Private Bank

CIO Strategy Bulletin

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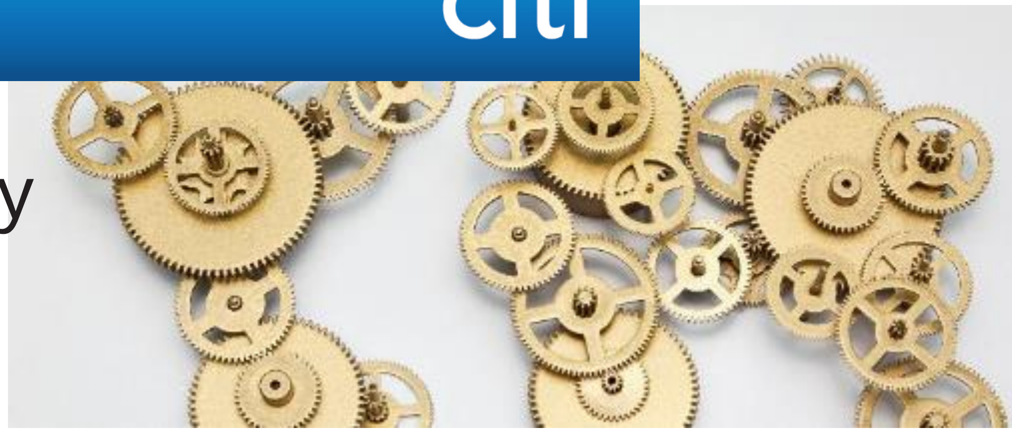

The Danger of “Growth at Any Price” and What to do About It

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Summary

- There is talk of a bubble in technology stocks. Still, this is not a “Dot Com” repeat. There is no tech sector recession in sight as there was in 2000. That said, in 2020 we have seen a “lift-off” where market caps are trending upwards faster than free cash flow and profitability.
- Fundamentally strong tech companies may end up a victim of their own success. Before the pandemic ends, investors must assess the sustainability of growth for many firms. Rising Free Cash Flow (FCF) and profitability may be elusive relative to rising expectations.
- We recommend an analysis of US large cap US tech-related holdings within portfolios to avoid total holdings exceeding 20% of portfolio wealth. For those with significant overweight we propose several strategies including selling the right to purchase a portion of the shares as an immediate income source, that can be used for further portfolio diversification.
- **Let the Reporting Games Begin**! Traders seeking outperformance from 2Q EPS results have a short-term focus. They often look to position themselves ahead of positive EPS surprises, strong guidance, and then sell on profitable trades. For long term investors we note that EPS surprises and returns over a mere 90 day investment period are *barely correlated*.

Is This Another “Dot Com” Bubble?

There is talk of a bubble in technology stocks again, with references to the 1995 to early 2000 period when the NASDAQ composite index rose 570%. The ten most valuable stocks in the S&P 500 and the Russell 1000 benchmarks now account for 30% and 26% (respectively) of these market indices and the five largest have reached a record high share for modern times. The ratio of the NASDAQ 100 to the Russell 2000 is at its highest level since the dot-com bubble burst (see Figure 1).

During prior periods when revenue growth was scarce over the past 20 years, software and other tech companies were generally more highly valued for the persistence of their revenue growth. At this moment, however, almost all software valuations are trading higher that their expected growth rates according to Citi Research (Do Unprecedented Times Justify Unprecedented Valuations? 7/9/2020).

Figure 1: NASDAQ 100 at Highest Level Relative to Russell 2000 Since the Tech Bubble

