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Andrew Slimmon June 2020 Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | JUNE 2020

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1. To reiterate what we said in the June 11 Market Alert you received, "The Disconnect Between the Stock Market and the Economy":

   It's my belief the market has gotten ahead of where the economy will be in 6 months. We are ripe for some consolidation, and that is exactly what happened at just about this same time back in 2009. The market rallied from March until June. At which time the market took a breather.[1]

   Quite simply, the historical data is pretty consistent. After a three month period of very strong returns, as we have experienced from the March lows, the market's rally typically runs out of steam. Not a disaster, but not much additional headway either.

   However, what is also consistent is that returns looking out **three and six months have been overwhelmingly positive after this pause period**.[2]

2. Recently, investment guru Jeremy Grantham was quoted on CNBC, saying:

   "My confidence is rising quite rapidly that this is the fourth 'Real McCoy' bubble of my investment career."

   The three previous bubbles Grantham referred to were Japan in 1989, the tech bubble of 2000 and the housing boom of 2007.

   His view is that the strong rebound in US stocks from the lows in March was "*crazy*".[3]

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[1] Market Alert: The Disconnect Between the Stock Market and the Economy. June 11th, 2020.
[2] Strategas: Technical Strategy-3 Months Off the Low. Now what? June 25th, 2020.
[3] Markets Insider. June 18th, 2020

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3. But is that really the case for all stocks?

   Who am I to question Mr. Grantham?

   But I will.

4. On the surface, he is certainly correct that relative to history the S&P 500 is expensive, trading in the 87th percentile in the aggregated index valuation metrics in the following chart according to Goldman Sachs.

DISPLAY 1

Valuation metric	Aggregate index: Current	Aggregate index: Historical %ile
US market cap / GDP	207 %	**99 %**
Forward P/E	23.2 x	**98**
EV / sales	2.5 x	**98**
EV / EBITDA	13.1 x	**95**
Price / book	3.4 x	**87**
Cyclically adjusted P/E (CAPE)	26.7 x	**87**
Cash flow yield (CFO)	7.2 %	**84**
Free cash flow yield	4.2 %	**50**
Yield gap vs. 10-year UST	367 bp	**26**
Median metric		**87 %**

Source: Goldman Sachs Macro / Micro as of June 12, 2020.

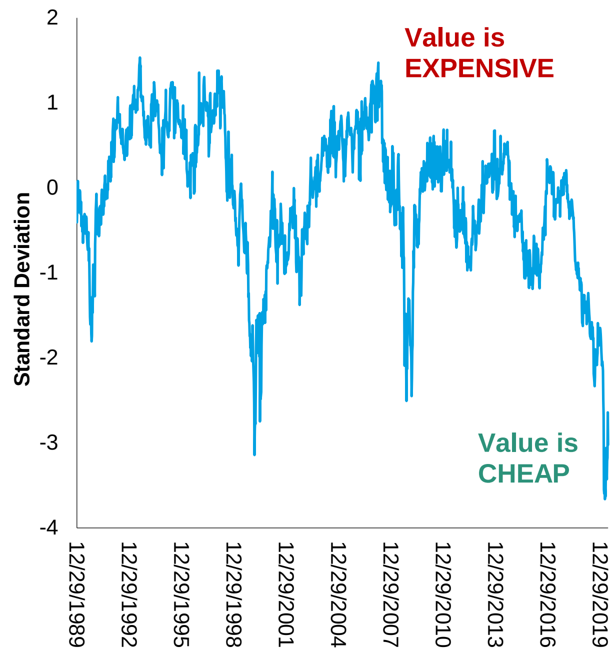
Valuation metrics for the S&P 500. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

5. On the other hand, does the following look like a bubble to you? Look how cheap value stocks are relative to history.

DISPLAY 2

The 100 Cheapest Russell 1000 Stocks versus History

December 29, 1989 – June 12, 2020



Source: Morgan Stanley Investment Management (MSIM), Applied Equity Advisors

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I am quite sure nobody in banking or energy (two industries heavily represented in the cheap bucket) would agree with Mr. Grantham that their company's stock was in a "real McCoy" bubble. Quite the opposite, in fact. A depression possibly, but not a bubble.

