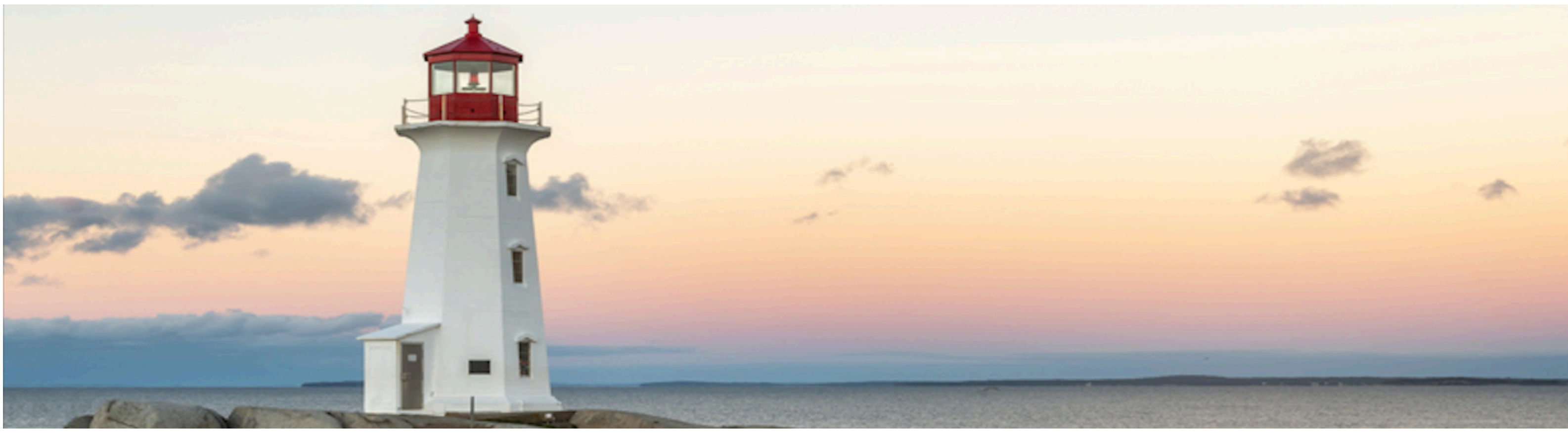
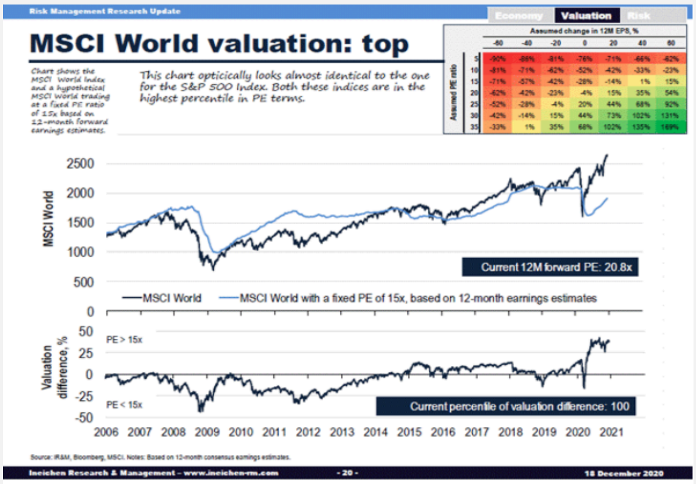


# ACAL 2021: PUNCHBOWL?

## THE PARTY CONTINUES - FOR NOW

There can be little doubt in anyone's mind that many markets are definitely in expensive territory. This at a time when global interest rates are at or near record lows (including real interest rates). A wide range of financial/economic measures and a long list of respected commentators are all describing the markets as expensive. So we are 2 months into the new year and the market party definitely continues, and our question is where is the punchbowl at this party?



