Experts can be wrong: inflation will not sink high-growth, tech stocks in 2022

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Abstract

Throughout 2021, growth stocks have been having a difficult time on Wall Street for fear that the Federal Reserve (Fed) will start hiking interest rates in 2022 to combat inflation, and this will weigh heavily on growth stock valuations. I challenge all three pillars of this argument: that inflation is a significant threat, that the Fed will be seriously tightening monetary policy and that high-growth tech stocks will tank as a consequence. The mainstream thesis is supported by a majority of experts, economists and market commentators. Let me explain why I am in a different camp.

Keywords: growth stocks, inflation, interest rates, Fed

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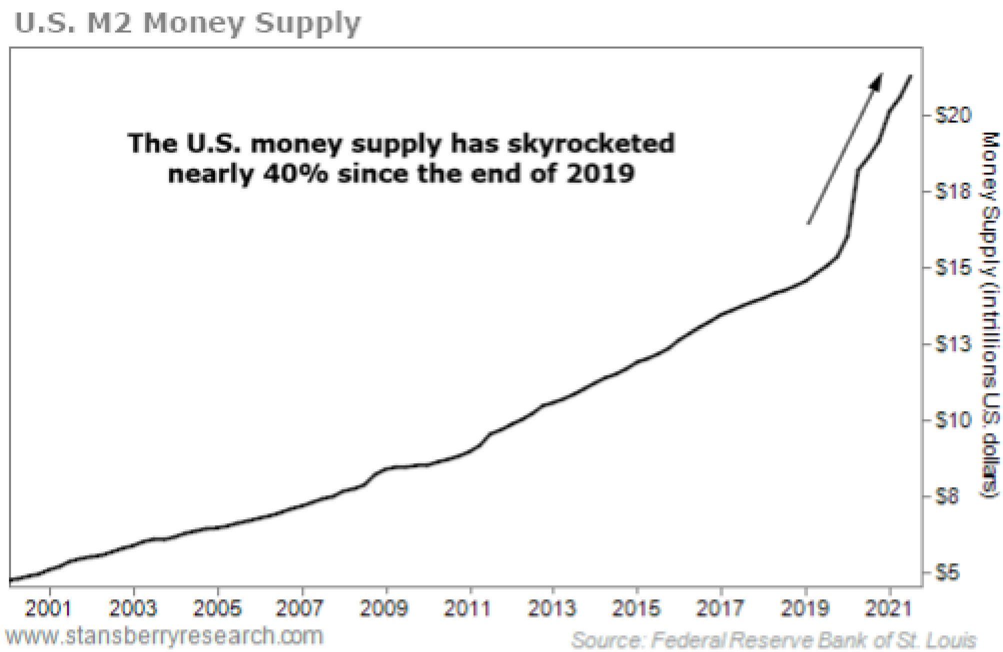
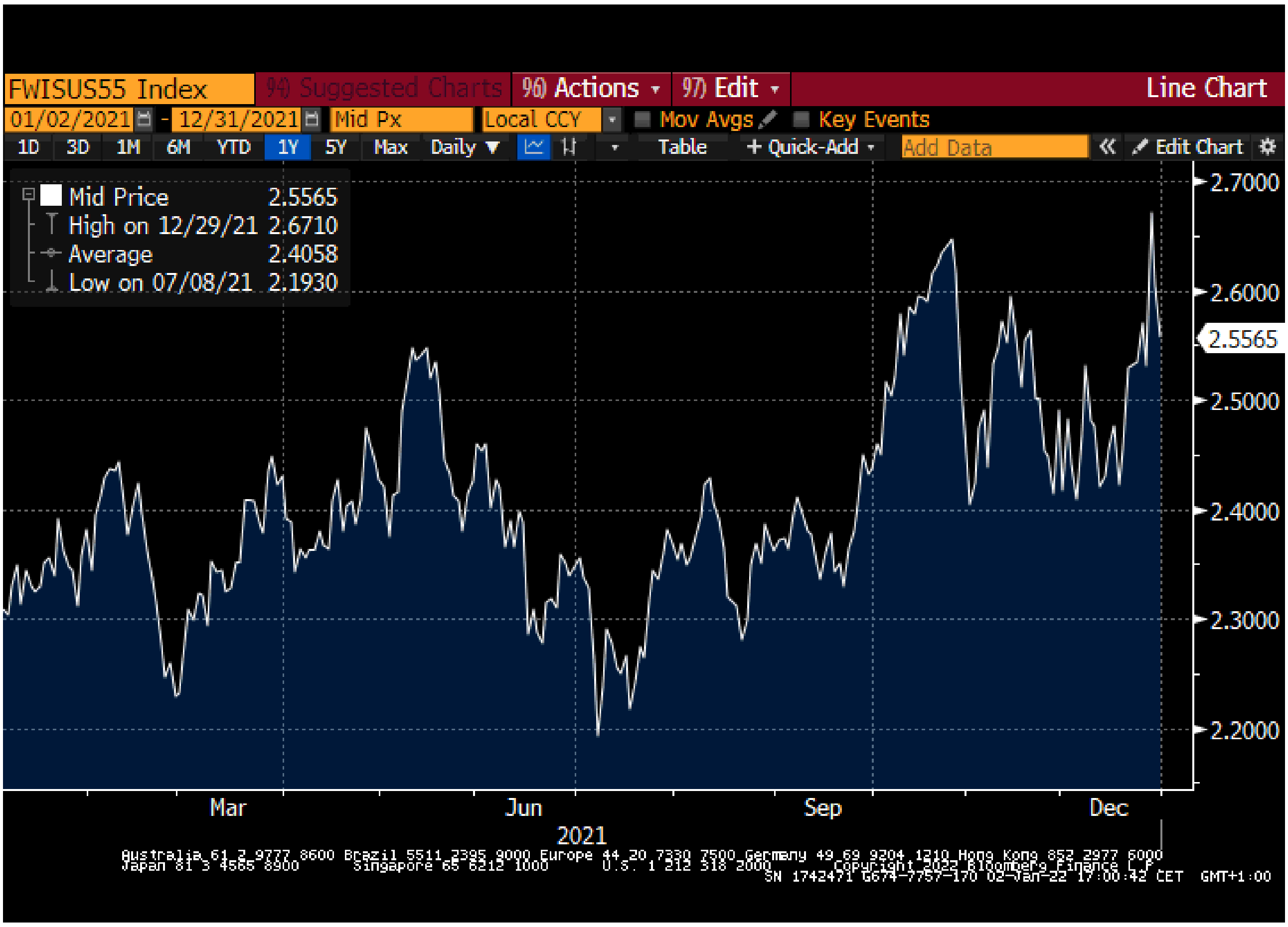
Argument number 1: Inflation is exploding higher and the Fed will tighten in response. My idea in short: do not fear this inflation, as it will abate.