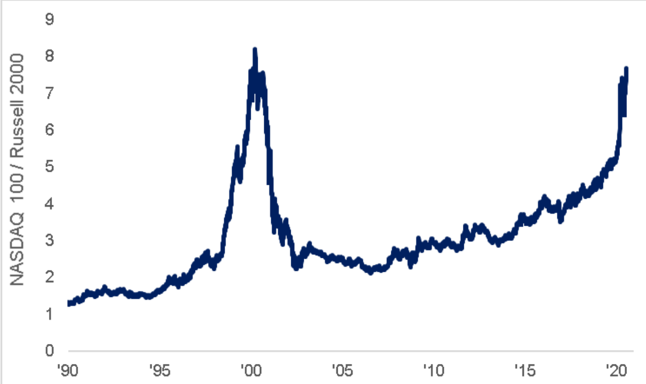
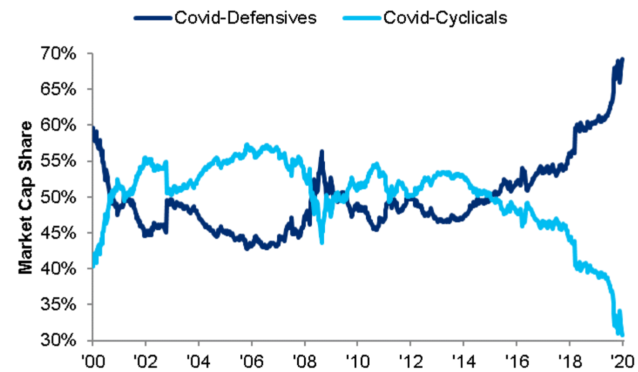


Figure 2: S&P 500 Covid-Cyclicals vs Covid-Defensives



COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex-Amazon
COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities, Amazon
Sources: Haver Analytics and Factset as of July 10, 2020. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

And there is a retail party going on. Citadel Securities noted that retail investors now account for about 25% of stock-market activity on peak trading days (Business Insider 6/17/2020) and Robin hood, the trading app popular with millennials, has opened 10 million new retail accounts. Finally, tech's rise is not a 2020 phenomenon. In 2019, Apple and Microsoft rose by 86% and 55% respectively and together accounted for about 15% of the gain in the S&P that year.

As we have written about before technology stocks are largely responsible for the marked outperformance of COVID-defensives shares during this pandemic period (see Figure 2 above). There are good reasons for their leadership. Significant trends in ecommerce, digital communications, the virtual office and cloud usage were sharply accelerated by the social impediments of the pandemic. Amazon, Target, Walmart and Shopify – to name just a few beneficiaries – are now penetrating their client base at a rate that may have taken four years or more to achieve and they did this in four months.

Entertainment is now largely a digital experience. YouTube or Netflix take you to museums or a tour of Roman ruins. The same is true for unstoppable trends like digital payments as cash is worthless during COVID. All of this would have happened anyway, but it did so at light speed since March. The future of entertainment arrived early and everyone is experiencing it.

There are other major macro reasons that tech stocks and defensive shares more broadly are doing so well. Consider government macroeconomic policies designed to offset an economic collapse: Zero interest rates, demand support measures, and credit expansion were implemented with lightning speed by governments that one thought could not act in unison. This firepower has been unprecedented with expenditures of more than $10 trillion committed to getting the world over the financial impacts of COVID-19.

The Value of Indices and of Not Timing Markets

Before we continue and address the primary question of this week's Bulletin, it is essential to make two obvious, essential points and one more nuanced observation. The value of indices is that they automatically reflect the changing economy. By owning passive index strategies, you do not need to rebalance from old industrials to digital leaders or from value to growth. And by owning them and not trading them, investors will earn the return of the overall economy. We think staying invested makes perfect sense, even if it appears indices are somewhat overvalued at any moment in time.

That said, failing to question an extreme market trend – as we saw in the late 1990s – can leave the average investor in a bad place. If portfolios are overexposed to a sector and especially to leaders that have outsized gains, actions to counteract such performance driven over-weights are recommended. That is why Citi Private Bank re-ran its Strategic Return Estimates mid-year. Our forecasted returns for US stocks have risen as of April, but our forecasts for non-US stocks have grown to an even greater degree. (Figure 3).