*Source: Alexander Einechen*

The response from the authorities to all this obvious market exuberance has been rather mute. Governments, under the cover of protecting their populations from covid, are spending taxpayers money like there is no tomorrow. The absolute value of this spending is far higher than ever before and has accelerated dramatically over the last few years. As a percentage of GDP, the borrowings have only been exceeded during WW2. The world's major central banks are issuing bonds and engaging in quantitative easing to maintain low interest rates to support their governments largesse.

To return to the original question – it seems the punchbowl is in the heart of the party and is being generously filled and overflowing!

## TWO MONTHS INTO 2021

The 'market', over the longer run, is not a bad judge of fair value of an asset. For long periods of time, asset prices are somewhere near what can be termed fair value (present value of future expected cash flows). The issue is, at times, human phycology can be the very dominant force that drives market sentiment, and takes the market to extreme valuations – a long way from long term averages. This is certainly the case today.

For example, the PE ratio of the S&P chart below is over the last 30 years. This fairly reliable measure of value, in normal times, has been taken to extremes (again).


In the last week of February, the market is spooked. US treasury market prices fell - yields soared – an extraordinary move last Thursday. Similar moves occurred in global bond markets. This is an alarming sign for expensive equities.

One thesis is that the massive government approved spending packages, that will coincide with the expected consumer reflation that will take place as the lockdowns end, is a massive stimulus. Possibly too much stimulus that will lead to inflation. Analysts are aggressively upgrading US economic growth forecasts for 1H21.

We are happy to see some froth being taken from some of the extreme equity valuations. We feel there is more to come at some point.

## TODAY'S TECH SPACE

With all this talk of bubbles and market excesses, it does not sit easily with me to write 'things are different this time around'. I remember reading these words in 2001. However, the 'fourth industrial revolution' of tech has been partly enabled by capabilities that have not been available in history (some below courtesy of Howard Marks)

### 1) INTERNET/DATA ENABLED TECH:

Many of today's successful tech companies have troves of data about their clients. This data is aggressively mined and used to create competitive advantages and moats. The use of this data also allows the tech companies to advertise to their many users and also keep clients from migrating to other platforms, products and services.

*The marginal costs of scaling over the internet are low, business can grow more rapidly than before*

*Most tech companies embrace big data in many ways – efficiency, attract new clients, improve client experience, individual pricing of goods/services, capturing the most valuable part of the supply/ transaction chain ……*

*The moat's protecting today's winners have never been stronger*

*Conversely, startups with capital and minimal barriers to scaling make big legacy businesses more vulnerable and uncertain than in history*

These characteristics have allowed tech companies to grow and thrive all over the world, in any number of sectors. They can provide new services and can also challenge established companies/industries that have been around for years. This is truly a global phenomenon and is very likely to be a key factor to deliver improved and smarter services (commercial and social) and will be a factor in reshaping global supply chains.

The tech space today has been termed the 4th industrial revolution. There are a few distinct segments. The most obvious has been mentioned above – the internet tech companies. These companies would include Amazon (ultimate logistics manager of merchandise, remodelling the retail experience and massive provider of cloud computing). Alphabet and Google have built businesses using the internet as the source, collector and distributor of information and using this information in an online The tech space today has been termed the 4th industrial revolution. There are a few distinct segments. The most obvious has been mentioned above – the internet tech companies. These companies would include Amazon (ultimate logistics manager of merchandise, remodelling the retail experience and massive provider of cloud computing). Alphabet and Google have built businesses using the internet as the source, collector and distributor of information and using this information in an online business (advertising, buying things that are not physical widgets like a hotel room, insurance).

Gojek and Grab grow by using the internet for the more efficient provision of goods and services, particularly in countries with poor infrastructure. They are like a hybrid of the two categories above.

### 2) BIO MEDICAL SERVICES:

This is already a huge field and there are a wide range of 'start up' businesses operating in the medical field. The opportunities in this space are huge and will certainly be assisted by the predatory pricing of American medical products/services, which leaves plenty of headroom for new concepts/ideas. At the other end of the scale, developing countries have difficulty providing swathes of their populations with basic medical services.

