Market Synopsis – August 2020

After crashing alongside the rest of the equity market in March, tech shares have soared back to new all-time highs. The tech-heavy Nasdaq 100 is up 31% since the start of the year. The "Awesome 8" (i.e. Amazon, Apple, Facebook, Google, Microsoft, Netflix, Nvidia, and Tesla) have gained an astonishing 59% on a market cap-weighted basis. Meanwhile, the median US stock has lost 14% this year – Figure 1. This level of outperformance cannot continue forever. Below we discuss five reasons as to why:

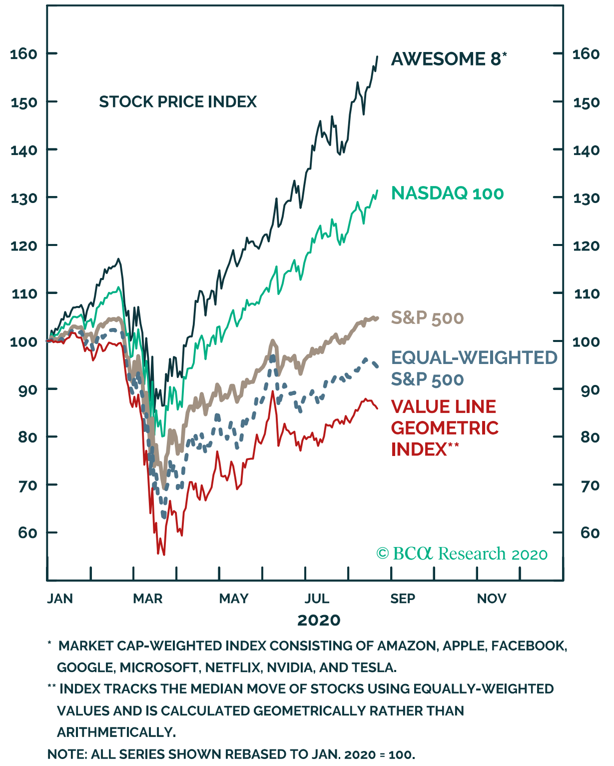

Figure 1 – Awesome 8 pushing tech shares to new highs

1. The dismantling of pandemic lockdown measures could shift consumer spending from online to brick-and-mortar stores

The pandemic has led to a major reallocation of spending from brick-and-mortar stores to online retailers. Sales at US online stores increased by 25% year-over-year in July versus -1% at physical stores. According to Bank of America, after rising steadily from about 5% in 2009 to 16% in 2019, the US e-commerce penetration rate has jumped to 33%, representing more than ten years of growth in only a few months. There is little doubt that we are still amid a secular transition towards e-commerce. However, it is likely that the dismantling of lockdown measures – hopefully facilitated by the release of a vaccine in the near future – will bring back some spending to brick-and-mortar stores. This could produce a temporary air pocket in sales for online sellers, a risk that does not seem to be fully discounted.

Meanwhile, other tech companies that have benefited from the pandemic could face headwinds. Netflix saw its global subscriber count jump 27% in the second quarter relative to a year earlier. If someone did not bother to purchase a Netflix subscription in March or April, how likely is it that they will subscribe for the first time in September? Along the same lines, global PC and server shipments surged to multi-year highs earlier this year as millions of people were forced to work from home. This likely brought demand for computers and peripheral equipment forward, which could produce a spending vacuum over the next few quarters.

2. Interest rates are unlikely to fall much further, which will remove one of the tailwinds propelling tech outperformance

Technology companies are used to cutting prices on older models as newer, more innovative versions come to market. In this sense, deflation is built into their business models.

Many tech companies also trade on long-term growth prospects, which means that changes in discount rates have a disproportionately greater impact on the present value of their cash flows than for slower growing companies. All this means that tech shares tend to outperform in environments where inflation and interest rates are falling.