Figure 3: Updated Strategic Return Estimates

	2020	2020 mid-year*
Higher SREs		
Global Developed Market Equity	5.10%	6.20%
Global Large cap equity	4.40%	5.50%
Global Small/Mid cap equity	9.20%	11.60%
Global Emerging Market Equity	10.90%	11.70%
High Yield	3.50%	5.90%
Global Emerging Fixed Income	4.70%	6.20%
Lower SREs		
Global Developed IG Fixed Income	2.10%	1.10%
Developed Government Bonds	1.90%	0.70%
Developed Corporate Bonds	2.70%	2.60%
US Cash	1.80%	0.60%
Hedge Fund	5.30%	4.40%

*Preliminary directional SRE changes based on returns through 30 Apr 2020.
Source: Citi Private Bank Global Asset Allocation team. 2020 SREs based on data through 31 Oct 2019. Strategic return estimates are no guarantee of actual results. Past performance is not indicative of future results. Shown for illustrative purposes only. Strategic Return Estimates (SRE) based on indices are Citi Private Bank's forecast of returns for specific asset classes (to which the index belongs) over a 10-year time horizon. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes utilize a proprietary forecasting methodology based on the assumption that equity valuations revert to their long-term trend over time. The methodology is built around specific valuation measures that require several stages of calculation. Assumptions on the projected growth of earnings and dividends are additionally applied to calculate the SRE of the equity asset class. Fixed Income asset class forecasts use proprietary forecasting methodology that is based on current yield levels. Other asset classes utilize other specific forecasting methodologies.

Are Our "Unstoppable Trends" Mispriced?

Amazon, which dominates e-commerce, has evolved into a far more integrated technology logistics enterprise than a mere digital retailer. It charges a "membership fee" and provides "free delivery", while owning an end-to-end ecosystem that allows you to speak to order, listen to any song and watch original entertainment content, all while providing cloud services to its merchants. That's remarkable and revolutionary. The Covid economy - with its requirement for remote life and work and with social distance – requires digitization. As an example, e-commerce retail sales have jumped to 18% of total US retail merchandise sales. "Non-store" retail sales growth near 11% has been 4.5X the growth rate of the remainder of retailing. This occurred over the past decade, but has been "supercharged" by Covid (see figure 4).

In 2020, Amazon's shares have risen to an aggregate value of over $1.5 trillion from $900 billion at the start of the year, gaining the market cap of entire companies like American Express on any given day. We fundamentally see no return of market share to traditional retailers or a broader deterioration in Amazon's wider business. Though its shares may well rise more in the coming year, its annualized return of 120% (as seen year-to-date) is unsustainable.

Figure 4: "E-Commerce" (Non-Store Retailers) as % of Total US Retail Sales

Sources: Haver Analytics as of July 8, 2020.

Still, this is not a "Dot Com" repeat. Unlike the late 1990s, when hundreds of tech "concept" firms with little immediate profit zoomed to more than 15% of US market capitalization, today's tech firms are large, highly profitable conglomerates. Some have called them "ecosystems" over which great swaths of commerce depends. This matters for broad portfolios as the top 5 US tech-related shares are closing in on 15% of total *world* market capitalization. Thus, even highly diversified investors across world asset classes, will have a sizeable share of their wealth in these few US firms. But there are rising warning signs. Their dominance has raised competitive concerns in the US and regulatory actions in the European Union. How these few firms are regulated with respect to competition is an important long-run question for investors.

We therefore think that some "unstoppable trends" are *on their way* to becoming meaningfully mispriced (see figures 5-6). When firms grow, increase their cash flows, and improving balance sheets, their "book values" grow. But as figure 5 shows, relative to that book value, tech firm valuations are rising faster than almost all other firms. This means that their growth in the future is expected to rise even more quickly. So the question we must ask is whether that future growth is likely given that the pandemic and its unusual impacts will end.

