Is the Stock Market Partying Like It's 1999?

As equities reflect optimism about innovation and economic recovery, naysayers continue a familiar refrain. Here's why we think they are off base.

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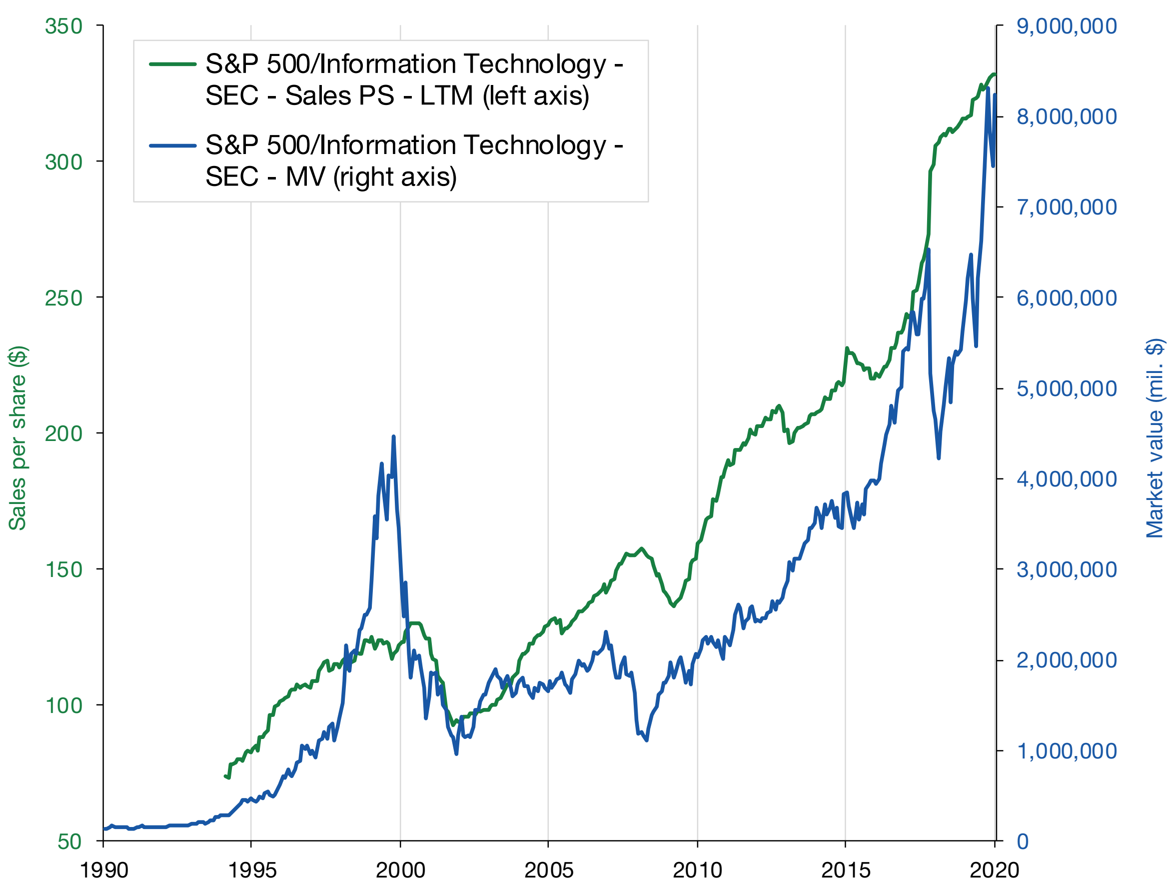
Figure 1. Unlike 1999-2000, Tech Sector Gains Have Reflected Actual Sales

Sales per share (left axis) and market value (right axis) for the S&P 500 Information Technology sector, November 30, 1990–November 27, 2020



Source: FactSet. Data as of November 27, 2020. "Sales PS – LTM" refers to sales per share for the trailing 12-month period. "MV" refers to market value. Sales per share data covers the period December 30, 1994–November 27, 2020.

