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MACROCOSM

Growth: Over Valued and Under Attack

Wednesday, April 9, 2014

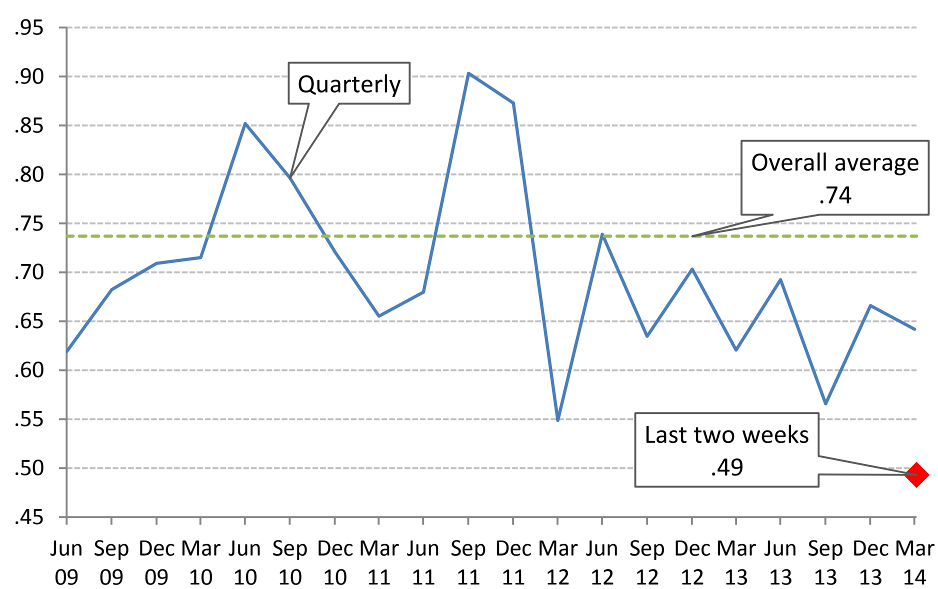
Donald Luskin

As winter ends, cyclical and political triggers for the worst growth stocks chill in five years.

With some of this bull market's best-performing sectors under intense selling pressure in the last two weeks, it's hard to believe that the S&P 500 hit all-time highs just last Friday. It's been a strange and disturbing couple weeks, to be sure.

- Over the last two weeks US stocks have been less correlated across sectors than at any time in the present bull market that began in March 2009 (please see the chart below).

Correlation between the ten S&P 500 GICS Level 1 sectors



Source: Bloomberg, TrendMacro calculations

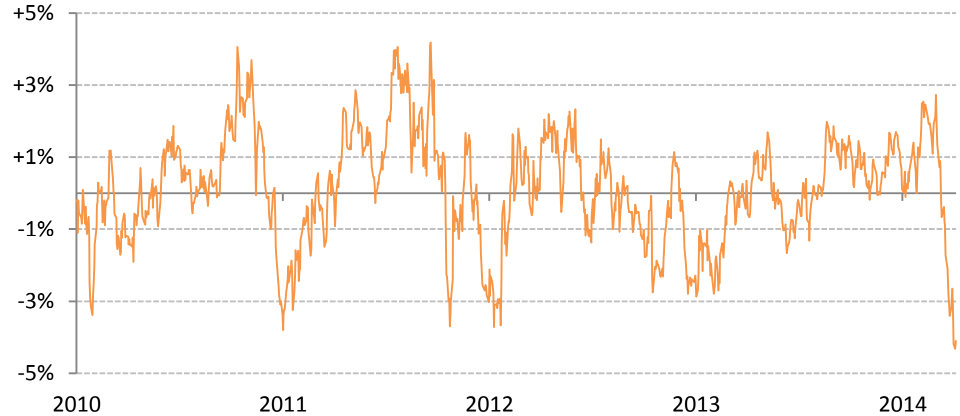
- This discorrelation has been most pronounced between "growth" and "value" stocks.
- This appears to be a seasonal effect. In this bull market, every year, in the first quarter, growth has sharply underperformed value. But in the present episode of growth the underperformance is the sharpest so far (please see the chart on the following page).

Update to strategic view

US STOCKS, US MACRO: Even as stocks made all-time highs, growth sectors have experienced their worst performance in this five-year bull market. We think this is cyclical speculative reaction, driven by recent extreme relative overvaluation -- not a signal that there is an imminent threat to economic growth or earnings. That said, the correction in growth stocks has taken place against the backdrop of anti-growth political events including attacks on innovative trading technologies, biotech's pricing model, Tesla dealerships, the Koch brothers and China's RMB depreciation -- and a slew of egalitarian policy proposals from the White House. It all exerts a chilling effect, but it's just political theater as the mid-terms approach, in which GOP Senate control is all the more likely. As with the economic effects of the chilly winter, this too shall pass.