No doubt at 6.8% the inflation rate is the highest recorded in the U.S. economy for the last 40 years. Even worse, the PPI indicator is growing higher than the CPI, signalling further increasing upward pressure ahead. It is entirely possible that inflation goes higher from here in the initial months of 2022. No doubt the Fed is behind the curve in dealing with a phenomenon it has defined "transitory" all along. Only the blind could not see the explosion of the M2 money supply (cash, checking and savings accounts, and money-market mutual funds) gauge that rose 40% from $14 trillion in 2019 to above 21 trillion in 2021 as a harbinger of price pressure (for context, M2 had been growing at 6% clips since 2001 till 2019). Consider also that one quarter of all dollars existing have been printed in the past year and a half.



After long decades in which inflation has never really been an economic issue, lots of commentators are now drawing parallels with the rampant inflation period of the 70s. There sure are some similarities - rising oil price, supply chain constraints, labour shortages, negative real wage growth - and also some other curious parallels (a long war in Afghanistan versus Vietnam just finished, a cold war with China instead of the Soviet Union). But this picture does not hold, as today things are drastically different. Oil price is not up the 16-times magnitude of those days, otherwise it would price at $600. Consumers are also in a better position today to weather higher prices as we spend less on energy overall– in the 1970s, for instance, gasoline made up 6% of spending, compared to 2% today. On the supply side, global trade has risen so much that the supply of goods has not been a problem since, except currently, driven by the Covid-19 pandemic. The argument for a return to 1970s inflation implies that current supply issues are set to become permanent or semi-permanent. Today's supply chain bottlenecks are not a result of a global economy unwinding, but rather a product of economic closures and restrictions being met with a drastic shift in demand for goods versus services. Companies are dealing with this problem, as they are re-designing their supply chains and are busy building factories closer to home (Intel in Europe, Taiwan Semiconductors in America, just to stay in the much-mentioned microchip sector). And we are starting to see some early signs of easing of this supply chain problem: automakers are reporting a diminishing shortage of chips, prices of indicative items like the Baltic Dry Exchange, which measures demand for capacity to ship dry goods, has dropped 50% from its 2021 highs, lumber price has also dropped from its highs, the IHS Markit Manufacturing Purchasing Managers Indices in Russia, India, China, Indonesia, Japan, Malaysia, and Vietnam have all improved dramatically over the past few months, signalling improving manufacturing capacity in those emerging markets. The jobs market is very tight, wages are rising, prices are rising but largely in response to too much demand bumping up against temporary supply chain issues. There are 11 million available jobs in the United States, compared to 6.9 million unemployed people actively looking for work. Opportunities for Americans looking for work or looking for a job change are many. U.S. companies are setting aside an average of 4% of total payroll for wage increases in 2022. Retail spending has also been strong – the National Retail Federation expects that U.S. November-January retail sales will jump by approximately 10% from a year ago, bringing the total to as much as $850 billion. Another piece of optimism comes from the fact that one of the biggest drivers of deflation over the past three decades has been a drop in the velocity of money – i.e. companies have been spending money less quickly due to a proliferation of productivity-boosting technology. This secular trend has not reversed course, so once short-term supply chain pressures ease, we can expect declining money velocity pressures to kick back up and continue to pull prices lower. Finally, comparables will be easier in 2022. Throughout 2020, inflation was averaging below 2%. When measuring against 2%, it is easy to come up with big numbers. However, starting in the second quarter of 2022, inflation will be measured against the much higher numbers we've seen throughout 2021. Hence tougher comps will naturally suppress headline inflation in 2022. Conclusion: **the economists are getting too sanguine on the inflation outlook.** We are probably going to see a drop in its headline in 2022 which will still be above the Fed target of 2%, but a few years of moderate overshooting will have to be balanced with more than 10 years of undershooting that same target.

But let us turn to what the market is telling us. The following chart shows the 5x5 years forward-forward in Libor/inflation swaps, a forward indicator followed by central banks as a gauge of market expectations. Right now, it is saying that market dealers are expecting a 2.5%-inflation five years from now. This level is a bit higher than last year but basically in line with the past average, and clearly does not buy the idea of permanent higher inflation at the level we are experiencing now.

