3 Reasons Growth Stocks Could Keep Falling in 2022

Description

This holiday season, growth stocks are taking a beating. The NASDAQ-100 is falling, and some individual growth names within it are falling far more. Work-from-home stocks, e-commerce stocks, and other previous winners are down in a big way. The COVID-19 pandemic is surging once again, but investors no longer seem to think that small tech upstarts are going to make boatloads of money off it.

They're probably right. While the latest COVID-19 variant is a big concern, vaccination rates are improving, and boosters are now available. It doesn't look like we'll see another March 2020 anytime soon. So, growth stocks that got big in the COVID era may have much further to fall. Here's why.

History suggests it could happen

If you look at history, you see clearly that stock market selloffs can take a long time to play out. The Dotcom crash that started in 2000 didn't hit bottom until 2002. The 1929 "Great Crash" saw a downturn from which it took many years to break even. Historically speaking, corrections take time to unfold. So, it should come as no surprise if growth stocks continue falling into 2022. That wouldn't even be a particularly long correction.

Interest rates are rising

Another factor that could lead to weakness in growth stocks is rising interest rates. Higher interest rates hurt growth stocks — especially tech stocks — because they make outsized future profits less valuable. Tech stocks are seen as having the *potential* for high future earnings, while being subject to immense risk. When bond yields go up, the "risk-free" rate of return increases. As a result, it becomes less sensible to gamble on big tech profits. Why take on all that risk when you can get an okay return for free?

I think this argument can be somewhat overrated. While interest rate hikes are coming, nobody is expecting 1980s-style double-digit rates. The interest rate hikes next year will be quite tame. However, they are a factor that can lead some investors to sell tech stocks.

Some growth stocks are very overpriced

Last but not least, there's the simple matter of valuation. The NASDAQ-100's P/E ratio — 29 — is pretty high right now. It's not the highest it's ever been, but it's up there. And individual growth stocks are even more expensive than the NASDAQ-100 is.

Take **Shopify** (TSX:SHOP)(NYSE:SHOP) for example. It's, by all accounts, a great business. It has high revenue growth, high profit margins, loads of positive momentum, and more. It also has celebrity users, valuable industry partnerships, and other soft factors going for it. But if you look at its valuation multiples, they are just unbelievable.

SHOP trades at 199 times adjusted earnings, 49 times GAAP earnings, 38 times sales, and 15 times book value. That's so expensive that the company would need to grow at high rates for a long time to be worth it. And while SHOP's 46% revenue growth rate is solid, it's down from the 90% growth it was cranking out in 2020. So, there is some real deceleration here that could pressure on those multiples.

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