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TECH TITANS: SUPER ENTERPRISES IN A CLASS ALL THEIR OWN

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IN A NUTSHELL

_ Technology is no longer an equity sector, it is an asset class.
_ The earnings season suggests the winning factors will persist, no rotation to value.
_ U.S. long-term real interest rates grind lower and lower: normal is a mystery.
_ Weak dollar plays might become more pronounced, but be selective.

TECHNOLOGY IS NO LONGER AN EQUITY SECTOR, IT IS AN ASSET CLASS

It is an understatement to say that the tech titans reported superb earnings last week. Their results, delivered during a period of economic and social upheaval, signaled a new era of super enterprises in this world. These companies reported profits that tremendously beat consensus expectations and in sizes that redefine the operating scale of a leading multinational. The results demonstrated that these companies have different sensitivities to U.S. or global gross domestic product (GDP) than in their past and most firms. Granted, the pandemic brought unique circumstances and opportunities to these businesses unlike past recessions; but the speed at which these enterprises responded to the situation and with efficacy and efficiency as demonstrated by meeting a surge in customer demand, at usual prices and service quality while substantially increasing profits, is why superb is an understatement.

The five tech titans with near or over a trillion plus equity capitalizations actually sit across three sectors. They no longer fit the traditional cyclical or defensive classifications. They are indeed growth stocks, but something different from many growth stocks of the past. These companies represent intangible assets at colossal scale. Intangible assets that stem from their virtual world products like software and internet services, but also unparalleled competitive advantages from proprietary operating systems, robotics, logistics, networks that are the result of decades of high and successfully directed research and development investment. Most successful companies have some of such intangible assets, but these tech titans are concentrated masses of such intangible assets that is enabling them to compete successfully against entire swaths of the economy and not just several competing firms. These five firms made 16.8% of S&P 500 profits in the second quarter and are 22.6% of index capitalization now.

While size alone might justify it, we see reasons to treat the tech titans, including several from Asia, as their own asset class or supercluster within equities for reasons beyond size. Asset allocation strategies consider the mix of nominal and real assets, but intangibles might be a different third type of asset. Sensitivities to inflation, interest rates, beta, and cross asset correlations are essential considerations. These sensitivities might differ for intangibles from other equities. For instance, we think intangibles could offer better inflation protection and likely benefit the most among equities from low long-term real interest rates. Intangibles can help to better diversify portfolios heavy on nominal assets or the more traditional physical real assets; as they offer huge economies of scale at growth and they can be nimble in responding to certain economic shocks. However, they are also at risk to being made obsolete by newer intangibles or innovation. Thinking about equities in a tangible vs. intangible underlying asset sense could provide insights beyond the usual equities by region, sector, cyclical/defensive, growth/value contexts.

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EARNINGS SEASON SUGGESTS THE WINNING FACTORS WILL PERSIST, NO ROTATION TO VALUE

After week three, 78% of S&P 500 earnings per share (EPS) reported and the blended actual and remaining estimates bottom-up second quarter S&P 500 EPS is 26.51 dollars. The final result should be a bit above 27 dollars. We were looking to earnings season for clues if now is the time to rotate to more cyclical value stocks. However, results suggest that significant challenges remain at most cyclical value industries and that their valuations are dependent on a strong rebound in profits in 2021. Whereas, the growth sectors of tech and health care and other key growth stocks are delivering earnings and growth today that support their valuations. We think the third quarter will be a continuation of growth outperformance and we will likely wait until after the election before taking a more pro-cyclical value stance. We believe digitalization and duration to reign for now.

U.S. LONG-TERM REAL INTEREST RATES GRIND LOWER AND LOWER: NORMAL IS A MYSTERY

Long-term U.S. nominal and real interest rates continue to drift lower, despite the worst of the recession likely being behind and trillions more stimulus to come. We are extremely uncertain as to what normal interest rates are or when they come. Our best guess is that eventually 10-year Treasury Inflation Protected Securities (TIPS) yields will return to at least zero and 10-year Treasury yields to at least 2%, or expected inflation, from the -95 basis points (bps) and 55bps yields observed today. We think the fundamentals of fair interest rates need reexamination and we welcome all ideas.

WEAK DOLLAR PLAYS MIGHT BECOME MORE PRONOUNCED, BUT BE SELECTIVE

As U.S. 5+ year real interest rates decline, on slowly rising inflation expectations yet lower Treasury yields, the dollar is coming under pressure vs. other low yielding currencies. Real interest rate differentials between two currencies times the number of years it is expected to last can justify deviations in foreign exchange rates from purchasing power parity fair value estimates. We think recent EUR/USD gains are justifiable, but further quick gains would weigh on Europe's recovery and likely unwelcome by policy setters. We think weak dollar plays require selectivity, there are many other factors influencing the outlook for most energy and industrials right now. A moderately weaker dollar will more reliably benefit multinational consumer staples through foreign currency earnings translation.

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GLOSSARY

One basis point equals 1/100 of a percentage point.

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

Correlation is a measure of how closely two variables move together over time.

Cyclical is something that moves with the cycle.

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

In economics, a nominal value is not adjusted for inflation; a real value is.

Purchasing power parity (PPP) is a technique used to determine the relative value of currencies, whereas the purchasing power in both currencies is the same.

In economics, a real value is adjusted for inflation.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

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

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	07/15 - 07/16	07/16 - 07/17	07/17 - 07/18	07/18 - 07/19	07/19 - 07/20
U.S. Treasuries (10-year)	8.0%	-3.8%	-2.7%	10.6%	13.8%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 8/5/20

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