

BSP Equity Market View: Remain constructive (but beware of a few bubbles forming)

In this issue of the Thinking Man, we discuss the recent volatility in the equity market, and provide our positioning recommendation for the last stretch of the year. 2020 has been a rollercoaster year for investors, especially in technology stocks. After gaining almost 76% from its March 23 low through September 2, the tech-led Nasdaq Composite index fell 10%, to 10,847.69, over the next three trading days, making it the swiftest correction on record.

However, this recent correction does not necessarily mean that the rally is over, or that the bubble has started to burst. Actually, we believe that the forces that drove leading stocks (such as the Big 5 Tech giants or other information technology mega cap stocks, like Salesforce and NVidia, which are part of our BSP Equity List) to amazing heights remain firmly in place. The three building blocks of the market's health do not indicate that a short-term correction should continue and rather suggest a continuation of the bull market. These building blocks are the core of the L.E.S. Model (Liquidity, Earnings and Sentiment) developed by Strategas about 20 years ago, which we will delve into below.

L: Liquidity

There is abundant liquidity in the market, a condition that is unlikely to change in the near future as the Federal Reserve (Fed) has committed to a "whatever it takes" approach in order to keep the economy afloat. Fed Chairman, Jerome Powell, has clearly stated that the policy committee is "not even thinking about thinking of raising interest rates", which probably means that there will not be any rate hike rates for the next 3 to 5 years. As it stands now, liquidity is about as positive as one could expect. M2¹ is growing at 23% year over year, the Federal Funds effective rate is at 9 basis points, and the yield curve steepness, as measured by the spread between

¹ M2 is a calculation of the money supply that includes all elements of M1 as well as "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds, and other time deposits.

The Thinking Man's Approach



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Ignacio Pakciarz | CEO

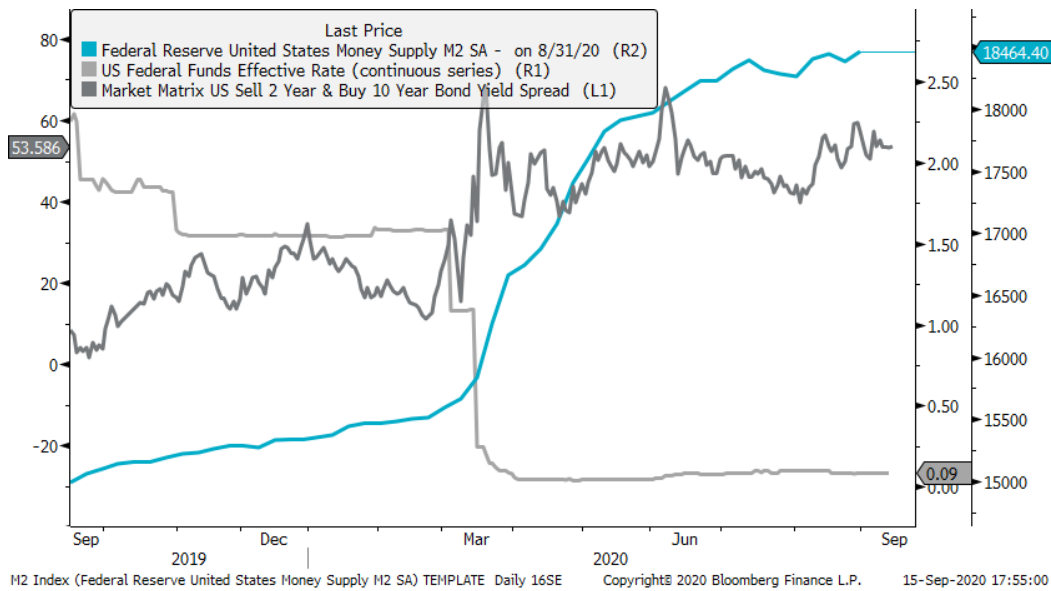
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- Following the Covid-19 crash of the first semester of the year, equity markets have rallied significantly, especially over the summer, boosted by tech mega cap stocks.
- However, since the beginning of September, equity markets have sold off, with the Nasdaq leading the downward trend.
- Despite the recent volatility, we maintain our moderately constructive view, as we do not believe that current conditions point to the end of the recent rally.
- In fact, the L.E.S. model developed by Strategas remains supportive for the equity market, based on ample liquidity, positive earnings metrics, and not overly optimistic sentiment.
- The current equity risk premium versus the real yield in Treasuries, continue to point towards market conditions where TINA will be a predominant supporting force.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com



the 2-year and 10-year Treasury is at 54 basis points, compared to almost zero a year ago (see chart below).