Figure 5: S&P Industrials vs Information Technology Price/Book Ratio

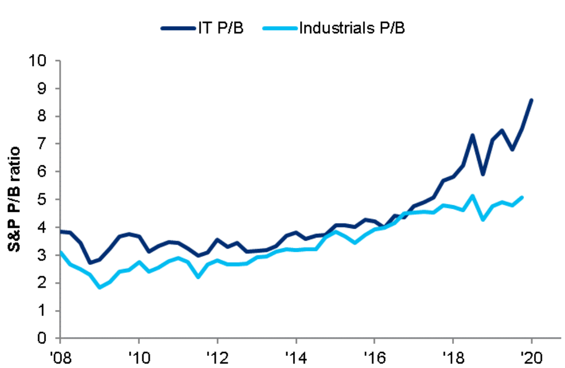
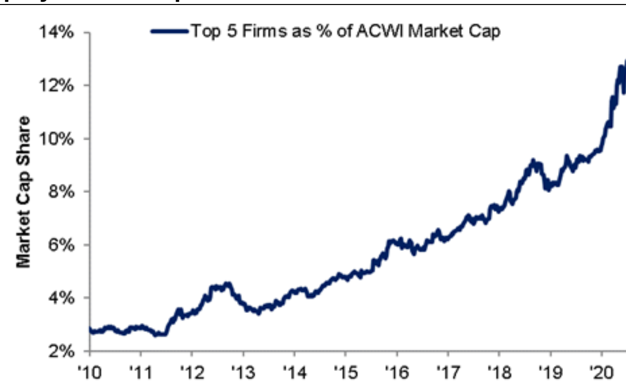


Figure 6: US's Top-5 Tech Related Stocks as % of Global Equity Market Capitalization



Sources: Haver Analytics as of July 8, 2020. Note: 2Q 2020 P/B data hold book value constant at 1Q 2020 level. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

The History of Bubble Making

There are many lessons from history that inform bubble making and bubble bursting. The 1990s – particularly the second half - had been one of strong economic growth driven by technological change. High real interest rates among other factors constrained many activities away from the tech boom itself. As the 1990s ended and technology investment spending collapsed from its own excesses, interest rates were taken down with it. In 2001-2002, investors were therefore quite skeptical that a new US recovery could find "leadership" from any sector. Ultimately, a real estate boom – and eventual bust – filled the void (see figures 7-8).

Figure 7: Tech Collapse of 2000-2002…

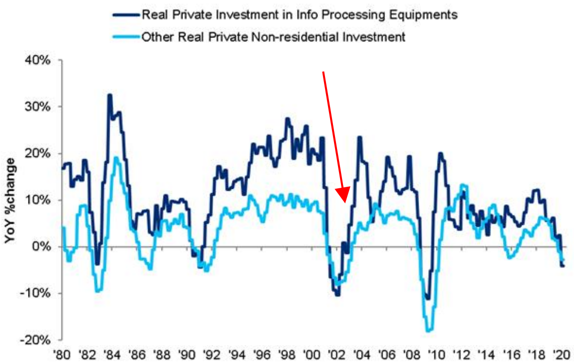
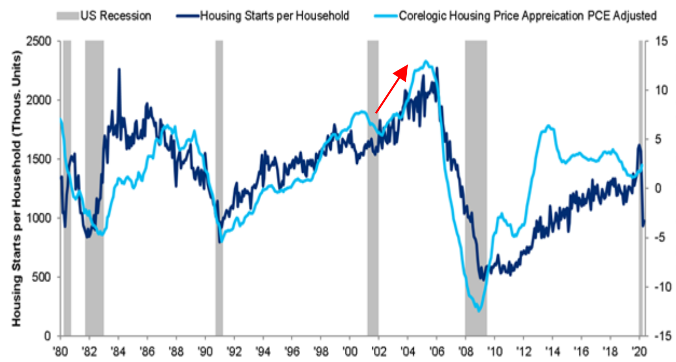


Figure 8: …Helped Drive 2002-2006 Housing Boom



Sources: Haver Analytics as of July 8, 2020.

The 1990s tech bubble was caused by a confluence of events, including many that were related to the development and adoption of technology itself. Business fundamentals were very positive. "The Internet" became a highly useful tool for all. Building a web presence became an existential business priority. Business "mobility" changed work as we know it. Those of us over 40 years old likely remember our first Blackberry with great fondness. The information age had truly arrived.

At the same time, there were numerous fundamental excesses – millions of miles of unused fiber optic lines preceding the data to fill them. Multi-billion dollar valuations for hundreds of firms hinged on impractical ideas. Huge premium valuations were paid for tech acquisition targets, while employee stock option compensation "mistakenly" accounted for as "free."