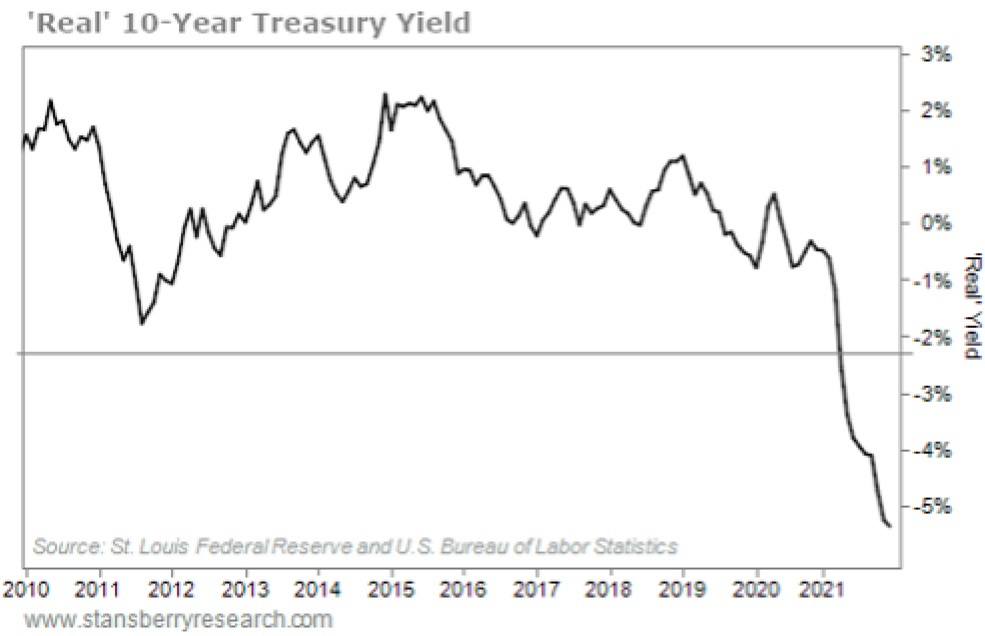


Source: Bloomberg

If monetary policy will not be significantly tightened, then inflation will probably keep showing exactly where it has been prominent so far: in financial asset prices. This constitutes a relevant source of growing inequality in society; but this topic is for another post. A cynical note as final confirmation of my thesis that inflationary pressure will moderate in 2022 and beyond comes from the Fed Chairman himself: Jerome Powell threw in the towel and removed the word "transitory" from his language. A sign it could be.

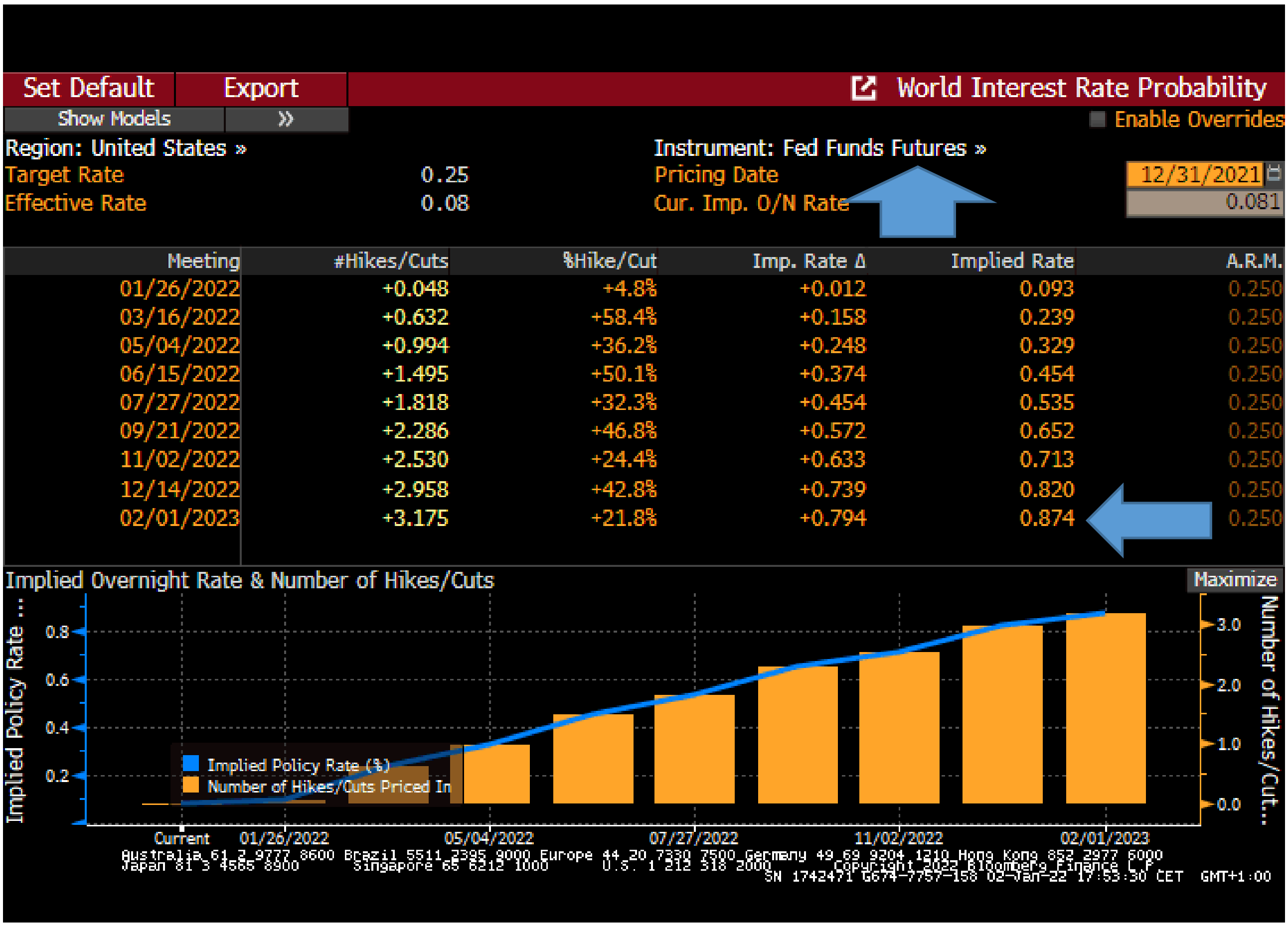
Argument number 2: the Fed has finally turned hawkish and will tighten monetary policy. My idea in short: not so fast, the Fed will chicken out ASAP.

