1000 Value Index is down 9.3% YTD (see relative price performance charts below).





The primary reason for the underperformance of growth stocks YTD has been a) the much faster than expected rise in market interest rates as central banks are perceived to be in catch-up mode vs. inflation b) difficult year-over-year comparisons for these stocks as the pandemic pulled forward demand during 2021, especially for e-commerce companies, and c) mixed earnings performance with some fundamental challenges appearing for some mega-cap tech / e-commerce / consumer discretionary companies after a multi-year period in which these companies' business models appeared immune to any setbacks.

Importantly, when we refer to growth stocks, we are referring to the large-cap growth stocks in the Russell 1000 Growth Index (such as Microsoft, Apple, Amazon, Meta, Nvidia, etc.). We are not referring to the pandemic boom and busts stocks (names such as Zoom, Peloton, DocuSign, Teladoc, Wayfair, Etsy, etc.). While many of these pandemic boom stocks are trading at stock prices far below pre-pandemic levels, they either face speculative prospects in the post-pandemic world or have profits far out in the future (which in a rising interest rate environment that is not conducive to those types of companies). Further, they comprise a de minimus portion of the Russell 1000 Growth Index and broader market benchmarks.

The much faster than expected rise in interest rates in 2022 has been the main driver behind growth stocks' underperformance thus far.

- The 2-Year US Treasury yield has risen by 200bps over the past four months (an unprecedented level vs. history) while the 10-Year US Treasury yield has also risen by 150bps (from 1.5% to almost 3%) in that time frame. Since the GFC, the 10-Year US Treasury yield has only briefly touched 3% before retreating quickly as economic growth began sharply slowing.
- When interest rates rise sharply, the cash flows of stocks with a higher portion of their valuation coming from out-years or terminal value are discounted to present value at higher discount rates (resulting in lower values). Another way of looking at it is that investors place lower multiples on next-twelve months earnings or revenues on more expensive stocks during periods of rising interest rates.
- Concurrent to the sharp rise in interest rates, a few high-profile mega-cap technology/e-commerce / consumer discretionary stocks showed chinks in their business models over the last quarter or so (Meta and Netflix as key examples). During Q1, Amazon experienced a sharp slowdown in year-over-year e-commerce sales growth against an extremely difficult comparison of pandemic highs in H1 2021, further dampening sentiment for these stocks.

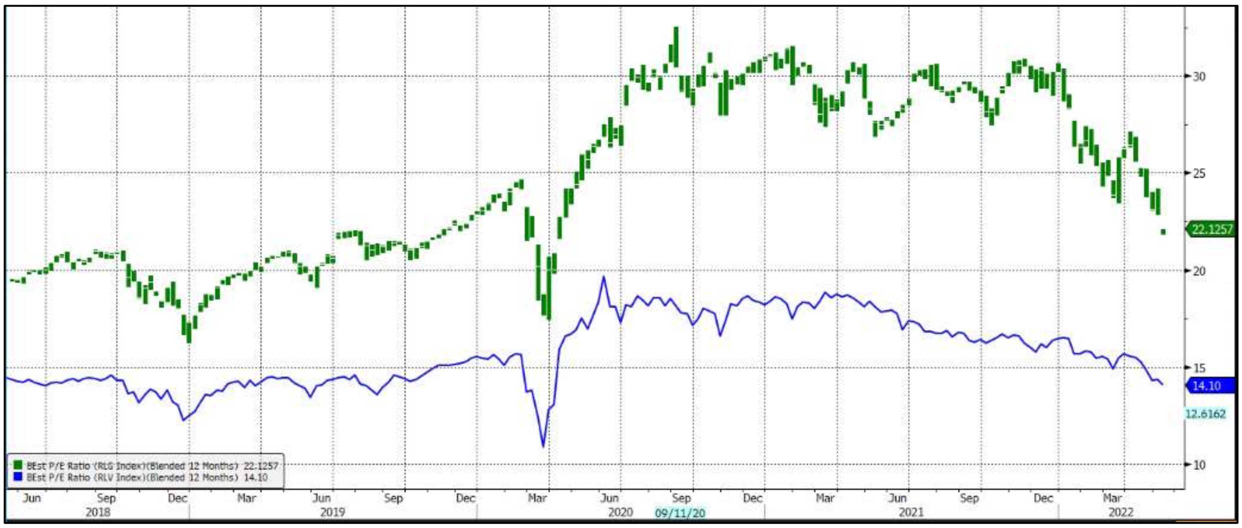
Outlook for High-Quality Growth and Technology Stocks Going Forward

For purposes of this memo, our discussion centers around high-quality growth stocks which are largely found within large-cap technology, e-commerce, and consumer discretionary sectors (examples include Microsoft, Apple, Amazon, Google, Nvidia, and Meta as examples of prominent companies in the Russell 1000 Growth Index). In addition, there are other names that do not have as high of an index weighting but display similar characteristics such as Salesforce.com. These companies have established strong business models and moats, above-average revenue growth, attractive profit margins, high returns on capital, good capital allocation and attractive re-investment opportunities.

As seen in the graph below, the valuations for the Russell 1000 Growth and Russell 1000 Value indexes are now essentially at pre-pandemic levels. During this swift market selloff, investors are not discerning between quality growth stocks and the high-flying uber-growth stocks. Companies with strong fundamentals (great unit economics and market share gains) in attractive sectors with compelling mid-term structural dynamics such as software are being sold off in the same manner and magnitude as fad stocks such as Peloton. Sentiment is extremely poor with stocks going down days after delivering strong earnings and providing robust outlooks. If companies miss earnings expectations or key investor metrics, their stock prices are getting absolutely crushed.