There was also an external and unexpected catalyst that helped to drive valuations to the point of great overconfidence and excess. This was a massive inflow of foreign savings into US assets from collapsing emerging markets, most clearly in Asia (see figure 9).

Figure 9: Asian Crisis 1997-1999 Spurred On Tech Boom…

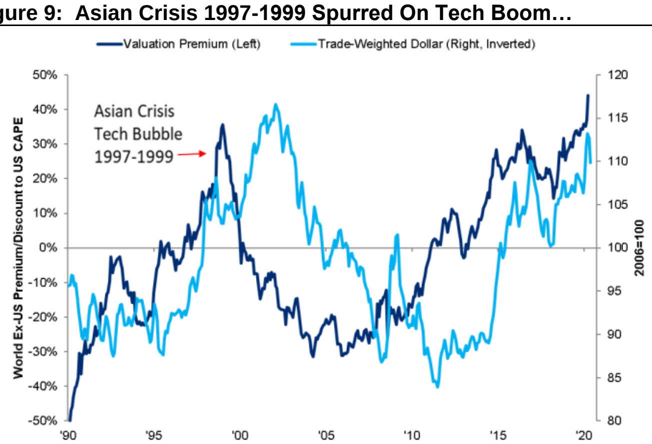
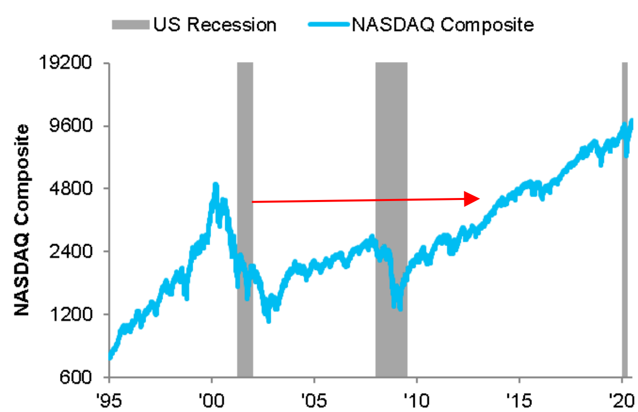


Figure 10: …Which Took a More Than a Decade to Recover



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Once again, the Federal Reserve had eased monetary policy. It had feared the risks of an imported crisis while domestic conditions were still strong. The US IT sector went on to a bubble and bust. Valuations were so high that for IT as whole that a lost decade of returns followed (see figures 10).

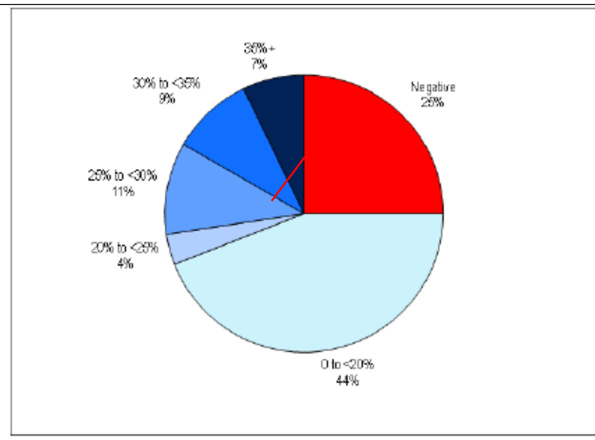
Bubble, Bubble, Does Covid Spell Trouble?

Present fundamentals support a premium valuation of the “digitization” assets that are helping the world adapt to Covid. There is no tech sector recession in sight as there was in 2000 (see figures 11-12). Apart from the games played around earnings releases (see section below), there is no fundamental reason for an immediate correction.

But here is how a fundamentally strong sector may end up a victim of its own success. Free cash flow and profitability will matter more and more as the pandemic grows and finally ends. What we have seen in 2020 is a “lift-off” where market caps are trending upwards faster than profitability (see figure11). And we can also see that a sizable number of software firms are not generating FCF and only a few are doing so at sustainably high levels. (figure 12.) Investors must, therefore, assess the sustainability of growth for many firms and rising concerns that rising FCF and profitability may be elusive relative to rising expectations.