After waving its white flag, the Fed has started to be worried and in need to "do something" about inflation. It has thus indicated an accelerated end to its bond-buying programme, which will probably terminate in march 2022; it has also signalled three probable rate hikes in 2022, perhaps three more in 2023 and two additional ones in 2024. In the tightest possible scenario, this means that Fed funds rates will target 2% in 2024. Hardly a terrifying number. By comparison, when in the 70s inflation reached 13%, then Chairman Paul Vocker raised rates to 22% to squash it. Nothing similar is ever going to happen today. The Fed is now a prisoner of its own frantic money creation and its acquiescence to fund basically unlimited spending by the federal government on programmes of stimulus spending; hence, it finds itself between a rock and a hard place. If it raises rates above the inflation peak, it risks killing the economic expansion and producing a cascade of bankruptcies, considering the record level of corporate and student (not retail) debt and its poor quality. In terms of quantity, corporate debt has nearly doubled to around $11.5 trillion from $6 billion before the last financial crisis. In terms of quality, more than half (57%) of all investment-grade debt is in the lowest-rated tier (BBB-rated). This is the highest percentage of BBB-rated debt ever; bad news also in the sub-investment grade debt, where the lower part – in other words, the worst of the worst – makes up 35% of all junk-rated debt today; leading up to the last financial crisis, that percentage was only around 15%. And, worse still, around one out of every four companies in the U.S. can barely pay the interest on their debt, the so-called "zombies." So, a drastic rise in rates will burst this bubble and probably cause an economic recession. A similar danger looms on government debt, which, while in no risk of default, can see its servicing cost skyrocket at the expense of crowding out other more necessary items of public spending and investments. On the other hand, if the Fed decides to stay put, as it did till now, its dovish stance, which has already been criticized harshly, will fuel even more inflationary expectations. So, the choice now looks higher rates or higher inflation: the inflate or die trap. Technically the Fed should obviously reduce the quantity of money sloshing around the system. To do this, it is not sufficient to reduce the stimulus by reducing and halting purchases of treasuries and mortgages: it would have to start selling the treasuries it owns and reduce its record balance sheet. Plus, it could ask banks to tighten lending. And it should raise rates above the inflation level. In my opinion, none of this is going to happen, terrorized as it is of derailing economic recovery. The Fed is thus left with the very mild response mentioned, the ending of its bond purchases and the sequence of small rate rises indicated. At this slow pace of hikes, in principle it will take forever to catch up with current inflation. But as I wrote in my argument number one above, inflation abating should do the trick for the government. An unintended but perfect situation will probably develop for the authorities. First of all, however mild this tightening might be it is still a rate hike, which should benefit the U.S. dollar. A strong U.S. dollar will eventually help reduce inflationary pressure, since almost all commodities are priced in U.S. dollars. Furthermore, since approximately half of the sales in the S&P 500 are outside of the U.S., many multinational companies will be benefitting from a currency appreciation. Secondly another major advantage for the government is negative real rates. Despite the changes, real interest rates are likely to be negative throughout 2022. Real interest rates are yields minus inflation. For example, the 10-year Treasury note yields about 1.5% while inflation is at 6.8%. The real rate is negative 5.5%. This rare and unusual situation produces winners and losers. Ordinary pensioners, savers and investors lose out as with negative real rates, investors fall behind after inflation. On the other hand, debtors win, especially the biggest of them all - the government, which can happily sit and watch its mountain of unpayable debt reduced by 5% per year.



Inflation targeting by central banks has always proved to be elusive. Let's take the Fed's 2% target: the Fed has missed it for the better part of ten years. Inflation has been undershooting the target since the 90s. As David Stockman has written, "any and all versions of the CPI and the PCE deflator are such crude approximations of real-world inflation as to be utterly unfit for monetary policy purpose." The very use of the term "target" implies a level of control they do not have. The powers of central banks are big but remarkably imprecise.

