ClearBridge Investments

Is Tech Correction a Head Fake or Bursting Bubble?

September 14, 2020

Key Takeaways

- We believe the recent correction in technology and related momentum stocks is healthy and probably has more to go but will not be long lasting or mark the end of the bull market that started in late March.
- Large cap benchmarks such as the Russell 1000 Growth Index are at their most concentrated in history yet past periods of market concentration have not always led to equity declines.
- While some investors may compare the current period to the speculative dot.com bubble, the current fundamental backdrop for IT and similar growth stocks is stronger. The potential for earnings improvements as the global economy recovers as well as near zero interest rates also suggest the overall equity market is less overvalued than current P/Es indicate.

Despite Swift Selloff, Momentum Stocks Substantially Higher for Year

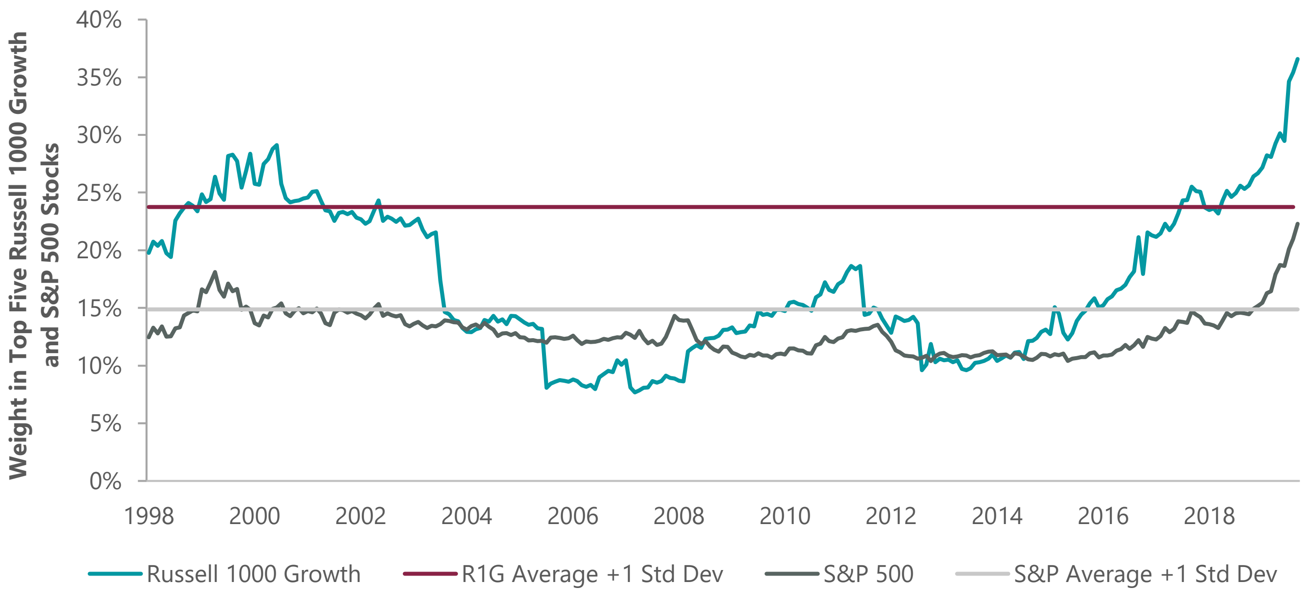
From COVID-19 induced market lows in late March, U.S. equity markets have rocketed to record highs, led by a small number of mega cap growth and momentum stocks centered in the information technology (IT), consumer discretionary and communication services sectors. The latest run for momentum ended abruptly last week as the NASDAQ 100 Index fell into correction territory over just three trading days.

The selloff marked only the fourth time in history that a three-day decline of 10% or more occurred while the index was still trading above its 200-day moving average. In other words, despite the speed and magnitude of the decline, technology and related stocks are still up substantially in 2020.

Notwithstanding the steep declines in some momentum stocks, overall market breadth has held up quite well. This leads us to believe that the latest correction is healthy and probably has more to go, but will not be long lasting or mark the end of the bull market that started in late March. The unwinding of extremes among NASDAQ stocks in particular is likely not over.

As that unwinding works its way out, we examine how past periods of extreme market concentration compare to the present and what clues they could provide on the direction of the overall market. The greatest concentration of performance has occurred in large cap growth benchmarks such as the Russell 1000 Growth Index. As of August 31, the five largest stocks in the index comprised 36.6% of its total value -- the highest concentration on record (Exhibit 1).

