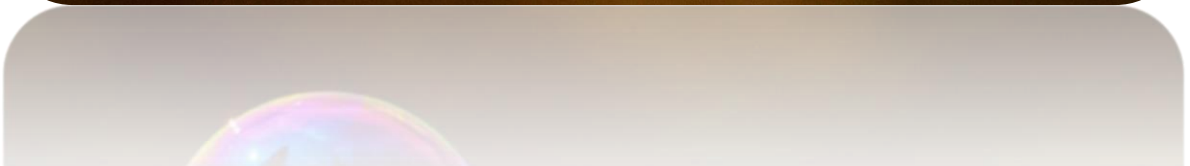




HCP Asset Management
16.12.2020

IS THIS AN ECHO BUBBLE?

A look at FATMANGs & the
Digital Acceleration





Tech bull market driven by lockdowns and monetary stimulus ...

Twenty years ago, the Y2k.com bubble burst after technology stocks had appreciated by more than 630 % over the five years before, an advance of more than four times the overall market. The poster child stock of this bubble was Cisco which reached a market cap of USD 550 bn, trading at 35x trailing sales. The shares subsequently lost 90 % from peak to trough, and never recovered Y2k levels. Many other highfliers of that period disappeared completely or continue to linger around at much lower levels.

This year, technology shares were leading the 2020 rally by advancing 38 % versus the overall market being only up only 14 % year-to-date. In a pandemic, the need for more digital tools to communicate, interact and transact has been a strong tailwind for the industry. Over the last five years, the tech sector has risen more than 200 %, roughly three times the market.

YTD performance led by Information Technology stocks

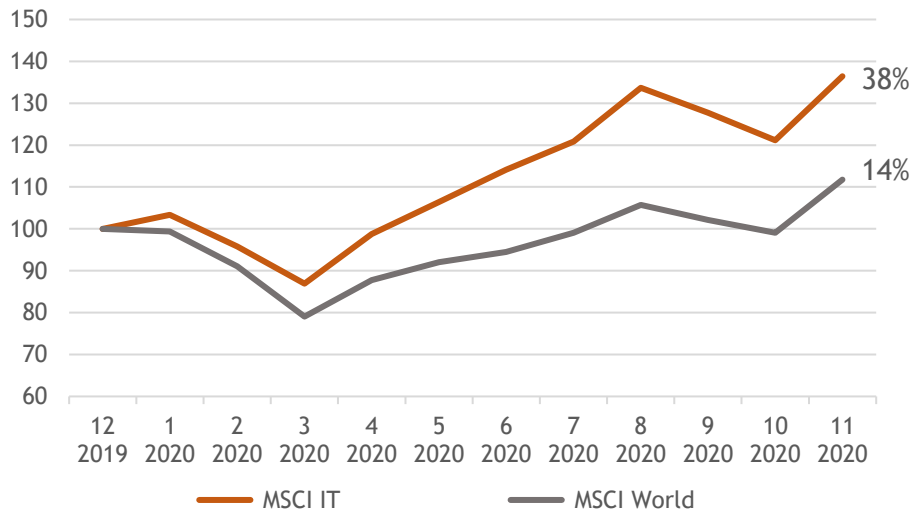


Figure 1. MSCI IT versus MSCI World, Source: Bloomberg

That leads to the question if this is just another bubble: *an echo-bubble of what has happened twenty years ago as a new generation of investors entered the market?* A new generation without bad memories of the post-2000 sell-off and excited by the digital acceleration stories so plentiful these days.

Comparing the respective numbers over five years, a 200 % increase till 2020 for technology versus 630 % in the Dotcom bubble, it looks at first glance that this time there is still a long way to go to reach the excesses of 2000. Back then the sector traded at 81x trailing earnings versus “only” 36 now. However, focusing on the tech sector alone disregards companies from other industries such as Amazon which are also tech-driven businesses.



... is translating into outsized tech stock gains

The cheerleaders of the 2020 advance have been the FATMANG¹ group, the FAANGs plus Tesla and Microsoft. Tesla is probably the poster child of this rally, up 14-fold over the last five years and trading at 21x trailing sales. The FATMANG basket has advanced 58 % this year and 390 % over the last five years. The group is trading now at 108x trailing and 56x forward earnings. Given the tremendous growth of its members, its market cap share of world equities has tripled from 5 % to 15 % since 2015 (see figure 2).

