Navigating a Tough Environment for Growth Stocks

Amid volatility, focus on what drives stocks over the long term.

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KEY INSIGHTS

- The outlook for inflation and interest rates appears likely to drive markets and the economy in the near term.
- Investors could be tripped up by the prevailing uncertainty and lose sight of long-term opportunities in growth stocks.
- We focus on the rare companies that we think can sustain a high level of earnings and free cash flow growth. Those qualities should matter over the long run.

The first three quarters of the year were painful for many asset classes. Growth stocks especially were hit hard. Stubbornly high inflation, which reached levels last seen in the late 1970s and early 1980s, and the Federal Reserve increasing interest rates in response were key headwinds. Both inflation and rising interest rates erode purchasing power and, as a result, tend to pressure stocks and bonds. Russia's invasion of Ukraine, an energy crisis in Europe, and the lingering effects of the worst pandemic in more than 100 years also complicated matters.

Further volatility could be in the cards for stocks as the effects of inflation and tightening monetary policy filter through to the economy and corporate earnings.

In our efforts to add value for clients, we remain focused on those rare companies that we think, near-term challenges aside, can sustain a high level of earnings and free cash flow growth. Those qualities should matter over the long run because a company's stock tends to follow the financial performance of the underlying business.

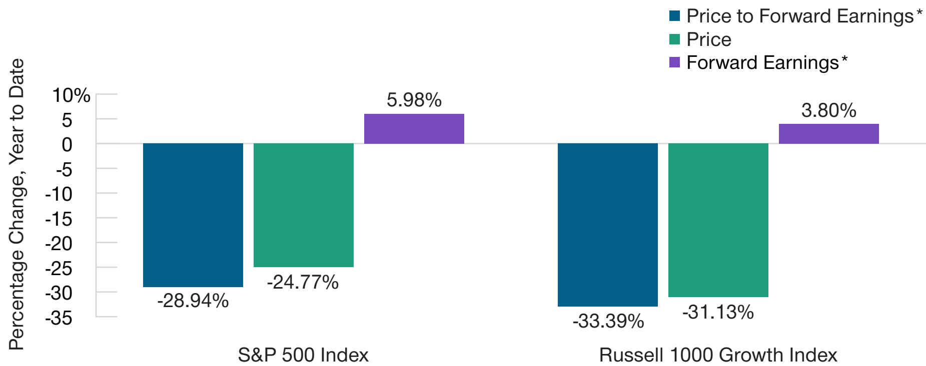
Inflation and Rising Rates Pressure Valuations and Earnings

Inflation and rising interest rates tend to pressure asset prices by reducing the present value of future cash flows. Growth stocks have typically exhibited greater sensitivity to these factors because investors have demonstrated a willingness to look further into the future when evaluating a company's prospects. The strong runup in growth stocks during the pandemic may also have made them more vulnerable in a pullback.

Much of the pronounced weakness in growth stocks and the broader market has stemmed from valuation compression, as opposed to a deteriorating outlook for corporate earnings (Figure 1).

Breaking Down the Breakdown in Stocks

(Fig. 1) Bulk of weakness has come from valuation compression



As of December 31, 2021, to September 30, 2022.

Past performance is not a reliable indicator of future performance.

*Uses next 12 months data for earnings. Earnings estimates are used because the stock market tends to be forward-looking in nature.

Source: T. Rowe Price analysis using data and analytics provided by FactSet Research Systems, Inc. All Rights Reserved. (See additional disclosure for Standard & Poor's and FTSE/Russell.)

Actual outcomes may differ materially from estimates.

> Growth stocks could return to favor when inflation appears to be trending lower and the Fed could slow the pace of rate increases.

Depending on the duration and magnitude of the Fed's rate-hiking program, the price portion of the price-to-earnings multiple could remain under pressure.

On the positive side, this leg of the level-finding process seems to be farther along. Growth stocks could return to favor when inflation appears to be trending lower and the Fed might slow the pace of rate increases.

Inflation and Fed policy should also shape the outlook for the economy and corporate earnings, which, in turn, could drive volatility. By increasing interest rates, the central bank seeks to tame inflation through higher borrowing costs, which can slow the economy by prompting consumers and businesses to curb spending and investment.

The big question is whether the central bank can engineer a soft landing for the economy: a goldilocks environment where inflation is not running too hot and growth is not running too cold.

Healthy employment trends and consumer balance sheets in the U.S. suggest that we may experience a recession of a magnitude typical for the business cycle—as opposed to something akin to the 2008–2009 financial crisis. Still, we need to be wary of the potential worst-case scenario: an environment with elevated inflation, higher unemployment, and stagnant economic growth. The Fed faces a tough challenge in that the effects of its interest rate hikes take time to show up in the economic data, potentially increasing the risk of tightening monetary policy too far.

Not all companies will be affected equally by an economic slowdown. Growth stories that are less sensitive to the economy could become more appealing on a relative basis.

