“Technology Stock Bubble”

Market Commentary – June 2020

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. decreased at an annual rate of -5.0% in the first quarter of 2020. This is lower than the advance reading of -4.8%. Unemployment, which was only 3.5% in February, jumped to 4.4% in March and then 14.7% in April. The U.S. Bureau of Labor statistics keeps records dating back to 1948, and the old record high unemployment rate was 10.8% in November and December 1982. Unemployment likely soared higher in May 2020, as more than 40 million jobless claims have been filed since the coronavirus was declared a pandemic. The reopening of states, however, should encourage businesses to rehire workers. The real question is how many jobs will be permanently lost because businesses downsized or closed their doors for good. Time will tell. In the meantime, Q2 GDP, to be announced in July, will be one for the record books.

The Federal Reserve has unleashed the power of its balance sheet and the financial markets are responding favorably. Prior to the 2008 financial crisis, the Fed held only $0.9 trillion in assets on its balance sheet. By January 2015, several rounds of quantitative easing inflated the balance sheet to $4.52 trillion of Treasury and mortgage-backed securities. As the economy was clearly in recovery, the Fed trimmed its balance sheet assets down to $3.76 trillion by September 2019. To address some technical issues in the repo market, as claimed by the Fed, the balance sheet crept up to $4.16 trillion by February 2020. And then COVID-19 hit. The Fed’s balance sheet has skyrocketed to an all-time high of $7.1 trillion by May 25, 2020. This mountain of liquidity infused by the Fed has undeniably played a key role in pushing the stock market higher. Investors should be concerned, however, about when the money spigot shuts off (although there is no end in sight as of now). Will stock prices fall without being propped up? The next Federal Open Market Committee decision on monetary policy is scheduled for June 10.

The dominance of Microsoft, Apple, Amazon, Alphabet (Google), and Facebook has formed a bubble reminiscent of the technology bubble in 1999 and early 2000. These five stocks make up 20% of the S&P 500 *market cap weighted* index (the version normally quoted). An *equal weighted* S&P 500 also exists, where the 500 companies are each weighted by 1/500 (0.2%) of the index. In 2020 year-to-date (without dividends), the S&P 500 market cap weighted index is down -5.8% while the S&P 500 equal weighted index is down -13.0%. This is a 7.2% difference for two indexes with the same 500 companies! The comparison is even more stark from January 1, 2017 to May 29, 2020: the market cap weighted index (without dividends) is up 36.0%, while the equal weighted index is up 16.4%. It is shocking that *the same 500 companies* could yield nearly a 20% different return over 3.5 years. Too many investors have “outperformed” the index by simply piling into the same five mega-cap tech stocks.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) during 2021 is $162.53, which implies a price-to-earnings (P/E) ratio of 18.7 with the S&P 500 at 3,044. The earnings yield (E/P) of 5.34% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.65%. While the P/E ratio is being skewed by expensive technology stocks, low interest rates should allow the P/E of the market to levitate at higher valuations. The best deals, however, are in small cap value.

The stock market rally from the low in late March has been nearly as breathtaking as the plummet to those lows in late February and March. Going forward, the high-flying tech stocks may have more difficulty moving higher and the beaten-down small and mid-cap value stocks may finally have their day. Subject to the unique risk profile of each client (including willingness and ability to take risk), we have been aggressively buying value stocks of all market caps since the March stock market freefall. Just like a farmer who has planted a variety of crops, we must patiently wait for these positions to grow over time.