EQUITY OUTLOOK

Winter 2020: A Tough Market for Value Investors

February 2020

Executive Summary

Value investors today must feel the same way as the aging sheriff in the book and movie *No Country for Old Men*, as though equity valuation systems and norms have changed and that they are no longer a match for the market mentality of today (or criminals in the case of the Academy-Award winning movie.) Growth stocks have dramatically outperformed value stocks in this bull market, and while there have been moments when the cyclical areas have shone, growth and technology have eventually come back to the forefront. When we look at the S&P 500 index today we see that in many cases, valuations are getting stretched, growth has dominated value for a decade and the market's leadership is dominated by technology-oriented stocks. Can this continue and which sectors are best positioned to thrive in the coming year? We will take a look at these topics here.

Market Valuation

The market is currently trading at close to 19X forward earnings with a dividend yield below 2% (see Table 1). These are on the high end of the historical norms, and with the length of the cycle combined with meager earnings growth, we cannot help but feel some concern for the outlook of the stock market at this point. While low interest rates are typically a positive for price to earnings multiples, a 1.7% dividend yield is not that compelling when you take into account the fact that it was over 2% not that long ago. Income at an attractive price is getting harder to come by, so stock and sector selection are important if you are looking at a portfolio from a total return perspective because future returns will be more reliant on earnings growth and multiple expansion. Yield alone will not likely help an investor achieve their goals at these levels.

Table 1: Valuations of the S&P 500

	P/E LTM	P/E CY1	P/E CY2	P/E NTM	PSales	PBV	PCF	EV/EBITDA	EV/Sales	Div Yield
S&P 500	21.97	20.56	19.01	18.79	2.40	3.67	14.27	14.59	2.91	1.70
Information Technology	29.03	25.87	23.37	23.07	5.60	8.39	20.16	19.16	5.75	1.12
Health Care	22.42	17.66	16.44	16.26	1.88	4.70	16.95	15.62	2.60	1.57
Financials	14.15	14.05	13.38	13.26	2.22	1.44	9.58	14.14	2.71	1.92
Communication Services	22.71	21.60	19.76	19.52	3.34	3.72	12.36	11.88	3.84	1.18
Consumer Discretionary	26.77	25.87	23.55	23.25	1.83	8.64	15.36	15.51	2.15	1.19
Industrials	20.89	20.23	18.72	18.43	1.89	5.14	14.85	12.92	2.28	1.74
Consumer Staples	22.04	21.97	20.72	20.57	1.62	6.35	17.01	15.41	1.90	2.60
Energy	14.45	19.60	16.52	16.34	1.02	1.41	6.49	8.18	1.37	4.27
Utilities	23.47	22.08	21.15	21.04	3.00	2.41	11.72	13.99	4.85	2.85
Real Estate	37.42	21.94	20.93	20.79	7.45	3.97	21.78	21.96	9.77	2.78

Source: Factset Research Systems

With the stock market up over 30% last year without the earnings growth to justify it, and with the concerns with the spread of the coronavirus and other issues plaguing the market right now (not to mention the global economy) we believe that we need one of three things for markets to justify the current multiples. Earnings growth needs to reaccelerate to drive stock prices (we are seeing some signs of that), the consumer needs to remain strong, and/or we need manufacturing to take the baton from consumers.

Market Concentrations

In the real economy, technology has been in a secular growth pattern for many years, and the stock market has clearly reflected that phenomenon. Five technology stocks currently make up nearly 20% of the market capitalization of the S&P 500 right now (see Table 2).

Table 2: Top 10 Constituents of the S&P 500 Index

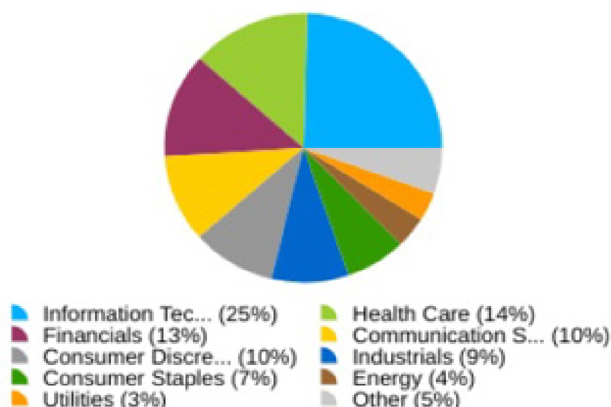
Company Name	Symbol	% Weight
Microsoft Corporation	MSFT-US	5.18
Apple Inc.	AAPL-US	4.83
Amazon.com, Inc.	AMZN-US	3.20
Facebook, Inc. Class A	FB-US	1.85
Alphabet Inc. Class A	GOOGL-US	1.63
Alphabet Inc. Class C	GOOG-US	1.62
Berkshire Hathaway Inc. Class B	BRK.B-US	1.60
JPMorgan Chase & Co.	JPM-US	1.56
Johnson & Johnson	JNJ-US	1.44
Visa Inc. Class A	V-US	1.27

