

CIO Strategy Bulletin

September 6, 2020



The 2020 Tech Growth Equity Summer Barbeque

David Bailin, Chief Investment Officer

Steven Wieting, Chief Investment Strategist and Chief Economist

Joe Fiorica, Head – Global Equity Strategy

Shan Gnanendran, Joseph Kaplan, Melvin Lou and Malcolm Spittler contributed

Summary

- Tech stocks are finally seeing a tiny bit of “selling pressure” after a run that has surpassed all expectations. Expect further volatility due to the Presidential elections and ongoing pandemic.
- The value of diversification for US-centric investors is going to be higher in the decade ahead. US equity valuations are at an historic high relative to others. As the world finds a true solution to Covid, this could provide a catalyst for performance in shares other than technology.
- Just as it is impossible to time markets, pick bottoms or tops, or predict election outcomes, it is not possible to know precisely when to diversify portfolios. Covid’s arrival has moved every asset price in the world. Covid’s departure will do the same. Extreme valuation differentials whether between COVID-defensives and COVID-cyclicals or between US and non-US equities are stronger indicators for action. Valuation extremes may not resolve tomorrow or next month, but capturing such moves is where portfolio “alpha” is found.

Balancing Near Term Performance and Investment Goals

Just what type of market are we in?

Tech stocks are finally seeing a tiny bit of “selling pressure” after a run that has surpassed all expectations, especially during a pandemic. Risk assets were reacquainted with gravity this past week as the Nasdaq 100 fell by 3.1%, though the index remains up 33.1% year-to-date. Cyclical sectors outperformed, with energy, financials, and real estate largely spared from Labor Day air pocket. And all of this occurred during a week when the employment report was quite positive. In August, 1.3 million net new US jobs were added 5 months after peak fiscal support. This also came in a month when seasonal adjustment makes a strong result difficult.

Expect further volatility. The US election season is in full swing, with three debates scheduled between September 29 and October 22. Having been unable to pass any additional stimulus measures following the expiration of federal unemployment benefits on July 31, Congress is currently engaged in negotiations to pass its annual budget that expires at the end of September. Meanwhile, it remains an open question whether virus cases can stay under control throughout much of the northern hemisphere as certain jurisdictions attempt to open schools amid an approaching flu season. Even with treatments on the horizon, economies continue to adapt to Covid reality. This means high levels of gross firing and hiring across industries, as well as continued substitution of goods from services.

But let’s step back. 2020 may turn out to be the biggest year for IPOs since 2014 when Alibaba went public. 111 companies have raised \$37.8 billion so far this year. That does not include Special Purpose Acquisition Company

(“SPAC”) investment vehicles. There have been 86 SPACs raised in 2020, a total of \$34.4 billion, including the \$4.0 billion by Bill Ackman’s Pershing Square.

What we are seeing is that investors want growth, in many cases *growth at any price*. Plunging interest rates have magnified the perceived value of returns driven by future growth over immediate income. The pandemic is also a large part of the story, reshaping the economy, while changing where growth is occurring. Work-from-home has pulled forward demand for the modernization of technology infrastructure. Companies that provide tools and solutions that make remote work faster and easier are thriving. That said, many are also unprofitable and their valuations are based on multiples of revenues and exponential revenue growth expectations.

An Apple A Day? (*)

The value of a whole portfolio can’t benefit as much as its best single holding. On August 19, Apple Inc. became the first US enterprise to achieve a \$2 trillion value. Even after falling 10% in the past three days, it retains a +\$2 trillion valuation.

Apple was founded 44 years ago and went public 40 years ago. Twice in the past 30 years, its equity fell more than 80% in value. Yet since its last decline of 82% ending in April 2003, the shares have returned 51,600% on price and 64,800% with dividends reinvested.

By the end of 2003, the bulk of Apple’s early investors didn’t hold their shares. The “tech wreck” period that ended the 1990s bull market left many technology shares deeply out of favor by investors. Apple was and is a great example of why market timing is a poor strategy. Since 2003, Apple -- the business, not the stock -- demonstrated fundamental outperformance, wrecking many competitors along the way.

Do You Suffer from Investor Myopia? See Your Doctor or Investment Counselor (*)

When returns of certain shares within portfolios are “off-the-charts” – think of the year-to-date gains in Tesla (+399%), Nvidia (+115%) or Amazon (+78%) – many investors start to hate their laggards and curse their diversification. “Investor myopia” sets in during even brief periods of very strong or very poor markets. This year, we’ve already had both.