We do not expect inflation to surge over the next two years. Nevertheless, the deflationary impulse from the pandemic is likely to abate as spare capacity is absorbed and overall demand recovers. Interest rates are unlikely to fall much further, which will remove one of the tailwinds propelling tech outperformance.

3. Tech valuations have gotten increasingly stretched

Based on full-year estimates, the Nasdaq 100 trades at 32-times 2020 earnings and 27-times 2021 earnings. The Awesome 8 shares are even more pricey, trading at 43-times and 34-times this year's and next year's earnings, respectively. Outside the IT sector, the S&P 500 trades at 26-times 2020 earnings and 20-times 2021 earnings. It should be noted that these numbers overstate how expensive the non-tech part of the S&P 500 index really is because Amazon resides in the consumer discretionary sector while Facebook, Google, and Netflix sit in the communication sector. In fact, only three of the Awesome 8 are in the S&P 500 IT sector (Tesla has yet to be admitted into the S&P 500, despite having a market cap that would now make it the 10th most valuable company in the index, right ahead of Procter & Gamble). While the PE ratio on tech shares is still well below the nosebleed levels reached during the dot-com bubble, other valuation measures are approaching their prior peaks. The S&P 500 IT sector now trades at 6.2-times sales, not far below the peak price-to-sales reached in 2000. Tech stocks trade at 9.6-times book value, the highest level since early 2001, and more than double their peak valuation level in 2007.

4. Many tech giants have become so big that further gains in market share may be difficult to achieve

The Nasdaq's lofty valuation presumes that earnings will continue to rise at a rapid pace for many years to come. That has certainly been true for the past decade. The Nasdaq 100 enjoyed annualized earnings per share growth of 16% since 2010, 2.5-times the pace of the S&P 500 index and 3.2-times faster than the non-IT constituents of the S&P 500. Indeed, most of the outperformance of tech shares can be chalked up to their faster earnings growth.

But will such earnings growth continue? That is far from certain. Bottom-up estimates foresee earnings per share among Nasdaq 100 members rising by 20% in 2021. This is below the projected earnings growth of 27% for the S&P 500. One sees a similar pattern within S&P 500 sectors: The IT sector is expected to see earnings growth of 15% in 2021 compared with 31% for non-IT sectors. Admittedly, the faster projected earnings growth of non-tech companies in 2021 will constitute a reversal of this year's pandemic-induced earnings collapse, from which tech was largely insulated. Thus, there is a base effect at work. Nevertheless, if most investors focus mainly on annual growth rates, they could become fixated on non-tech shares. Looking further out, the rapid growth in tech earnings could decelerate as many of today's tech giants struggle to expand market share. Close to 75% of US households already have an Amazon Prime account. Slightly over half have a Netflix account. Nearly 70% have a Facebook account. Google commands 92% of the internet search market. Together, sites owned by Google and Facebook generate about 60% of all online advertising revenue. New opportunities for growth will undoubtedly arise, but there is no guarantee that today's leaders will be able to take advantage of them. History is littered with tech companies that failed to keep up with a changing world: RCA, Kodak, Polaroid, Atari, Commodore, Novell, Digital, Sinclair, Wang, Iomega, Corel, Netscape, Altavista, AOL, Compaq, Sun, Lucent, 3Com, Nokia, and RIM were all major players in their respective industries, only to fade into oblivion.

5. Regulatory and tax policies could negatively impact several prominent tech names

Historically, the US government has taken a *laissez-faire* approach towards the tech sector. As an avowedly pro-business party, the Republicans were happy to dire deregulation and low corporate taxes, while lauding Silicon Valley's dynamism and global dominance. The Democrats also had a cosy relationship with the tech sector. Political donations from tech company employees are heavily skewed towards Democratic candidates.