Source: FactSet Research Systems

This concentration is not just happening at the market level. Manufacturing is getting pushed aside by the service industry in terms of expenditures made by corporations. Many enhancements are being made to technology, and dollars are being spent on regulatory compliance, but this economic recovery has been atypical in that manufacturing and capital expenditures have not picked up in typical fashion. We can see this not only in the real economy, but also in the divergence between stocks related to technology and stocks related to global cyclical areas of the market with commodity exposure.

In terms of the makeup of the S&P 500, the Energy sector is now less than 5% of the index's market capitalization, and the Materials sector is now only 3%. To put that into perspective, Information Technology is 24% and Communication Services (basically more technology, just more geared towards media and entertainment) is over 10%. It is very clear that investors are going where the growth is.

Figure 1: S&P 500 Sectors by Weight



Source: Factset Research Partners

Table 3: Sector Valuations

GICS Sector	Symbol	Market Value	% Weight
Information Technology	99900701	6,837,427	24.61
Health Care	99900565	3,849,467	13.86
Financials	99900621	3,480,188	12.53
Communication Services	99900793	2,915,707	10.50
Consumer Discretionary	99900285	2,722,675	9.80
Industrials	99900125	2,497,984	8.99
Consumer Staples	99900477	1,973,687	7.11
Energy	99900001	1,032,567	3.72
Utilities	99900821	945,180	3.40
Other	-	1,523,370	5.48

Source: Factset Research Partners

We mentioned previously that five technology stocks make up 20% of the market capitalization of the S&P 500. Innovation exists and growth is there, but the price that investors are willing to pay for growth indicates that it is scarce in a developed economy such as ours. As long as technology continues to inspire consumers to spend more to connect with others and to entertain themselves, and as long as technology continues to advance the way corporations do business, the sector will continue to grow and to warrant the interest and the valuations that it is seeing now. Until the global manufacturing economy recovers, the cyclical areas of the market will continue to struggle, and trying to invest in those areas will be like catching a falling knife.

Recommended Sectors

2019 was a great year for stocks, remarkable given where 2018 ended. It was led by the usual suspects (Consumer Discretionary and Technology), but Utilities and Consumer Staples also did well. At the end of the year, areas that had struggled (Energy, Financials and Materials) came back. The share prices of cyclical areas with global exposures began to shine throughout the fourth quarter of 2019 at the same time their earnings outlooks were being lowered, but they are weak once more in 2020.

The fact that defensive, stable areas such as Consumer Staples and Utilities were able to do reasonably well in 2019, a very hot year for stocks, gives hope that investors can have stable returns without investing 100% in growth and technology. While the shares of some of these defensive areas might be expensive relative to their low growth rates, they are a good cushion in a portfolio in case of a market downturn, and they are stable in that they serve basic needs of consumers.

Growth is strong in areas related to cloud spending, internet retailing, gaming, and media streaming, but has been weak in areas related to commodity demand such as Energy and Materials. Anything related to global manufacturing has been weak, and with the coronavirus taking the world by surprise at the beginning of 2020, it does not appear as though that area is going to be the answer to continued stock market gains (at least not for now.)

Conclusion

While we saw a dramatic shift in factor performance from growth to value/defensive to cyclical in the last quarter of last year, we think it would be a huge leap of faith to assume that these areas are "in the clear." We are kicking the tires in these sectors but note that in 2020, it is back to the races for secular growers like Technology, and investors are favoring Growth over Value once more. We believe this will continue and trying to invest heavily in cyclical areas is risky as these areas are commodity-price driven and are prone to wide swings. Offsetting Technology holdings with defensive areas of the market while keeping an eye on the cyclical areas in case of a potential recovery are our recommendations for portfolios at this point in time. ▲

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