Figure 11: S&P IT Sector Market Cap and Profit Share of S&P 500

Figure 12: ’19-21 FCF Estimates of Software Firms



Sources: Haver Analytics as of July 8, 2020 (left) and Citi Research, Do Unprecedented Times Justify Unprecedented Valuations? 7/9/2020 (right). Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Some firms can grow and become dominant without a focus on future profitability. If one thought that Tesla makes the world’s best vehicles, the vehicle of the future, then it is not so hard in our view to understand why it could achieve the highest market capitalization in the global autos business, even if this requires loss-making investments for a significant period. That’s precisely the path Amazon followed to revolutionize retail. These fundamentals do not imply overvaluation on a traditional price/earnings basis. But to pull off this rare feat, such companies require continued technological dominance and vast market share gains to come. Investors will not always give tech firms their blind confidence when it comes to meeting the growth targets necessary to achieve long-term profitability and “grow into” massive valuations. For many large tech firms, market share gains cannot be achieved indefinitely without some slowing toward the overall economy’s growth rate.

Other highly valued firms are more experimental. Some will succeed in markets and contribute greatly to the economy by their innovation. Yet, there are a few not-so-small “concept” firms where business models are failing or will fail. Other smaller tech firms with rapid growth rates and high valuations will simply lose to their competitors. This means the aggregate market cap for the sector will not gallop ahead.

As the 1990s tech bubble showed, much of the technological progress imparted lasting value on the economy despite market turmoil. The firms that survived that period are now some of the world’s largest and most profitable. Then as now, investors are prone to making mistakes in valuation while chasing markets ever higher before experiencing negative returns.

What to Do With Your Zooming Portfolio

US large cap shares are the largest asset class within our asset allocation framework and should be over 20% of a moderate-risk portfolio that includes alternatives such as private equity, real estate and hedge funds. The allocation to IT shares – and the IT-related shares within other sectors including Consumer Discretionary and Telcos could be as much as half of that allocation.

Furthermore, as part of our Investment Philosophy and our associated asset management framework, we’ve designated that no more than 15% of a total investment portfolio be classified as “opportunistic” for moderate-risk investors. For those with higher risk tolerance or those taking very well measured and understood risks, the share could be somewhat higher.

We would therefore suggest an analysis of client large-cap US tech-related holdings to avoid allocations that exceed 20% of portfolio wealth. For those with portfolios overweight to tech, there are several strategies to consider depending, in part, on your level of experience and risk tolerance:

- The first is to sell some of these positions and invest the proceeds into our other recommended over-weights in cyclical shares, including industrials, small- and medium-cap stocks and certain non-US markets. One could even move into health care shares that have a much higher potential of sustained profitability given demographics, though these have also performed well in 2020.
- A second strategy could provide potential hedging and income opportunities based on your financial situation. This could provide an immediate income source and can potentially manage concentration risk. This income can be used to add diversification through other investments.
- Finally, there are ways to add diversification through capital markets products that can be designed to diminish overall technology sector risk.

To be clear, we do not want to eliminate the strongest growth opportunities from portfolios now. Please speak with your investment professional to determine which strategy may be suitable for your specific circumstances. But it is absolutely true that owning growth at any price is a bad strategy. As discussed in our 2019, 2020 and Mid-Year Outlook, "Digitization" is an Unstoppable Trend. While we recommend that clients maintain positions, we do not recommend that they exceed defined portfolio limits.

Second Quarter Results: Let the Trader Games Begin!

This week begins quarterly earnings reporting season, led by some of the big US banks Tuesday. For the S&P 500 as whole, EPS expectations are dismal, with profits expected to have fallen nearly 45% in Q2 (Figure 13). While the US economy in the calendar second quarter performed somewhat better than our early expectations, we would not be surprised if actual profits decline by 50% or more, driven by the outsized losses of a few firms.

