GLOBAL & LOCAL

Fear of Missing Out Anyone?

Image: Shutterstock

The fear of missing out is probably one of the biggest mistakes an investor can make. It is only human to want to be part of something that seems to be an undeniable success. Unfortunately, by the time that these "opportunities" reveal themselves to be such a sure thing, it is often already too late to benefit from them.

Our friends at Integrity Asset Management made a similar case in point in their monthly newsletter that was published this week. We would like to share an extract with you, with their permission.

"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!"

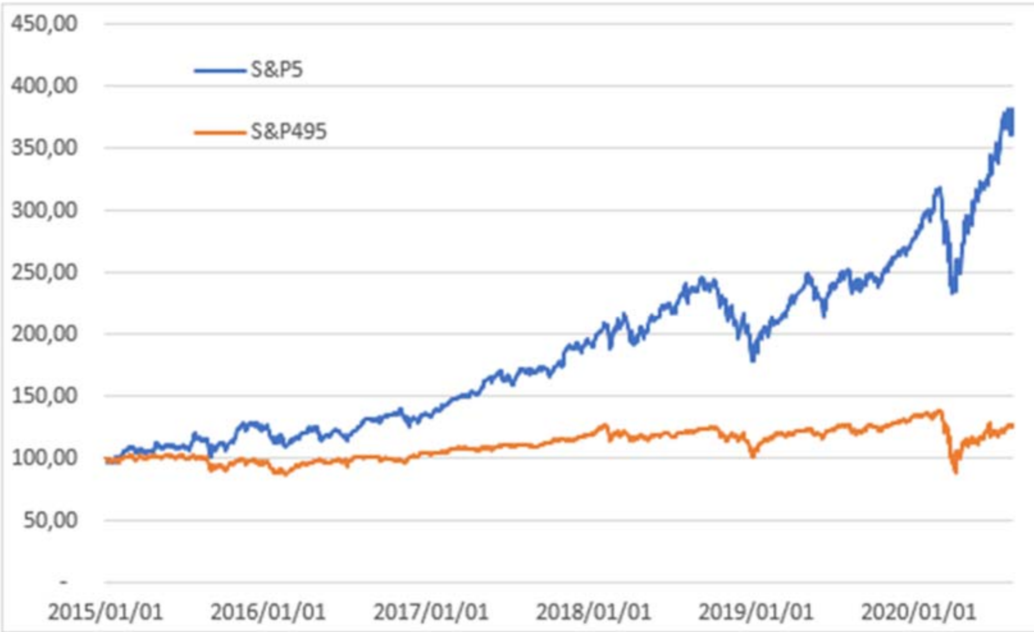

Figure 1, Source: Bloomberg

Looking back over the post war period, each decade over the past 60 years has experienced its own financial excess, from the Large Cap/"Nifty 50s" in the 1960s to the metals mania in the 1970s and the Japanese surge in the 1980s.

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 cutting the Fed Funds rate by 75 basis points in 1998. Around the turn of the millennium, the Fed increased its balance sheet by USD 90 billion as a precautionary measure against Y2K. With the ensuing euphoria, investors pushed the NASDAQ's valuation to a P/E ratio of 72, extrapolating much-too-strong earnings growth, very far into the future. 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 and over the last 10 years, we are back to the tech sector leading the charge.

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.*

For now, the pillars of the tech bubble remain intact and 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. 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.

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. This creates two problems for investors: When cornered, President Trump often lashes out at foreign economies, which leads to geopolitical tensions. The heated rhetoric 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, 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 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."

Against this backdrop, we continue to favour a strategy most likely to generate the highest reward-to-risk ratio i.e. 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. Beware the FOMO *(Fear of Missing Out)*!