MV CAPITAL MANAGEMENT

Weekly Market Flash

Anatomy of a Bubble

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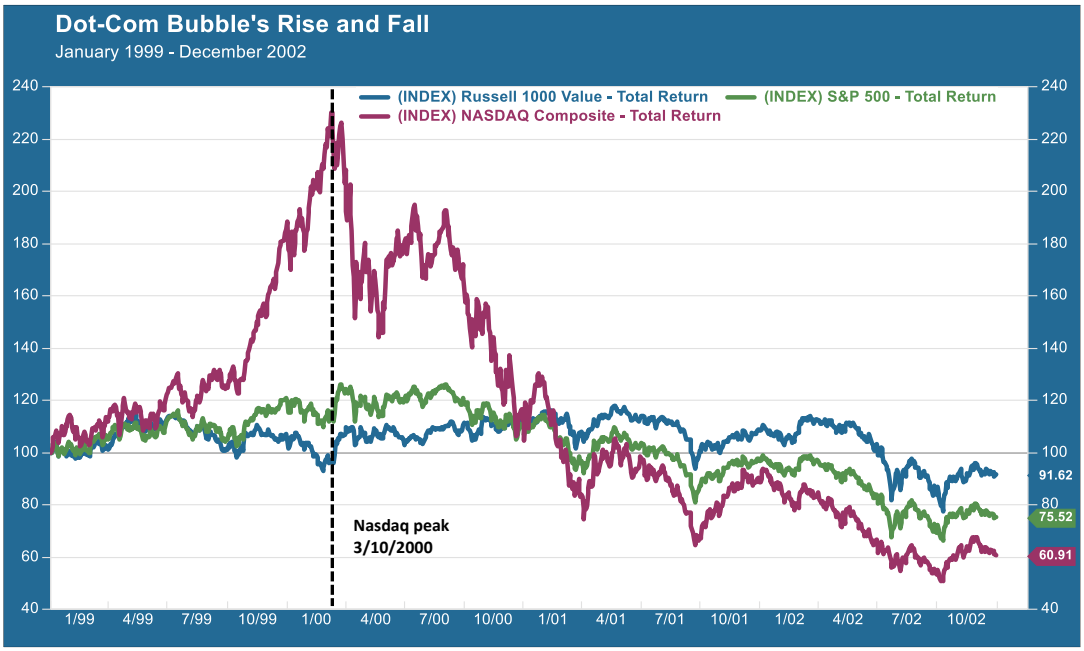
Is it finally happening? Investors this week seem to be having a nasty case of the March 2000s. That was the peak of the famous dot-com bubble, when the tide went out on the high-flying Internet stocks that had been powering stock indexes, and none more so than the Nasdaq Composite, home to the lion's share of those tech darlings. The Nasdaq has been feeling some déjà-vu vibes this week. After touching its latest year to date high on October 7, the index finished the day Thursday around six percent below that high. Meanwhile, investors flocked into safer spaces, with both the S&P 500 equal-weight index and various measures of value stocks helping to offset the pullback in the broad-based AI trade.

The latest excuse for the reversal of fortune in the AI trade appears to be a sequence of earnings reports that, while mostly showing continued double or triple digit growth in revenues, fell short of the very elevated expectations bar observers had going into the earnings calls. Of course, we have been here before, and very recently at that. AI-related shares fell sharply during the middle of the summer, only to recover and resume their upward trajectories. But the market chatter this time is different – there is more of a sense that time may be close to up for some of the flimsier companies in the mix. So let's take a closer look back in time at that March 2000 madness, and see if there are any insights to be gained.

The Stocks That Fell to Earth

The chart below illustrates the run-up in tech stock prices that turned manic in the last few months of 1999 and then abruptly fell to earth.



Source: MVF Research, FactSet

As the chart shows, the drama was all about the tech. The broader S&P 500 (green) and particularly the comparatively boring companies that made up the Russell 1000 Value index (blue) followed a more

subdued trajectory for a number of months after the tech collapse, and only turned more structurally negative in the latter part of 2001 as the overall economy headed towards a recession. At the end of it all, four years after it began, the Nasdaq was about 40 percent below where it was at the beginning of 1999. The S&P 500 was around 25 percent lower while the Russell 1000 Value was just a bit more than 8 percent off the 1/1/99 starting point.

The Rhymes of History

History doesn't repeat itself, but it does rhyme from time to time, as the well-worn adage goes. The tech bubble's bursting was the product of a number of different factors, including valuation metrics like price-to-sales and price-to-earnings at highs never before seen in US stock market history, a large number of companies coming into the market via initial public offerings with questionable business models, and the expiration of lock-up periods for the private investors who had gotten into these companies early in their venture capital days.

Smaller, vulnerable companies are also in the crosshairs today. The poster child for this cohort is CoreWeave, a so-called "neocloud" company that rents out important components of AI infrastructure like Nvidia's high-performance Graphics Processing Units (GPUs) as a service to other companies – basically a software as a service (SaaS) model focused exclusively on AI tools. CoreWeave's shares are down nearly 50 percent from their high point, and some of its outstanding debt has entered into distressed territory.

Debt, Lots of Debt

Debt was not really a central theme of the dot-com bust-up, but it very much in focus today. One of the big negative takeaways from this week's batch of earnings reports was just how much the capital spending binge on AI infrastructure has eroded the cash flow positions of the large hyperscalers, leading them to need tens of billions of dollars in debt financing. Of the four hyperscalers – Amazon, Alphabet (Google), Meta and Microsoft – only Microsoft is still free cash flow-positive. All of them have reiterated their plans to keep on spending as they seek long-term advantage in what they expect will be the central defining strength of the US economy for years to come. But there is still a great deal of uncertainty about whether this massive amount of investment will ultimately generate sufficiently positive returns, and that uncertainty was very much on display this week.

Beyond the Bubble

Whether or not we are at that bubble-bursting juncture today – and that is entirely debatable – it is wise to remember that the dot-com bubble had a second life after the carnage of the 1999 – 2002 period. Yes, plenty of companies in the mode of Pets.com went out of business, never to be seen again, but others prospered mightily. All those high-flying projections of the Internet market – the eyeballs, the demand for fiber optic capacity and all the rest – those eventually came true and then some. If artificial intelligence does become embedded in all facets of the economy – and there is reason to ascribe at least a reasonable probability to that outcome – then it will be important for one's portfolio to have exposure to it.

Portfolios positioned for the long term need to look beyond the factors that affect short term performance. But the short term is likely to continue to be a bumpy ride.

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