[Strategy Dashboard home]

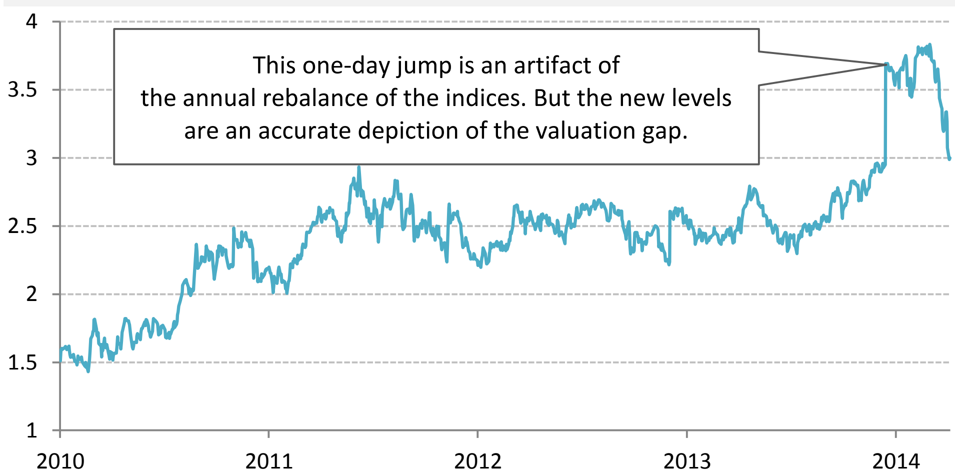
Rolling one-month returns: S&P 500 Growth minus S&P 500 Value



Source: Bloomberg, TrendMacro calculations

- *We don't want to wave this away as only a seasonal effect. But neither do we want to jump to the conclusion that this is a unique and meaningful signal that the market sees an imminent threat to growth. We continue to expect that once the excessive optimism of the fourth quarter and the near-record cold winter work their way through the macro statistics and the earnings season just beginning, the economy and the earnings environment will stand revealed as attractive and improving.*
- We'll take about alternative explanations shortly. But for now we are inclined to interpret this as a speculative correction. Prior to the sell-off, the valuation gap between growth and value had grown to its widest in the current bull market (please see the chart below).
- This is consistent with widespread reports that momentum-driven hedge funds have been over-exposed to these overvalued stocks.
- But we think this over-exposure has a little more than the usual hope, greed and fear paradigm behind it. There's also an element of frustration that is unique to the present market moment.

Forward PE multiple: S&P 500 Growth minus S&P 500 Value



Source: Bloomberg, TrendMacro calculations

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Recommended Reading

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Bank for International Settlements Papers
March 2014

[Reading home]

- About six weeks ago, when the stocks that have been hit the hardest were still making new highs, a hedge fund manager we've known well for many years -- not a client -- told us about his new-found affection for biotech stocks. His view was that while most of risk-averse corporate America is delivering mediocre earnings growth through cost-cutting, biotech companies are taking the entrepreneurial risks that will lead to earnings breakthroughs.
- He was quite late. Some of the biotech stocks we follow have already been five-baggers and ten-baggers over the last year and a half. But his rationale -- to the extent that it was something more than an excuse for jumping into proven high-fliers -- makes a certain kind of sense. *In the Not So Great Expansion following the Great Recession, true fundamental growth stories have been scarce -- and scarcity always commands a high price.*
- *If we are right that over the coming quarters the caution-constrained mediocre growth we've had for the last five years will give way to superior confidence-driven growth* (see "A Major Upgrade to our Strategic Outlook" September 12, 2013), *then growth will have become less scarce and more abundant -- and thus less valuable in terms of relative equity valuations.*
- Isn't that completely consistent with this strange episode in which growth stocks have been so punished while stocks overall have made new all-time highs? Could this just be turbulence as the equity risk premium transitions from the low end of its crisis-era range to the high end of a new range consistent with less risk in the global economy (see "Regime Change for Equities" November 26, 2013)?

To be sure there are other explanations beside the simple valuation argument, and our anecdotal narrative of it. Clients have cited a number of growth threats that have materialized over the last several weeks -- and it's certainly possible that growth stocks, however overvalued they were, are reacting to them like canaries in the mineshaft.

