July 2022

Regime Change

In politics, a regime change occurs when one governmental structure is removed and replaced with another; in economics, the term can refer to a shift in the interplay of various parts of the economic or financial system. Political regime changes are easy to identify – think military coup. Defining when an economic or financial regime change has occurred can be more difficult. That said, there is a common fallout, and that of course is new leadership.

Recent actions in the global financial and economic landscape suggest that a regime change may be upon us. Today's change centers around inflation and interest rates but could also be extended to wider issues such as deglobalization and decarbonization. The focus of this piece will be on regime change as it pertains to financial markets.

Inflation, it could be said, was somewhat contained over the past 40 years, almost benign, and certainly not of the "runaway" variety. Surely this is not the case today. Inflation is soaring as economies deal with the fallout of an extraordinary period of super-charged monetary stimulus alongside supply disruptions brought on by pandemic-induced industrial closures and commodity shortages. The big question for many is whether these inflationary pressures will soon abate or whether these forces will be with us for some time still; and as this question gets debated, inflation's work may have already been done as it relates to regime change within the financial markets.

Governments around the world are now in the process of lifting interest rates off historically low levels to combat the swift rise in inflation, attempting to choke off growth and dampen inflationary pressures. Interest rates inflecting higher after a near 40-year decline also suggests that structural change is perhaps occurring. So, what does a high-inflation, rising interest rate environment look like in terms of stock market valuations? We have had a glimpse over recent months as the air has escaped from many over-inflated securities, but we also have history as an important guide. When money is free and plentiful, speculators are willing to pay seemingly limitless levels for financial assets. There is now a real cost to money, something that will require a new set of tools when analyzing and valuing businesses going forward – or perhaps just the dusting-off of an old set.

Market regime changes have seen significant losses incurred as leadership changes hands, often unwillingly, from the excessively valued stock market darlings of the day to the more modestly valued, basic-economy type businesses. Two standout periods over the past 50 years in which a significant regime change occurred within the financial markets serve as important windows into what we may be dealing with today. One was the bursting of the Dot Com bubble of the late 1990s. The other, and perhaps the more relevant window on the current environment, was the collapse of the Nifty-Fifty stock phenomenon of the late 1960s and early 1970s. Both periods were defined by excessive investor optimism toward an exciting and highly promoted area of the market, optimism that led to a belief that no price paid was too much for these "sure thing" stocks.

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The Dot Com era of the late 1990s was driven by a spectacular investment boom in all things related to the internet. Hundreds upon hundreds of companies went public, almost all lacking profits, some even lacking revenues in what was a massive speculative period for growth investing. Valuations for the market darlings of the day reached stratospheric levels, with several mega-cap stocks eventually comprising a large share of the S&P 500 Index. The tech-heavy Nasdaq Index, the poster child for the Dot Com era peaked on March 10, 2000, at $5,048.62, a level it would not reach again until March 2015 – 15 years later! From that March 2000 peak, all the way down to the trough it reached roughly two and a half years later, the Nasdaq would lose nearly 80% of its value. A few factors contributed to the bursting of the bubble, number one amongst them was rising interest rates. The Federal Reserve raised rates several times prior to the peak in an effort to cool down the red-hot market. Evidence of an economic slowdown was also present in March of 2000 as was a drying up of IPO financings, both adding additional blows to a faltering market. In the years leading up to the market peak, stock leadership became very narrow. In fact, almost all sectors outside of tech and telecom were labelled “old economy” and were shunned by the market at large. Needless to say, the valuations of the “old economy” stocks became very cheap in both a relative and absolute sense.

It took numerous months and many market downdrafts for investors to fully throw in the towel on the Dot Com darlings, but by then regime change had already occurred. After being neglected for a lengthy period, the “old economy” (the value stocks of the day) went on to meaningfully outperform the overall market for the better part of the next decade.

The Nifty Fifty was the name given to a group of U.S. growth stocks that performed very strongly in the latter half of the 1960s and into the early 1970s. The 1960s were buoyant years for the U.S. economy and there was a growing sense that American industry would dominate the global economy – these 50+ growth stocks embodied that new sense of economic superiority. The group included well-known companies such as Procter & Gamble, Philip Morris, Pepsi, Pfizer, Merck & Co, Eli Lilly, Coca-Cola, IBM, Gillette, Wal-Mart, Disney, Eastman-Kodak, Polaroid, Johnson & Johnson, and McDonalds; and all shared similar characteristics: high-quality franchises benefiting from robust economic growth, high returns on capital and strong balance sheets. Given their ability to deliver healthy profits and solid returns for investors year after year, many investors took the view that the Nifty Fifty stocks should be bought and never sold; and because of this, by the early 1970s these stocks had become the darlings of many institutional and individual investors alike and came to trade at very high valuations. To cite a handful of examples, popular stocks such as Johnson & Johnson was valued near its peak at over 57x on a price/earnings ratio, McDonald’s +70x, Disney +70x, and Polaroid Corp + 90x – this against an overall market multiple of just over 18x. The lengthy period of exuberance came to an end in 1973 as the U.S. economy faltered against a backdrop of rising inflation, political instability, rising interest rates and fuel shortages.

