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The US market is not absurdly valued and there are good reasons why tech stocks are outpacing the rest of the US indices

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"Whenever you find yourself on the side of the majority, it is time to pause and reflect." Mark Twain

The media has been awash with how 'uneven' the gains in the US stock market have been over the past seven months. Tech stocks have far outpaced other sectors, sparking either alarm or joy depending on your weighting to the sector.

The targeted tech stocks are well known: Amazon, Alphabet (Google's parent company), Apple, Microsoft and Facebook. These five stocks together are the largest in the S&P 500 and account for a quarter of the market rally since the market troughed in late March this year. Their weighting in the S&P 500 index, at 20%, is the largest weighting for the top five since 1980. If other well-known tech businesses (like Netflix and Tesla) are included this proportion would rise to nearly 25%.

Chart 1: Top five stocks power market rally

Source: Bloomberg, FT Calculations

Smart people are raising the alarm about this. In his latest piece, James Montier, from respectable US asset management firm GMO, has even gone so far as to say the current valuation of US tech stocks in relation to their prospects is quite, "absurd", and the U.S. stock market looks like "Wile E. Coyote, running off the edge of a cliff".

But is the market running off the edge of a cliff?

If the stock market is so 'wildly absurd', why are banks on single digit PE multiples? Why is Exxon Mobil (once a stalwart of the Dow Jones Index) now a mere $177 billion dollar market cap company with an 8% dividend yield? Why are aviation, restaurant and travel stocks not 'in the stratosphere' with the tech stocks? Why are consumer staple stocks not trading on 30-40x earnings? Perhaps there is an alternative explanation: that the market is a bit more efficient than commentators give it credit for.

The US market looks expensive as a whole because it contains a higher proportion of more valuable businesses

Over a quarter of the S&P500 index comprises technology companies, which command higher ratings than financials or industrial stocks[1] (due to their lower capital intensity, higher growth rates and stronger moats). So, simply by virtue of the US having a far larger listed technology sector, its equity market will command a higher valuation in aggregate.

Going forward, since most new IPO's are 'tech related' (i.e. higher value businesses) we should expect the percentage of higher rated stocks in the S&P 500 to increase materially over the next 10 years. Areas of the economy that are in decline, like shopping malls and fossil fuel stocks, will continue to decline as a percentage of the index.

While competition will ultimately level the valuation playing field again, for the time being the S&P 500 will command a much higher P/E multiple than it has in the past, for this very reason.

Quality is priced perfectly wherever you look

The US technology stocks receive a lot of attention, but when we look at European stocks on a sector basis, rather than as an aggregate, they can even be considered more expensive than their US equivalents[2]. However, because there are so few high-quality tech businesses in Europe, their impact on the indices aggregate P/E is lower. Take Delivery Hero for example, a German takeaway business trading at 15x trailing 12-month sales; or Ocado, a UK grocer trading on 315x trailing 12 months EBITDA. There are many more examples.

Another point to consider when determining whether the market is cheap or expensive is to understand its forward looking nature

The stock market doesn't mirror what is happening in the economy. The stock market is forward looking, and the degree to which it looks forward is dependent on your belief in how well it operates as a 'discount machine'.

Take Amazon for example. At the height of the dotcom bubble in December 1999, Amazon was trading at $107 per share. Despite the fact that Amazon's share price fell to $8 in early September 2001, you could have paid $485 per share in 1999 (four and a half times the share price at the time) and still earned an annualised return of 10% if you held your investment to August 25, 2020[3].

So is the discount machine working? Was Amazon's price correct in 2001 and wrong today? Or is the reverse true - is Amazon's price correct today and wrong then? Even after 20 years of growth, Amazon's share of US retail is only 4%, making it smaller than Walmart's. Perhaps we will be conducting the same analysis in 20 years' time, and my successor will lament why we didn't own more of Amazon[4].