With the Nasdaq up 14% since the beginning of August, this week’s “two-day sell off” brought the tech-focused index back to levels last seen just 12 days ago. We saw increased volumes in cash and options exchanges in what was to have been a quiet week ahead of a long weekend in the US. Signs of complacency in equity markets were everywhere. The VIX rose along with the stock market through August. Intra-stock correlations abated, signaling a sign of overconfidence in concentrated holdings. Short interest fell to very low levels for the strongest US market performers. (See Figures 1-3).

Figure 1: S&P 500 and VIX (Implied Volatility Index)



Source: Factset as of September 4, 2020.

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Figure 2: Low intra-sector correlation tends to encourage “off-benchmark” speculation

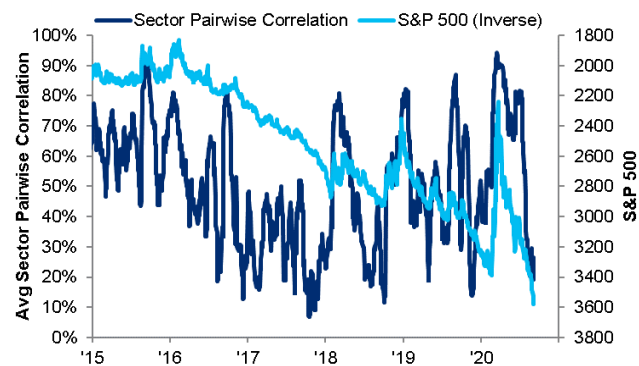
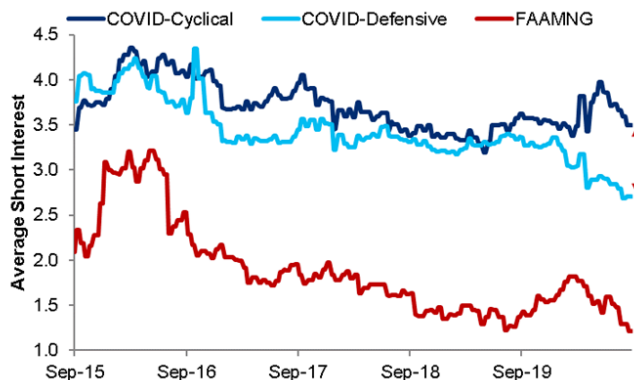


Figure 3: Falling short interest, especially among big tech



Source: Bloomberg and Haver Analytics as of September 4, 2020.

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FAAMNG: Facebook, Apple, Amazon, Microsoft, Netflix and Google.

COVID cyclicals: Financials, industrials, energy, materials, real estate, consumer discretionary ex-Amazon

COVID defensives: IT, healthcare, communication services, consumer staples, utilities, Amazon

The Momentum Principle

We are experiencing a period when circumstance and momentum have propelled certain industries to valuations that diverge powerfully between winners and losers, and exceed reasonable levels for the extreme winners. But unlike isolated systems, where momentum can be maintained due to the absence of external forces (i.e. friction), the stock market and economy are rife with such forces, ranging from systematic trading to elections. And we are beginning to see these forces affect tech. Figure 4 shows how the 200-day moving average has changed by sector over the past 10 years.

The greatest declines this past week were in COVID-defensive shares with the COVID-cyclicals performing comparatively better. This parallels the “Russian Vaccine” moment when markets were momentarily taken with the possibility of a faster return to normal. In short, there will be a time when valuations normalize, when the divergence between the beneficiaries of the pandemic fall and the winners of the post-COVID environment emerge (see figure 5).

Figure 4: S&P 500 IT and Financial Sectors and Their 200-Day Moving Averages

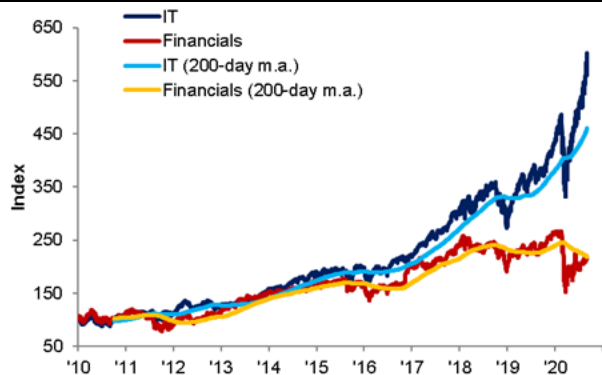
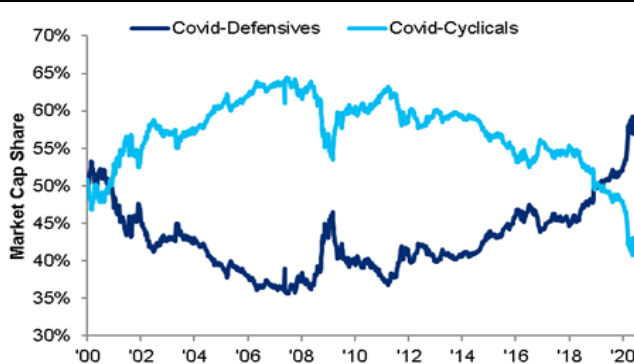


