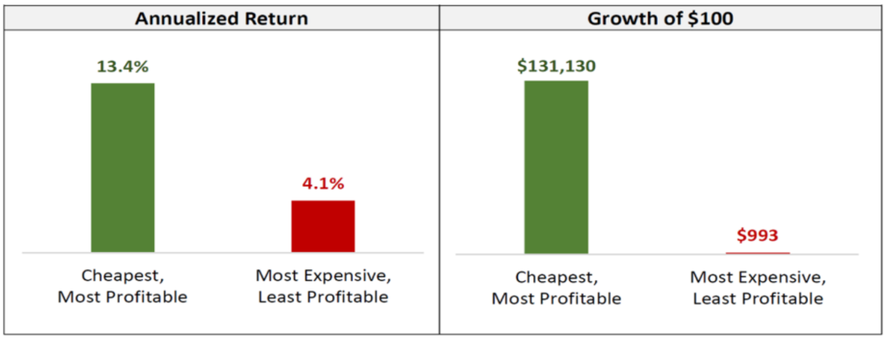
INVESTMENT UPDATE: THE TECH EFFECT ON US MARKETS

7th August 2020

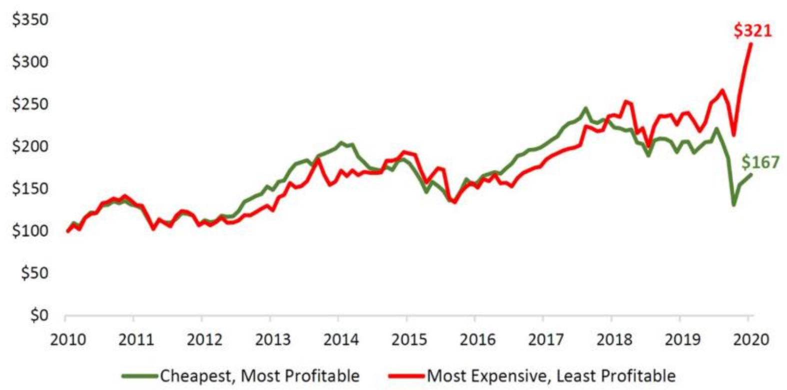
US shares have led the markets following the correction that started in February and continued into March. Here, Omnis' Chief Investment Officer, Toni Meadows, explains some of the reasons behind this.

Traditionally, US companies with the cheapest share price but generating the most profit have outperformed those with relatively expensive shares but lower profits. The difference in returns is stark. As you can see from the chart below, if you'd invested $100 in the cheapest companies in 1963, when records began, it would be worth $131,130 today. In contrast, a $100 investment in the most expensive would have returned $993 over the same period.



Long horizon investor outcomes, US equities from 1963 to 2020 (Source: Verdad Advisers)

However, in the last 10 years, this trend has reversed. $100 invested in the cheapest companies would have turned into $167 today, while the same amount invested in their pricier peers would be worth $321.



Growth of $100 in global developed equities from 2010 to 2020 (Source: Verdad Advisers)

LOOKING 'UNDER THE HOOD'

To put this into context, you have to look 'under the hood' of the US stock market, so to speak. Recent performance by the S&P 500, an index of the 500 largest listed companies in the US, has been driven by five well-known stocks- Facebook, Amazon, Apple, Microsoft and Alphabet (parent company of Google). They make profits, but not as much as you might expect given their high valuations. For instance, let's assess in simple terms, the amount of money left over after funding their current operations, which can be reinvested in the company to help it grow or distributed to shareholders in the form of dividends. Apple's amount of cash that it generates for investment is 4% of the share price and Amazon's is 2.6%, both higher than you'd receive for investing in a government bond over 10 years but relatively low compared with other mature companies.

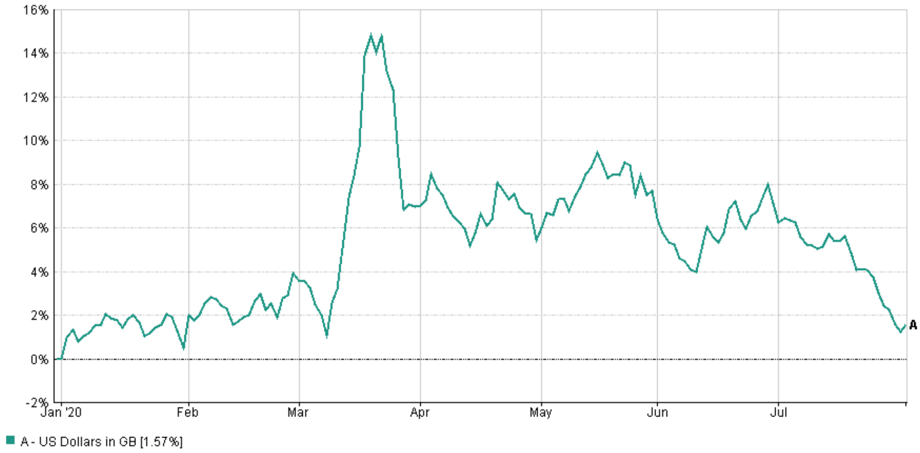
There are effectively two markets within the S&P 500 as a consequence of the high valuation of these five stocks. While they've delivered returns of 33% since January, the other 495 shares listed on the index have collectively fallen by 5%. To sum up, the US stock market has never relied so heavily on the performance of so few.

In our view, these companies need the future to be perfect for them to justify their current share prices. In fact, they've become even more expensive since Covid-19 and are subsequently distorting the market. Yes, they will have benefited from the disruption caused by Covid-19 but none of the businesses are without competitors and there is a high likelihood that they will be subject to increased regulation at some point. They may be good, but we don't think they'll be infinitely profitable. That said, we don't believe rising profits have been driving their share prices, rather it has been investors who have been prepared to pay a high price for shares which they hope will provide continued growth. At some stage, investors will refuse to pay more, although we don't know when.

THE MIGHTY DOLLAR

The other factor you have to take into consideration when investing in US shares is the country's currency. The US dollar is typically considered a safe haven in times of market turmoil, and it strengthened against major global currencies as the coronavirus spread earlier in the year. However, it started to weaken in May as the Federal Reserve (US central bank) introduced various measures to offset the effect of lockdown on the domestic economy.

The dollar's value against other currencies has a direct impact on returns. The chart below shows the change in the value of a dollar bought by a UK investor since the start of the year. As you can see, it increased by around 15% in March, which means any US shares held in pounds rose by an equal amount. Those gains were then handed back from March onwards as the dollar weakened. This effect also explains why UK investors haven't benefited to the same extent as their American counterparts from the recent outperformance by the US.



Value of one dollar in pounds (Source: Omnis investments)

So what does the future hold for the US currency? The US is the largest economy in the world and its currency plays a key role in the financial system. At times of stress the US Dollar often rises as a safe haven and store of value but there are reasons to believe that the US Dollar is currently overvalued. Based on the Big Mac index - a measure of the proportion of income required to buy a Big Mac in US dollars compared with other countries - the dollar appears expensive against most currencies outside the financially prudent Northern Europe.

THE POWER OF DIVERSIFICATION

As I said, we can't pinpoint exactly when investors will lose their appetite for the big five technology shares. Neither can we predict which direction the dollar will move in over the coming months. The most effective way to protect your portfolio against this uncertainty is to spread your money across different regions and asset classes. That way, if one underperforms, then others should make up for it.

Toni Meadows
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