I would call these stocks the "no McCoys".

6. What is interesting is the trading resurgence by individual investors. If you watch CNBC at all, I am sure you have heard some Wall Street expert cast doubts on this group, suggesting they are causing a bubble.

   Nearly 800,000 people opened new accounts at the three biggest online brokers in March and April, amid the heart of the COVID-19 lockdown.[4]

   But look at the stocks being bought by these new traders:

   Indeed, the characteristics of the stocks they have bought tell the tale. Their penchant for down-and-out (or even bankrupt) stocks is well documented. The most popular stocks on Robinhood had low valuations and low share prices….[5]

   These new traders are buying the cheap stocks, many of which fall into that unusually cheap value bucket.

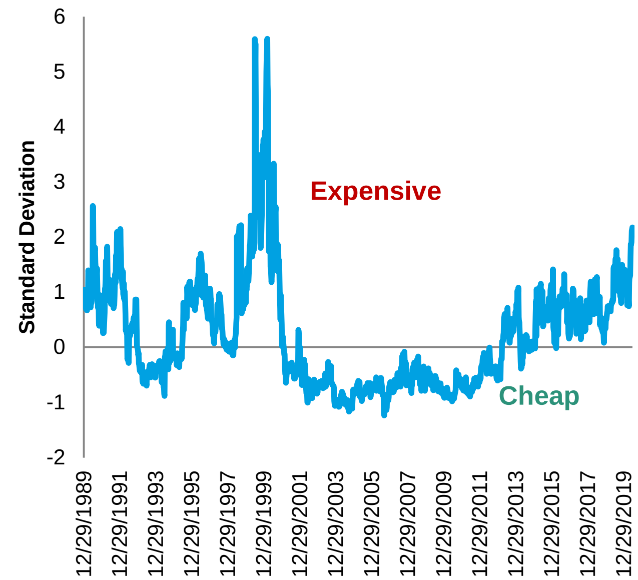
   A "bubble" requires speculation in outrageously priced stocks, not in low-valued stocks.

7. If the market is expensive, yet value stocks are very cheap (the current retail speculation is in these cheap stocks), then clearly there must be a group of "*super*" real McCoys where the real bubble is.

   They do exist.

DISPLAY 3

The 100 Most Expensive Russell 1000 Stocks versus History
December 31, 1989 – June 23, 2020



Source: Factset, January 1990 through June 2020.

Valuation differential between the most expensive decile of the Russell 1000 based on price-to-book in terms of standard deviation versus that of the market median. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

The 100 most expensive stocks in the Russell 1000 are now more expensive than they have been since the 1999 technology bubble.

None of these stocks are "planes, trains, automobiles, or casinos" which seem to be the new retail traders' focus.[6]

44 of these 100 most expensive stocks are technology stocks, and 29 are LOSING money. Of the 100 best performing stocks this year, the average P/E is 195x.[7]

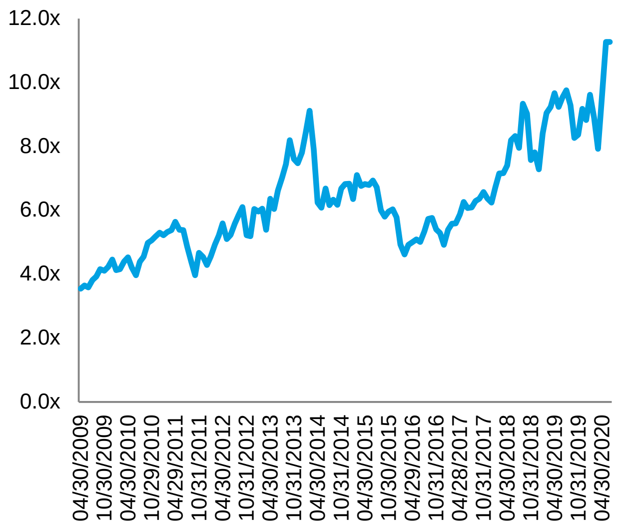
[4] Fox Business: June 13th, 2020.
[5] Empirical Research Partners. Market Structure: June 25, 2020
[6] Twitter. June 4th, 2020
[7] Russell 1000. Factset. June 25th, 2020

Here is a sector heavily dominated by the "super" real McCoys:

DISPLAY 4

Valuation of Top Software Companies in the US

April 30, 2009 – June 23, 2020



*Top software companies in the US by market cap to sales

Source: Factset., April 30, 2009 through June 23, 2020.

