Irrational Exuberance All Over Again?

July 2024

With the stock market hitting new all-time highs during the second quarter, largely driven by big-cap tech and the promise of artificial intelligence (AI), the oft-mentioned parallels to the late'90's tech-craze are once again front of mind. The similarities are striking, although it's the differences that we're focused on. We'll summarize some thoughts below, but it is important to understand the rapidness with which the AI space is evolving, and the long-term winners (and losers) are far from known at this point.

The late 1990s tech bubble and today's AI-driven market enthusiasm share some similarities, but also have notable differences:

Similarities:

1. *Market dominance by tech companies: Both eras are characterized by a small number of large tech companies dominating market performance. In the late 1990s, it was the ICMILO (Intel, Cisco, Microsoft, IBM, Lucent, and Oracle) group, while today it's the FAAMA (Facebook, Apple, Amazon, Microsoft, and Alphabet) stocks[2].*

2. *Narrow market leadership: In both periods, a small number of stocks contributed significantly to the broader market returns, with many of these star performers belonging to the technology sector[2].*

3. *Underperformance of value investing: Both eras have seen prolonged periods of value investing underperformance, with growth stocks outperforming value stocks[2].*

4. *Investor enthusiasm: Both periods are marked by high levels of investor excitement around new technologies - the internet in the 1990s and AI today[4].*

Differences:

1. *Pace of market growth: While both periods show strong market performance, the current rise in prices is happening at a slightly lower, steadier rate compared to the rapid escalation seen in the 1990s[2].*

2. *Valuations: Although valuations of the largest tech companies are currently high, they are not as extreme as during the dot-com bubble. The price-to-sales ratios of today's tech giants, while elevated, are nowhere near the levels reached in the late 1990s[2].*

3. *Profitability: Many of today's large tech companies are profitable, unlike the cash-strapped internet startups of the dot-com era that often had no realistic path to profitability[3,4].*

4. *Market maturity: The current tech market is more mature, with established companies like Apple, Microsoft, and Google leading the charge, as opposed to the numerous unproven startups that dominated the dot-com bubble[4].*

5. *Economic context: The dot-com bubble coincided with the longest period of economic expansion in the US after World War II, while today's market is navigating a more complex economic landscape, including recent inflationary pressures and potential recession concerns[3,4].*

6. *Regulatory environment: Today's tech companies face greater regulatory scrutiny and challenges compared to the relatively unchecked growth during the dot-com era[1].*

While there are concerns about the current market's enthusiasm for AI-related stocks like Nvidia, which has seen significant price increases reminiscent of Cisco's rise during the dot-com era, the overall market dynamics appear more tempered[4]. However, caution is still warranted, as the abundance of cash waiting on the sidelines and potential Federal Reserve actions could still lead to asset price inflation and bubble-like conditions[4].

In conclusion, while there are parallels between the two periods, the current market appears to be more grounded in fundamentals and less speculative than the dot-com bubble. Nevertheless, investors and policymakers should remain vigilant to avoid the pitfalls of "irrational exuberance" that characterized the late 1990s tech bubble[4][5].

Citations:
[1] https://en.wikipedia.org/wiki/Dot-com_bubble
[2] https://russellinvestments.com/us/blog/could-the-tech-bubble-burst-again-how-todays-market-stacks-up-against-the-90s
[3] https://www.goldmansachs.com/our-firm/history/moments/2000-dot-com-bubble.html
[4] https://markets.businessinsider.com/news/stocks/stock-market-outlook-90s-dotcom-crash-tech-bubble-nvidia-yardeni-2024-1
[5] https://www.britannica.com/event/dot-com-bubble

So, I'll cut to the chase here: The above simple analysis was the 3-second product of a query using perplexity.ai, one of the latest and more interesting AI tools that I've come across. The prompt was, "Compare and contrast the late 90's tech market stock bubble with the AI-driven mania of today." Simple ask, 3 second answer (maybe it was 2!). Admittedly, this is AI in its basest form – nothing too complex here; however, perplexity.ai's ability to analyze, source and present clearly data-driven answers is a far cry from many Google searches, which often lead to advertising influenced or bot-driven results.

What does this all mean for investors?

A glance back in time reminds us that the NASDAQ, chock full of high growth technology-oriented stocks, soared 570% from 1995 until March of 2000, a 45% compound annual rate of return. In March of 2000, the mania broke and the NASDAQ began a sickening slide of nearly -80%, not bottoming out until October of 2002. Many fortunes were made and lost during the '90's tech bubble; but a $1 invested in January 1995 and held through it all compounded at only 5.6% by October 2002.

Many investors (and portfolio managers) were overly concentrated in tech-stocks during this time. The poor prudent investor that diversified struggled mightily, avoiding any and all cocktail party chatter about their investment portfolios. From March of 2000 until the onset of the Great Recession (October of 2007 for our purposes), the diversified investor got some revenge. While the NASDAQ declined -6.9% per annum and the S&P 500 grew by 3.1% annually, US small-caps (S&P 600) rose at a 10.1% annual rate, international developed stocks (MSCI EAFE Index) gained 6.7% per annum and emerging market equities (MSCI EM Index) soared 15.6% per year!

Despite the somewhat sanguine conclusions drawn above by perplexity.ai, the parallels with the late '90's appear close enough in our eyes to feel that caution is warranted. According to

Strategas Research Partners, at the end of Q2 the top 10 stocks in the S&P 500 index accounted for 77% of the YTD return, while NVIDIA alone accounted for 32%, both near all-time records. Extreme index concentration can expose investors to greater volatility than normal. Nottingham regularly discusses this at our weekly investment meetings, analyzing various hedging and diversification strategies in case things go south.

As we enter the 3rd quarter of 2024, our outlook remains for an economic soft-landing, although the odds for something more challenging would appear to be growing. Employment and inflation remain critical to our thesis, and both seem to be holding up well. Consumer spending remains buoyant, although the consumer may be getting a little stretched as the impact of higher borrowing costs hits home. Corporate America itself appears to have a firm foundation currently. As for the political situation, we'll avoid that for now so as not to end on a sour note.

The Fed is likely to begin lowering interest rates in the late 3rd or early 4th quarter. This should normalize the yield curve, bringing back the more traditional upward sloping shape, with short rates falling and longer-term rates holding firm. Equities, which typically do well during a Fed pause, tend to sell off following the start of rate cuts, as often the economy is slowing and growth expectations are reduced. Equity investors should stay alert to further down-side risk if growth slows more rapidly than anticipated, though that is not our base case.

There should be no shortage of drama and market-moving events over the coming months. Politics will take center stage as we move towards the Fall. Geo-politics are always a concern. Corporate earnings and consumer spending typically follow each other. Employment, inflation and the Fed will remain front of mind for the balance of the year.

As this is the second straight *A View From the Top* discussing market parallels with the late '90's, you know where our heads are at and where our concerns lie. The list of potential pitfalls for investors is long, but our hope is that you leave the worrying to us. Enjoy these summer months, which tend to be glorious but fleeting here in the northeast. Please reach out to us with your thoughts and concerns. We wish you all a safe, happy and pleasant summer.

Sincerely,

Larry Whistler, CFA
President
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