



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

October 2020

The Bifurcated U.S. Stock Market: the Sensible and the Speculative

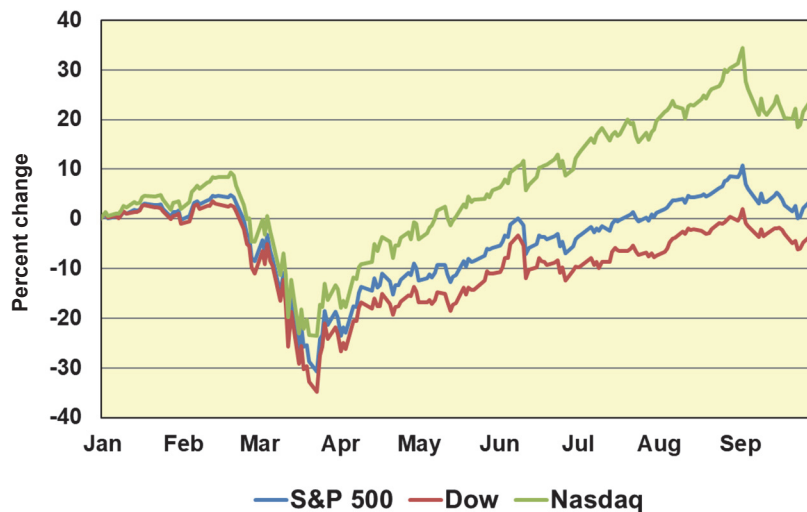
Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one.

Extraordinary Popular Delusions and the Madness of Crowds, Charles Mackay, 1841

What a year! 2020 is one year that none of us will ever forget. Surreal is a word that has become overused, but it is perhaps the only word that describes what we have experienced this year. If you had been told in January that a virus would cause the country to be locked down for months, that many would no longer go to the office but would work from home, that schools and colleges would close down, that most voluntary travel would end, and that all music, art, and sporting events would be canceled, you would not have believed it. Then, if on top of that, you were told that the worst crowd violence, riots, and looting in five decades would spread across the country, you would think that you were losing your mind. And finally, if you were told by market pundits that the broad U.S. stock market would be at a higher level than at the beginning of the year, you would know that the world had gone mad. But this, indeed, is exactly what we have experienced.

The chart below shows the path of the stock market for the first three quarters of 2020. With the realization in February and March of what COVID-19 would do to the global economy, the S&P 500 Index plunged 35.4%. But Congress, the President and the Federal Reserve acted quickly, decisively, and in concert to support the economy, and the stock market bounced back strongly, turning in the best performance in the second quarter for any quarter in twenty years. As the chart below shows, the price of the Dow Jones Industrial Average was down -0.91% for the year-to-date through September 30th, while both the S&P 500 Index and the NASDAQ Composite ended the period in positive territory. And the spread between the 24.5% increase of the NASDAQ Composite and the Dow Jones for this period is the main theme of this commentary.

S&P 500 Index / Dow Jones Industrial Average / NASDAQ Composite
January 1, 2020 – September 30, 2020