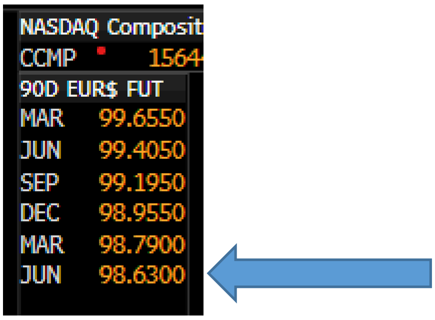
I believe that basically, **the Fed will put an hawkish mask on to buy time and will most likely chicken out as soon as it sees inflation come down in the second half of 2022**. My view is supported not only by Prof. Nouriel Roubini of NYU, but, more importantly, by Mister Market. In fact, yields on the 10-year Treasury have already been higher. Back on 31 March, for example, the yield on the 10-year Treasury hit its high of 1.765% for the year. (The low for 2021 came on 4 January at 0.917%). Longer-term yields, like those on the 10- and 30-year Treasury, are likely to respond more to inflation than to those hikes planned at the Federal Reserve. If the current inflation of 6.8% starts to moderate because it is indeed transitory as I posit, then these yields are likely to stay in the range set in 2021. This seems to be the message from the market. Yields are currently sitting at 1.50% for 10-years, while 30-years yields stand at a non-threatening 1.90%. Wall Street seems comfortable with the thesis that a 10-year rate of 2% or less isn't likely to hurt stocks, much because at that level or lower bonds simply do not offer investors enough incentive to move out of stocks. Further confirmation comes from analysing the short end of the curve through the string of deliveries for end-2022 of the Fed Funds Future quoted on CBOT.



Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
01/26/2022	+0.048	+4.8%	+0.012	0.093	0.250
03/16/2022	+0.632	+58.4%	+0.158	0.239	0.250
05/04/2022	+0.994	+36.2%	+0.248	0.329	0.250
06/15/2022	+1.495	+50.1%	+0.374	0.454	0.250
07/27/2022	+1.818	+32.3%	+0.454	0.535	0.250
09/21/2022	+2.286	+46.8%	+0.572	0.652	0.250
11/02/2022	+2.530	+24.4%	+0.633	0.713	0.250
12/14/2022	+2.958	+42.8%	+0.739	0.820	0.250
02/01/2023	+3.175	+21.8%	+0.794	0.874	0.250

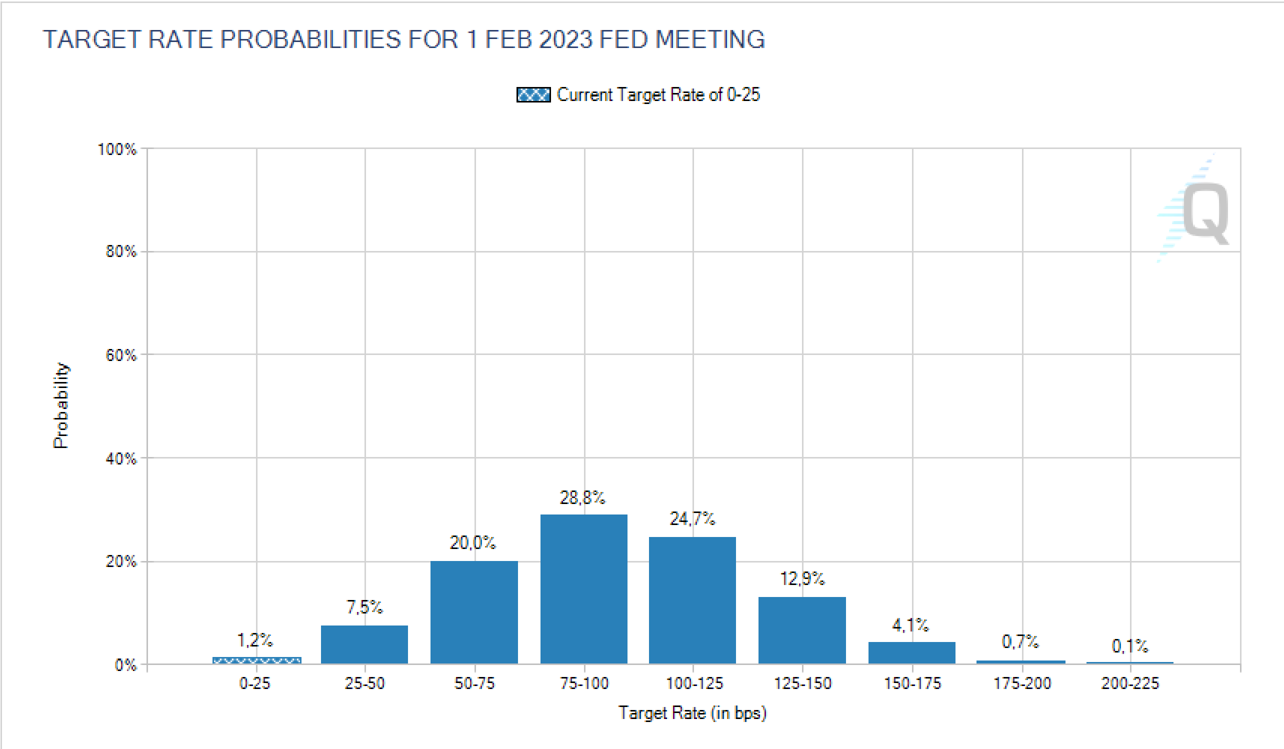
Source: Bloomberg

You can see from the above chart that the market is pricing a 0.874% O/N rate one year out from today with three rate hikes. And we get a similar message from looking at the following string of quotes of the EuroDollar Futures, with June 2024 implied 3-months rate trading at an uninspiring 1.37%.



Source: Bloomberg

To further corroborate my thesis, let us look at a device created by the CME, called the Fedwatch tool. As we can see in the chart below, the market estimate for the Fed FOMC meeting of 1 February 2023 shows a 29%-probability of rates being in the 0.75%-1.00% range, and the 1.00%-1.25% range a probability of 25%; higher ranges have negligible associated probabilities.

