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State of Play

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Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. Growth stocks, led by the big five technology companies in the US, continue to beat expectations but are their share values realistic or is this a bubble set to burst?

Record earnings numbers announced by the technology giants restarts the debate about a possible bubble

On Friday 10 March 2000 the technology dominated NASDAQ Index reached its peak of 5,048 following an unprecedented rise from around 1,000 in 1995. This five-fold increase in share prices was in large part due to investor herd mentality chasing quick returns by speculating as prices rose. Also, private equity firms who use investors cash to spot opportunities in new ventures helped turn an initial fad into an investor stampede. As with most bubbles in investment history, the crash that followed was severe and for those who were unaware of the high price they had paid for start-up ventures who were yet to turn a profit, the losses were almost absolute. By Friday 4 October 2002 the Index had fallen back to 1,139, a loss of 76% in just over two years. It took 15 years for the NASDAQ Index to recover that first peak with many 'dotcom' businesses going bust during this torrid period.

Sometimes delving back in time can help us to understand what lessons can be learnt and the signs to look out for in the future. Today, over 20 years since the 'Dotcom' crash, some market commentators once again are starting to voice concern about history repeating itself following the latest round of earnings numbers from the 'big five'. Apple, Microsoft, Alphabet (Google's parent company), Amazon and Facebook make up over 20% of the US stock market and have an enormous influence over investor portfolios, especially with so many pension and collective funds now being passive (meaning they track markets by replicating the companies within them, often at the same proportion of value they represent).

Last week saw Microsoft, Apple, and Alphabet all posting enormous earnings numbers, bringing in a combined $56.8bn (US dollar) in after-tax profits, almost doubling the earnings from the same time last year. Apple reported the latest quarterly sales and earnings data which continue to beat market expectations as revenues rose 36% to $81.4bn, a record for its third quarter and way ahead of the forecast of $73bn. The highlight was a 60% rise in sales in China representing the strongest geography with the largest margins coming from their pricier 5G-enabled iPhone 12 handsets as sales of these grew 50%. Apple continues to be the world's most valuable company with a market capitalisation of $2.4tr (yes that is trillion – not billion). Apple shares have grown 50% in the last year alone and 557% over the last five years and over 1000% over the last 10, now making up 6% of the overall US market.

The big question for markets and investors alike is whether this seemingly continuous rise will continue, or whether the market has priced into their share prices a much rosier future than is realistic? When you compare factors from the dotcom bubble and present day there are some stark contrasts worth highlighting. For one thing all these companies are well established and have been delivering fantastic earnings for many years. When you analyse the data to compare valuations from 20 years ago some of the measures quoted to indicate how overpriced they are today need important context to enable fair reflection. As an example, 10-year US bond yields at the time of the dotcom crash were 6% in March 2000, today they are just over 1%.

Why is that so important? Well, when investors look for returns, especially to beat, or at least keep pace with inflation, there always remains a trade-off between risk and return. At present the risk-free returns from government bonds are negative when factoring in the current US inflation rate of 5.4% over the last 12 months with the outlook unlikely to change much in the short-term as central banks hold their nerve quoting inflation as a temporary environment due to economies reopening and other short-term inflationary influences. This forces investors to seek returns elsewhere forcing them up the risk scale to try and keep pace with rising prices. This increased demand in turn pushes up prices and makes them more expensive for people to buy. If the risk free rate offers 6% and long-term inflation is lower than this the desire or motivation to seek additional risk for most investors doesn't exist.

The doubt that hovers over their valuations today is driven by some important considerations. Firstly, their market dominance has been challenged in recent years as regulators and law makers try to take steps to dilute their market advantage and control. Also, since the pandemic began, consumers have been forced to transact online more than they would in the 'normal' unrestricted world we enjoyed before COVID-19 emerged. Now that economies are reopening, will life simply return to normal or will some of the habits and changes in consumer behaviour remain forever? Certainly, the earnings statements from Facebook and Amazon are an indication that their growth in earnings and sales are slowing, both companies choosing to caution the markets about what to expect in the future. The key to some commentators reaching for the 'bubble' word is uncertainty. Uncertainty that their strong growth can be maintained and, if inflation rises for a sustained period central banks may have to act faster and push up interest rates sooner and further than anticipated making lower risk assets more attractive and share prices, especially growth stocks, overpriced triggering a sell-off.

Lastly, and importantly, when you look at a commonly used market valuation metric - the price of their shares reflected against the company's earnings - Amazon apart (at 58 times), the other four are only just above the current overall market ratio of 26 times. The long-term average for the S&P 500 Index (the largest 500 companies listed on the US market) is around 16-18, but this also takes into account the time before the financial crisis when interventions by central banks and policy makers caused interest rates to fall to record lows coupled with printing vast quantities of money to provide liquidity to support businesses and banks alike. An easier comparison is between the big five and Tesla, the electric car maker, whose shares rose 700% last year before falling back earlier this year. Whilst the profits they announced recently continue to grow, as does the number of cars it makes and sells, their price to earnings ratio currently is 1,113 (no that is not a typo!).

Clearly for most retail investors trying to decide on whether the big five are expensive or not is an unlikely consideration, but it may create uncertainty on when they feel comfortable investing after reading stories in the press and on social media. It is not hard to find two articles on the same day justifying completely different views and the reasons for this, making it even more difficult for investors to make what they feel is the right decision for them. Whilst it is impossible to predict what will happen to share prices in the future it is prudent sometimes to take stock and reflect on market conditions to guide you, especially for fund managers who are responsible for arriving at informed decisions on behalf of their clients. These experts constantly assess different metrics, economic data, and other important political factors often reflecting on history to guide their decisions in an attempt to navigate short-term market conditions whilst trying to achieve their clients long-term investment goals and objectives. As always it pays to be diversified in an investment portfolio that matches your risk comfort and return expectations. If you are in any doubt or you feel you need support and guidance seek advice from a Professional Financial Adviser.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Multi-Asset Solutions UK, as he shares his thoughts on the main themes dominating markets.

Note: Data as at 4 August 2021.

Important Information