Source: Bloomberg

Macro Conditions in 2020

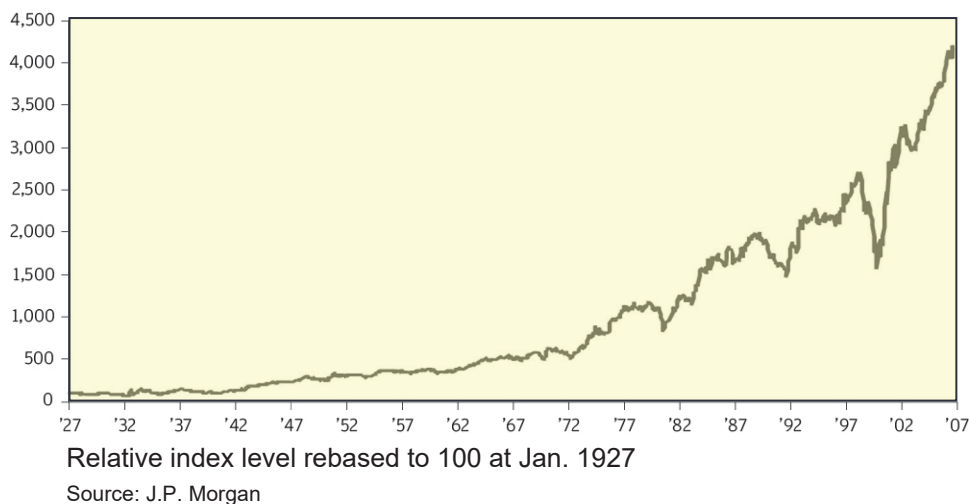
To understand what has happened to the stock market over the recent past and the current state of play, we need to examine some of the key economic and political factors which have taken place this year and still prevail in the U.S. When the COVID-19 virus struck America in full force in early March, causing the nationwide lockdown, everyone knew that the economy would come to a standstill, unemployment would soar, and GDP would plunge. These things did happen, and fear and pervasive anxiety gripped many Americans. Fortunately, the CARES Act was speedily enacted, injecting approximately \$2 trillion into the economy. However, as a result, the projected U.S. budget deficit for the fiscal year which ended on September 30th will total \$3.3 trillion – more than double the largest fiscal deficit in the Obama presidency. At the same time, the Federal Reserve swung into action, injecting massive monetary liquidity to stabilize the capital markets. In 2020, the Federal Reserve's balance sheet has grown \$3.1 trillion to \$7.1 trillion currently, and the M2 money supply has grown 24.1% from a year ago. The Fed also lowered interest rates to the lowest level in U.S. history. The yield on all U.S. Treasury obligations with a maturity of ten years or less is under 80 basis points or 0.8% annually.

Remarkably, this massive creation of money and rock-bottom interest rates has not yet triggered a rise in inflation. Inflation continues to be very tame – below, in fact, the 2% target of the Federal Reserve. The reason for this is that most people are not spending money, for there is little to spend it on. Travel is still nearly dead, many retail stores and restaurants continue to be shuttered, and sporting events are being held with few if any spectators. Banks see little loan demand. In fact, credit card debt is being repaid. The modest amount of money which is being spent is on home improvements and on home purchases. But money is definitely at work in the stock market. And the retail investor is back in the stock market in force. The combination of money being easily available at almost no cost and many people working from home with more time on their hands has brought back the individual investor. According to some sources, a quarter of the trades each day are executed by the retail investor – more than double the number in 2019. And there has been a large increase in speculation and the use of options. This helps set the stage for the current bifurcation of the stock market. There are really two things going on: a wide divergence between growth and value stocks, and a gulf between speculative stocks and blue-chip stalwarts. First the growth/value dichotomy.

Growth Stocks vs. Value Stocks

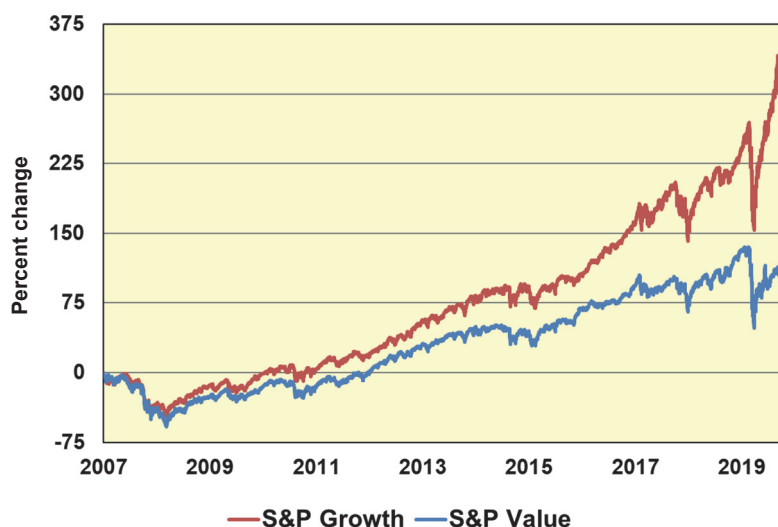
For an eighty-year period from 1927 to 2007, value stocks outperformed growth stocks by a very wide margin. Since 2007, however, growth stocks have significantly outperformed value stocks. There are several reasons for this. The first is that financials are the largest part of the value index, while technology stocks make up the largest part of the growth index. Since the Financial Panic of 2008, financial stocks have performed very poorly relative to both the S&P 500 Index and to the various growth indexes. This is due to the need of most banks to rebuild their balance sheets as well as the meager net interest margins caused by the low interest rates. Energy stocks are also part of the value indexes, and they have underperformed badly – especially recently with the COVID-19-induced plunge in global GDP, which has caused a decline in demand for oil and gas. The chart on the following page shows the historic outperformance of value stocks until recently:

