September 25, 2020

A TALE OF TWO MARKETS

"Congratulations. I knew the record would stand until it was broken" – Yogi Berra

One of the strangest aspects of this year's stock market behavior is not the fact that the S&P 500 index dropped as much as it did in March, but that it reached a new high barely five months later, at a time when there was no clear resolution of the COVID issue. The reason is that while Main Street was struggling more than Wall Street, even on Wall Street itself, there has been enormous variation in performance by industry. There were some obvious winners, some obvious losers, and a whole lot of companies about which the future was just not at all clear, and whose performance reflected that. The performance of the market was effectively bifurcated. There was a tiny subset of (surprise!) technology stocks that were driving the return of the S&P 500 all by themselves. They were big, they were expensive, and they were shooting the lights out. In this *Investment Strategy Update*, we look at the state of the market as it peaked in early September to explain the corrective process we've been seeing since. We follow up by assessing what it means for our future investments.

The Big Five versus Everyone Else

As conservative investors, we looked on with bemusement as the stock market advanced relentlessly through the summer, and especially through August. At the time of the market peak on September 2, an analysis of stock performance made clear that what we view as the "stock market", the S&P 500, had become lopsided. The five largest stocks in America were Apple, Amazon, Microsoft, Alphabet (Google), and Facebook. Together, they totaled one-quarter of the index's valuation. Four of them were each worth more than $1 trillion, and almost no other stock was even close. The S&P 500 is a market capitalization-weighted index. Because these Big Five were so large and their average return was 59%, at that time they also contributed nearly all of the year-to-date total return of 12.3%. The rest of the stocks made a minimal contribution to the return for the year. As a proxy for a truly "average" stock, the equal-weighted S&P 500, where each stock has the same influence on performance regardless of size, was approximately flat.

The extremity of the situation went further. Given BTR's value-oriented investment process, we try to avoid overpaying for stocks, regardless of whether they are traditionally considered "growth" or "value". By September 2, the S&P 500's Price-to-Earnings ratio (P/E), or the number of dollars one pays for each dollar of earnings, had reached 27 times, whereas its historical average is more like 16 times. Although they were generating good earnings under the circumstances, four of the Big Five were trading at or near 40 times 2020 earnings, with Amazon above 135 times. More to the point, rising P/E ratios were the primary reason for their performance. In fact, on average, P/E expansion accounted for 89% of the Big Five's returns, with only 11% derived from earnings growth. To put it another way, more than three-quarters of the S&P 500's total year-to-date return was a result of the five biggest stocks getting more expensive.

Why Worry?

History has shown that when the market has become as expensive as it was, one can expect some sort of correction. While valuation is not a great timing tool, such a circumstance clearly indicated to us that the market was overheated. We knew perfectly well, having invested through the late 1990s, that it could remain so for an extended period of time, but it seemed prudent not to chase it. Further, as the *Wall Street Journal* noted in late August, a drop in the correlation of performance between the normal S&P 500 and its equal-weighted version tends to be a harbinger of bad news. Their chart going back to 1990 showed downward spikes in mid-1999, late 2000, late 2006 and early 2018. We probably don't need to spell out why the spike in 2020 may be cause for continued caution.

Other signs of weird market behavior abounded. The Big Five had moved way beyond their moving averages. As a technical analyst might say, they were very "extended." Tesla, which was still only being considered for inclusion in the S&P 500, had been in "ludicrous mode" since March, rising from $70 to just over $500. Its P/E was 728 times this year's earnings, and had it been added to the index at that point, it would have been the seventh largest component. Alas for Tesla, it didn't get added. Finally, individual investors have on peak days this summer represented 25% of market activity, compared to last year's 10%. It is now well known that buying of call options by the likes of upstart brokerage firm Robinhood's small investors (not to mention the large institution Softbank) had meaningful influence.

There are, of course, fundamental explanations as to why the market may have become imbalanced. First, based on the June quarter's earnings, the stocks that have been driving the market are clearly beneficiaries of the COVID phenomenon. Individuals are doing a lot more shopping at Amazon, and they are replacing their old smartphones and computers. Businesses have accelerated their moves to cloud computing, and three of the Big Five just happen to be the three biggest providers of such infrastructure. Finally, although there does seem to have been some negative impact on advertising, the digital giants are holding their own in that business. It begs the question: How much better can these trends get?

Second, the Federal Reserve Board was being extremely accommodative regarding liquidity and interest rates. The clear message Chairman Powell has been sending since February is that the Fed will have the country's back. Target short-term interest rates are essentially zero. What does this mean for stocks? All else equal, falling interest rates increase a stock's value. This works particularly in favor of a stock with no dividend and lots of expected growth far in the future. The future cash flows are discounted at a low rate for a long period, thereby boosting its value. In contrast, the value of a high-yield stock with minimal growth may not react much, if at all.

Investment Implications

We are going to take the Fed at its word and assume that short-term interest rates will be safely on the floor for a while longer. For this reason, we don't intend to increase our clients' bond allocations. If we can maintain something close to the minimum target weighting in bonds, we will consider that sufficient. However, in this environment, where any bond that could be called has been, even achieving that goal will be a challenge. Interest rates across the yield curve are so low that there is almost no way to get a reasonable return without buying either poor credits or very long-dated bonds.

