Market Update

September 20, 2021

Over the next few weeks, a lot of data points will be hitting the tape. We have the looming debt ceiling. Janet Yellen penned an op-ed on Sunday referencing the debt ceiling and the potential for economic catastrophe if lawmakers do not take the proper steps to address it. She expects the US to run out of money to pay its debts sometime in October. This is the same scenario we faced back in 2011, in the end, US debt was downgraded and the market went through a 20% correction. The infrastructure package is looking further and further away as lawmakers struggle to compromise. At this point, it is not looking as if the $3.5T package is going to get through in its entirety. The Federal Reserve meeting takes place this week and all eyes will once again be on Chairman Powell. Hints on when tapering will occur, will be what we are focused on. We expect the wording to be along the lines of: “if we see continued further progress, reduction in asset purchases will likely be appropriate this year.” If the time table is moved up however, it will give further strength to the dollar, and we believe will place a further strain on US equity markets. We will be diligently watching all of this and will stay in continuous contact.

Overseas, China is going through its own Lehman Brothers moment. Evergrande is one of the largest property developers in China. It has approximately $300 billion of debt on the books and it looks like a default is imminent. As we saw in the US in 2008, contagion from this size of fallout can be a major trigger to financial instability across the country. The question on our minds remains -- will the Chinese Government step in and inject liquidity into the system to keep the contagion from spreading? As it currently stands a default of this magnitude would reduce Chinese GDP anywhere from 1-4% in Q4. Even though this does not directly affect the US markets it will be something to keep a close eye on, as it may change risk sentiment on a global scale.

We also want to take a moment and discuss some of the action we have seen in the US equity markets over the past few months. After the resurgence of value stocks for nearly nine months, we have seen growth once again take market leadership. As a value/quality manager, who focuses on intrinsic values, it has been especially delicate. From the end of June through July, growth stocks rose by over 1100 basis points relative to value. We have been asked multiple times recently if we believe the rotation to value is over. The short answer to the question is “no” and we continue to believe this is one of the best times in 20 years to invest in the unloved style. During market style rotations it is natural to see a pause in the outperformance of one style to another. However, valuations in growth stocks remain at historic levels and we continue to believe that there are major pockets of excess valuation in the market, and most of this excess is in the growth style. There is an interview that was done by Bloomberg in 2002 with then CEO of Sun Microsystem’s, Scott McNealy, that summed up the dot.com bubble pretty well:

“2 years ago, we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?”

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We are currently experiencing the same overvaluation scenario that we saw then. Currently, 25% of the US stock market is trading over 10x sales. We are not saying that all of these companies are going to crash and burn. A few will grow into those valuations but the vast majority will not. We are going to continue our fundamental approach and not chase these stocks higher. We will continue to build our portfolios and trust our valuations the same way we always have. If we are posed with a question as to whether we would rather gain a few % points to the upside or protect principal on the downside, we will always choose the protection of principal.

We will continue to navigate this difficult environment to the best of our ability. As always, we at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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