Relative Performance of U.S. Value Stocks vs. Growth Stocks 1927 – 2007



As can be seen above, growth stocks had a great run in the 1990s, leading up to the internet bubble. After a painful period of consolidation, which lasted most of the first decade of the 21st century, growth stocks came into their own again with the internet and social media revolution. The iPhone was introduced in 2007, Google became a verb in the English language, and Facebook and Twitter changed the world for many, all leading to remarkably strong sales and earnings growth in this sector. The NASDAQ Composite, which consists of the stocks of approximately 2,700 companies, is chockablock full of technology companies. Currently, Apple, Microsoft, Amazon, Alphabet (Google), Facebook, and Tesla account for more than 40% of the weighting of the NASDAQ. The stocks of these mega-cap names have been on a roll for the past decade. The chart below shows the outperformance of the Growth Index over the Value Index since 2007.

S&P 500 Growth vs Value Total Return Index 2007 – 2020



Source: Bloomberg

One of the key rules of the stock market is reversion to the mean. In this case, it should mean that ultimately the worm will turn, and value stocks will once again outperform growth stocks. But there is

another stock market rule: the trend is your friend. And in this case, there are many reasons why the trend of outperformance of growth stocks may continue for quite a while. As we have written before, negative real interest rates have the effect of enhancing the attractiveness of the stocks of companies with soaring growth rates. This is because future returns are discounted to their present value by rock-bottom interest rates, leading to dramatically higher present values. And there are a plethora of businesses in the SAAS (Software as a Service), communication, and technology industries that are flourishing with the move to the cloud and the remote-work environment. The stocks of these businesses have been some of the big winners this year. Other key market favorites this year are six mega-cap stocks which have had an outsized influence on the performance of the stock market in 2020. The table below shows the influence these FAANG + Microsoft stocks have had on the market through September 30, 2020:

	% Weighting of S&P 500 Index	Total Return
S&P 500 Index	100.00%	5.57%
Apple	6.68%	58.84%
Microsoft	5.72%	34.43%
Amazon	4.88%	70.40%
Google (Alphabet)	3.15%	9.42%
Facebook	2.28%	27.60%
Netflix	<u>0.83%</u>	<u>54.54%</u>
Total:	23.54%	34.15%
Remaining S&P 500 Index	76.46%	-3.22%

The losers in 2020 to date have been banks and most other financials, companies in the travel and lodging world, REITs, industrials, retail firms and energy companies. The value indexes are full of companies in these sectors.

The Speculative Bubble

With the cost of money being close to zero, along with the return of the retail day trader, stock valuations in certain growth sectors of the market have lost their moorings. The market's current love affair with companies with blistering sales growth but negative earnings is reminiscent of the "internet bubble" of 1997-2001. The table below shows the valuations of key players in this classic bubble:

December 31, 1999		
Company	P/E Ratio on Forward Earnings	Market Capitalization/ Sales Ratio
America Online	195	36.5
Cisco	95	26.5
Lycos	318	40.8
Microsoft	66	30.0
Oracle	90	16.4
Sun Micro	77	9.7
Yahoo	627	281.0

A number of these companies failed or were acquired; others survived the mania. However, it took Microsoft and Oracle more than 15 years to regain the price that their stocks reached during the internet bubble, and Cisco currently trades at roughly 50% of its peak price reached in March, 2000.

