Investment Weekly

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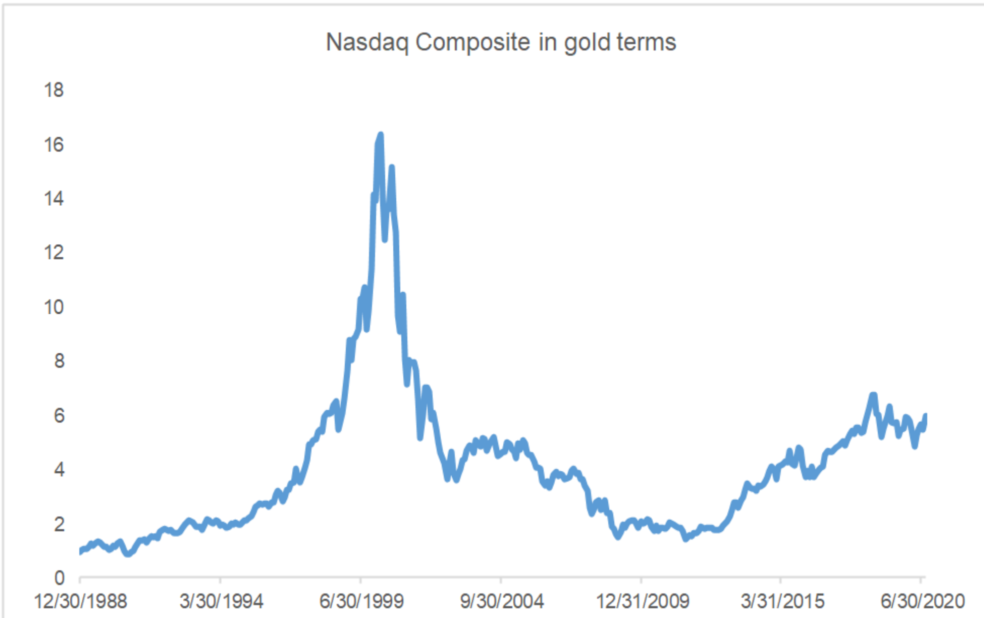
Stock markets do not move in a straight line, up or down

- **The wobble in technology shares last week was to be expected, given how fast they had moved up.**
- **While some valuations are stretched and investors may reassess some targets, there are many reasons to remain relatively bullish on risk assets.**
- **Ultra-low interest rates for a very long time, and potentially more quantitative easing across the world suggests high growth and high-yielding assets will remain in favour.**
- **The FAB AAC remains slightly underweight in equities, and overweight in IG bonds and gold.**



Investors shuddered towards the end of last week as a sudden sell-off in tech stocks erased two weeks of gains for most US indices. As the NASDAQ Composite index fell 6.2% on Thursday and Friday, sending it back to levels of 21 August, commentators were quick to start making comparisons to both the burst of the dotcom bubble, and to the March sell-off.

However, it is hard to argue that either of those actually applies. In fact, the occasional correction is to be expected, and may be a sign of a healthy bull market, especially after a strong run.

The NASDAQ retreat began after it closed above 12,000 on Wednesday, the first time this milestone was reached. Some profit-taking would not be uncommon after such a key line had been crossed, especially because the NASDAQ surmounted two big round numbers this year for the first time: 10,000 and 11,000. The third one was bound to generate some second thoughts.

In fact, the technology-heavy gauge had seen an almost parabolic upward move since its low on 23 March, and a bit of retracement to bring it back to a normal trajectory is healthy. The index had rallied 75.7% since the market low and 2 September, just before the sell-off began.

A good part of these gains were driven by a few companies seen as major beneficiaries of a secular behavioural change accelerated by the lockdowns that ensued the Covid-19 pandemic. And this may help to explain the sudden sell-off. Apple's stock, for instance, rallied 134.26% over the same period, while that of Microsoft and Amazon gained 70.4% and 85.6% respectively. Facebook rallied 104.3%, and Google advanced 62.9%.