For the investors in the Nifty Fifty stocks, the proverbial punchbowl had been left out far too long and unfortunately the resulting hangover was a doozy. The prices of the Nifty Fifty had become bid up amid expectations of continued exceptional growth, which proved unsustainable; and while the group as a whole saw stock price declines on average of approximately 50% over the next two years, those Nifty Fifty stocks with the highest P/E multiple at the peak had the lowest subsequent returns, as highlighted with the steep declines in following chart:

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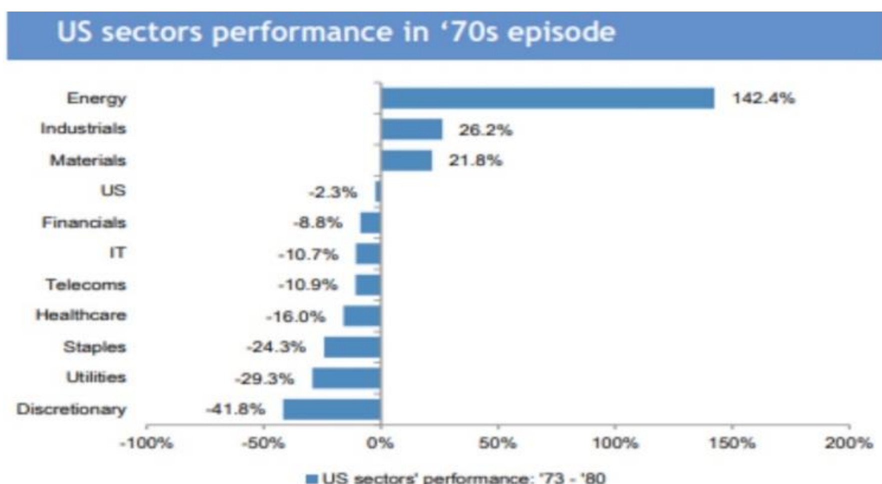
Source: Ritholtz Wealth Management. July 2020.

Lesson #1: Stock de-ratings of highly valued companies can often be swift and severe.

Many companies that comprised the Nifty Fifty went on to consistently deliver good earnings growth over the ensuing post-bubble years, yet given the lofty valuation levels reached, it took a decade or more in many cases for the stocks to recover back to their prior heights. A prominent example would be Coca-Cola, which grew its earnings by +200% over the post 1972 decade, yet the stock was still showing a negative 10-year return through the final months of 1982.

Lesson #2: Even high-quality businesses can be poor investments if purchased at extended valuations or not sold as valuations become stretched.

With a slowing economy, sharply rising inflation, and interest rates moving higher, the stocks that led the market to its January 1973 peak were no longer working – leadership change was about to occur. As mentioned, many of the basic-economy stocks did not participate in the markets Nifty Fifty runup and were thus offering very attractive valuations post the 1973/74 market collapse. As can been seen in the following chart, the sectors that included the vast majority of the Nifty Fifty stocks (healthcare, staples, discretionary) were amongst the worst-performing sectors for the remainder of the decade. Sectors such as energy, industrials, and materials benefited from their initial valuations in addition to the inflationary tailwinds that would help their bottom lines.



Source: J.P. Morgan. Global Equity Strategy. July 2022.

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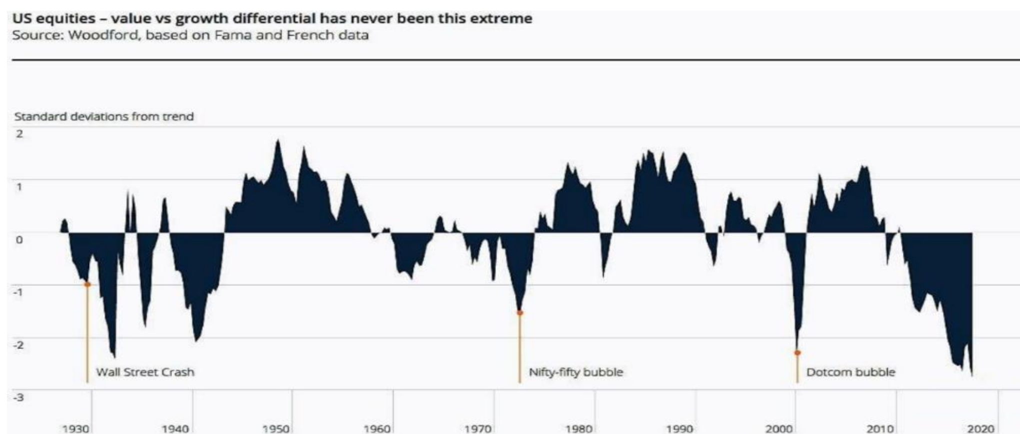
The similarities of today's market with the Nifty Fifty era are numerous; and while history doesn't necessarily repeat, it can rhyme. Take the market darlings of the past seven years: Facebook, Amazon, Apple, Netflix, Google and Microsoft (the FAANGM stocks). Together, this select group of high-quality growth stocks grew to represent +22% of the S&P 500 Index at their peak in 2020 thanks to their explosive rise over the prior decade. These six stocks (along with a small handful of others) became the "sure thing" stocks of the day given their perceived never-ending ability to produce growing cash flows and earn increasing returns on invested capital...sound familiar? Unlike many of the leaders of the Dot Com era that lacked earnings and cash flow, the FAANGM stocks were more akin to the Nifty Fifty stocks of the 1960s: quality, leading businesses with growing earnings, solid balance sheets and high returns on capital. What could go wrong owning these unassailable companies? Well, as we have seen before, a great company does not necessarily make a great stock, and exceptional growth is difficult to maintain.

Additionally, a key support factor of the lofty multiples accorded to these growth stocks was the long-held tenet that interest rates would remain lower for longer. Rising inflation has forced a U-turn on accommodative monetary policy and thus fundamentally changing the view of lower-for-longer interest rates. For the first time in a long while investors are having to think about what it means if interest rates moved higher as opposed to the last decade where rates were expected to be stable or declining. The game appears to have changed once again. Surging inflation, rising interest rates and valuation compression suggest a regime change is likely upon us.



Source: Fama and French data.

As Goldman Sachs recently stated, "The drivers of the returns and leadership of the market should be very different from the last cycle and should result in a different approach to investment strategy…Investors should also position for a continued rotation out of growth and into value".

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