September 30, 2020

The list of companies below represents some of the leading players in the current “bubble.” There are several hundred more companies with similar profiles in the technology and biotechnology sectors:

Company	P/E Ratio on 2021 Operating EPS	Enterprise Value/ Sales Ratio
Coupa	459	29
CrowdStrike	579	26
Datadog	691	42
DocuSign	237	22
Okta	2620	25
Shopify	476	35
Snowflake	negative	62
Tesla	145	10
Veeva	90	25
Zoom Video	183	45

Clearly, valuations for these stocks have gone wild. It is important, however, to emphasize that all ten of these companies have great products and services, strong managements, large target markets, and demonstrably super sales growth. And, it is the sales growth – not the earnings growth (as few have earnings) – which is driving the speculation in the stocks. The current crop of speculators have forgotten the rule that states: the trend is your friend until it is not. These sorts of valuations are predicated largely on the “Greater Fool Theory.” This theory assumes that the buyer of an asset at greatly overvalued prices will be able to find an even greater fool to purchase the asset at a still higher price. The most famous example when the Greater Fool Theory reigned was the Tulip Mania in Holland in the 17th century when huge prices were paid for assets which had no real value at all – in one case, a tulip bulb fetched a price of \$10,000. Such crowd behavior is well described in Charles Mackay’s classic published in 1841, *Extraordinary Popular Delusions and the Madness of Crowds*, from which the quote at the commencement of the commentary comes. Our advice for those speculating in these stocks is: Caveat emptor! Look back twenty years and learn.

Currently, the S&P 500 Index is trading at a P/E of 21 or 22 times 2021 operating earnings – rich but not excessive in the current inflationary environment with interest rates below 1%. This assumes that following the estimated 3-4% contraction of 2020 GDP, the U.S. economy will rebound 5-6% in 2021. And in this strangely bifurcated U.S. stock market, there are many quality blue chip companies trading at sensible valuations. A few examples are listed on the following page:

**U.S. Large Capitalization “Stalwart Companies”
at Sensible Valuations**

Company	Price 10/2/20	2021 EPS (Non-GAAP)	2021 P/E Ratio	2021 EV/Sales
Abbvie	\$ 86	\$ 12.23	7.0	4.0
Alphabet (Google)	\$1,456	\$ 56.51	25.8	4.4
Apple	\$ 113	\$ 3.92	28.8	6.5
Comcast	\$ 45	\$ 2.95	15.4	2.8
Deere	\$ 225	\$ 10.26	21.2	3.4
Johnson & Johnson	\$ 146	\$ 9.02	16.2	4.6
JP Morgan	\$ 98	\$ 8.63	11.3	2.7
Merck	\$ 81	\$ 6.24	12.9	4.4
Microsoft	\$ 206	\$ 7.82	26.4	8.3
Northrup Grumman	\$ 314	\$ 25.22	12.4	1.8

The average P/E for these ten blue chips is 17.7 – well below the P/E of 21.5 on the 2021 operating earnings of the S&P 500 Index. All but Google pay a dividend, and the other nine have a history of raising their dividends each year.

The fundamental determinants of stock prices over the longer term are earnings (not sales), interest rates and liquidity. These three legs of the stock market’s stool appear to be reasonably firm – notwithstanding the COVID-19 and election uncertainties. If the current bubble of speculative and momentum stocks is burst and/or the political crosscurrents cause a sell-off, the stocks of the above companies should withstand the correction far better than the market’s current speculative darlings. While we do not foresee a repeat of the 35% February/March plunge, increased volatility is likely over the coming months. Accordingly, we will continue to focus on preserving capital by investing in quality, reasonably priced growth companies, like the ones above, with great brands and sound business models, solid balance sheets, and strong earnings.

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Investment Management

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