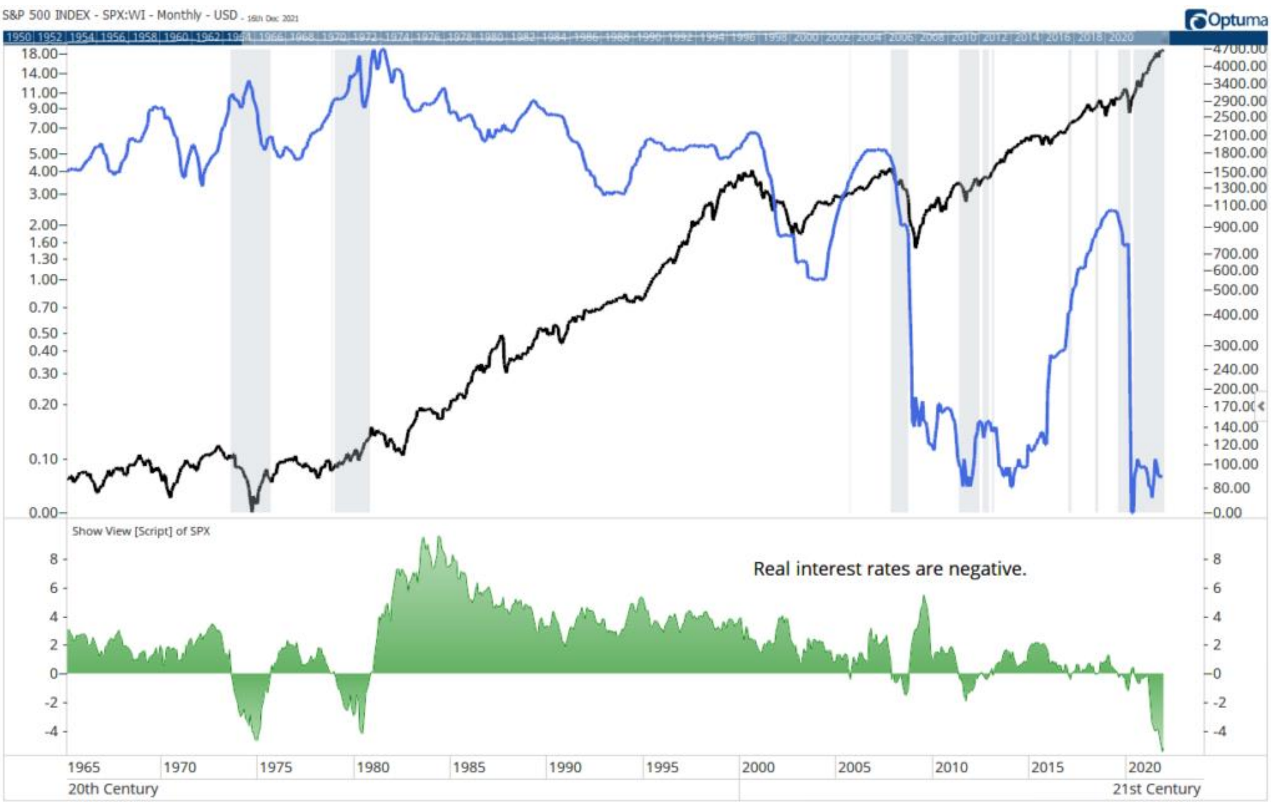


Source: [Countdown to FOMC: CME FedWatch Tool (cmegroup.com)]

One final point: the biggest bond guru of the world, Bill Gross, stated this year that 10-year yields have nowhere to go but up. Time will probably prove him correct, but just by a whisker. I would be surprised to see long yields much above 2% in 2022.

Argument number 3: high-growth, tech stocks will tank in a higher rate environment. My idea in short: rate hikes are positive for tech stocks; 2022 will be a better year than 2021 and they will resume their path higher.