We believe the Fed's rationale is based on a reasonable assessment that the economy has a long way to go to get back to February levels. Whether this takes another year or another three years is up for debate, but it hinges on something we can't yet assess with certainty: the availability of an effective vaccine that people are willing to take. It seems like there will be at least one vaccine available this fall, but everyone on Planet Earth knows that the process has been expedited, so safety concerns will linger. Still, if an early vaccine is given to front-line workers for a few months without negative side effects, the general public will probably start to get in line for their shots. In short, it is possible that the COVID-related economic woes will be behind us before next summer.

It is fair to say that prior to COVID, the U.S. economy was roaring. Unemployment was so low that there were more job openings than unemployed individuals, so inflation seemed imminent. The recession of 2020 was triggered by lockdowns and therefore hit the demand side of the economy, as people couldn't spend as and where they normally would. Once they have the confidence to go back to their old habits, the businesses that were able to survive will re-hire more aggressively and the unemployment rate will continue its already significant drop. We know that some jobs have been lost for good, but as economic activity recovers, longer-term interest rates should rise as the yield curve normalizes. This increase will have a correspondingly negative impact on longer-term bond prices.

The flip side of our desire to maintain minimal exposure to bonds and cash is that we should not fight the Fed, but rather invest where they are incentivizing us to invest. That is, in stocks. For well over a year, BTR has had a neutral to conservative view of the stock market. As the economic cycle expanded through 2019 and the S&P 500 struggled to rise above 3,000 our general plan was to trim equities. After all, at that time and level of earnings, the market already looked expensive to us. A correction of some kind seemed due. Little did we know it would take the form it did in late February and March, but now we're past that. Barring the failure of all of the vaccine candidates, we can see the light at the end of the tunnel. Even if winter brings renewed higher case counts, much of America is fed up with staying at home. A more targeted approach to protecting the most vulnerable, as opposed to another complete lockdown, would seem more likely.

Consequently, with interest rates so low and the end of COVID hopefully in sight, our focus remains on what stocks we might buy. This effort is consistent with the first part of this *Update* because despite what we considered the frothy behavior of a small number of technology-oriented stocks, most stocks are behaving in a rational manner. Of course, the stocks we have in mind largely fall in the "value" category. There are two major advantages to such stocks as the economy improves. First, they are more economically sensitive, so they will be the ones to benefit the most from the economic recovery. Second, they are genuinely cheap.

The sector we hold top of mind for additional investment is Finance. This has been a tricky year for lenders. With tens of millions of job losses, it was natural for the market to take down banks and credit card lenders aggressively. Although they are generally off their lows, the market recovery has mostly passed them by. The irony is that while they very responsibly took charges against anticipated credit losses in both the first and second quarters, there have been minimal actual losses. Supplemental federal unemployment payments meant that at least two-thirds of unemployed people received more not to work through July than they would have by working, and the average person received well over 30% more. The massive 33.7% personal savings rate in April is testament to that. Now that those benefits have been reduced, we will see whether delinquencies rise. To date, the number remains low.

In the currently highly-charged political environment, we make no prediction about whether the government will be able to agree on a compromise stimulus bill prior to the election. However, given the banks' substantial reserves for future losses, any improvement over their current forecasts will leave them with excess reserves. Conveniently, management will release these "hidden reserves" reliably into earnings over the coming years. At barely 10% of the S&P 500, Finance is not a dominant sector. However, it is approximately 18% of the Russell 1000 Value index. If we're looking for a cheap and economically sensitive sector, and we are, this leaves us a lot of room to add equity exposure.

The Industrial sector is also a good place to look for value stocks. Some of the components are very economically sensitive because they deal with big equipment or other forms of capital expenditures. Manufacturing has been showing a strong rebound already, as has construction, but we will be looking for a meaningful expansion of industrial activity around the world. After all, this has been a global recession. Interestingly, the success of technology stocks in the past few years has particularly benefited America's markets, which allowed BTR to maintain our natural preference for domestic investments. As the global economy picks back up, we may focus more on heavily export-oriented economies as a source of new investment ideas.

Energy is yet another sector that is traditionally value oriented. However, its struggles since 2014 have not abated, and it is our opinion that even a global recovery and expansion will not sufficiently increase global demand for fossil fuels to make this a sector to which we would add exposure, despite the attractive yields and solid management.

A final area of focus for new money is gold, which is a particularly unusual commodity. Although it has industrial uses, it is also largely viewed as a hedge against a variety of circumstances, including inflation, deflation, and straight-up chaos. The firm's interest in it was piqued this summer, and we remain interested, given the weakening U.S. dollar.

Conclusion

The story of the Big Five in 2020 is not a new one. BCA Research noted this month that since 2015, the Big Five have contributed 53% of the total return of the S&P 500. While that ratio was closer to 100% of this year's return, and therefore caught the world's attention, that process may well be over for some time to come. Markets inevitably change and investment styles swap leadership. The transition from the late 1990s to the early 2000s amply demonstrated this. Perhaps this year's activity did not constitute a Technology bubble of that magnitude, but the similarities are striking. We've seen enough evidence to suggest that our focus right now needs to be on positioning clients for the economic recovery we know has begun. It could still be derailed, so we will be careful, as always, but the coming few months could be busy.