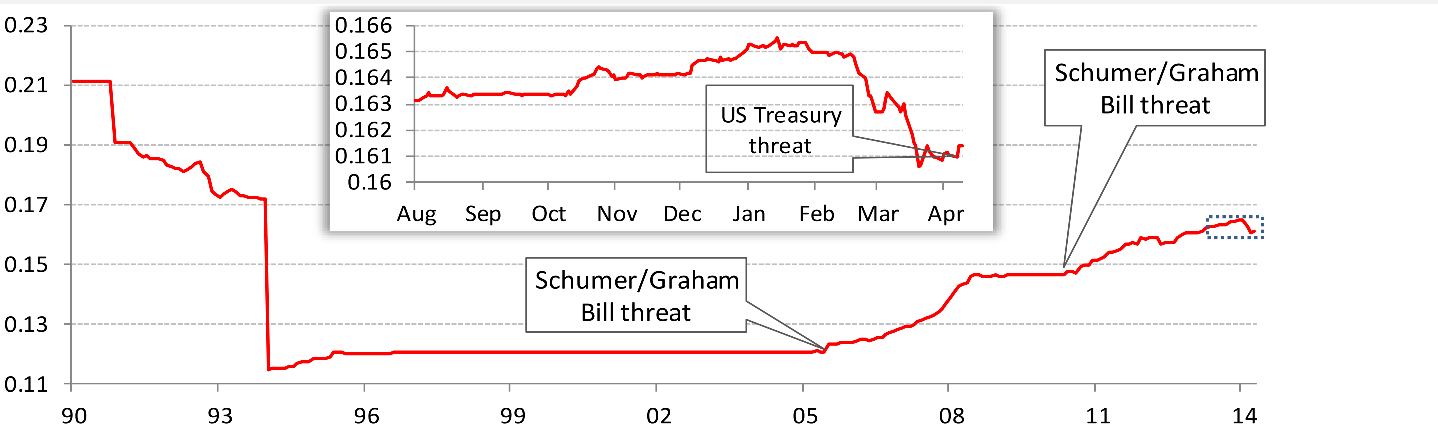
There have been several threats coming from the US political environment that may have had some degree of a chilling effect.

- After US stocks opened at all-time highs on Friday following a fairly positive jobs report (see "On the March Jobs Report" April 4, 2014), they reversed sharply following news that Attorney General Eric Holder had confirmed to the House Appropriations Committee that the Department of Justice is conducting a criminal investigation of so-called high frequency trading. Following publication of Michael Lewis's incendiary book on the subject, this ended a week of mini-frenzy for regulatory intervention -- ostensibly intended to level the playing field, but if implemented having the effect of crippling technology innovation in market infrastructure. Goldman Sachs let it be known yesterday that it may shut down its Sigma X trading venue, in part due to growing criticism.
- The threat most obviously connected in time to the start of the growth sell-off was the announcement on March 20 that Representative Henry Waxman (D-CA33) and the other ranking

Democrats on the House Energy and Commerce Committee had sent an aggressively worded letter to Gilead Sciences (please see the important note at the end of this report) protesting the price of Sovaldi, the breakthrough Hepatitis-C treatment. While these minority members of the House have no legislative power to do anything about it at the moment, it was a shot across the bow: in a post-Obamacare world in which government is increasingly responsible for the cost of treatments, the rents pharmaceutical companies can expect to earn on their blockbuster drugs may be lower than what is built into today's earnings models.

- Tesla Motors -- a favorite momentum stock for the last couple years -- achieved a victory of sorts two weeks ago in its battle with the New York Automobile Dealers Association over its direct ownership of sales outlets. The agreement protects Tesla's five existing New York showrooms, but future showrooms will be operated as dealerships. And in New Jersey, Tesla outlets have been banned from sales activities -- apparently with the complicity of Governor Christie, who ought to know better. So while optimists may argue that Tesla has achieved a technology breakthrough in automobiles, these battles are rubbing investors' faces in the reality that in today's regulatory environment innovators face very high hurdles.
- The demonization of the Koch brothers and Koch Industries -- at first only an over-the-top outburst by Senate Majority Leader Harry Reid (D-NV), has now become an organized battle-front for Democrats at risk in November's mid-term elections.
- While all of these attacks on business have been going on, the Obama administration has been grinding out anti-growth policy initiatives -- including the minimum wage, wage equality, and stricter overtime rules. None of these has much chance of being enacted into federal law or regulation. But they nevertheless increase public demand for such things -- some of which, as a result, are indeed being enacted in Democrat-controlled states. And they raise the stakes on the coming mid-term election.
- And yesterday, after three months of a depreciating Chinese remnimbi (please see the chart below), the US Treasury has