Figure 5: Global “Covid Cyclicals” vs “Covid Defensives” as % of World Market Capitalization



Source: Bloomberg and Haver Analytics as of September 4, 2020.

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IT represented by the S&P 500 IT sub-sector, Financials represented by the S&P 500 Financials sub-sector

The relative strength index (RSI) was introduced by J. Welles Wilder Jr. in 1978. RSI assigns stocks a formulaic value between 0 and 100 based. Levels of 70 and 30 are considered warnings of [overbought](#) and [oversold](#) assets, respectively. Ultimately, RSI is a tool to identify low-probability and high-reward periods. When combined with moving averages, RSI often indicate a trend reversal on the horizon.

So, let's have a look at the RSIs for major US and foreign equity indices. As you can see, "overbought" conditions in the Nasdaq were triggered on Tuesday of this week. By comparison, European and Latin American markets are within normal ranges (Figures 6 and 7).

Figure 6: Nasdaq Relative Strength Index

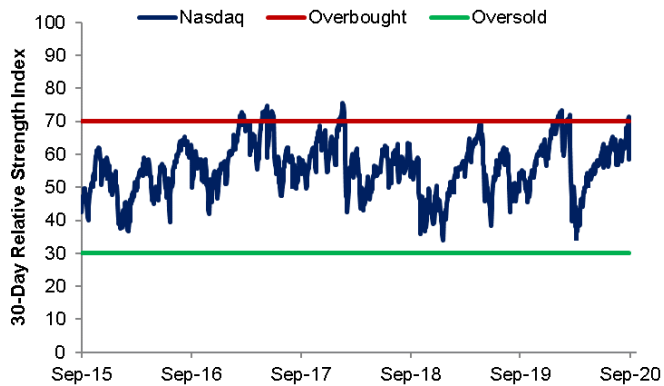
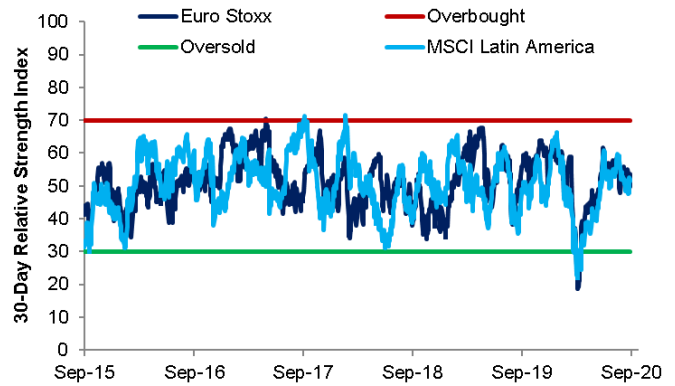


Figure 7: Europe / Latin America Relative Strength Index



Source: Bloomberg and Haver Analytics as of September 4, 2020.

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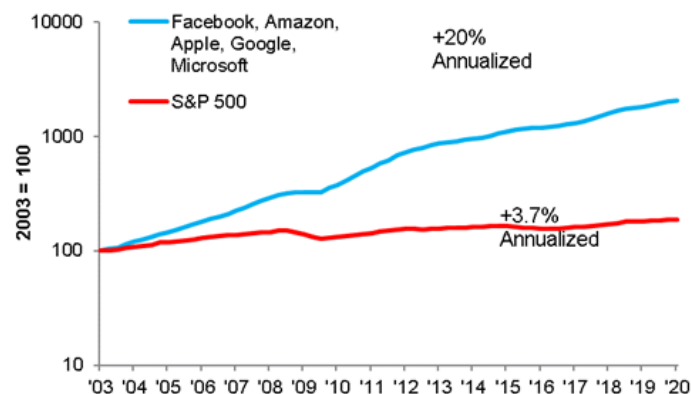
Equity Appreciation Is Non-Linear (*)

The fundamentals of the five largest US firms by market cap – Apple, Amazon, Face Book, Google and Microsoft supported their equity market outperformance over most of the past two decades. It is no coincidence they are all tech related. They outgrew the S&P 500, the US and the World economy steadily.