Things may not be as easy for the tech sector going forward, however. Conservatives have accused social media companies of stifling their voices. According to a recent Pew Research study, 53% of conservative Republicans favour increasing government regulation of big tech companies, up from 42% in 2018. For their part, Democrats have expressed concerns about the growing monopoly power of tech companies and their perceived nonchalant attitude towards consumer privacy. A Biden administration would not be as tough on tech companies as say, an Elizabeth Warren administration. Nevertheless, Biden has said that breaking up big tech companies is "something we should take a really hard look at." He has also argued that online platforms should not be granted legal immunity for user-generated content.

On the tax side, Biden has vowed to reverse half of Trump's corporate tax cuts, while introducing a minimum 15% corporate tax. The latter could disproportionately affect several prominent tech companies that have taken full advantage of the current tax code to minimize their tax liabilities.

Meanwhile, tech companies are increasingly finding themselves in the crossfire between China and the US. While Joe Biden would not be as quick to impose unilateral tariffs on China as Donald Trump, the rivalry between the two nations will intensify over the coming decade as they reduce their economic interdependency and vie for military advantage in Asia. This could have adverse implications for tech firms' ability to maximize global market share, let alone optimising global supply chains.

Tech shares are overrepresented in growth indices, while financials dominate value indices. Thus, it is not surprising that the relative performance of tech versus financial stocks has closely mirrored the relative performance of growth versus value stocks – Figure 2. If tech shares shift from being leaders to laggards, value stocks will shift from being laggards to leaders.

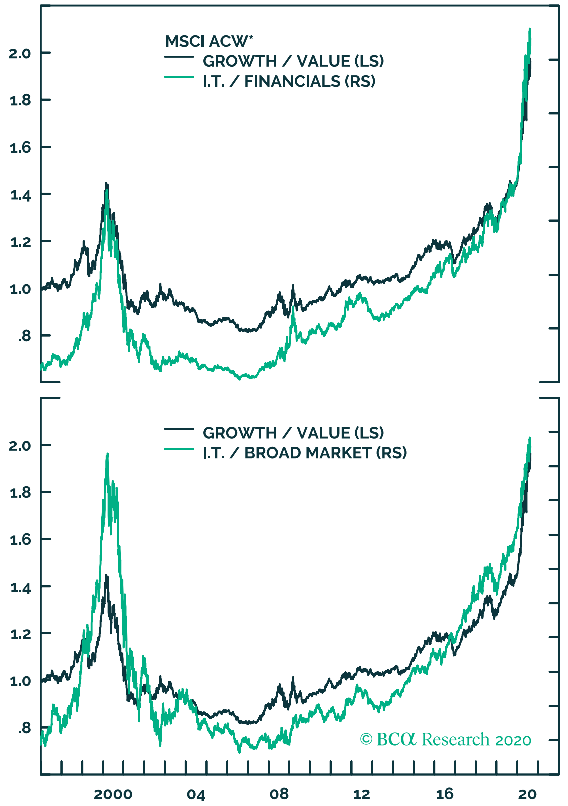

Figure 2 – Tech shares vs financials mirrors growth vs value

Value shares usually appear "cheap" in relation to growth shares, but the valuation gap is much larger today than in the past – larger, in fact, than at the height of the dot-com bubble – Figure 3.