FATMANG market cap as % of equity markets*

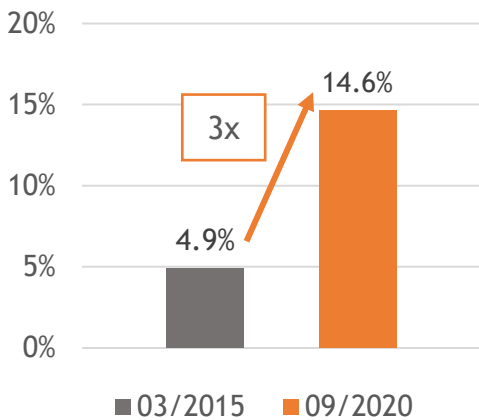


Figure 2. Source: Bloomberg, HCP Asset Management, * as measured by the Bloomberg Developed Market Index

This means nothing else that very few stocks have driven earnings growth for world equities over the last years and have also propelled market indices higher. If any of those giants were to struggle in the future, it will likely have a strong impact on the major indices.

The key reason behind this increase: There was no earnings growth outside of FATMANG as the figure 3 below documents. With growth being scarce, investors flogged to these companies and paid up for them.

EPS evolution: FATMANG vs World Equities (Index normalized to Q1 2015 = 100)

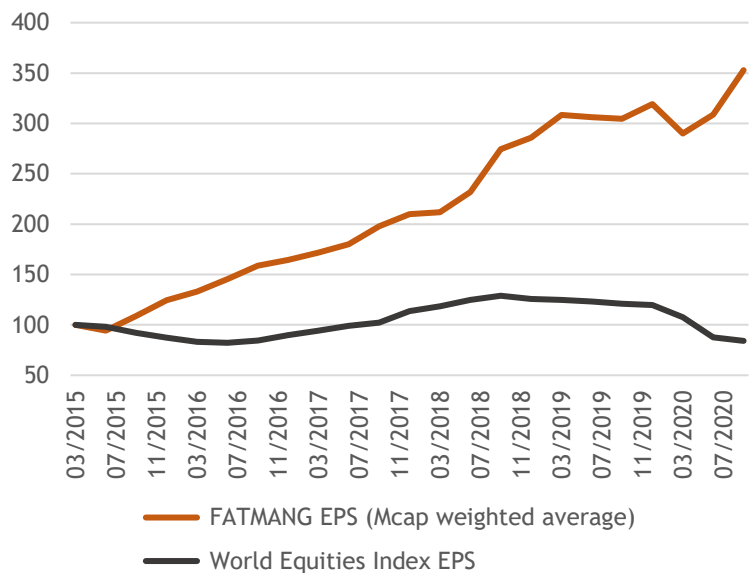


Figure 3. Source: Bloomberg, HCP Asset Management

¹ FANG has been the established acronym for the four big tech leaders since some years. With the change of name from Google to Alphabet, the group should be called FANA and instead of FATMANG AFATMAN. Fat pitches is a term often used in trading, but we have refrained to go for A FAT MAN for obvious reasons.



Key risks to consider

For next year, analysts forecast for the first time in a while a significantly stronger earnings growth outside of FATMANG, namely 26 % versus 20 % for this tech leader group, and 13 % for the overall tech sector (see figure 4). While this is because of a lower base in 2020 for non-tech shares, it may lead to a rotation away from FATMANG in 2021.