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Stock Market

"I was dreamin' when I wrote this, forgive me if it goes astray
But when I woke up this mornin', could've sworn it was Judgment Day"
—Prince, "1999"

With the Dow Jones Industrial Average recently eclipsing 30,000 for the first time, and the S&P 500 and NASDAQ hitting fresh highs, a chorus of dystopian market forecasters have continued to warn of doom and gloom for the equity market. The laziest among them point to the market froth of 1999 as the note-worthy parallel to today's resilient equity performance.

Interestingly, many of these prognosticators have been singing this same refrain since the end of the Great Financial Crisis of 2008–09, arguing now in hindsight that they will still be proven correct (they're just early) and that "judgment day" for market bulls is coming as it did in 2000-2002…at some point.

Yet if we focus on business fundamentals rather than speculative, bearish hunches, the outlook for select segments of the U.S. economy is both compelling and sound, in our view. We continue to see extraordinary gains from the technology revolution in many areas:

- *E-commerce* continues to thrive, with a strong acceleration in adoption.
- *Cloud computing* is seeing similar adoption as companies overhaul their IT infrastructure.
- *Biotech* continues to experience tremendous growth thanks to the benefits of the genomics revolution.
- Finally, *artificial intelligence* is augmenting the productivity and profitability of many industries.

What is more, we have seen "green shoots" of recovery in more cyclical industries that are not threat-ened by the displacement risks of innovation.

These examples differ greatly from the speculation of the 1990s, where disruptive new technologies were priced as though broad market adoption and profitability had already arrived rather than being a decade or two away.

So as we assess these strengthening areas of the economy and the equity markets at the tail end of 2020, we'll address the concerns of the "dystopians" by highlighting three key distinctions between the market environments of today—and the tech-led "bubble" of 20 years ago.

2020 vs. 1999: Three Key Points

1. The current environment suggests a more favorable outlook for risk assets.

In 1999-2000, the moment seemed invigorating, but there were dark clouds visible on the horizon. One could argue the opposite is true today. With the prospect of an end to the pandemic in 2021, along with a potential rebound in the economy, we think optimism for much stronger corporate revenues and earnings is justified. And the growth that ensues will most likely continue to be non-inflationary, we believe. It is worth noting the difference between interest rates today and the late 1990s and early 2000s. From November 1998 to May 2000, the U.S. Federal Reserve (Fed) raised the federal funds rate from 4.75% to 6.5% in order to cool off an overheated economy. Rhetoric from Fed policymakers turned increasingly hawkish in February 2000 as inflation rose to over 3% and the effective fed funds rate peaked at 6.53% in June 2000. Conversely, the fed funds target today is between 0% and 0.25% and inflation has been persistently below 2%. Moreover, Fed Chairman Jerome Powell has expressed more concern over deflation rather than inflation amid the COVID-19 induced recession, indicating potentially lower short-term rates for longer.

As for longer-term rates, the 10-year U.S. Treasury yield in January 2000 was 6.79%, whereas today it continues to linger below 1%. Comparing that yield to the current earnings yield of roughly 4% on the S&P 500 supports the argument that that risk assets remain comparatively attractive, in our view.

Furthermore, low inflation tends to be favorable for longer-duration assets, such as innovation stocks, and it is worth noting that the Fed's new policy of average inflation targeting limits scenarios where monetary policy would tighten compared to its previous framework. Against this backdrop, we think it is unlikely that we will see any near-term rate hikes, a markedly different situation than the series of tightenings in the late 1990's.