Chinese RMB versus USD

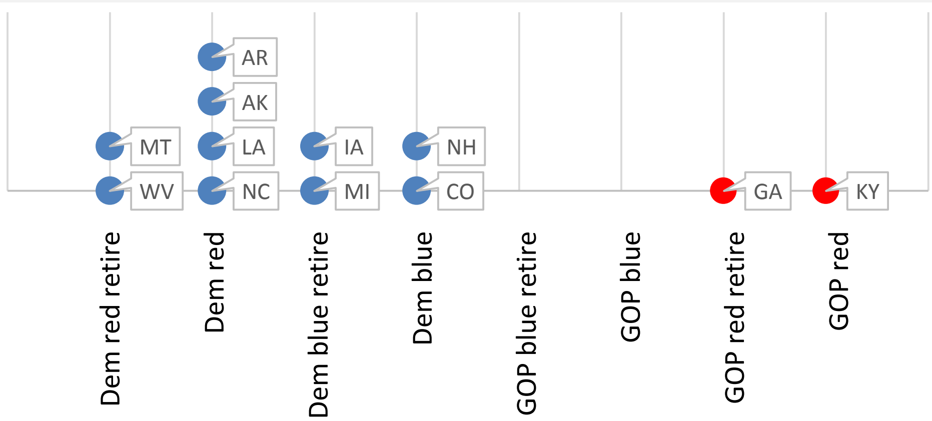


Source: Bloomberg, TrendMacro calculations warned China ahead of this week's G20 meeting that this raises "serious concerns." Almost nine years of RMB appreciation has been triggered by two cycles of US threats to impose punitive tariffs unless China rebalanced is supposedly undervalued currency (see "Tsunamis! Killer Asteroids! Protectionism!" April 21, 2005, and "No Protectionism Threat: Yuan To Bet?" March 18, 2010). That has led to severe imbalances in China's banking system, as speculative inflows funded the shadow banks. Now the attempt by Chinese authorities to discipline speculators by demonstrating that the RMB is not a one-way bull bet has awakened US protectionism -- the last thing China needs as it undertakes the dangerous task of bubble-pricking.

- Finally, we think some of the chill in the air is the result of the market now having had two disturbing experiences with new Fed Chair Janet Yellen -- her first FOMC press conference, in which she appeared completely out of control of her message to markets, and her first public speech which she conducted in the manner of a political rally (see "On the March FOMC" March 19, 2014, and "On Yellen's First Public Speech as Fed Chair" March 31, 2014).

A common element running through all these threats is political posturing ahead of November's mid-term elections, in which we believe more than ever that the Republican's will take control of the Senate, with an increasing number of Democratic seats now in play (please see the chart below).

Competitive US Senate races ● **Dem incumbent** ● **GOP incumbent**
Red states voted for Romney 2012, Blue states voted for Obama



Source: Cook Political Report, TrendMacro calculations

- In this environment the Democrats' job now is to make the strongest possible populist appeals -- many of which entail anti-growth and anti-business policies -- force the GOP House to vote to block them, and to vilify GOP candidates and their backers.
- This is all pretty harmless -- with the GOP firmly in control of the House, there's not much mischief the Democrats can actually do. It's mostly theater.

And incidentally…

In this atmosphere, clients have expressed worry about the announcement last week by the Commerce Department's National Telecommunications and Information Administration that it will withdraw from its supervisory role in ICANN, an organization that administers elements of the infrastructure of the internet. The concern is that the Obama administration intends to cede authority to some international body, such as the United Nations, which could impose taxes, censorship or other burdens on users or infrastructure firms. We do not believe this is anything to be concerned about. The US's intent is get government -- itself -- out of the internet, replacing it with a "global multistakeholder" model in which it "will not accept a proposal that replaces the NTIA role with a government-led or an inter-governmental organization solution."

- But it does put a chill in the air, and all the more so in light of last week's forced resignation of Mozilla Foundation chair Brendan Eich, because he had given money to support a California law banning same-sex marriage. *That was an example of how populist fury can do more than just vandalize a Google bus -- it showed that businessmen can become victims of digital lynch mobs. Social media are a force-multiplier that can be applied to companies and entire sectors. So the worst-case scenarios facing Koch, Tesla, Gilead and securities exchange operators are potentially something more than mere tail events that can effectively be ignored. They become at least fat-tail events -- still unlikely, but not to be ruled out.*

Bottom line

Even as stocks made all-time highs, growth sectors have experienced their worst performance in this five-year bull market. We think this is cyclical speculative reaction, driven by recent extreme relative overvaluation -- not a signal that there is an imminent threat to economic growth or earnings. That said, the correction in growth stocks has taken place against the backdrop of anti-growth political events including attacks on innovative trading technologies, biotech's pricing model, Tesla dealerships, the Koch brothers and China's RMB depreciation -- and a slew of egalitarian policy proposals from the White House. It all exerts a chilling effect, but it's just political theater as the mid-terms approach, in which GOP Senate control is all the more likely. As with the economic effects of the chilly winter, this too shall pass.

[Note: the author of this report has, and has had for many years, a position in his personal account in the stock of Gilead Sciences. He sold a portion of his position several weeks ago, and reserves the right to buy or sell shares in the future with no further notice.]