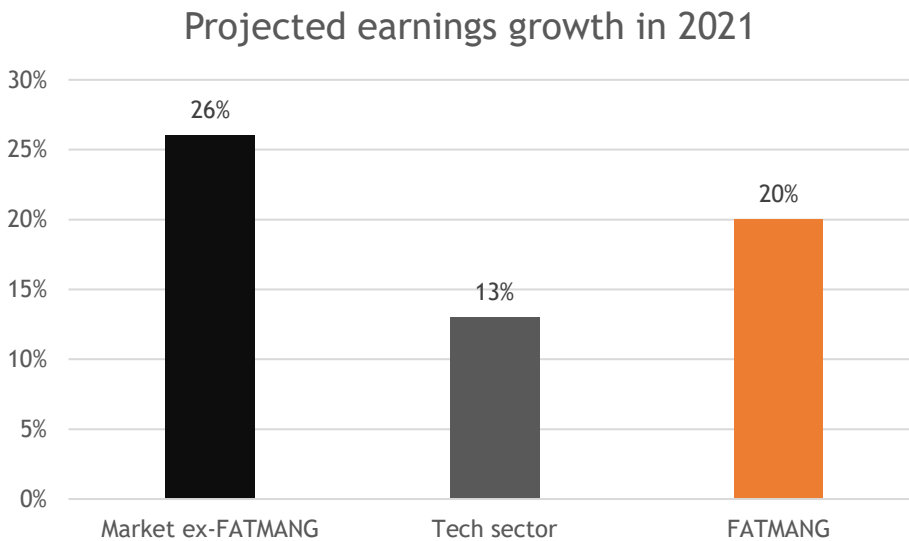


Figure 4. Projected earnings growth, Source: Bloomberg

With these companies continuing to grow their share of the market, regulatory concerns have become louder. While this so far has been mainly a European issue, we now see such developments also in the US as well. Key clients (e.g., Fortnite, Expedia) have voiced concerns about the dominant position of the US tech giants. The US has little interest in hurting the industry which has been the key success for them over the last twenty years, but the more smaller US companies get negatively impacted, the more likely regulatory action will be.

We could possibly see some of the following actions: Facebook may have to spin off Instagram and WhatsApp. Google may have to part from YouTube, Chrome and Android. Apple may be forced to cut the fees in their app store. Amazon may have to spin off Amazon Web Services, and Microsoft its cloud business. Furthermore, any data regulation may severely change the whole dynamics of every advertising business. Hence, investors need to very carefully monitor the upcoming regulatory action. We may first see only monetary penalties but would not be surprised that some of the above more drastic actions will be implemented.

The FATMANG basket has started to underperform since the US election. While it is early days, it may be a sign of things to come.



SPACs, IPOs and New Kids on the Block

The drastic increase in money supply with measures such as M2 being up 24 % year over year has been leading to an asset inflow into financial markets.

M2 Money Stock (USD trn)

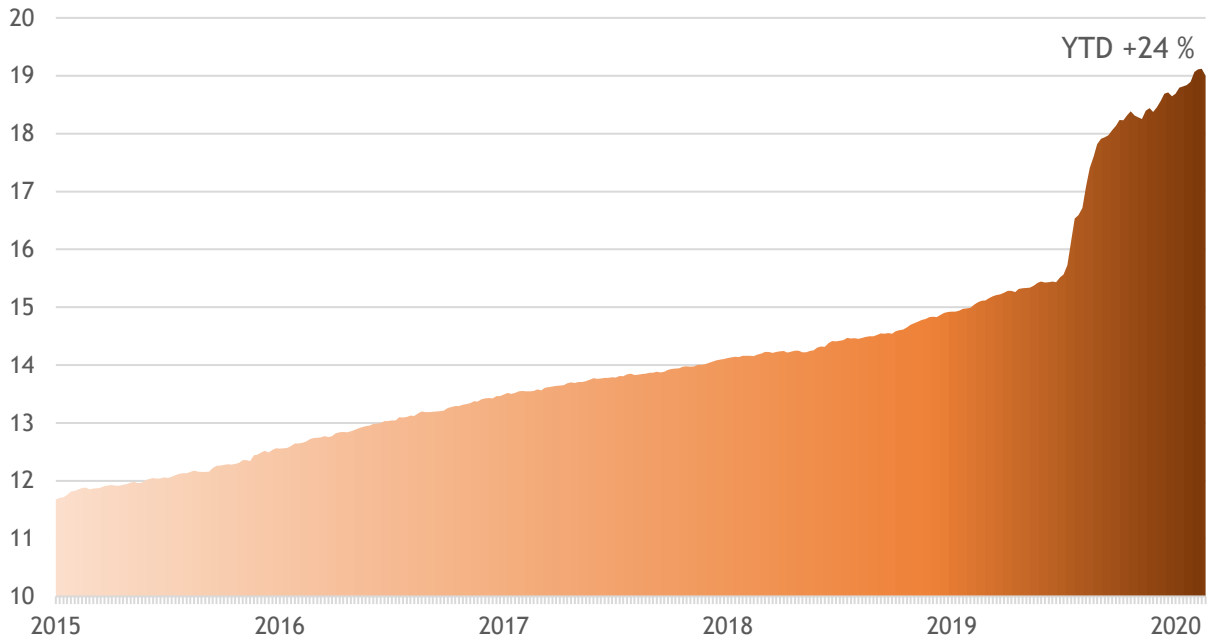
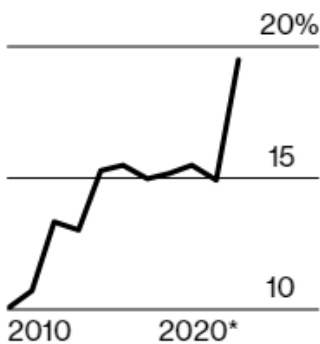


