Notes From the North: Market Outlook

September, 2020

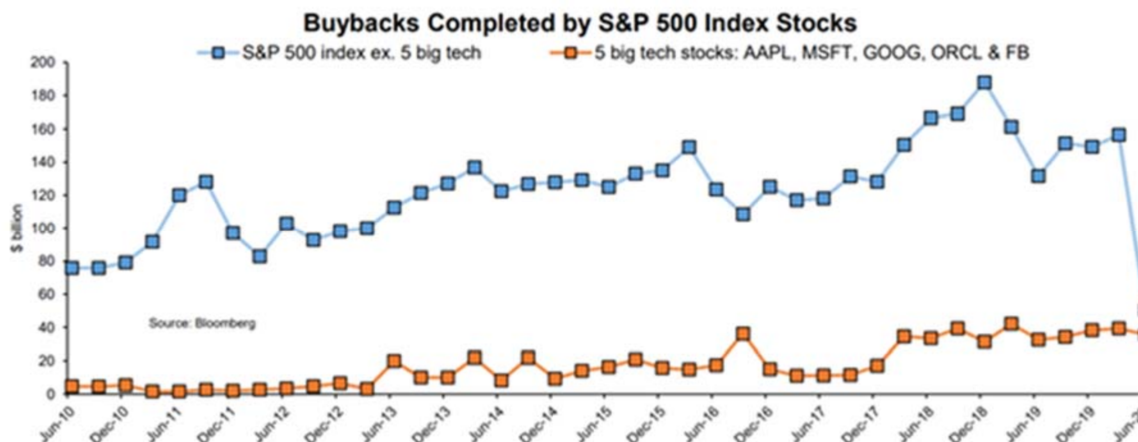
The latest missive from our friends at Gavekal reminded us of Charles Kindleberger (1910-2003), a noted economist who studied and wrote about financial panics (Mania, Panics & Crashes: A History of Financial Crises), the power of contagion, and the benefits of a potentially stabilizing financial hegemon such as the U.S. Federal Reserve. In addition to weighty tomes, as Gavekal notes this month Kindleberger also observed that "there is nothing so disturbing to one's well-being and judgment as to see a friend get rich."

This may also describe the current state of affairs between financial professionals and “retail” investors. Account openings and trading have been in a bull market since the pandemic locked many in their homes. It’s easy to see why every newly-opened investment account might start with a few technology stocks when everyone owns an iPhone and spends much of their day on Zoom. The technology sector has been the primary driver of the market again in 2020, and professionals with risk management and diversification mandates have been frustrated to watch their undisciplined retail friends get rich. But *is* everyone getting rich? As of the close on 9/11/20, the FAANGM stocks (Facebook, Amazon, Apple, Netflix, Google/Alphabet and Microsoft) had allowed the S&P 500 to chalk up a year to date gain of 4.8%. However those same 500 stocks, equally-weighted rather than market capitalization-weighted, lost 4.4% in the same time frame. The Dow Jones Industrials Index is down 1.3%; the Russell 2000 (smaller companies) is down 9.4% and foreign stocks (as measured by the MSCI EAFE Index) are down 4.9%.

Some of the out-performance of technology stocks could be justified since many of these companies actually benefited from the Covid crisis. As well, the pandemic-driven decline in interest rates theoretically increases the value of *future* cash flows. This tends to raise the valuation of a technology stock (with the expectation of cash flows in the future), compared to value or defensive stocks, whose cash flows are more likely to be happening now.

Another driving factor in the separation between technology stocks and everything else may be found in corporate buybacks. We’ve discussed buybacks in past Notes, highlighting that corporate buybacks have been a huge source of demand for equities during a period when all other sources (pension funds, mutual funds, foreign central banks, sovereign wealth funds, banks and insurers) have become net sellers in recent years. In 2020, excluding the technology sector, corporate buyback demand for stock has evaporated.

The chart below depicts the precipitous decline in stock buybacks completed by S&P 500 companies excluding the five largest technology companies (Apple, Microsoft, Google, Oracle and Facebook). Buybacks for that group of five remained steady, although they have ticked downwards in the quarter just ended.



Notes From the North: Market Outlook, cont'd

Technology companies tend to use stock options for a significant portion of employment compensation (30-50% according to Gavekal). Given the continuous stream of stock option issuance, technology companies also tend to use stock buybacks to keep their overall share float level. Vincent Deluard, Gavekal's guest writer on 9/11, sums it up thus: "By outsourcing much of their payroll expense to the stock market, big tech companies are able to save on taxes and conserve cash." Roughly 25% of the total stock buyback of the Big Five tech companies over the last ten years has been an offset to employee compensation. As of June, stock-based compensation for the NASDAQ 100 companies (most technology stocks are listed on the NASDAQ) amounted to roughly 25% of total earnings.

What have insiders been doing with their stock holdings? For Nasdaq 100 companies, corporate insiders sold $10.4 billion in their companies' shares this quarter, up 171% from the same time last year. Nasdaq officers and directors bought just $35 million of their own shares, down 67% from last year. This seems like a statement that might be worth considering. Longer term trends are shown in the chart below:

We do recommend caution here with the high-flying tech stocks, so where might an investor think about putting new money? Peter Berezin, BCA's chief global strategist, and JP Morgan share similar views that we find useful. Both would hold more cash than usual during the next three months. BCA and JP Morgan expect bond yields to be relatively unchanged over the next two years so the return from bonds will be limited to the paltry current yield provided at today's levels. Over the next year, Berezin thinks U.S. value stocks such as large banks should out-perform cash and bonds. Foreign stocks are another option. Berezin finds them cheaper than U.S. stocks, and also likely not as affected by uncertainties that may be introduced by our Presidential election.

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