Market Synopsis – July 2020

Global markets continued its ascent during July mostly due to surging tech shares. The extreme resilience of a few tech titans has resulted in an incredibly concentrated equity market, in which the market capitalisation of Google (Alphabet), Amazon, Microsoft, Apple and Facebook equals that of 224 deep value and early cyclical equities in the S&P 500. This irrational exuberance is clearly visible from Figure 1: Without its five largest constituents (Apple, Microsoft, Amazon, Google and Facebook), the S&P 500 would have increased by only 23% in the past five years instead of its current 54% return. To further accentuate the extent of the market's frothiness, it is incredible to consider that these five tech titans have added USD 4.8 trillion to the S&P 500 market capitalization versus USD 3.8 trillion added by the next 495 companies!

We thus believe that tech shares are in a bubble. Looking back over the post war period, each decade over the past 60 years has experienced its own financial excess:

In the 1960s, the mania surrounded the so-called "Nifty 50s", as exemplified by Disney. The Nifty 50s were large-cap companies with solid franchises and a proven track record of dividend growth. Meanwhile, the period of low inflation from 1960 to 1966 allowed the US Federal Reserve ("Fed") to keep monetary policy accommodative. When inflation began to rise in 1966, the Fed lifted interest rates to 7.75% in 1973, and the bubble evaporated with the recession that started that year.

In the 1970s, the mania involved precious metals, such as gold and silver. Through the 1970s, precious metals benefited from the 33% fall in the USD, the surge in inflation from 2.9% in 1970 to 14.7% in 1980, and the Fed's incapacity to get ahead of the inflation curve through most of the decade. Then-Fed Chair Paul Volcker burst this bubble when he boosted interest rates to 19% in 1981 to kill off inflation. This also ignited the 93% USD rally that culminated in 1985.

In the 1980s, the mania centred around Japan. The Japanese economy experienced a miraculous post-war expansion, with real GDP per capita surging by a cumulative average growth rate of 7% between 1945 and 1980. By the mid-1980s, the prevailing belief was that Japanese firms would dominate every industry globally. After the Ministry of Finance allowed the JPY to surge

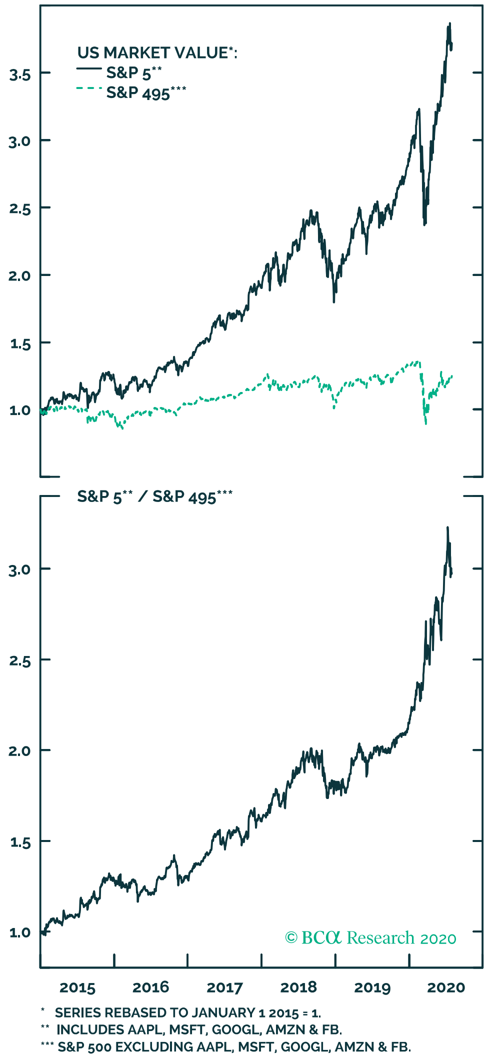

Figure 1 – Tech shares are in a bubble

following the September 1985 Plaza Accord, the Bank of Japan ("BoJ") cut interest rates by 2.5%, creating very easy domestic monetary conditions. This lax policy setting unleashed a surge in credit and asset valuations that pushed up the Nikkei 225 five times by the end of the decade and resulted in an 860% increase in the value of Japanese banks. The BoJ lifted interest rates by 3.5 percentage points between 1987 and 1990. The market peaked in December 1989 and the Nikkei collapsed by 82% during the next 19 years.