In this environment, high-quality growth stocks are becoming increasingly compelling from a valuation standpoint (in addition to their more attractive mid-term earnings growth prospects). *While we do not pick individual stocks at BCA or recommend them to clients*, we highlight for illustration purposes a couple of examples below where the risk/reward dynamic seems compelling.

<u>Russell 1000 Growth vs. Russell 1000 Value NTM Price / Earnings Multiple</u>



<u>Amazon</u>

Amazon is down 37% YTD after appreciating 76% in 2020 and 2% in 2021. Amazon's market capitalization is now $1.1 trillion. Amazon essentially consists of two businesses: a) Amazon Web Services ("AWS") which is its cloud software, hosting and services division which is still growing 35% YOY despite having $62bln in 2021 revenues and b) its e-commerce business consisting of Prime memberships, US and International sales of goods as well as third-party fulfillment and advertising. Looking out to 2024 results (which the stock market will look at in the next 12-18 months), the AWS division should grow to $130-$140bln in revenue and have 35%+ operating margin (conservative since that includes GAAP-required stock compensation expense). Applying any reasonable multiple to the AWS division yields a value ranging between $1.1-$1.3 trillion. As such, investors are essentially getting Amazon's e-commerce business (2024 estimated revenues of $500 billion+) for free. Applying even Walmart type multiples to this division suggests that this division is worth between $500bln to $750bln. As such, one could quite easily justify a $3,100-$3,700 stock price for Amazon within 12-18 months, representing a return of 45% to 75%. Amazon's e-commerce division also faces easier comparisons beginning in H2 2022, which should help sentiment.

<u>Salesforce.com</u>

Salesforce.com is one of the enterprise software companies providing customer relationship management software to businesses. The Company has expanded its horizontal and vertical market share and product suite through strategic acquisitions over the past few years. In Nov. 2021, the stock touched its highs of $310 before falling to $250 in December after issuing conservative guidance. Since the beginning of the year, the stock has declined from $255 to $212 by end of March and $161 as of May 11, 2022, a 37% YTD decline.

- The Company has guided to high-teens organic revenue growth, improving operating margins and 25%+ free cash flow growth for 2022 and is likely to generate similar results in future years (barring a recession).
- Yet, the stock's valuation has compressed to 25x forward FCF / share vs. the market's 20x FCF / share valuation (despite growing 3x the market rate).
- On 2024 numbers, the Company should be able to generate between $9.25-$10.00 FCF / share. Applying 25x-30x multiples (reasonable against a market multiple of 17x) would result in a $230-$300 stock in 12-18 months or 40%-85% upside from current prices.

Again, BCA does not recommend individual stocks for clients. These examples are just meant to highlight the potential appreciation that exists among quality growth stocks that have been aggressively sold off in the 2022 growth stock carnage.

Conclusion

The outlook for the broader equity market is highly uncertain over the next 12 months as unpredictable macro variables (inflation, interest rates and geopolitical forces) are a foremost consideration. As we discussed earlier, there are three plausible scenarios that could arise affecting equity market performance. With rapidly changing conditions, we do not have high conviction probabilities for these various outcomes, but we think we're in the right ballpark.

High-quality growth stocks have significantly underperformed the broader market and value stocks YTD. The selloff has intensified since the end of March. Over the next 6-12 months, sentiment around these names may continue to be unfavorable as inflation and interest rate dynamics will serve as the primary contributors to stock price performance (with fundamentals taking a back seat).

We also recognize that the current macro-economic regime may persist for longer with interest rates rising higher than investors expect. This environment would likely increase the risk of a recession in 2023 or 2024 which likely would lead to increased broad-based selling of equities. Hence, high-quality growth stocks may continue to underperform market benchmarks over a shorter-term time period. In the current environment, it appears that investors are only buying energy stocks or at the other end of the spectrum, defensive stocks such as utilities or consumer staples (which are now richly priced vs. history). However, for investors with a multi-year outlook, the recent selloff has resulted in valuations becoming much more compelling and the risk/return tradeoffs becoming very attractive for several high-quality growth companies.

For those clients that have the scope to add to equities, we would recommend gingerly adding to quality companies with above-average revenue growth, high margins, strong free cash flow and re-investment capabilities, and attractive balance sheets. These companies' stock prices have declined between 25%-40% thus far in 2022, following valuations that expanded significantly over the past five years (as investors solidified their views regarding the quality of their businesses and ability to deliver attractive earnings growth in a variety of economic scenarios). Valuation multiples have contracted for many of these high-quality companies (with several offering potential total returns of 40%-70% over the next 18 months to two years).

As always, we welcome the opportunity to speak further. Please let us know if there are any topics you wish to discuss further.

Regards,

The BCA Team

APPENDIX – S&P 500 Performance by Sector

S&P 500 Performance by Sector	Weight 12/31/21	Perf. 2022 YTD
Technology	29.1%	-23.6
Communications Services	10.1%	-26.4
Consumer Discretionary	12.7%	-28.7
Healthcare	13.3%	-10.3
Financials	10.7%	-14.3
Industrials	7.8%	-12.9
Consumer Staples	5.9%	-1.1
Materials	2.7%	-9.9
Real Estate	2.7%	-19.2
Utilities	2.5%	0.3
Energy	2.5%	41.3
S&P 500	100.0%	-17.1