Markets Jittery Driven by Big Tech Volatility

Markets continue their tumultuous year as the U.S. heads toward elections. After many indices notched new highs in September, nearly every sector of U.S. markets has declined on growing concerns over new domestic and international economic shutdowns and the lack of further government stimulus. On October 28th, the Dow industrials lost 3.4%, recording its fourth losing session in a row and worst day since June 11. The S&P 500 fell 3.5%, bringing the index down more than 8% from its record close in early September and barely up on the year. A significant driver of the losses were the stock prices of Facebook, Google parent Alphabet and Twitter, which each dropped more than 5% each as their CEOs endured congressional hearing regarding their companies' roles in moderating public discourse.

Yet, the five biggest tech companies by value—Apple, Amazon, Alphabet, Facebook and Microsoft generated 18% more revenue during third quarter than a year earlier, propelling their stocks forward the next day.

The influence of the big tech companies remains the major force driving markets. Essentially any index with meaningful exposure to big tech is up around 20-30% over the past two years while indexes without these components, such as the Russell 2000, are down by about the same amount. The exceedingly large disparity of sector performances combined with ongoing economic uncertainty – and elections – begs the question of what to do now.

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From an economic perspective, the economy is recovering significant ground lost during the coronavirus shutdowns. The annualized third quarter GDP increase of 33.1% set records for growth, but the numbers are highly deceptive given that they follow the record 31.4% second quarter annualized decline. During fourth quarter, the rate of increase will drop sharply, and more than half of the economists surveyed by the Wall Street Journal do not expect the economy to return to pre-pandemic levels until next year. The economy is projected to contract 3.6% this year versus fourth quarter of 2019.

Even if the strong recovery materializes as hoped, stocks valuations will remain high. Yet the market may stay elevated, at least in the near term.

Return expectations for 10-year U.S. Treasures remain below 1%, which is likely to continue pushing investors into riskier assets such as stocks to find better returns. Investors expecting long-term rates to remain low generally target cash flows further into the future. With today's ultra-low interest rates below 1% for a 10-year treasury, a three percent risk premium for stocks equates to an earnings yield of about 4% which implies a P/E ratio of 25 (1.00/4%). While this is much higher than the historical average, it is not a coincidence that an equally-weighted index of technology stocks trades at 26.89 times forward earnings as of late October. (One can also grasp the sensitivity of this calculation. Using the same assumptions above with a 10-year treasury yield of only 2% would change the implied P/E ratio to 20 for a 20% decline.)

Recent volatility of big tech stock prices reveal potential challenges to further significant price increases. First, interest rates can hardly go lower. Second, price to earnings ratios have already risen dramatically accounting for much of the gain of stocks over the past decade, and particularly over the past year. At the beginning of 2020, Twitter forecast operating earnings of 91 cents per share, and by October, projections were lowered dramatically to a loss of 87 cents per share. Yet, Twitter's stock price has non-

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sensically risen 45%. Similarly, Apple, Alphabet and many others big tech companies have seen large stock gains on the year despite lowering 2020 earnings expectations. Apple's forward price-to-earnings ratio has jumped from 21 to 30 this year, and has risen from 16 about two years ago, as its stock price has surged faster than its earnings. Other stocks are trading on pure speculation such as Tesla and Zoom with P/E ratios of 800 and 600 respectively. Tesla's stock value is roughly five times the combination of Ford and GM while Zoom is valued at nearly double the entire airline industry.

For nearly all of the tech sector, and much of the rest of the market too, greater stock value derives from assumptions about earnings far into the future. The result is much greater exposure to potential threats that could emerge over time. In addition, it appears that the 2020 surge in earnings for some big technology companies has been assumed to be a new trend rather than the result of a significant one-time shift.

As a result, today's high valuations seem near the edge of justifiable, or possibly well past it with much good already priced into today's stocks. Potential risks seem to be largely ignored.

Today's valuations also seem unusually high heading into a contentious election. A Trump win likely offers the least disruption to markets while a Biden win introduces much greater uncertainty. If a Biden win is accompanied by a Blue Wave, the likelihood of a more hostile business environment including increased personal and corporate taxes seems likely to rattle markets. Higher corporate taxes would most impact the earnings of the most profitable companies, such as big tech, which in turn would hit broader markets disproportionately hard.

Still, once a new president is decided, the market could rise even higher as individual investors are increasingly driving stock prices, and they tend to jump in most enthusiastically at the very end of long market run-ups. Unfortunately, late market run-ups at high valuations have historically come just before severe contractions, and there is no reason to believe that this time would be any different.

Looking longer-term past potential tax and regulatory challenges which could also cause a recession, the next big move is likely to be higher interest rates. While rate increases are likely at least a couple years away, higher rates would almost certainly present significant challenges to all risk markets including stocks and credit markets.

In addition, the traditional stock and bond portfolio is changing. The expected hedge of putting 40% of a portfolio into bonds is unlikely to work well in the future. If the stock market stumbles due to rate increases, investors holding just stocks and bonds would likely see all their holdings decline. For many investors, portfolio construction may need to be rethought with the loss of bonds as a negatively correlated asset for stocks.

The run-up in tech has very possibly largely played out leaving stocks expensive and increasingly vulnerable to bad news. Stocks can always go higher, yet today's rich valuations suggest investors would be well-served by adjusting expectations and possibly their portfolios to account for likely long-term headwinds.

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