E: Earnings

Corporate profits are expected to continue recovering, given the significant economic improvement and the booster effect that Covid-19 has brought to corporate productivity growth. On the economic improvement front, annualized Gross Domestic Product (GDP) growth in the third quarter of 2020 is expected to be at least between 30-35%. Growth should start to normalize in the following quarters, albeit at a faster pace than before the pandemic. Annualized fourth quarter GDP growth is expected to be at approximately 5%, with a similar growth for the first quarter of 2021.

The key earnings metrics we consider are the following²:

- Earnings Growth: Third quarter earnings for the S&P 500 are estimated to decline by 22.2%. If this is the actual decline for the quarter, it will mark the second largest year-over-year decline in earnings reported by the index since the second quarter of 2009 (-26.9%).
- Earnings Revisions: On June 30, the estimated earnings decline for the S&P 500 for the third quarter was 25.4%. Currently, eight out of eleven sectors have smaller earnings declines or higher growth rates, as there have been significant upward revisions to earnings per share (EPS) estimates.
- Earnings Guidance: For the third quarter, 22 S&P 500 companies have issued negative EPS guidance, whereas 43 have issued positive EPS guidance.
- Valuation: The forward 12-month price to earnings ratio (P/E) for the S&P 500 is 21.7x. This P/E ratio is above the 5-year average (17.1x) and above the 10-year average (15.4x).

² <https://insight.factset.com/topic/earnings>



- Earnings Scorecard: For the second quarter, with 100% of the companies in the S&P 500 having reported actual results, 84% of the companies reported a positive EPS surprise and 65% reported a positive revenue surprise (above analyst consensus expectations). The second quarter marked the highest percentage of S&P 500 companies reporting a positive EPS surprise since FactSet began tracking this metric in 2008.

We expect a similar third quarter with significant EPS revisions, and similar EPS positive surprises. Even as the earnings picture is not optimistic across-the-board, it largely remains supportive of equities. Positive earnings revisions represent about 74% of all earnings revisions now.

S: Sentiment

Aside from the nosebleed valuation levels of the market's 10 largest stocks, it would also be difficult to describe investor sentiment as overly optimistic. There have been net outflows from both domestic and international equity mutual funds and ETFs and the AAI³ Sentiment Survey of individual investors shows little widespread irrational exuberance. Investor sentiment – as a whole – seems reasonable. It is also worth mentioning the recent retail investors' newfound interest in trading. Retail investors currently account for 44% of total trading volume, significantly higher than the 25% trading volume that occurred in 2009. We believe this actually constitutes a healthy broadening of the investor base.

Going forward, stocks will almost certainly remain volatile, but we believe that the apparent tech bubble will continue to inflate, as the selling pressure will likely dissipate in the short-term. However, there are certain areas of the equity market that look like bubbles. Clear examples are the Big 5 and other mega cap tech stocks (e.g. Salesforce, NVidia), the electric vehicle sector (e.g. Tesla, Nikola) and stay at home stocks of companies whose trends were highly accelerated by Covid-19 (e.g. Peloton, Zoom). Lastly, a signal of a market bubble is reflected in the boom for Special Purpose Acquisition Company (SPAC) structures. These vehicles, which are the new Wall Street darling, are companies with no commercial operations and are formed solely to raise capital through an initial public offering (IPO) for the purpose of acquiring an existing company.

As equities, especially in the U.S. have rallied significantly, despite Covid-19 headwinds, long-term equity returns might be below average. On the other hand, returns in the short and medium-term should be attractive, as long as there is a change in leadership that allows a market consolidation. We are convinced that markets should continue to rotate towards cyclical sectors such as transportation, manufacturing, industrials and financials, as wells as into mature tech companies, which include Qualcomm, Cisco and Oracle. The rotation should continue over the next few weeks, but will likely intensify as the announcement of a vaccine gets closer (1Q 2021), and distribution commences sometime in the second half of 2021 (2Q/3Q 2021). Hence, our recommendation to clients is to have a "barbell strategy" with

³ The American Association of Individual Investors (AAII) is an independent, nonprofit education group that provides the tools, resources and programs of education to assist individuals in successfully building and managing their own assets. The AAII Sentiment Survey has been conducted weekly since July 1987 and asks AAII members whether they think stock prices will rise, remain essentially flat, or fall over the next six months.



exposure to the momentum mega cap stocks, but also starting to include exposure to value plays, such as the cyclicals and mature tech mentioned previously.

Finally, from a relative valuation perspective, we believe that even as equities might look expensive compared to its historical valuations, in reality they remain attractive compared to fixed income securities and cash. As our colleagues from Strategas note, the equity risk premium (ERP) versus the real yield in Treasuries suggest that current market conditions are representative of "TINA on steroids". TINA, short for "There Is No Alternative", will continue to provide support for the market, as long as rates remain low, and market liquidity remains abundant, which is our base case for the next few years. Hence, our view of the equity market remains moderately constructive as we enter into the last stretch of the year, which includes the highly anticipated and potentially contested presidential election.



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