As Figure 8 shows, the US's five largest firms by market cap grew their revenues at a 20% compounded rate over the past 17 years with little variation. This is an environment when real GDP grew by 2.0% and the average S&P company grew revenues by just 3.7%.

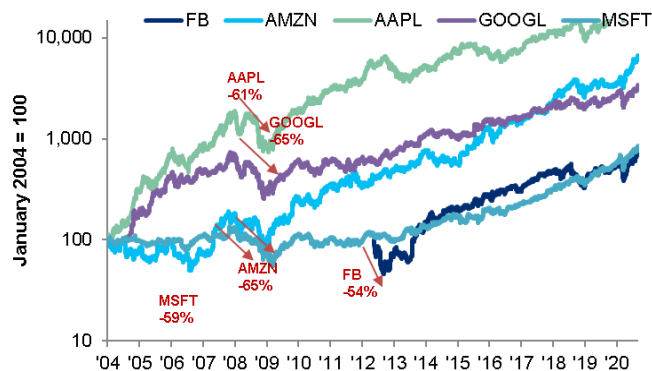
Even this outstanding growth did not prevent severe price corrections of more than 50% in every one of the top five (see figures 9-10). Three of the firms posted their most severe equity price declines in an overlapping period. Yet up until this past week, pandemic investors have resisted calls for greater diversification (please see our [CIO July 12 Bulletin](#)).

Figure 8: Revenues of 5-Largest US Equities vs S&P 500



Source: Factset as of September 4, 2020.

Figure 9: FAAMG Share Prices Rebased and Notable Corrections of Past 15 Years



Source: Factset as of September 4, 2020. Past performance is not indicative of future returns.

**Figure 10: Why Diversify?
FAAMG Share Prices Maximum Drawdowns**

	Peak	Trough	Decline
FB	May-18, '12	Sep-04, '12	-53.6%
AMZN	Oct-23, '07	Nov-20, '08	-65.3%
AAPL	Apr-02, '91	Dec-23, '97	-82.2%
GOOGL	Nov-06, '07	Nov-24, '08	-65.3%
MSFT	Nov-01, '07	Mar-09, '09	-59.1%

The Future Value of Diversification is Rising

As Figure 5 shows, Covid's arrival has moved every asset price in the world. Covid's departure will do the same. Markets are fully focused on sorting the immediately strong from the immediately weak (see figure 11). While volatility is likely in the short-term, we would view any moderate market correction as a buying opportunity for long-term investors, especially for assets that are priced as though Covid is forever.

We believe that the value of diversification for US-centric investors is going to be *higher* in the decade ahead. US equity valuations are at an historic high relative to others and have been for a significant time (see figure 12). As the world finds a true solution to Covid, this could provide a catalyst for performance in other shares, away from tech-centered, interest rate-driven equity performance we have described in our [August 16 bulletin](#).

Figure 11: Fundamentals Diverge From Covid, So Do Equities

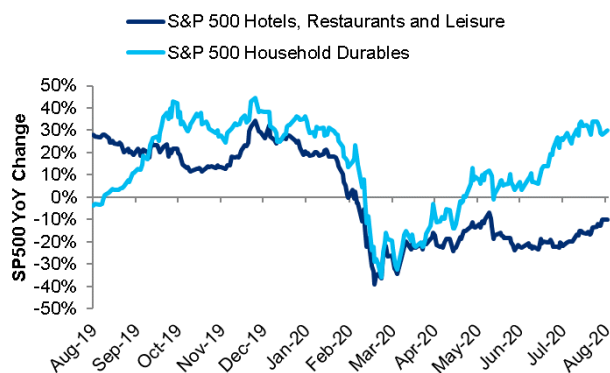


Figure 12: Valuation of Non-US Equities Relative to US Equities (Cycle Adjusted)



Source: Bloomberg and Haver Analytics as of September 4, 2020.