In the 1990s, tech companies and the NASDAQ captured investors' imagination. The internet, computing power and software, all drove an increase in productivity growth to a two-decade high and investors understood that the sector's earnings prowess was only beginning. Moreover, as inflation fell through the 1990s, then-Fed Chair Alan Greenspan kept policy rates flat for four years before

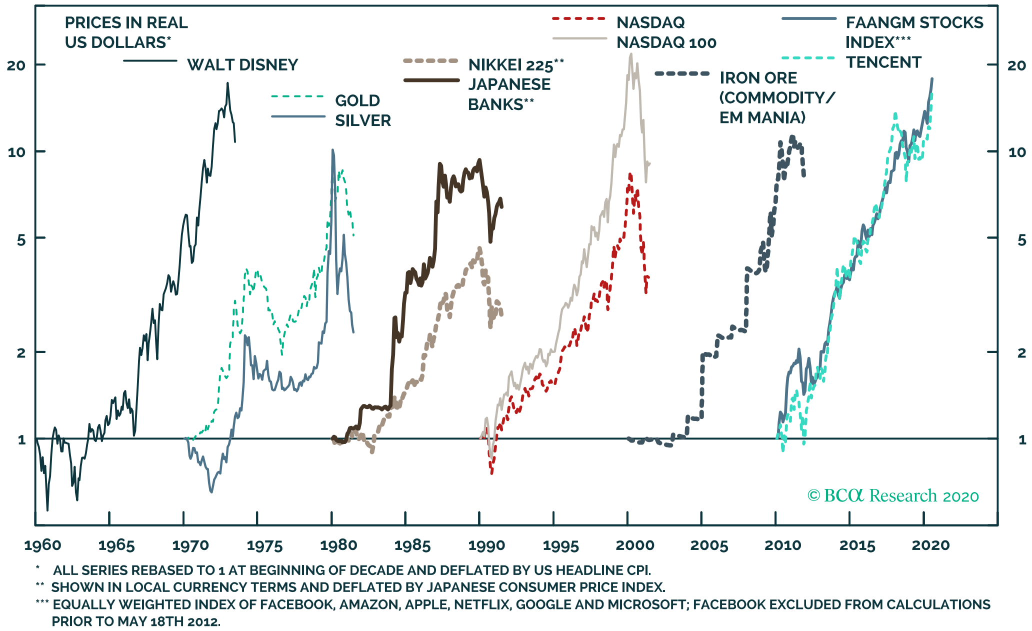

Figure 2 – New decade, new bubble

cutting the Fed Funds rate by 75 basis points in 1998. Additionally, around the turn of the millennium, the Fed increased the size of its balance sheet by USD 90 billion as a precautionary measure against Y2K. Consequently, with the ensuing euphoria, investors pushed the NASDAQ's valuation to a P/E ratio of 72, extrapolating far into the future much-too-strong earnings growth. The bubble imploded when the Fed normalised policy.

In the 2000s, the dominant story was the unstoppable upswing of the Chinese economy, the nation's rapid urbanization and insatiable demand for commodities. The lack of investment in commodity extraction through the 1990s exacerbated the rally in natural resources. The easy Fed policy of 2000 to 2003, implemented in the wake of the bursting of Dotcom bubble, and the USD's 40% plunge between 2002 and 2008 added to the bullish mix in favour of resources. Commodity indices surged and iron ore, which derives a particularly large share of demand from construction in China, increased 12-fold between 2000 and 2011. The rise in the broad trade-weighted USD along with a slowdown in Chinese growth initiated in 2010 ultimately quashed commodities.

Three forces fuelled each of these manias: An extended phase of easy monetary policy; a narrative that drove funds towards fashionable assets; and an extended period of superior returns that accentuated the inevitability of participating in the bubble. This is also true for the last ten years which belonged to the so-called FAANGMs and its Asian cousins, of which Tencent is the poster child – see Figure 2 for all these manic periods.

Historically, bubbles often abort at the end of the decade in which they materialise. Will this ongoing mania suffer the same fate as its predecessors? For now, the pillars of the tech bubble remain intact and it might continue bulging for a while longer. Bubbles are however highly dangerous for investors. A lack of participation in a mania often results in acute underperformance for institutional investors but staying invested in the bubbly asset too long can be even more lethal for a portfolio's performance. Another risk inherent to bubbles is that they are often volatile; the current tech exuberance will not be different. In the second half of the 1990s, the NASDAQ experienced ten 10% or more corrections and tumbled by more than 20% in 1998 before leaping to new highs. Currently, we monitor three potential risks that can initiate a period of correction in tech shares over the remainder of 2020 and beyond:

1. Tech earnings do not meet the hype

Today, tech shares are vulnerable to a sharp pullback because investors are willing to bid up these shares considering their perceived high growth rate. This sector specific euphoria increases the likelihood that if quarter tech earnings releases disappoint, then a significant correction will occur in widely held companies. The share prices of Microsoft, Netflix and Snapchat have been punished following disappointing Q2 results.

