COMMENTARY

GLOBAL ALPHA

February 9, 2018

Dear clients and colleagues,

Volatility is back, or is it? Is this the end of the "bull" market or just a healthy and overdue correction?

This equity rally started in March 2009 and is the second longest in history. In the last 109 months, the S&P 500 has returned 368% including dividends. Equity valuations are expensive. The current price-earnings ratio of 23x has only been surpassed once before, during the Tech Bubble of 1999, and the price-to-sales ratio is at an all-time high.

Exuberance is back: there are record inflows into equities, driven by retail investors, FAANG valuations are reaching the stratosphere and Amazon sells for 175 times next year's earnings. We are also seeing extreme speculation in biotech companies.

In the last few years we have experienced an extraordinary combination of factors which drove equities up: record low interest rates, central bank interventions, benign inflation and a slow and steady recovery in major economies. These factors are now being normalized or withdrawn.

So is this the end of the uptrend for equities? We do not believe it is, at least not yet, but rather a long overdue and healthy correction. The last few weeks have witnessed important corrections in the most-speculative assets such as cryptocurrencies (Bitcoin) and, to a lesser and less-publicized extent, cannabis companies. However, we have not seen other high beta sectors, such as biotechnology and technology, experience a steeper correction than the rest of the market.

The global economy should experience good growth in 2018. The rise in employment will continue to stimulate the economy and central banks will raise rates slowly as they won't want to risk stopping the expansion. In this scenario, company profits will increase, and we do not foresee significant multiple contraction.

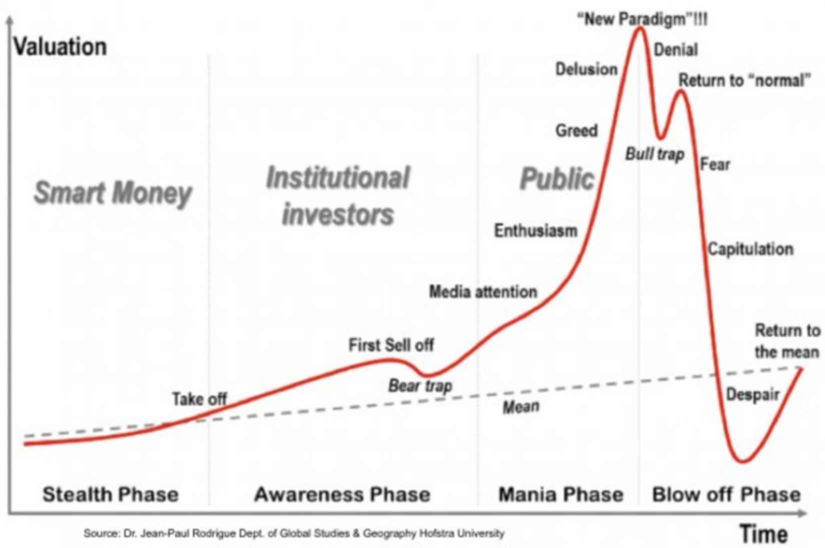
However, in order for the expansion to continue, we need to see a rotation into late cyclical companies like industrial and financials. Where would the money come from?––most likely technology and biotech stocks, which have yet to experience a significant correction. Why will they correct?

Rising rates

US 10-year treasuries are up approximately 50 basis points (+0.5%) in the last three months and are now around 2.8%, after having been as low as 1.4% in 2014.

High price-earnings companies or concept stocks, like biotechs, will often have little or no earnings until far into the future. With rates going up, the net present value of these future cash flows is greatly reduced.

Where can the market go?



For FAANG stocks, we believe that we are getting very close to a "new paradigm". We would certainly caution investors to be careful.

However, when comparing the MSCI International Small Cap Index and the Nasdaq-100 Index, we see a very different picture:

Source: Bloomberg

With respect to cryptocurrencies, and Bitcoin in particular, the chart below shows the price of Bitcoin in the last year. After reaching a record $19,511 in December 2017, Bitcoin currently trades around $7,000, still up sevenfold from last March.

Source: Bloomberg

We do not believe in Bitcoin and other current cryptocurrencies. A currency needs to be backed by tangible assets. If a central bank decided to launch a cryptocurrency, or even if Apple launched a cryptocurrency, backed by its balance sheet, to enable customers buy some of its products and services, these we would trust. However, in their current format, Bitcoin and its copycats are doomed to fail. They are not efficient as currencies for procuring goods and services. They are not, as was originally envisioned, limited in their supply. They do not, like gold, offer a true store of value. They are subject to technological failure and hacking. They are a tool used by criminals to launder money. We are pleased to see governments taking a role in regulating the market and safeguarding investors.

What are we doing in this period of high volatility? Not much. Our portfolio is well diversified across all 11 sectors and in more than 30 different industries in all major regions and currencies. We will use judicious selling to increase the weight of certain companies that offer the best fundamentals.

We encourage you to go read our weekly comments produced during the Global Financial Crisis (September 2008 to March 2009) or the Euro crisis (spring of 2011) to have a better idea of how to react in times of uncertainty.

Have a good weekend.

The Global Alpha Team