Why Growth Stocks Are Selling off Right Now

Description

There’s a rotation happening in the stock market right now that’s hard to ignore. Investors are shifting their focus from growth stocks, which have outperformed to an incredible degree in recent years, toward those they see as having greater cyclical exposure to the recovery.

This makes sense, considering inflation expectations have been triggered due to mass vaccinations globally. In this type of environment, cyclical stocks should do very well. Additionally, the valuation gap that exists right now between growth and value stocks is massive. If investors believe in the buy low, sell high mantra, this shift makes sense.

The thing is, growth stocks have been vastly overvalued for some time. Here’s why:

Growth has become more attractive in relation to fixed income assets

Many investors will have heard of the 60-40 portfolio (60% stocks, 40% bonds).

For decades, this sort of asset allocation has been commonplace for investors. Fixed income (bonds) provide very stable yields from which one is able to earn income. Stocks tend to provide more total return (capital appreciation plus dividends) at a higher risk.

With the onset of the pandemic came yet another round of quantitative easing. Central banks around the world began buying bonds at an incredible pace. Buying bonds naturally reduces their yield, allowing governments and corporations to borrow at lower rates. This injects liquidity into the markets, and provides the “stimulus” everyone talks about.

The unintended side effect of lower bond yields is higher asset prices. Think about it this way: homes become more expensive, because mortgage rates go down. The same is true for stocks.

Higher-growth stocks that don't pay dividends used to be compared to bonds that did. Today, these same growth stocks look pretty darn good compared to bonds which also yield next to nothing.

Accordingly, with bond yields near-zero, there's little reason to hold fixed income securities. Many stocks provide dividend yields well in excess of bond yields right now, and this has resulted in a massive capital shift away from bonds and into stocks. Retirees need to earn meaningful income, and can't do so in the bond market right now.

The "TINA" (There Is No Alternative) trade is a term that describes this phenomenon.

Why are growth stocks suffering right now?

Rising inflation expectations due to anticipation the economy will reopen has resulted in a dramatic increase in long-term bond yields.

Why does this matter?

It's complicated, but as bond yields rise, growth stocks become less valuable, as valuation models discounting future cash flows take into account the growth rate of a stock relative to the risk-free rate. What's the risk-free rate? Usually government bonds (treasuries). As treasury yields rise, the increased value growth stocks can provide relative to bonds wanes.

That said, growth investors may note that governments have an incentive to keep rates lower for longer. After all, treasury yields are the interest rates the government needs to pay on its debt. We all want lower interest rates on our debt, and lower interest rates juice the economy, so many economists think rates will have difficulty rising due to the sheer amount of debt in existence today.

That's a lot to digest, but the bottom line is: rising rates aren't good for growth stocks in the near-term, but growth stocks are still likely to do very well over the long-term.

What growth stocks are worth looking at right now?

Stocks like **Shopify Inc.** (TSX:SHOP)(NYSE:SHOP) that don't pay a dividend, and aren't likely to for some time due to its growth plans, are examples of what's been going on right now. Shares of Shopify are now trading at a 25% discount to their all-time highs amid these developments.

That said, for those who believe as I do that growth stocks will continue to outperform over the long-run, Shopify's a solid choice. It's achieved the title of the largest company in Canada by market capitalization for a reason.

Growth stocks may be under pressure over the short-term, but this could provide a great buying opportunity for long-term bulls on companies like Shopify.

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