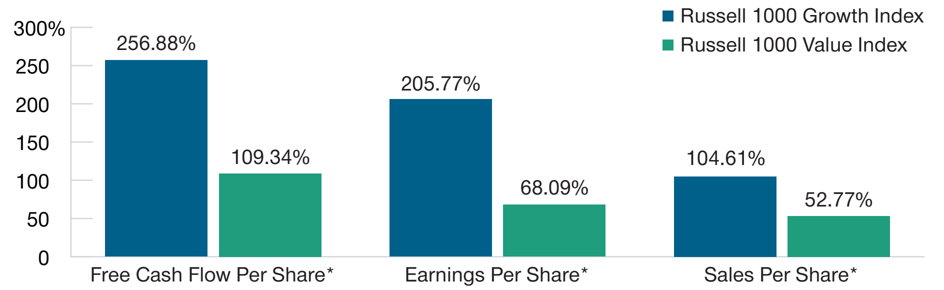
Balancing the Short Term and the Long Term

What gives us confidence in growth investing over the long term? The extended runup in growth stocks that occurred in the aftermath of the global financial crisis was supported by meaningful increases in free cash flow per share, not just expanding valuation multiples (Figure 2).

We believe that some of the powerful trends that have driven outsized growth

Growth Stocks Have Exhibited Strong Fundamentals

(Fig. 2) Cumulative change in key financial metrics



June 30, 2007, to September 30, 2022.
Past performance is not a reliable indicator of future performance.
*Per share free cash flow, earnings, and sales are 12-month forward estimates.
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remain intact and should have room to run, even if these stories may seem old hat to many investors.

Consider the shift from data centers that information technology (IT) departments build and administer internally to cloud-based infrastructure maintained by a third party. This migration started almost 15 years ago but remains at only 10% to 15% of the addressable market, by our estimates. The move to cloud-based platforms and infrastructure could be a multi-decade growth story.

Transitioning data centers and workloads to the cloud saves businesses money by lowering their IT costs. And these investments can also result in meaningful efficiency and productivity gains. The pandemic underscored this point, as employees shifted to remote work seamlessly. Access to low-cost computing power via subscriptions that can be scaled up or down also tends to encourage innovation. In our view, this potentially durable tailwind may benefit established companies, including Microsoft and Amazon.com.

We were big believers in the transition to electric vehicles (EVs) a decade ago and regard this trend as potentially one of the most compelling growth stories of the next 10 years. The size of the market could be significant. Even with a pandemic and significant supply chain disruptions, demand for light vehicles in 2021 exceeded 17 million units in North America and totaled more than 78 million globally.[1] The tailwinds for EV demand appear to be strengthening, thanks to supportive government policies and growing awareness of the need to reduce greenhouse gas emissions.

But exposure to a compelling growth trend is not enough. A nuanced understanding of individual companies and industries is critical. We favor EV-focused carmakers that we believe offer compelling product lineups, already have models rolling off their assembly lines, and lack the financial and operational baggage carried by legacy auto companies.

Long-term tailwinds aside, investors must also account for some sensitivity to the economic cycle. Therein lies the potential risk in this environment—and the potential opportunity. The market is often quick to respond to the pace of

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earnings or cash flow growth in the near term. However, the market may struggle to gauge the potential durability of this trend over a longer time frame.

Potential Opportunities Beyond the Biggest Stocks

At the end of September, the five largest companies by market cap accounted for roughly 22% of the S&P 500 Index and 38% of the Russell 1000 Growth Index.[2] This high level of concentration means that large-cap growth investors' relative performance often hinges on making the right call on a handful of the largest stocks: Apple, Microsoft, Amazon.com, Tesla, and Alphabet (Google's parent company).

We remain very thoughtful about our positioning in the established tech giants. Key considerations include:

- Valuations,
- How effectively they are investing in growth initiatives,
- The levers they could pull to create value, and
- The extent to which they are returning capital to shareholders.

These entrenched businesses have advantages of scale, but constant due diligence is required to evaluate whether they can overcome the law of large numbers. Achieving a robust rate of earnings or cash flow growth becomes more challenging off a large base.

Albeit painful in the near term, the difficult economic environment should expand the opportunity set by creating some coiled springs, or names where the mismatch between valuation and potential growth may create a compelling risk/reward profile.

In managing the strategy, we are always on the lookout for companies that we believe are responding to the difficult environment in ways that can create value over a longer time frame.

Investors need to remain patient amid the prevailing uncertainty to avoid being tripped up and losing sight of the longer-term opportunities in high-quality growth stocks.

T. ROWE PRICE BEYOND THE NUMBERS

Hitting the Road

Meeting with management teams from private and public companies and visiting their facilities are critical to our due diligence.

Nothing beats going on the road to meet management teams and visit their facilities. We have stepped up our travel as we search for insights and opportunities. Being on the ground helps us to build an understanding of a company's culture, operational prowess, and other intangibles that we believe can be important to potentially durable growth.

We are finding more opportunities in the public markets. However, the challenging environment seems to have made private companies more willing to meet, even if they are not actively seeking funding. These visits can provide useful insights into how an industry might be evolving and possible future areas of disruption.

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MAIN RISK

The following risks are materially relevant to the portfolio:

Style risk—different investment styles typically go in and out of favor depending on market conditions and investor sentiment.

GENERAL PORTFOLIO RISKS

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

ESG and sustainability risk—may result in a material negative impact on the value of an investment and performance of the portfolio.

Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

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