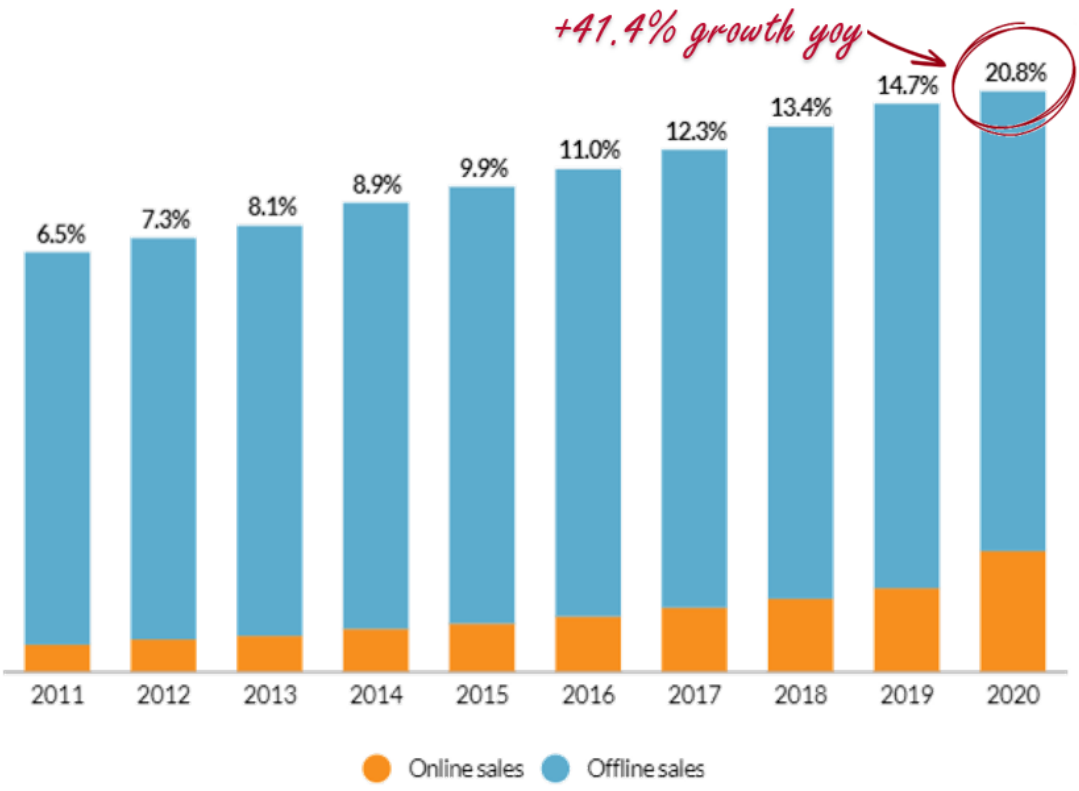
Am I cherry picking by using Amazon? Of course. But that is what an active manager is supposed to do. This is the task we set our minds to every day, and as any stock picker will tell you – it isn't easy. Even when you find that glorious stock which can compound for many years, the temptation to book your profits and take your money off the table is powerful when a stock has already performed well, even though the stock may have many more years to run.

We should not be surprised that a few stocks explain most of the market's gains – we should expect this to be the norm not the exception. Since 1926, most stocks have underperformed Treasuries and just 86 stocks have accounted for half the market's total wealth creation[5].

If you allocate to an active manager, he or she needs to focus on finding these wealth-creating opportunities. Perhaps the answer to the bifurcation in the stock market returns is due to the fact that the internet is fundamentally changing how the world operates. The world is changed, and what we are seeing is the divergence between the businesses of the future and 'the rest'. If this is the case, perhaps the market is doing a good job of discounting the businesses prospects of the few, very high-quality tech winners.

The COVID-19 pandemic has increased the moat and growth trajectory of many of the tech stocks – which is in direct contrast to the remaining businesses on the S&P500. The chart below shows the increase in online sales as a percentage of total retail sales in the US in the second quarter of 2020 versus the same period for the past 10 years. The market for e-commence has expanded enormously (41.4% year on year), and much of this growth is here to stay.

Chart 2: Online sales in the second quarter of 2020 as a % of total retail spend, $ bn



Source: Digital Commerce 360 analysis of U.S. Department of Commerce data

Does this mean stocks outside of the technology and online space are worthless? Absolutely not. But it does mean that they could be priced in relation to their prospects, and the same applies for tech stocks.

Valuing tech stocks is hard. The landscape is changing quickly, capital is cheap and the COVID-19 crisis has amplified their growth trajectory. Even during ordinary times, picking winning stocks on a consistent basis is incredibly challenging. Traditional valuation metrics, growth rates and heuristics of competition and reversion to mean, often need to be adjusted to appreciate what these stocks are capable of. But these learnings can also be very profitable: I can recall when NetEase, a gaming company, used to change hands at 11-12x earnings. Once the power of their business model became apparent, the P/E doubled to low 20s at the time of writing[6].

References:

[1]*This shows in the numbers — the trailing PE of the S&P's technology sector is 35x versus 16.6x for financials.*

[2]*https://ftalphaville.ft.com/2020/08/18/1597755931000/Three-charts-on-the-price-of-European-equities/*

[3]*Source: Bloomberg. In 1999 you could have paid $485 per share (four and a half times the share price at the time) and in 2001 you could have paid $530 per share (sixty-six times the share price) and still have generated a 10% annualised return if you held your investment to August 25, 2020.*

[4]*Note we are long Amazon in all our global strategies.*

[5]*Source: Hendrik Bessembinder, professor and Francis J. and Mary B. Labriola Endowed Chair in Competitive Business at Arizona State University's W. P. Carey School of Business*

[6]*Note: We are long NetEase in our global strategies.*

Glacier Research would like to thank Pieter Hundersmarck for his contribution to this week's Funds on Friday.

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