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CAPE: Cyclically Adjusted Price to Earnings ratio a valuation measure defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation

We remain optimistic regarding the prospects for cyclical assets as we look out into a New Economic Cycle in 2021 and beyond. The relative underperformance of “defensives” in this latest selloff is just the latest sign that COVID-winners are trading richly versus those sectors that remain depressed along with the broader economy. The potential for positive results from one of the handful of late-stage COVID vaccine trials could inject jet fuel into cyclical shares in the months ahead.

Tech spending will not decline, but its rate of growth may slow. Unlike the “tech wreck” period of the early 2000s, this is not a period when tech firms will see losses (see figures 13-14). Even after this year’s sharp rally, and “oh so sudden” drop this week, many shares offering “Growth at a Reasonable Price” can still be found in the Tech sector.

This is why we suggest investors limit tech holdings as appropriate. As we wrote on July 12th, even without a fundamental downturn, we would hold Technology, Media and Telecom (TMT) exposure to 50% within US equities. If one is a diversified global investor with alternative and illiquid assets such as real estate in portfolios – we would recommend US TMT sector equities represent 20% of portfolio wealth.

Drivers of the post-Covid equity market will likely include shares in a wider group of sectors both inside the US and out. Value exists in shares with lower forward-looking valuations and higher than average historic EPS growth. These include many companies in the Financial, Healthcare and Industrials sectors globally (see figure 15).

Figure 13: Intellectual Property (i.e. Software) % of US GDP

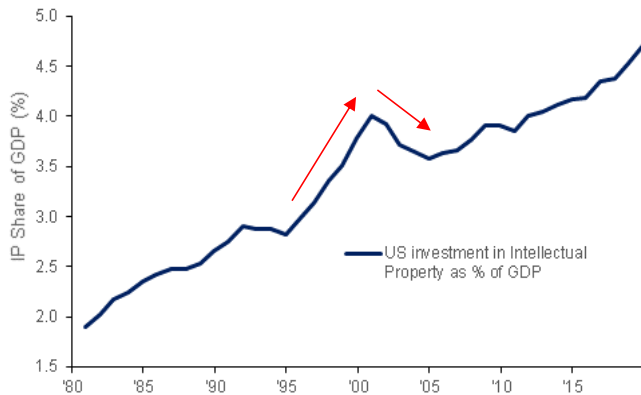


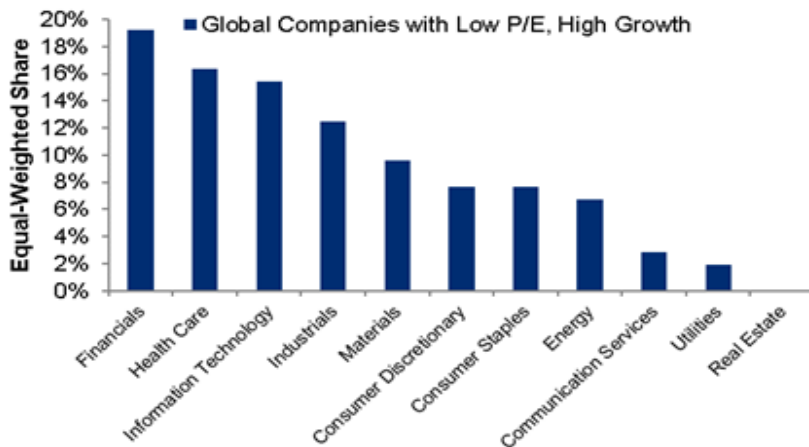
Figure 14: US IT Sector Market Cap and Profits % S&P 500



Source: Factset as of September 4, 2020.

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Figure 15: In Which Sectors Can We Find “Growth at a Reasonable Price”



Source: Factset as of September 4, 2020.

Acting Now Versus Acting Later

Just as it is impossible to time markets, pick bottoms or tops, or predict election outcomes, it is not possible to know when to diversify portfolios. In our view, extreme valuation differentials whether between COVID-defensives and COVID-cyclicals or between US and non-US equities, are stronger indicators for action. Valuation extremes may not resolve tomorrow or next month, but when they do so, they tend to move quickly and decisively. And capturing such moves is where “alpha” can be added to portfolios. Last week, we discussed the benefits of considering Brazil

opportunistically ([Double Header: "Redefining Value" and "Opportunity: Brazil"](#)). And last week, Brazil, global financials and real estate zigged while US markets zagged. That's precisely why we want to see broadly diversified global portfolios, especially for US centric (dollar and equity) investors.

(*) The aforementioned discussion regarding individual technology companies is shown for illustrative purposes only and is neither a solicitation to buy nor a recommendation to sell.

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