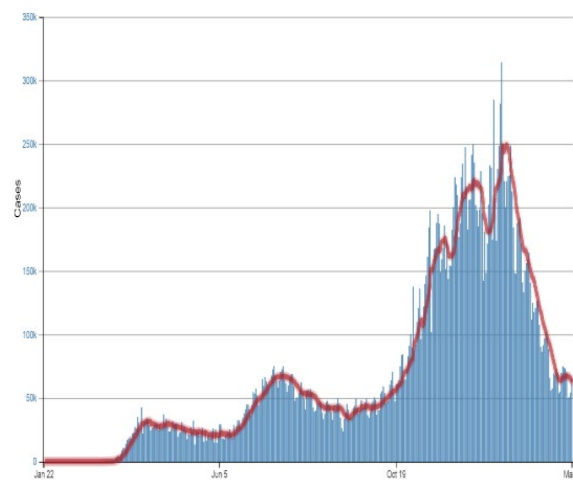
Making sense of recent technology and growth share price movements

Higher U.S. bond yields imply lower Nasdaq equities valuations

Not surprisingly the Coronavirus (COVID-19) pandemic has had a profound influence on global capital markets over the past year plus. Yet, the pandemic appears to have peaked and new infection rates, hospitalisations and deaths are now in steep decline in the U.S. and other major developed countries. This is primarily due to immunity from past infections and the rollout of vaccines. Indeed, the remarkable success of biotech and pharma companies in developing and certifying for emergency use multiple COVID-19 vaccines in record time and with a high degree of immunity conferred (up to over 95%) is an exceptional achievement.

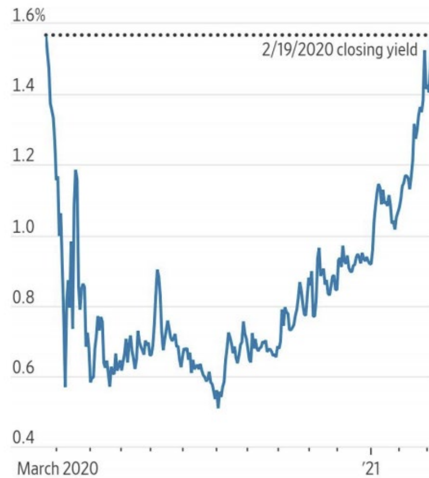
Daily Trends in Number of COVID-19 Cases in the United States Reported to CDC



Source: U.S. CDC (Centers for Disease Control and Prevention)

Major vaccine milestones include the Pfizer–BioNTech COVID-19 vaccine receiving U.K. Medicines and Healthcare products Regulatory Agency (MHRA) emergency use approval on 2 December 2020, quickly followed by approvals from many other countries' health authorities. The good news continued with emergency use approvals in the U.S. and other countries of COVID-19 vaccines developed by Moderna and Janssen/ Johnson & Johnson. The Oxford-AstraZeneca COVID-19 vaccine has also received numerous emergency approvals and is playing a major role in vaccination efforts in the U.K., E.U. and Australia.

As a result, capital markets are increasingly looking past the pandemic. The prospect of economies soon reopening (including to travel and tourism) is supporting a strong recovery in hotel, travel, energy, materials, and industrial share prices. Within the U.S. specifically, growth and inflation outlooks are also being influenced by the pending passage of a large US$1.9 trillion Federal stimulus plan that passed both the U.S. Senate and U.S. House and is expected be signed into law this week. This stimulus is on top of several U.S. Federal stimulus packages passed in March and April 2020 totalling ~US$2.8 trillion and a $900 billion package passed in December 2020. In total, U.S. Federal budgeted COVID-19 stimulus plans will total an extraordinary ~26% of annual U.S. Gross Domestic Product (GDP).



Sources: Tullet Prebon, Wall Street Journal, March 3, 2021

Market expectations for a sharp recovery in economic activity from last year's highly depressed levels and signs of rising inflationary pressures are pushing long rates upwards. For example, the yield on the 10-year U.S. Treasury note was just below 1.6% at the start of March 2020, bottomed at below 0.6% in September 2020 and this week surpassed 1.55%. While U.S. Federal Reserve Bank, or U.S. Fed, remains committed to a highly stimulative monetary policy, it is so far unclear what level of rates or broader financial market conditions would prompt the Fed to take aggressive action, possibly by reprising the Fed's Operation Twiss from 2011 and 2012 to push down long-term rates by making large monthly Fed purchases of long duration Treasury notes.

At the beginning of the COVID-19 pandemic, technology stocks were comparatively less impacted by social distancing, work from home, travel restrictions and other emergency measures implemented to stop or slow the spread of the coronavirus. In many cases, tech companies were perversely helped by these measures. For example, closing movie theaters helped Netflix, work from home and virtual on-line events helped Zoom, the closing of non-essential retail stores greatly helped online focused retail business, and there were many other such examples. Growth stocks also benefitted from sharp declines in risk-free rates, as assuming all other things remain equal, share prices and discount rates move inversely.

Sources: FactSet, Wall Street Journal, March 4, 2021

Now we are seeing these trends unwind, at least partially. Cyclical, economically leveraged stocks and shares in sectors that suffered during the lock downs (for example, hotels, travel, physical retail, and energy stocks) are now capturing investors' attention. These more value-oriented stocks are also much less impacted by rising risk-free rates as their valuations and earnings multiples are much less demanding. For example, even after Tesla's recent circa 30% share price decline since late January, Tesla's stock price is still up over 300% over the last 12 months and its consensus FactSet 2021 P/E multiple is 155 times. For reference, Volkswagen, Toyota, BMW, Daimler, GM and Ford's P/E ratios vary between 8.5x and 12.7x.

Clearly, Tesla's valuation reflects very robust earnings growth expectations over multiple years far out into the future. Even assuming these aggressive implied earnings growth expectations are entirely correct, which may be questionable given rising electric vehicle competition, increasing risk-free rates greatly erode the present values of Tesla's earnings far in the future. Similar math applies for other growth and technology stocks trading at earnings multiples that are far elevated above their pre-pandemic P/E ratios. Shifting momentum and investor sentiment also are important considerations.

A rotation from growth stocks into value shares was anticipated coming into 2021, as the spread in returns between growth and value stocks has been exceptionally wide (for example, the S&P 500/ Citi Growth index gained 31.9% in 2020 while the S&P 500/ Citi Value index had a -1.9% loss). This rotation is normal and unlikely to greatly concern the U.S. Federal Reserve. A broad sell-off of U.S. equities large enough to impact consumer spending intentions and corporate investment plans would be another story entirely. In such a scenario, the U.S. Fed would likely act aggressively to suppress and control longer-term risk-free rates. We believe many parts of the Australian and global share market are reasonably valued and are excellently positioned to benefit from a global economic recovery.

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