These five names have paced the rally and dominate most US large-cap indices. They represent 23.2% of the S&P 500 and 47.3% of the NASDAQ 100, the 'pure tech' version of the NASDAQ Composite.

In gold terms, technology stocks remain very far from their dotcom bubble highs

Hence, what happens to these companies affects the whole market. And, perhaps, Apple was part of the reason for the sell-off. The company did a 4 for 1 stock split on Monday which reduced the nominal value of its shares, making them more liquid and accessible to retail investors. The move resulted in a 7.5% rally in two days. However, those gains also resulted in Apple being valued at 36.6 times its expected earnings for the next 12 months. Some may see that as excessive.

That is not to say that Apple is overvalued. Part of its valuation is determined by profit growth expectations. Indeed, looking at expected profits versus price a further year out brings the ratio down to 31.5.

Regardless of that, some investors took profits on the stock, driving its shares down nearly 10% in three days. That was among the reasons that the major equity indices dropped, and helped pace losses for most other technology stocks too. However, part of the reason why Apple shares are so highly valued relative to their own history (apart from the company's profitability), are interest rates.

When investors get almost nothing for parking their money in what is considered the safest asset (US Treasuries) they are forced to seek assets that provide higher returns, whether in terms of growth or yield. That is probably the main reason why technology stocks and high-yield bonds have rallied so much since the end of the first quarter. And that is probably unlikely to change anytime in the foreseeable future.

In fact, the result of the latest policy framework review of the Federal Reserve set that idea in stone. After studying how they determine interest rates and how it achieves their goals of price stability and low unemployment, policymakers decided they should target an average inflation rate instead of a fixed number. That confirmed that the Fed is willing to let inflation run above 2% for a considerable period of time before it starts to raise rates again.

This week will bring an updated read on dollar-based consumer prices, but in July inflation was running far behind that target, at 1%, according to the Bureau of Labor Statistics. And throughout the almost 10 years of near-zero rates in the US, core personal consumption expenditure, the measure the Fed favours, only breached 2% for a few months, and marginally. With US unemployment still at 8.4%, the highest since 2012, it is hard to see a lot of pressure on prices that would warrant raising rates for at least a couple of years.

Another major source of inflation, energy prices, is also in check. Today, Saudi Aramco reduced the price on its key Arab Light crude for Asian exports by more than expected, in a sign that demand recovery is a bit slower than expected.

Oil prices appear to remain stuck in a range. Besides that, technology that allows for better and cheaper shale oil exploration also means that higher energy prices could bring back that source of supply. In other words, energy is unlikely to add significantly to inflation for years to come.

Investors will watch the ECB meeting closely as the euro trades near the key US$1.2 level

Perhaps the biggest risk to low interest rates is more market-driven. International demand for US Treasuries, particularly from sovereign nations, has dropped recently as some of the geopolitical disputes with the US have driven countries to begin to replace US Treasuries for gold in their international reserves. Russia has done it, starting two years ago, while some other nations have expressed similar intentions.

The latest salvo in that battle may be a bit more concerning, though. A report in the Global Times, generally seen as a venue for Beijing to communicate policy change, indicated that China could try to reduce the percentage of US Treasuries in its reserves. The country is currently the largest single holder of those securities, and if it indeed starts selling, Treasury yields may begin to rise.

Eventually, higher Treasury yields may attract other investors, particularly if the US dollar drops further as a result of Chinese sales. Still, there could be some intermittent pressure on risk asset prices as investors reassess their value against higher-yielding bonds.

Furthermore, if the dollar drops much further, other central banks would likely take firmer action to stop the appreciation of their currencies. Last week, the European Central Bank's Chief Economist, Philip Lane, said the "euro-dollar rate does matter", indicating that policymakers in Europe are worried about the appreciation of the euro. In the past, the ECB has taken action when the euro appreciated too much and given the extent of the economic damage from the pandemic, it would not be surprising to see them do it again in a meeting this week.

The bottom line is that unparalleled liquidity, the main reason for the risk rally this year, should continue, and may increase further. Market volatility may rise at times, but money is likely to keep chasing higher returns.