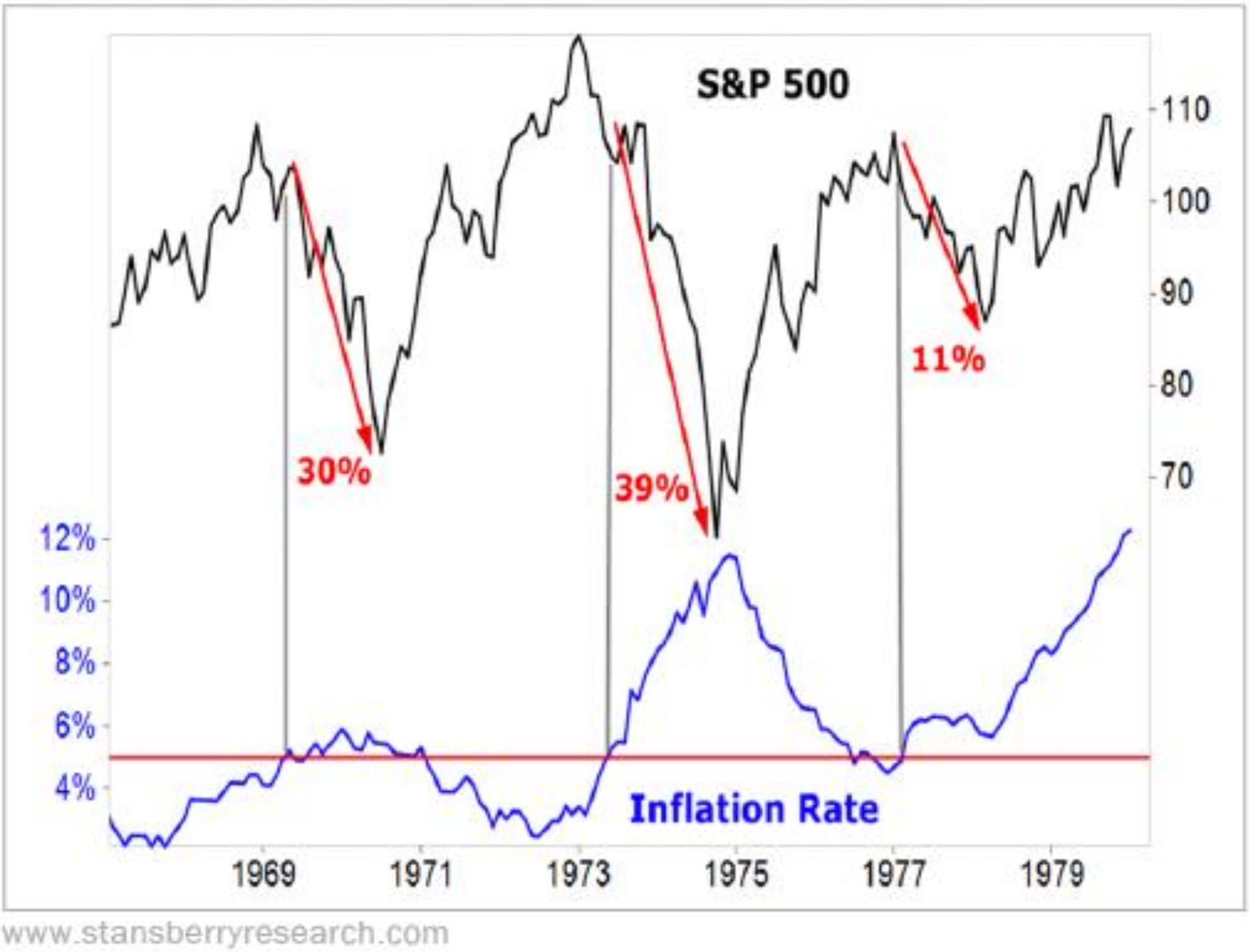
Historically, higher inflation does not sink markets. Higher rates do. And much higher rates than those planned by the Fed will be necessary to torpedo growth stocks. To start with, consider this chart showing the Fed Funds rate and the S&P500:



The first time the real rate turned negative, in 1973, investors were taken by surprise. The S&P 500 entered a steep bear market, losing 45% of its value in 24 months. Since then, the trend in the stock market has largely depended on the Fed's actions. When the Fed is fighting inflation by raising rates, stocks tend to rally. If the Fed cuts rates in a negative rate environment, stocks decline. Hence, as long as rates move higher in 2022, stocks should go up. The economy is largely in strong shape, but most people are unhappy about it. Indeed, what started as a year of investor and consumer enthusiasm for an economic boom has largely faded after the spring into a broad feeling of concern and disappointment. There are fewer signs of froth in the market, compared to the beginning of 2021 – the SPAC boom, Reddit investors, "meme stocks", cryptocurrencies, etc. – and the overall sentiment seems to be a cautious, negative stance. This makes for a very unloved economic expansion and bull market, which is good news for stocks.

Companies are indeed performing at the top of their historical range, but this is part of a long-term, secular trend in corporate profitability. There has been a steady move upward in returns on assets (ROA), with profitability consistently reaching higher highs and higher lows through cycles. As U.S. corporations have moved away from lower-return manufacturing business and into higher-return intellectual property-based businesses, firms have become more focused on operating efficiencies. Quality and efficiency regimes like "lean" and "six sigma" are all around, boosting aggregate ROAs. With this data, the movement of the benchmark S&P 500 Index over the past 20 years makes more sense. As long as capital remains free-flowing, companies maintain plentiful cash buffers to service their obligations, and as long as interest rates do not spike too high, a hot economy alone is no reason to panic, just like an overvalued market is not necessarily a reason to sell. Based on current valuations, the market expects Uniform[1] ROAs to expand to 13% in 2024. While it is not something to get excited like in 2021, it still means a robust economic performance. But is there a level of interest rates where things turn ugly, the average investor might reasonably ask? Well, looking at the chart below, relative to the 60s and 70s, it would seem that the "danger" area starts at 5%. After rates touch that level, the stock market tanks for about a year, after which it recovers.

[1] Copyright by Altimetry.com, Altimetry daily Authority; J. Litman



Source: Elaboration by Stansberry research; S. Sjuggerud

Other studies[2] show that there has basically never been a recession and market crash with rates below 4%. In 1999, stocks rallied despite rate hikes. And the last time the Fed started tightening monetary policy, from the beginning of the taper in December 2013 through after it began hiking rates in December 2015, the S&P 500 Index rallied 32.3% on a total return basis. At the same time, the dollar shot up almost 27%. And Goldman Sachs did a study recently where it found that U.S. stocks have outperformed inflation 100% of the time over any 19-year window. 100% of the time!
Let us now turn our attention from the wider stock market to the specific sub-set of high-growth technology stocks. These kinds of stocks have been suffering consistently since their all-time high around march 2021 and have been dropping significantly since. In fact, the Nasdaq lagged the S&P500 in performance for 2021, the first time this happens since 2016.
Apparently, this seems to be logical enough: my financial valuation 101 class teaches that the value of a stock is equal to the net present value of a company's future cash flows into perpetuity. That net present value utilizes a discount rate, which – per the widely recognized Capital Asset Pricing Model – is influenced by the target established by the Federal Open Market Committee's (FOMC) federal funds rate. So, the higher that interest rate, the higher the discount rate used in valuation models, and the lower the value of a growth stock today. This orthodox reasoning is widely shared by all commentators, experts, professors and practitioners. Hence, you have explained the recent weakness of growth stocks, particularly those companies which still have no earnings but are pushing hard on acceleration of revenue growth. The more those cash flows are achieved in the distant future, the more uncertain they are seen now, the lower their present value, i.e. the stock price will be. But