Retail investors indirectly amplify the risk created by potential earnings disappointments. Users of free trading apps, like Robinhood, are the marginal buyers, but more importantly their order flows are sold to large institutional houses who front run these small players. Large investors with immense buying power can swing the price of the stocks popular with retail investors. Hence, when small investors unload due to bad news, a selling deluge ensues.

2. A weakening USD

Tech shares thrive with a strong USD because it is synonymous with low inflation and low yields. Consequently, a rising USD puts upward pressure on tech multiples. As discussed in the past, various macro-economic trends are stacking up against the USD and should lead to an extended period of USD depreciation.

3. Run-up to the US elections

The US election also creates a serious risk for tech companies. President Trump's approval rating remains in tatters despite the vigorous rebound in US equities since March 23. His support at this stage of the presidential cycle lags that of previous presidents who were re-elected. This creates two problems for investors: When cornered, President Trump often lashes out at foreign economies, which leads to geopolitical tensions. The heated rhetoric (or should we say hatred) toward China will likely worsen in the coming three months, which raises the prospect of another leg in the US-Sino trade war, with negative effects for tech firms that extract 58% of their revenues from abroad. Furthermore, if former Vice-President Joe Biden clinches the presidency, then the Senate will turn Democrat. The Democrats will likely reverse Trump's corporate tax cuts, which would hurt all stocks and prompt some liquidation in tech holdings. The tech industry also remains an attractive target for populist ire because of its wide profit margins and elevated concentration and market power. During the run-up to 3 November, investors will be reminded that politicians on both sides of the aisle want to, probably correctly, regulate tech. Investors will need to raise the equity risk premium for the sector as these voices get louder.

The strength of the tech sector will be tested in the coming two quarters. Any short-term interruption to the mania prompted by the three risks mentioned above will cause a correction in the S&P 500 since the tech sector (including Google, Amazon, Facebook and Netflix) represents 40% of the index's market capitalisation. Despite this risk, we continue to anticipate that the S&P 500 will find a floor 10% – 15% below current levels. This since, as we discussed last month (June 2020 Market Synopsis), some crucial factors underpin equities: Global monetary policy remains extraordinarily accommodative, China is stimulating aggressively, Washington will not let a large fiscal cliff destroy the recovery ahead of a presidential election, and the weaker USD has a reflationary impact on global economic activity. Additionally, we still expect the second wave of COVID-19 to be less deadly than the first and result in much more limited lockdowns compared with March and April.

Against this backdrop, we continue to favour the strategy we detailed last month: "A strategy most likely to generate the highest reward-to-risk ratio will be to focus on assets and sectors that have not yet fully priced in the upcoming global economic recovery, unlike the broad equity market." The tech sector is particularly priced for perfection and at risk of correcting. "Various stock selection opportunities, especially in value investors' stomping grounds, are coming to the fore. The tide is slowly, but surely turning in active investment managers' favour – especially value managers."

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

Tel: (021) 671 2112
Cell: 072 513 2684 / 084 601 1025
E-mail: nic@integrityam.co.za / herman@integrityam.co.za
Website: www.integrityam.co.za

integrity asset management

Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 975.86	10.9%	30.2%	39.8%
Brent Crude	43.30	5.2%	-34.4%	-33.6%
USDZAR	17.0718	-1.8%	22.1%	20.5%
EURZAR	20.1049	2.9%	28.1%	27.5%
GBPZAR	22.3349	3.8%	20.5%	29.0%
JSE All Share TRI	8 601.49	2.6%	-0.7%	1.6%
JSE Resources TRI	3 882.41	8.3%	15.1%	28.6%
JSE Industrials TRI	14 941.88	-1.2%	8.4%	4.3%
JSE Financials TRI	6 331.89	1.2%	-32.6%	-31.3%
JSE Listed Property TRI	1 134.62	-3.2%	-39.5%	-41.2%
S&P 500	3 271.12	5.5%	1.2%	9.8%
Euro STOXX 50	6 854.12	-1.6%	-13.8%	-6.5%
FTSE 100	5 559.66	-4.2%	-20.4%	-19.2%
Nikkei 225	35 596.21	-2.6%	-7.2%	3.0%
Hang Seng	73 008.85	1.5%	-10.6%	-8.3%

Source: Bloomberg, as at 31 July 2020