

## How to invest like a – smart – lemming

**A veritable liquidity tsunami has lifted equities. With no fundamental upside left from here, now is the time to be selective.**

- \_ Price-to-earnings and price-to-sales multiples of global equities have become very expensive relative to their own history.
- \_ In general, risk-return prospects are currently unattractive for fresh equity money.
- \_ Selective investments still make sense in our opinion, but getting the timing right requires an understanding of changing market ecology, as much as traditional equity strategy.



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**W**hy even bother with equity strategy right now? Nine months into the pandemic, it is perhaps a good moment to admit upfront that there are limits to how far into the future even seasoned market participants can see. Especially at times like this. The pandemic hit the world economy with the suddenness of a natural catastrophe. Unlike an earthquake, say, it left its infrastructure largely intact and was followed by a veritable liquidity tsunami. Governments and central banks effectively orchestrated a leveraged buyout of the Covid-hit economy, temporarily replacing lost household and business income with transfer payments. "Robin Hood" retail investors have channeled big parts of this additional liquidity into the same secular growth stocks. This was exemplified by the world's largest technology companies reaching market capitalizations in the trillions – hard to imagine not so long ago.

All this reminded us of the timely book *Adaptive Markets* by economist Andrew Lo. "Financial markets are driven by our interactions as we behave, learn and adapt to each other, and to the social, cultural, political, economic, and natural environments in which we live," Lo writes.<sup>1</sup> Such collective learning works well, when conditions are stable. But if and

when the environment is hit by sudden shocks – a global pandemic, say, shaking all aspects of life – traditional investment tools and metrics might be insufficient in figuring out what may happen next.

Since March, equity markets have recovered much faster than we had expected. Despite a small correction in September, price-to-earnings and price-to-sales multiples of global equities have become very expensive relative to their own history, reaching unsettling levels that have only been surpassed during the technology, media and telecom (Dotcom) bubble. Another parallel is that the rising tide has not lifted all boats equally.

For example, all 69 subsectors of the Bloomberg World Index are in green territory since the market trough in March, as are most equity indices around the world. However, the divergences are equally remarkable. Among the global subsectors mentioned, the telecom, the banks and the oil-and-gas index each gained less than 20%, while alternative energy more than doubled. While the S&P 500 gained 50% since March 23, Europe's Stoxx 600 increased by a more modest 30%.

<sup>1</sup> Lo, Andrew (2019) *Adaptive Markets: Financial Evolution at the Speed of Thought*, Princeton Univers. Press, 2nd edition, p. 188

The latter also includes more than 20 members that lost more than 20% over the past 6 months.<sup>2</sup> Equity strategy, in other words, did come in handy, not least in terms of which companies and sectors to avoid.

We currently expect an earnings recovery to pre-Covid levels by year-end 2021 in the United States and Asia, driven by companies benefitting from accelerated digitalization. That includes the largest U.S. technology companies, together with a select number of Asian players. However, high unemployment, continued fall-out from the pandemic and the upcoming U.S. election leave a high level of uncertainty on our below-consensus estimates.

For the S&P we apply a 20 times earnings multiple (i.e. conceptually a 5% real cost of equity) on "normalized" 2022 earnings. Discounting to September 2021 results in a 12-month S&P target level of 3,300 and a Dax target of 12,700. In our view, only Asian equities ("first in, first out of Covid") offer modest return potential. Elsewhere, we see no fundamental upside from here, implying that risk-return prospects are currently unattractive for fresh equity money.

Could we be wrong and markets go even higher from here? Sure. Nothing seems to stop the lemmings right now and even we still think a tactical overweight in the already "over-owned" IT sector due to impressive business momentum (in sharp contrast to the situation in 2000!) is worth considering. Incidentally, we invoke lemmings on purpose, without meaning to offend anyone, least of all the actual, Arctic rodents. According to zoologists, local lemming populations seem to be subject to boom-and-bust cycles, probably linked to winter weather and snow conditions. If you plot their numbers, the picture looks oddly reminiscent of the patterns seen in the prices of speculative financial assets.