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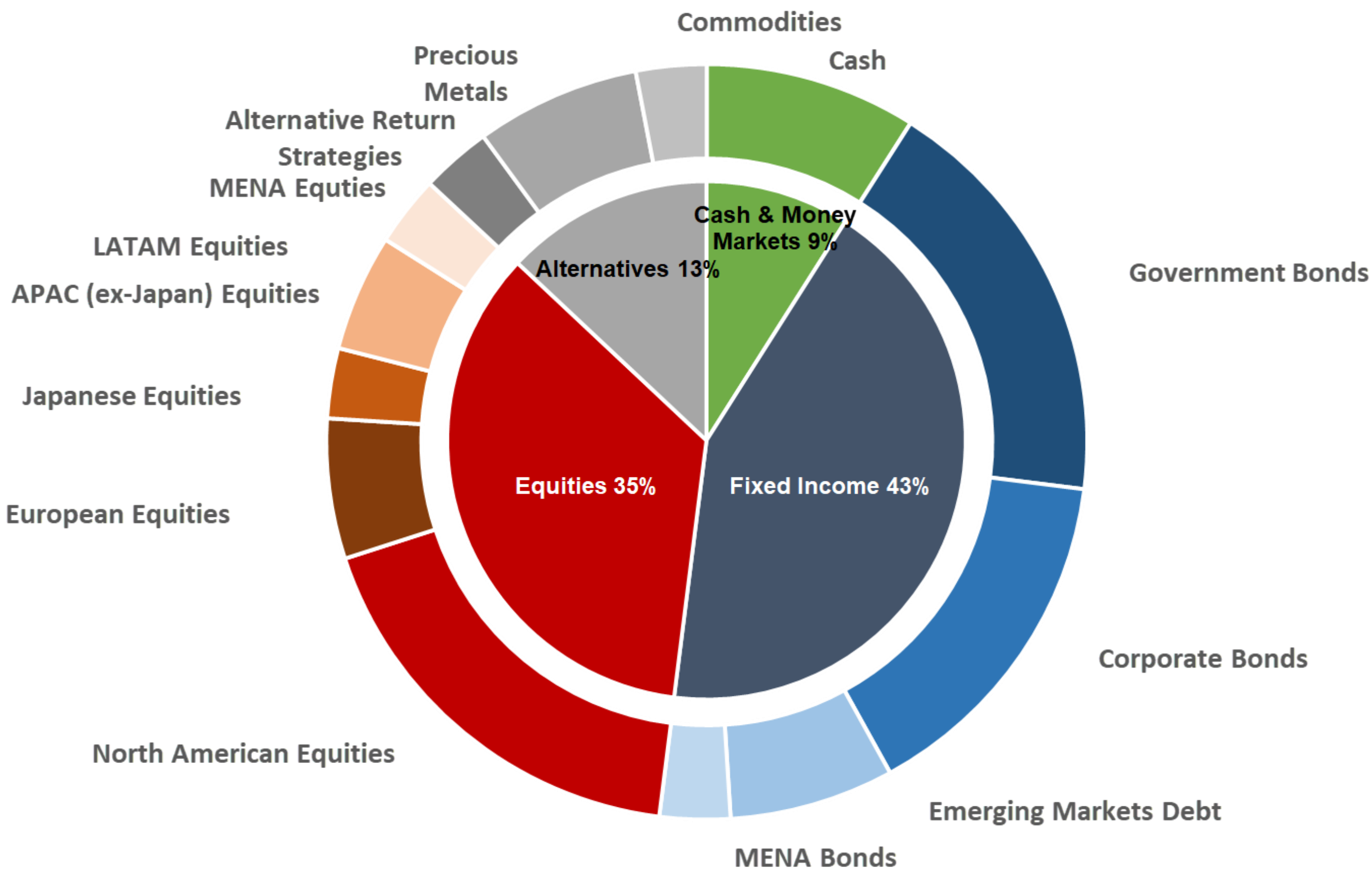
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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