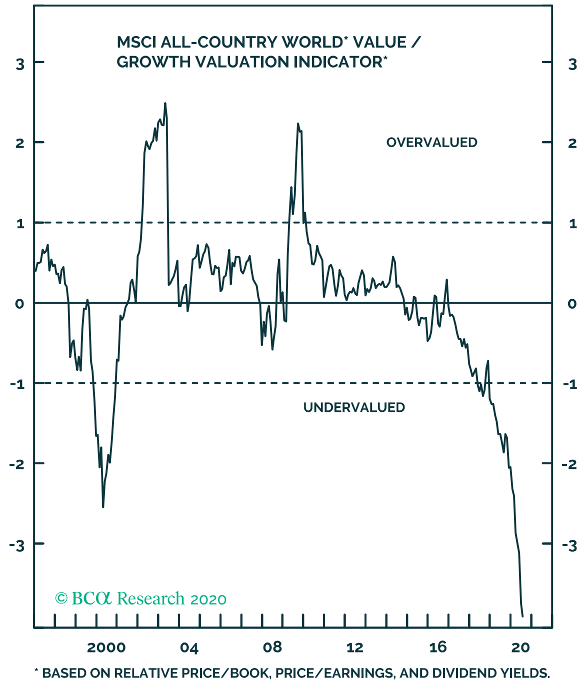

Figure 3 – Value and growth gap past dot-com levels

Despite their name, growth stocks usually underperform value stocks when global growth is on the upswing – Figure 4. Provided that progress is made towards developing a vaccine, global growth should remain above trend over the next 12 months, giving value shares a long overdue lift.

In addition, value shares also generally do better when the USD is weakening. Recall that tech shares did phenomenally well in the late 1990s when the USD was rising but faltered during the period of USD weakness from 2001 to 2008. The USD is likely to depreciate further in the months ahead. Stronger global growth and a weaker USD tend be good news for non-US stocks. As US tech stocks enter a holding pattern or even give back some of their irrational gains, equity markets outside the US will assume the upper hand.

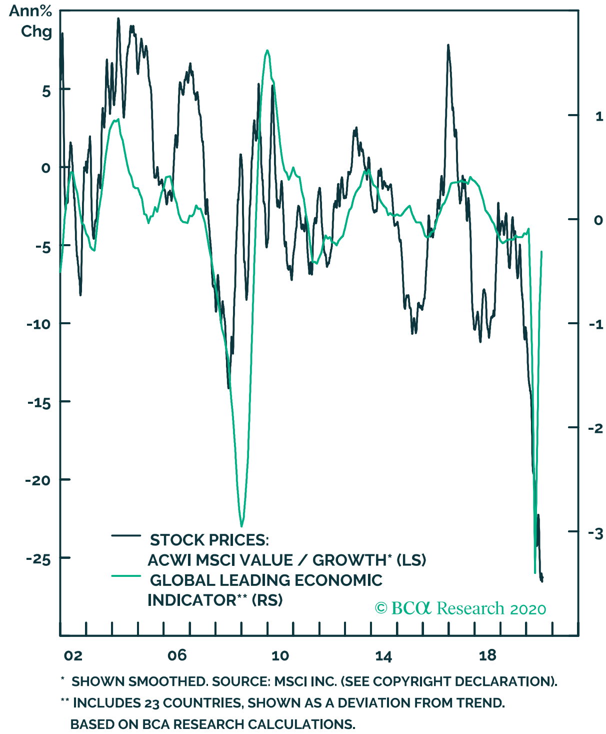

Figure 4 – Global growth positive for value shares

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 967.80	-0.4%	29.7%	39.2%
Brent Crude	45.28	4.6%	-31.4%	-30.5%
USDZAR	16.9288	-0.8%	21.1%	19.5%
EURZAR	20.2204	0.6%	28.8%	28.2%
GBPZAR	22.6531	1.4%	22.2%	30.9%
JSE All Share TRI	8 579.34	-0.3%	-0.9%	1.3%
JSE Resources TRI	3 904.26	0.6%	15.7%	29.3%
JSE Industrials TRI	14 991.01	0.3%	8.8%	4.7%
JSE Financials TRI	6 080.67	-4.0%	-35.3%	-34.1%
JSE Listed Property TRI	1 037.11	-8.6%	-44.7%	-46.2%
S&P 500	3 500.31	7.0%	8.3%	17.4%
Euro STOXX 50	7 072.35	3.2%	-11.0%	-3.5%
FTSE 100	5 657.01	1.8%	-19.0%	-17.8%
Nikkei 225	37 954.67	6.6%	-1.0%	9.9%
Hang Seng	74 864.41	2.5%	-8.3%	-5.9%

Source: Bloomberg, as at 31 August 2020