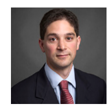
Navigating a Challenging Environment for Growth Stocks

We are positioned relatively defensively amid rate headwinds

May 2022

KEY INSIGHTS

- Large-cap growth stocks have struggled as Russia's invasion of Ukraine has compounded interest rate and inflation fears.
- Our price discipline led us to miss out on some of the market's most highly valued stocks over the past couple of years but has been a tailwind recently.
- We remain positioned relatively defensively as we expect growth stock valuations to move back more in line with longer-term averages.



Taymour Tamaddon
Portfolio Manager, US Large-Cap Growth Equity Strategy

While multiyear gains for large-cap growth stocks were fueled in part by innovation and earnings growth, a highly accommodative Federal Reserve and strong investor sentiment propelled segments of the market to extreme valuations. To date in 2022, many growth stocks have undergone a sharp correction driven by rising interest rates, inflation, and the Russian invasion of Ukraine.

T. Rowe Price has been investing in growth stocks since 1950, and our total large-cap growth equity assets under management exceed USD 343 billion (as of March 31, 2022).[1] Our extensive U.S. small-/mid-cap and non-U.S. research and portfolio management resources further complement our large-cap growth investing activities. Our experience shows that companies positioned to exploit change are among the most durable growth investments.

Taymour Tamaddon's investment experience began in 2003, and he has been with T. Rowe Price since 2004. Prior to this, Taymour was employed by Amazon.com in the areas of finance and merchandising and was previously employed by Booz Allen Hamilton as a consultant. Taymour earned a B.S., cum laude, in applied physics from Cornell University and an M.B.A. from Dartmouth College, Tuck School of Business, where he was an Edward Tuck Scholar with high distinction.

In this Q&A, Taymour discusses the current environment for large-cap growth stocks and his outlook for the asset class.

[1] The combined U.S. Large-Cap Growth Equity assets managed by T. Rowe Price Associates, Inc. and its investment advisory affiliates.

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Q: How would you summarize the market environment for growth stocks?

The last five years have been unprecedented in many ways. Over that period, large-cap growth stocks have seen their strongest returns since the late 1990s. The Russell 1000 Growth Index has also become highly concentrated. At their peak last August, the top five stocks by market capitalization accounted for nearly 40% of the index. Meanwhile, expanding multiples[2], rather than earnings and cash flows, have driven most of the index's appreciation. In sum, the market has been through a highly unusual period in which multiple appreciation has been driving the preponderance of the strong returns of a very concentrated index.

Q: How has this environment affected your investment approach?

We focus on estimating a company's growth rate, durability, and growth potential—and correspondingly spend much less time thinking about how its multiple might evolve. This is based on our belief that the biggest durable advantage you can have as an investor is correctly analyzing a company's potential earnings and free cash flow growth.

As part of this process, we develop three-year price targets for a stock, which helps prevent us from selling a position either much too early or much too late. Many large-cap growth stocks have well exceeded our price targets in recent years, encouraging us to sell and leading us to miss out on some of their spectacular gains.

Q: How is Russia's invasion of Ukraine likely to affect growth stocks?

At the start of 2022, I was hopeful that inflation would moderate meaningfully in the second half of the year, but I now think the increases in oil prices and other commodities following Russia's invasion are likely to keep it elevated for the duration of 2022. Many executives are telling me that they plan to implement additional price increases, if they haven't already.

The war is also going to have an impact on consumer confidence and, therefore, spending. The war is already weighing on consumers in Eastern Europe, of course, but we're also seeing early signs of an impact on consumer attitudes in Western Europe. How it will affect the U.S. consumer is harder to gauge given that year-over-year comparisons are already muddied by the stimulus checks sent out in the spring of 2021.

Q: What is your outlook for the market given these headwinds?

I envision two scenarios. In the first, investors anticipate a coming recession as inflation persists and the Fed reacts, meaning valuations could continue to compress over the next three to six months.

In the second, the Fed engineers a soft landing, raising rates enough to cause inflation to decelerate but not so much to harm the economy. In this scenario, valuations may recover a bit from current levels and growth stocks could do pretty well over the next 12 to 18 months. But we would still expect growth stock valuations to normalize sometime over the next three years—keep in mind that, even after the recent pullback, aggressive growth stock valuations are still sitting at roughly 2019 levels. Exactly when and how quickly is very difficult to predict, however.

[2] As typically defined by the multiple of a stock's price relative to the company's earnings or book value per share.

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