Figure 5. M2 stock, Source: FRED

US retail equity trades as % of all shares traded



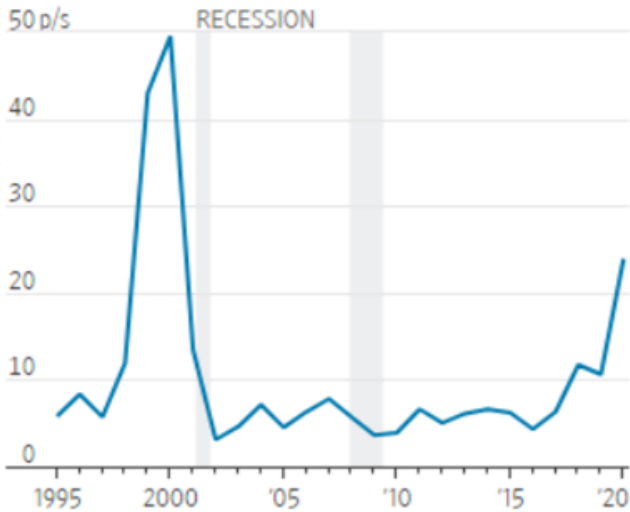
*Estimate

The popularity of retail investing has increased tremendously over the last decade, spiking in 2020. Ever lower fees, lockdown boredom, a lack of sports betting and casino gambling, fintech developments and new regulation allow and motivate more and more people to open their own online trading accounts. Retail investors historically represented 10-14% of the market. Now their share almost reached 20% on average and 25% on peak trading days.

Figure 6. Bloomberg Intelligence 02.12.2020., FT.com



Median price-to-sales ratio of tech IPOs



IPOs have been seeing their best year since 2000. For those who cannot wait for the proper due diligence of an IPO, the possibility of a reverse merger via a special acquisition company or SPAC has become immensely popular. Companies such as Nikola or Virgin Galactic chose that latter way. IPOs such as Airbnb saw their prices popping 100 % on day one, and the Renaissance Index of IPOs had its best year since 2000. It looks like a lot of companies which only recently claimed that being private is the best in the world, used the opportunity to become a publicly listed firm.