[2] Zacks Investment Management research; K. Matras

again, not so fast! The market is telling us a different story. The last time the Fed entered into a steady rate-hike cycle was in December 2016. Over the subsequent two years, the Fed hiked rates about eight times. During that time, growth stocks thrived. As an example, let's take Cathie Wood's flagship ARK Innovation ETF (ARKK), which represents a collection of the highest growth stocks in the market: it soared 90% from December 2016 to December 2018. By comparison, the S&P 500 rose just 9% over that same stretch. Growth stocks massively outperformed the wider market.

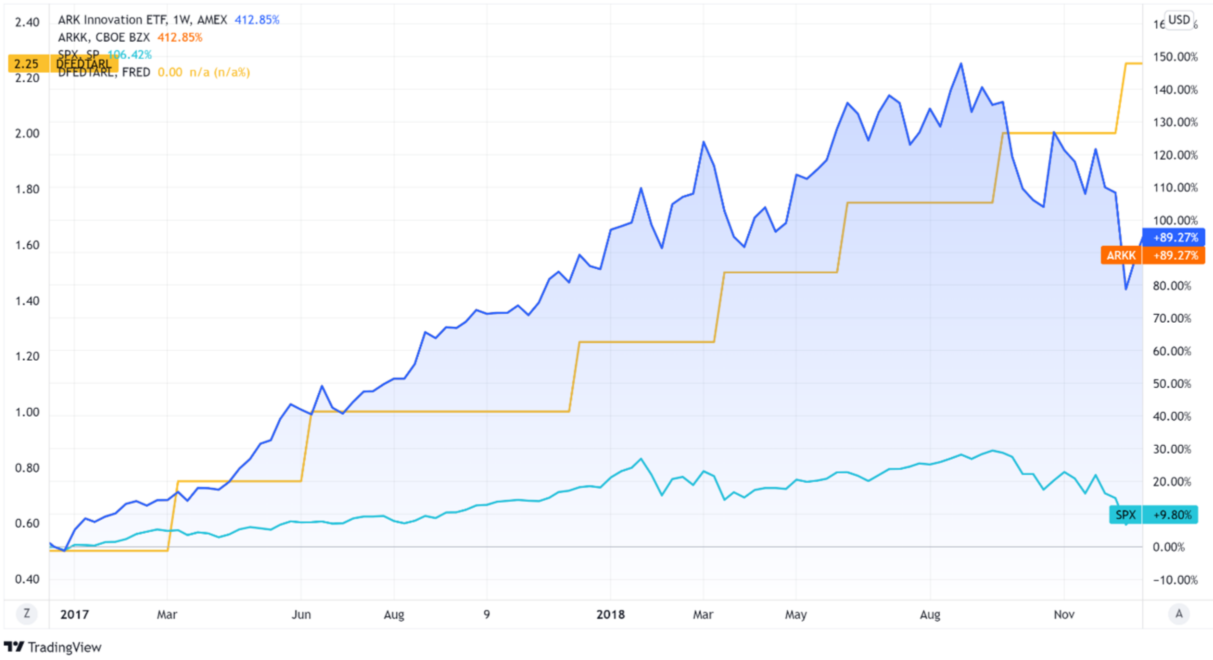


Chart courstesy of Investorplace.com; Hypergrowth investing, L.Lango

It is the fear of rising rates that hurts growth stocks, as everyone reads from the same script book and rushes to sell them; hence, the relative suffering of this category of stocks is confined to the anticipation of higher rates. Once this actually happens, these stocks benefit as their superior growth capacity is correctly judged more important than a small multiple compression due to slightly higher discount rates. And with good reason: more than 4.4 million new businesses were created in 2020 – the highest total ever recorded. It's also a 24.3% increase over 2019 and 51% higher than the 2010 through 2019 average. In the first half of 2021, more than 500,000 businesses were started. The economy is pushing strong. More companies are adopting automation. According to a recent Deloitte survey, around 73% of companies have embarked on a path toward intelligent automation and that is an enormous deflationary force which should reduce costs and improve productivity. Productivity-boosting technologies – like workflow automation, work-from-home, warehouse robotics, self-driving cars, and more – will continue to create deflationary forces in the economy long after today's supply chain disruptions pass. Some economic trends, driven by wider and wider adoption of technology, are unstoppable and gaining momentum: electric vehicles, autonomous driving, artificial intelligence, genomics mapping, biotech discovery of new drugs, cloud computing, just to name a few. Hypergrowth stocks are at the core of these forces and they will benefit from an expansionary economic environment. Michael Burry of Scion Capital foresees a major stock market crash. I dare say the opposite.

If history is any guide, we are seeing a similar setup as that of the 2016-2018 period. Last year featured fear of inflation and tightening of monetary policy expectations; 2022 will bring about a falling inflation and a very timid and gradual rise in rates. If any at all.

Conclusion

Contrary to experts' wisdom, the truth is that rate hikes are actually *great* for growth stocks. Once the rate rises will truly begin later in this year, if not earlier, growth stocks will soar. It's the "tech roaring 20s" ahead.