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22 years since the bursting of the Internet bubble

Market Comment, December 2022

More than 20 years have now passed since the famous bursting of the technology/Internet bubble. Following the rapid rise of US technology shares in the late 1990s, a period also referred to as the dot-com bubble, the global equity markets were characterised by a correction in IT stocks between 2000 and 2003. Are there any parallels between the correction in equities observed since the beginning of 2022 and the major correction experienced 22 years ago? What are the differences? One similarity is the emergence of a large-scale correction in equity valuations. As Mark Twain was reputed to have said: "History never repeats itself, but it often rhymes." Fundamental factors should always take precedence over fashion trends when it comes to making investment decisions. Stability and quality should thus remain a priority.

Some time ago, we compared the characteristics of two different genres of equities, which are widely referred to in the investment world as "value" stocks and "growth" stocks (see market commentary "The rise of value stocks"). In doing so, we pointed to the catch-up potential offered by "value" stocks, an observation that has proven to be absolutely correct. Some time has passed since then and several "high-flying growth" firms from the IT and Internet sectors have effectively experienced a moment of truth during 2022. In other words, it has become apparent that even renowned Internet and technology equities from the US are unable to escape the law of gravity forever.

We had already experienced this with Chinese Internet stocks, which were also finally engulfed by gravity, so to speak, after a long phase of very high valuations. Why have "growth" stocks from the US technology sector now also been hit? Are there any parallels and differences that can be identified when we look back to the enormous bursting of the Internet/technology valuation bubble some 22 years ago? Similar to 2000, there was a historically very marked expansion in Internet stock valuations in connection with the coronavirus pandemic of 2020/2021, as demand for Internet technology grew due to working from home. This was especially true for the so-called FAMAG firms, comprising Facebook (now called Meta), Amazon, Microsoft, Apple and Google. In many instances, Netflix is added to this group instead of Microsoft, meaning that the abbreviation is changed to FAANG. What all of these companies had in common was that following the onset of the coronavirus waves, both the market consensus and analysts came up with excessive, perhaps even fantasy-like forecasts for their profit and sales development, with this continuing to be the case even when the pandemic was already dying down.

However, the moment of truth came in the fourth quarter of 2022 when global growth began to slow, interest rates rose and many technology/Internet firms were unable to meet the high expectations pedalled by the market consensus. The results of these "high flyers" and their outlook for the future have thus clearly disappointed.

> "Highly valued equities face headwinds when interest rates rise or the economy slows."
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> Gérard Piasko, Chief Investment Officer

As was the case 22 years ago, the herd instinct and human nature of the market once again led to major exaggerations in several IT stocks, with some perhaps not having yet fully completed the correction process. While Meta (formerly Facebook) was hit hardest, others have also corrected significantly. This shows that the classic approach of fundamentally analysing stability in terms of a firm's balance sheet and business performance development is essential. At the start of 2022, Internet stocks were not quite as highly valued as they were at the turn of the millennium. However, they were not far off reaching this point, as a comparison of the Dow Jones Internet Composite Index or the technology-based Nasdaq Composite Index shows. Placing your trust in company profits forecast in advance by the analyst consensus is always a risky business and this was no different 22 years ago. At the same time, as was the case between 2000 and 2003, it has and continues to be seen that the "old economy" is making a comeback against the "new economy". Companies from traditional sectors of the "old economy" such as healthcare or energy have been more convincing in terms of their business performance and have held up better in a difficult environment with high interest rates than those seen prior to 2022.

For the future, it is important to continue to focus on precise fundamental analyses and to pay attention to the stability of a company's balance sheet and business performance. The phase of weaker growth and rising interest rates is not over yet. Generally speaking, companies with high valuations are exposed to greater headwinds when interest rates rise. Elevated interest rates reduce a stock's current value, especially in the case of equities with cash flows far in the future, which then have to be discounted with higher interest rates. When economic conditions become more difficult and interest rates rise, the market punishes equities that are overly sensitive to the economic cycle, while tending to reward companies that exhibit stability in terms of their balance sheet and business performance. In this sense, it is now even more important to focus on quality with respect to this investment stability and also to pay attention to reasonable valuations, as the economic environment will not become any easier.

Gérard Piasko

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