The list of developments in this field is huge – online doctors, gene editing to develop vaccines, basic health education, medical devices connected to smart phones (ECG, Ultrasound scans, etc) that are perfectly adequate for 80% of cases, treatments for complex diseases like cancer, Alzheimer's, immune mediated diseases, etc.

There are of course a few other 'tech disciplines' we should include in this list

### 3) HIGHER AUTOMATION:

Self-driving vehicles, more automation in production processes

### 4) AGRO TECH:

Growing plants in a more environmentally friendly way to provide protein and foodstuff for the worlds growing population (remember Full Nature). This field would also include growing biomass, artificial meat.

## WHAT IS A TECH COMPANY

*A tech company uses technology to create an advantage in terms of product uniqueness or scale or improved margins. Ask the question: Could this company exist without technology? If the answer is no, it has to be a tech company.*

## MARKET EXUBERANCE

It is worth taking a brief sober look at market exuberance and where 'group think' has taken sentiment. These are the very indicators that should remind you of the current extremes in parts of US markets, and other markets.

Without the need to go into detail, consider

- Gamestop shares (a company with limited intrinsic value involved in a short squeeze).

- 80% of today's IPO's have negative EPS
- SPAC's are hot. An 'investment celebrity' establishes a shell company, explains a purpose for this vehicle, raises millions and then invests this money on companies of interest. A type of reverse listing.
- US Treasuries, and other government bond markets are expensive. Within the last 6 months, yields have been the lowest in over 200 years
- 35% of the Russell 2000 stocks have no profits!
- Robinhood, a retail broker, selling its clients order flow to high frequency traders

More than enough signs to be cautious.

We strongly believe you need to develop a plan now to reduce/limit your exposure to the equities that are expensive. High priced equities (FAANGS, say) face a correction. We are not sure when the repricing occurs, as the market party can continue for some time yet.

Your plan also should incorporate 'keeping some powder dry' so when the time is right, you can take action and buy good value assets with a cool head.

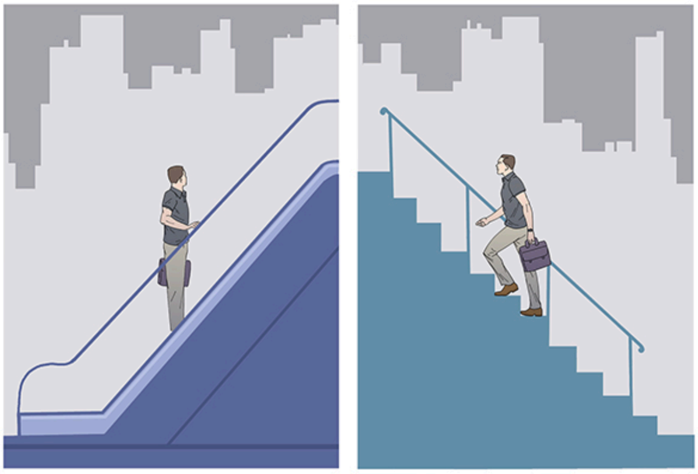
## VALUE VS GROWTH INVESTING

Being a value investor today is not an envious place to be. Their style has not delivered performance for a few years now. But they continue to wait patiently for the market correction that surely comes: After which value investors will buy at yields that will reward them for years to come.

The style of the moment is definitely growth and many tech stocks command elevated multiples of value, in several cases without generating a single cent of profit.

Today's tech companies are nearly all considered growth stocks. A few thoughts on the basic valuations of growth companies.

Most of the value of growth stocks depends on cash flows in the distant future that are heavily discounted in a DCF



*Growth and Value*

analysis. A change in interest rates can have meaningful impact on their valuations. (This effect is not so extreme on companies whose value comes mainly from near-term cash flows).

When they're rising, growth stocks typically incorporate a level of optimism that can evaporate during corrections.

Growth investing often entails belief in unproven business models that can suffer serious setbacks from time to time, requiring investors to have deep conviction so as to be able to hang on.