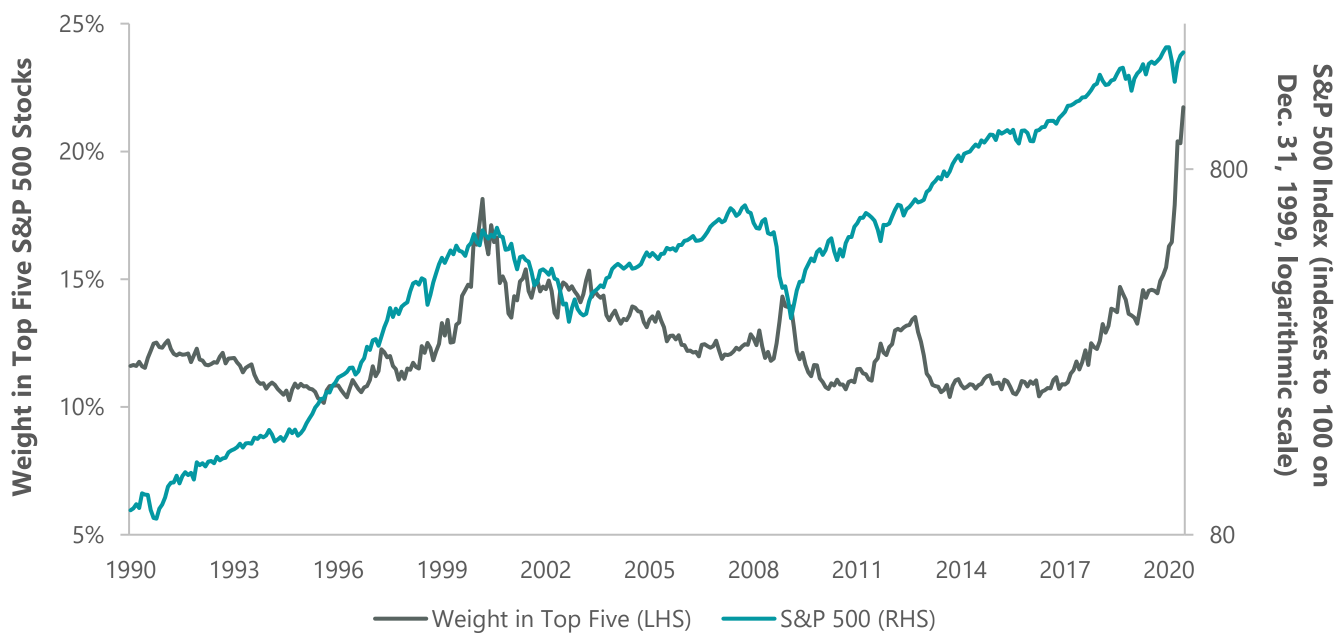
Exhibit 1: Growth Benchmarks Have Become Extremely Top Heavy



Data as of Aug. 31, 2020. Source: FactSet.

The concentration is slightly less pronounced in the S&P 500 Index, reflecting that the benchmark owns both growth and value stocks. Nonetheless, past periods of similar market concentration have been followed by short-term corrections like we experienced in the NASDAQ this past week. Many investors have compared the latest period to the dot.com bubble of 1999-2000, where profitless Internet stocks drove a speculative market that crashed badly. But as shown in Exhibit 2, other instances of extreme concentration have given way to higher markets.

Exhibit 2: S&P 500 Performance around Market Concentration Highs



	Weight in Top Five	S&P 3M Fwd Return	S&P 6M Fwd Return	S&P 12M Fwd Return	S&P 24M Fwd Return	S&P 36M Fwd Return
March 31, 2000	18.1%	-2.7%	-3.6%	-21.7%	-21.5%	-40.9%
Nov. 30, 2008	14.3%	-17.3%	4.1%	25.4%	37.8%	48.6%
Sept. 30, 2012	13.5%	-0.4%	10.2%	19.3%	42.9%	42.0%

Data as of June 30, 2020. Source: FactSet, ClearBridge Investments.

A big difference between 2000 and today is the market leaders, which have become known by the acronyms FAANG (Facebook, Apple, Amazon.com, Netflix and Google/Alphabet) or FAAMG (swapping in Microsoft), which are highly profitable companies holding global leadership positions in their respective markets. For this reason, we believe that a brief correction in mega cap momentum stocks will likely be followed by the resumption of a secular bull market led by these and other higher multiple growth stocks.