The course of the virus and economic impact will still drive much of the variation in the economy during the year ahead, but we expect Q2 will mark the low for economic activity and profits. Large profit declines or losses are likely in sectors like energy and consumer discretionary (Amazon's earnings contribution to the sector is much smaller than its market cap share). Industrials firms are expected to post earnings at around 11% of 2019 levels – an 89% decline.

What would someone look for if they were planning to trade in and out of shares around EPS results and forward looking comments? COVID-Defensives like IT are likely to demonstrate their immunity to the shutdown. The wide divergence in the profits landscape by sector likely reflects the unique reality of this virus-driven collapse. "Digital disruptors" that are allowing the economy to cope with Covid have seen either minimal disruption or outright demand strengthening. Short-term sentiment is clearly bullish for the sector as we described above.

Market bears, meanwhile, have concentrated their downside bets on COVID-cyclical sectors like real estate, materials, and industrials (figure 14). Sufficiently positive surprises among these beaten down sectors could lead to short-covering rallies as investors would be forced to reprice less dire earnings expectations.

With that said, our analysis shows EPS beats and misses have an almost negligable correlation to how shares actually perform over periods of 90 days or longer. Firms with sustained profit gains tend to rise in value. Those with sustained profit weakness fall. "The Covid economy" represents more than just a short-term adjustment, but the pandemic is far from permanent. Hence, we prefer our investments to combine "unstoppable trends" - when appropriately valued - for long-term holders combined with tactical opportunities we see arising in "Covid cyclicals" for those willing to invest for 1-2 years.

Here are some Q2 earnings signposts:

- With just 20% of S&P 500 companies providing estimates of future profits after Q1, any resumption of typical guidance in the coming weeks could give investors more clarity on firms' roadmaps to earnings recovery.
- Asymmetric reactions to earning beats and misses are possible. Crowded shorts could see knee-jerk share price jumps in the event of strong beats, while crowded longs may face a higher bar for continuing to please investors.
- Given the negligible impact of EPS beats on broad index returns, we caution diversified investors against placing too much focus on individual earnings beats and misses, as the maturation of the economic recovery should continue to drive markets and ultimately future earnings over the medium-term.

Figure 13: Q2 Consensus EPS by Sector (YoY)

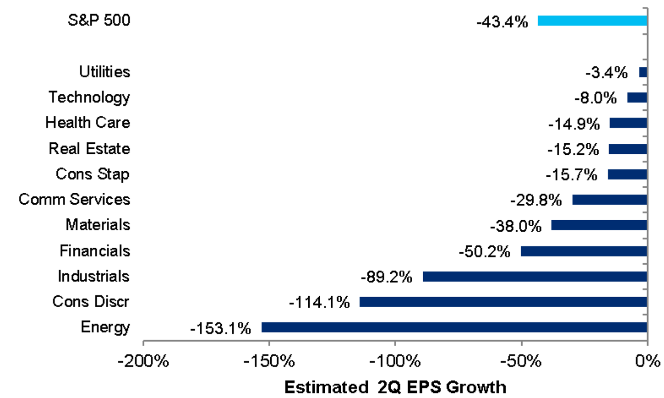
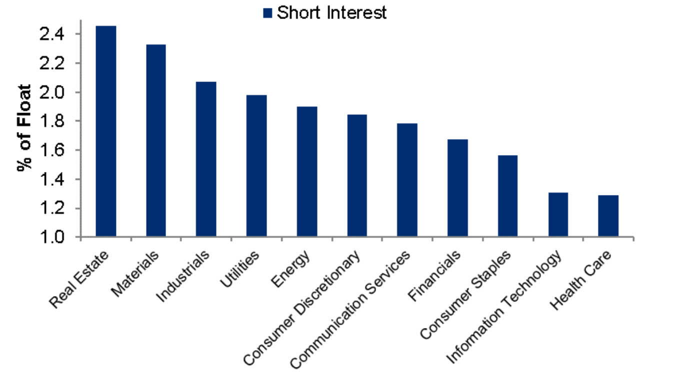


Figure 14: Short Interest by Sector



Source: Refinitiv as of July 7, 2020.

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