> *"If your long term growth rate exceeds your cost of capital, your present value is infinite" – John Malone*

## WHERE TO GO FROM HERE

As expected in a rising rate environment, we are witnessing the high PE stocks have run into some turbulence. US tech stocks remain very expensive, but there are many decent opportunities in Asia.

We believe it will take the next few months for bond markets to respond to the very strong economic growth that is already in the 'pipeline' (maybe not so broad as desired) and the inflationary pressures that may be unleashed from the sheer volume (and velocity) of money that is in the system when combined with the reworking of supply chains.

In this environment, many commentators advocate the cyclical trade. This is certainly popular and there are certainly pockets of relative value around.

Commodities, both hard and soft, have certainly started to move. Some of this can be attributed to a weak dollar, but more importantly there are certainly supply issues at play. Developments in the oil and copper price look promising.

The 'rare earth' demand is interesting (particularly given the paragraph below) in the short term, but if prices spike, greater capacity will be initiated with a few years delay to get the mining infrastructure built.

[Tesla, to meet its business plan, will require a large percentage of the worlds production capacity of cobalt, lithium and nickel. Even for a 'super achiever' like Musk, this is probably a step too far! There are a lot of other companies and countries that also desire these same resources. Producers are not able to ramp up production at short notice, so we watch to see how this plays out!?]

If interest rates continue their push upward, bank stocks also could provide some opportunities.

## THE GREAT REFLATION TRADE

There is a widespread expectation that the lockdowns (imposed by the authorities to try and contain covid) will be largely over towards the end of this year. The return to 'normal' will include a surge in consumer spending, including a bias towards services from goods – rather than online shopping, people will want to dine out and travel. As fear (of catching covid or of being laid off) subsides, people will feel less need to save. So, there is great expectation of this spending boom.

This swing in consumer behavior is expected to coincide with the huge spending packages that governments around the world have passed. The markets fear an outbreak of inflation and have responded to this situation with a significant rise in interest rates and commodity prices towards the end of February. (10yr US Treasury rising from 0.93 at the beginning of the year to 1.40% at the time of writing. CRB up from 178 at the end of the year to 203 today).

Similar to the last two market dips and recoveries (the end 2018/start 2019 and last year in March/April 2020) we expect the authorities, the Fed, to step up and make the assurances that market support and loose monetary conditions will continue.


So, these 3 factors (consumer spending, government stimulus and easy money) are on their way. The hangover after the party could be memorable – all the more reason to invest wisely today and not be carried away by the excesses.

## PROUD OF OUR INDEPENDENCE

Given we are a truly independent financial advisor, we use our 'freedom of selection' to source quality solutions that are amongst the best that are available. The investment solutions are incorporated into client portfolios always mindful of our clients big picture constraints (liquidity, diversification, risk profile, etc). Any structuring solutions generally simplify holdings while meeting client needs.

At Arete, we are proud that all of our solutions are bespoke solutions for each client. We have recently added a few new colleagues to our team and extremely happy they are all motivated by the strong client alignment (which is not so prevalent amongst the large private banks).

We highlight two of our successes over the last few years:

Arete Capital maintains a number of portfolio modules, that when combined with selected 'best of breed' products, we have been able to construct investment portfolios that meet a range of client needs.

Arete Capital has also been able to source access to several unique opportunities that have delivered good performance. We are delighted to be able to offer this to our clients since we have been very selective about the deals we progress. Our clients cannot find comparable opportunities in banks

A Global mandate, promoted by many banks, is not exactly the ideal solution in today's uncertain markets. We have made several good investment recommendations and a few of them are on our website. We encourage you to go take a look and see for yourselves what a truly independent adviser can offer.

## ABOUT ARETE CAPITAL ASIA

### RESPONSIBLE OFFICERS

Charles Luchangco & Terry Leeworthy
For details please visit http://arete-asia.com/

### OUR APPROACH

"Sit On the Clients Side of the Table" source Best in Class Solutions, and Negotiate the Best Terms for Clients