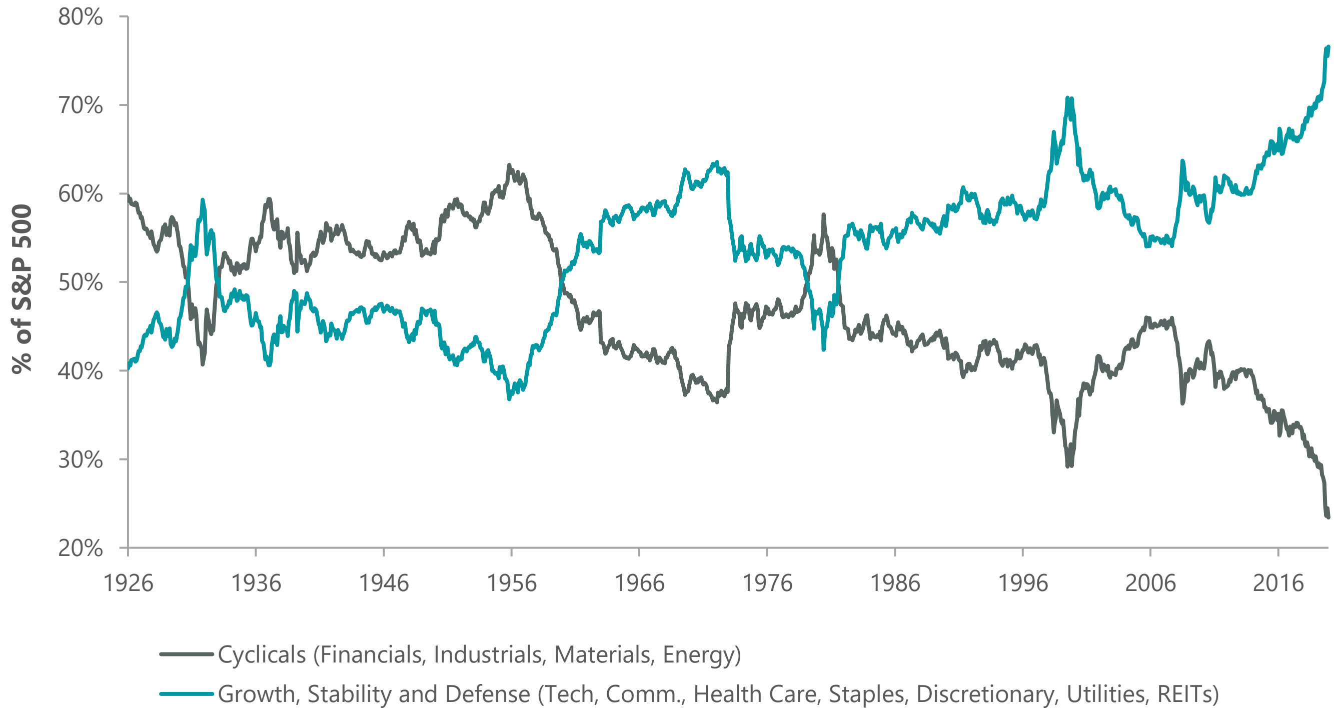
Fundamental Backdrop Sound in Growth Sectors

The move higher in markets (and IT specifically) has been supported by robust earnings. IT, consumer staples and pharmaceuticals were the only three industry segments to record positive earnings growth in the second quarter, while overall EPS growth was down 33% year-over-year. In essence, this cohort's outperformance is justified. Healthy balance sheets and strong cash flow generation among IT stocks also support continued buyback activity. In fact, for the first time in a decade, U.S. corporations have become net issuers of equity. However, growth stocks are the ones most able to maintain buybacks.

IT has been less impacted -- and in many cases gained market share -- by the crisis, especially when compared to consumer sectors. Technology should continue to be a winner in the ongoing structural disruptions like artificial intelligence, digitalization and electric vehicles. We caution, however, that IT and information security are a giant spend for enterprise customers and one that is facing greater scrutiny in terms of management approvals. Tech hardware has been hurt the most by this reticence to increase spending, but so far most software names have held up. While tech spending could slow, the sector's ability to maintain superior growth along with lower discount rates due to near zero interest rates means that long duration equities can maintain high multiples versus history.

And unlike the 1990s, where multiples were expanding on peak earnings, the recent run-up of P/Es has taken place in a recessionary trough. As we move into a more synchronized global recovery next year -- assuming the availability of a vaccine -- earnings could jump substantially and compound for a number of years. Therefore, valuations may not be as excessive today as they appear because the market is a forward discounting mechanism. The growing dominance of IT and related growth names in capitalization weighted benchmarks like the S&P 500 Index may also make the market appear more overvalued than fundamentals suggest (Exhibit 3).

Exhibit 3: Index Composition Supports Higher P/Es



Data as of June 30, 2020. Source: Cornerstone Macro.

Finally, the latest selloff has not been accompanied by meaningful moves in Treasury yields or credit spreads. This suggests the drawdown has been more about positioning extremes rather than a drastic reassessment of the health of the economic recovery.

Regardless of whether the recent rotation out of mega cap momentum names proves ephemeral, we believe market action year-to-date has obscured the existence of attractively valued investment opportunities in other areas of the U.S. equity market. As active managers with a long-term investment horizon, we will continue to maintain exposure to growth companies with strong business fundamentals while harnessing our proprietary bottom-up research in seeking to identify and capture these additional opportunities across our portfolios.

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