Perhaps, there is a lesson here for investors still preaching the TINA ("there-is-no-Alternative") and FOMO ("fear-of-missing-out") gospel. More broadly, one of Lo's key arguments is that during periods of heightened underlying uncertainty, investors react instinctively. This can create inefficiencies for

others to exploit, but doing so requires anticipating changes in market ecology, as much as traditional equity strategy. In other words, we did not anticipate the arrival of risk-loving retail investors as a consequence of Covid stimulus, either.

Of course, we also understand the dilemma investors are facing, given that the U.S. Federal Reserve (the Fed) has basically nailed down a close-to-zero interest-rate environment for years. However, we would argue that even in a period of negative real interest rates, investors should demand a significant equity premium. They should not succumb to a further deterioration of the risk-return relationship because equities remain fundamentally risky assets, highlighted by the approx. 35% decline of corporate profits in the second quarter of 2020.

With the CBOE Volatility Index (Vix) trading at elevated levels, there appears to be significant risk potential in the coming months. Nor is there any lack of potential triggers, including a disorderly U.S. election process, accelerated spread of Covid-19 during winter and positive – or negative - interim phase III data on potential vaccines in coming weeks. If positive, a vaccine breakthrough would likely lift hard-hit stocks like travel-related companies, civil-aircraft manufacturers or suppliers for "out-of-home consumption" such as beverages.

Despite the temptation to exit the herd in anticipation and shift style positioning towards "value," we nevertheless prefer to stick to the consensus "growth" style positioning and focus on stock-picking for now. "Value rallies" are likely to remain short-lived. Deep value sectors like fossil fuels and financials face significant structural challenges to their business models, driven by digitalization and the shift to renewables, though much of that is already priced in. We still overweight health care but realize that the sector typically trades quite volatile around U.S. elections. We warm up for the utilities sector due to likely "green-deal"-related growth prospects, even though we have not yet upgraded it to neutral. We remain on the sidelines for the listed-real-estate sector due to fundamental headwinds from e-commerce and working from home.

<sup>2</sup> All figures are as of 10/7/20.

<sup>3</sup> Kausrud, K., Mysterud, A., Steen, H. et al. (2008) Linking climate change to lemming cycles. *Nature* 456, 93–97. <https://doi.org/10.1038/nature07442>

## GLOSSARY

The **Bloomberg World Index** is a capitalization-weighted index of all equities included in the Bloomberg World Index Series. Equities in the series were in the top 85% market capitalization of their respective Bloomberg classification sector.

The **CBOE Volatility Index (Vix)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

**Cost of equity (CoE)** is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

The **dotcom bubble** refers to the rapid rise and eventual collapse of equity market valuations of technology stocks from the late 1990s to 2001.

**Growth stocks** are stocks from companies that are expected to grow significantly above market average for a certain period of time.

A **growth strategy** is an investment style that is focused on an investor's capital appreciation through capital gains. Investors following this strategy seek to invest in companies whose earnings are expected to grow at an above-average rate compared to the industry or the overall market.

In a **leveraged buyout**, a company is acquired using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition.

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

A company's **price-to-sales (P/S) ratio** is calculated by taking the company's market capitalization (the number of outstanding shares multiplied by the share price) and dividing it by the company's total sales or revenue over the past 12 months.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

The **U.S. Federal Reserve**, often referred to as "the Fed," is the central bank of the United States.

**Value stocks** are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

## PERFORMANCE / Overview

Performance in the past 12-month periods (in %)

	09/15 - 09/16	09/16 - 09/17	09/17 - 09/18	09/18 - 09/19	09/19 - 09/20
Bloomberg World Index	9.2%	22.5%	8.0%	-0.2%	12.5%
S&P 500	15.4%	18.6%	17.9%	4.3%	15.1%
Stoxx Europe 600	2.4%	17.1%	2.2%	6.6%	-5.6%

Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 9/30/20

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