Top software companies in the US as defined by market cap to sales. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

8. Going back to the 100 Most Expensive Stocks chart, while these are the stocks pulling the market to a rich valuation, the basket is currently only trading at the August 1998 bubble pricing. The bubble did not implode until March 2000.

   This is exactly what Mr. Grantham points out:

   "The great bubbles can go on a long-time and (ultimately) inflict a lot of pain." [3]

   So if the retail day traders are actually not causing the bubble, then who is?

   *With net exposure to Cyclicals vs Defensives still near multi-year lows and exposure to crowding (growth) near 2019 highs, **it's clear that Hedge Funds have yet to embrace cyclicality**…* [8]

   So the true "real McCoy" is not being caused by the new retail traders Wall Street loves to pick on but actually…the supposed experts on Wall Street!

9. Unfortunately, greed drives the justification to ignore valuation, as Mr. Grantham readily points out.

   Here are the five-year returns of various indices when the most expensive stocks **first hit** this high level of valuation in August,1998.

DISPLAY 5

Range 8/21/1998 to 8/20/2003 Period Daily No. of Period 1825 Day (s)

	Security	Currency	Price Change	Total Return
1)	RLG Index	USD	-20,85%	-17,84%
2)	CCMP Index	USD	-2.06%	-.42%
3)	RLV Index	USD	4.54%	16.78%
4)	SPXEWTR Index	USD	34.24%	34.24%

RLG: Russell Large Cap Growth
CCCMP: NASDAQ Index
RLV: Russell Large-Cap Value
SPXEWTR: S&P 500 Equal Weighted.

Source: Bloomberg

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Investing in growth stocks or the NASDAQ 17 months before the bubble burst in March 2000, the returns were *still negative over the next five years*. On the flip side, while value stocks continued to languish for another 17 months, they made positive returns over the next five years, as did the *average* stock in the S&P 500.

[8] Nick Savone. Global Reflections. June 12th, 2020

Here are the returns over the next five years from the date of the bubble popping:

DISPLAY 6

Range 3/10/2000 to 3/9/2005 Period Daily No. of Period 1825 Day (s)

Security	Currency	Price Change	Total Return
1) RLG Index	USD	-43.96%	-41.53%
2) CCMP Index	USD	-59.17%	-57.91%
3) RLV Index	USD	29.51%	45.54%
4) SPXEWTR Index	USD	61.47%	61.47%

RLG: Russell Large Cap Growth
CCCMP: NASDAQ Index
RLV: Russell Large-Cap Value
SPXEWTR: S&P 500 Equal Weighted.

Source: Bloomberg

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Ouch.

Either the bubble is going to continue to expand for the NASDAQ /Large-cap growth stocks as it did in 2000, or it will deflate soon. If it continues to expand, the pain will be greater than if it contracts sooner, as Mr. Grantham points out.

My conclusion is that the bursting of the bubble in 2000 did not bring down all stocks over a reasonable amount of time, and given how relatively cheap value stocks are today, I do believe that this would be the case yet again.

10. Finally, I would remind everyone, Applied Equity Advisors is not a dedicated value investor. We are biased towards value in the US, but we own several growth stocks given, as we articulated, there is a chance the bubble could grow bigger. It's one of the biggest benefits of being a "core" versus a style specific manager. We think the risk is heightened in a certain group of technology stocks which "feel somewhat safe" right now. However, as Mr. Grantham said, the timing of when that might reverse is uncertain.

In the end, I do agree. There is a bubble, just not for every stock.

Andrew

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