2. In 2020, the market has displayed greater fundamental strength.

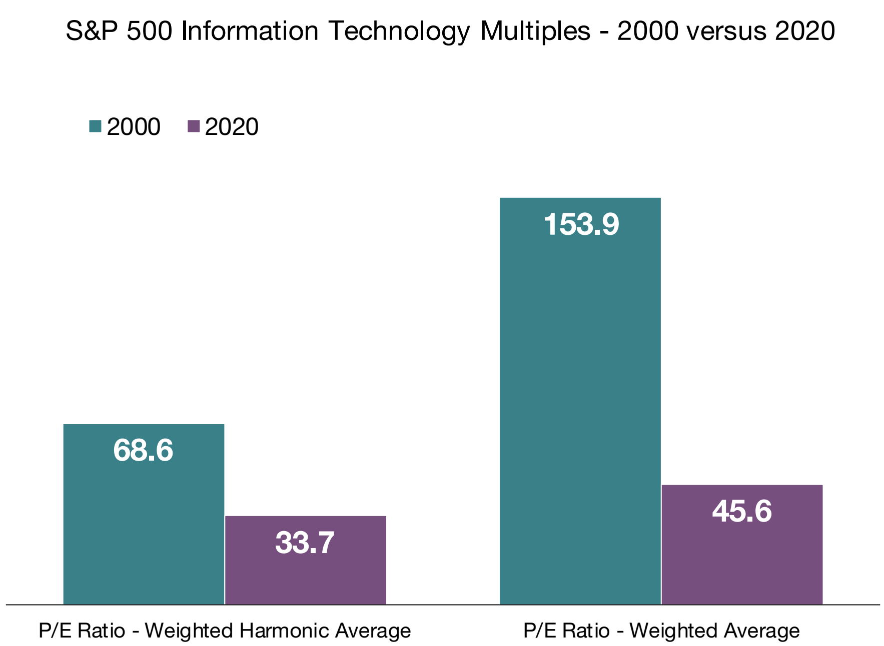
Figure 1, on Page 1, illustrates another significant difference between today and 20 years ago by tracking the market value and sales-per-share of the S&P 500 Information Technology sector over the long term. We can see that over most of this period the rate of growth in sales outpaced the rate of increase in the market values of those stocks. However, in the late 1990s, this relationship changed radically, with share prices soaring far ahead of the pace of increase in sales. In fact, we see sales flatten and then fall off substantially as the economy tilts into recession. Conversely, today, we have seen a sharp, sustained surge in sales that reflects the much healthier environment for key areas of technology that play an important part in the U.S. economy.

3. Today's market features more rational valuations.

The other refrain we hear most commonly in attempting to draw parallels between today and 1999 is that equity valuations are once again out of whack. Here again, when data is used rather than gut feeling, this argument falls flat. And there's no better place to focus than technology, which was the epicenter of the collapse in 2000-02. While valuation multiples within the information technology sector today are modestly higher than that of the overall S&P 500® Index, they are anywhere between one-half to one-third of what we saw in the late 1990s and early 2000s, depending on the methodology used. For example, on March 10, 2000 (when the Nasdaq Composite Index reached its highest level of the "dot-com" bubble), the information technology sector's P/E ratio was 68.6x, more than twice the current P/E ratio of the sector (as of November 23, 2020). It's worth noting that the standard methodology for P/E ratios uses data "harmonization" techniques that limit the impact of extreme outliers. When that technique is eliminated, the weighted average P/E of the tech sector in early 2000 was 153.9x, compared to 45.6x today. The disparity between the weighted average in 2000 and the weighted harmonic average points to numerous stocks with severely extreme valuations within the index.

Figure 2. How Do Today's Tech Sector Valuations Stack Up against the Peak Levels of the 1999–2000 "Dot-Com" Boom?

Price-to-earnings ratios at March 10, 2000 and November 23, 2020



Source: FactSet. Data compiled November 23, 2020. This chart illustrates the difference in valuations from (1) the date at which tech-sector valuations reached their highest level during the so-called "dot-com" bubble (March 10, 2010) and (2) and today's market (as of November 23, 2020). **Weighted harmonic average** reflects the exclusion of stocks with extreme outlying valuations to more accurately represent sector valuations.

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In contrast to the height of the dot-com bubble, the rally seen in technology stocks today has been driven by stronger earnings and better profitability. Based on the price-to-earnings multiples stocks in tech and other strong sectors of the market, there is little empirical evidence to suggest that we are witnessing history repeat itself.

More broadly, we continue to believe that there will be distinct winners and losers from the technology revolution that is being powered by innovation, and we believe this is a critical time for investors to be selective in their equity portfolios. But we should at minimum put to rest the comparisons to the equity market's overexuberant dot-com party of 1999.

Glossary and Index Definitions

Earnings per share (EPS) is a company's earnings divided by the number of shares outstanding. EPS can also be computed for an index such as the S&P 500.

Price-to-Earnings Ratio: Stock analysts calculate a price-to-earnings ratio by dividing a stock's current price by its earnings per share on a trailing 12-month basis. A forward price-to-earnings ratio is calculated by dividing a stock's current price by estimated future earnings per share.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.