Figure 7. Source: Jay Ritter, University of Florida

Great year for IPOs

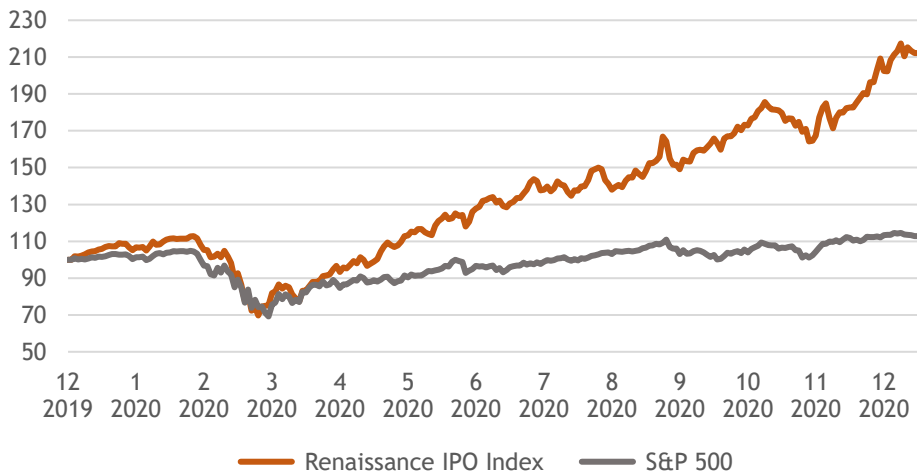


Figure 8. Renaissance IPO Index, Source: Bloomberg



New disruptors such as Snowflake trade at 100 times forward sales (see figure 7 for the trend in price-to-sales ratios for IPOs). Snowflake can grow into its valuation as its sales are projected to increase seven-fold over the next three years - implying a more “normal” sales multiple of 15 by 2023. We all know that new disrupting companies shall be valued off their market opportunity and not near-term sales, but we have identified currently fifty companies trading at more than 20x forward estimated sales. Not all will be winning, and a lot is priced in as their combined market cap is already USD 1.7 trn.

	Companies	EV/ Fwd Sales		Companies	EV/ Fwd Sales
1	SNOWFLAKE INC	99.4	27	MARKETAXESS HOLDINGS INC	27.5
2	KAHOOT! AS	56.1	28	OUTSET MEDICAL INC	27.3
3	ADYEN NV	54.7	29	ATLASSIAN CORP PLC	27.3
4	BILL.COM HOLDINGS INC	47.3	30	MONGODB INC	27.1
5	CLOUDFLARE INC	45.1	31	AGORA INCDR	27.0
6	UNITY SOFTWARE INC	43.3	32	PAYCOM SOFTWARE INC	25.0
7	AI INSIDE INC	41.3	33	EMEMORY TECHNOLOGY INC	24.7
8	PRO MEDICUS LTD	40.9	34	STONECO LTD	24.6
9	DATADOG INC	38.0	35	DOCUSIGN INC	23.0
10	FREEE KK	36.3	36	VEEVA SYSTEMS INC	23.0
11	COUPA SOFTWARE INC	35.4	37	GMO PAYMENT GATEWAY INC	22.9
12	ZSCALER INC	34.8	38	OBIC CO LTD	22.7
13	SHOPIFY INC	34.0	39	XERO LTD	22.4
14	ZOOM VIDEO COMMUNICATIONS	33.7	40	RINGCENTRAL INC	22.4
15	CROWDSTRIKE HOLDINGS INC	33.7	41	INFOMART CORP	22.2
16	PALANTIR TECHNOLOGIES INC	32.7	42	LIGHTSPEED POS INC	22.1
17	BIGCOMMERCE HOLDINGS	31.1	43	TWILIO INC	22.0
18	APPIAN CORP	31.1	44	RAKUS CO LTD	21.5
19	NCINO INC	30.8	45	VISA INC SHARES	21.4
20	OKTA INC	30.5	46	SLACK TECHNOLOGIES INC	21.4
21	MING YUAN CLOUD GROUP	29.3	47	FIVE9 INC	21.0
22	JFROG LTD	29.2	48	OPEN LENDING CORP	20.6
23	ZOOMINFO TECHNOLOGIES INC	28.2	49	HENNGE KK	20.3
24	FASTLY INC	28.2	50	SIMULATIONS PLUS INC	20.1
25	SCHRODINGER INC	28.2	51	MSCI INC	20.1
26	FORTNOX AB	28.0			

Table 1. List of companies trading above 20x forward sales, as of 14.12.2020, Bloomberg



Of course, we see a digital acceleration driven by the pandemic. However, the buyers of technology also need a budget, and typically transformations take longer than hoped by the sellers. Hence, projected growth rates may not be realized, leading to valuation resets in these highfliers. Another key risk is that in case the stock market sees a melt-up from here, the Fed will be forced to pullback monetary support, especially in the light of more intense inequality discussions.

It is not about value or growth

The pace of technological innovation will, however, lead to a demise of business models which cannot adopt. There has been an intense discussion when value will turn around and start to outperform growth stocks again. A company valued cheaply on the market but not able to adapt, will stay a value trap and eventually die. The key differentiation for stock pickers in the coming years will be to identify those companies which benefit most from the digital transformation by implementing the tools necessary for this shift.

The narrow leadership has helped passive asset management

Who needs an active asset manager if you simply buy the FATMANG basket and outperform markets? With these names taking a larger percentage in the indices, passive management is supported - until everyone is in and the trend turns. Or until these companies start to underperform the market in terms of earnings growth...

*Cumulative net inflows over the past decade,
bonds and equities (USD trn)*

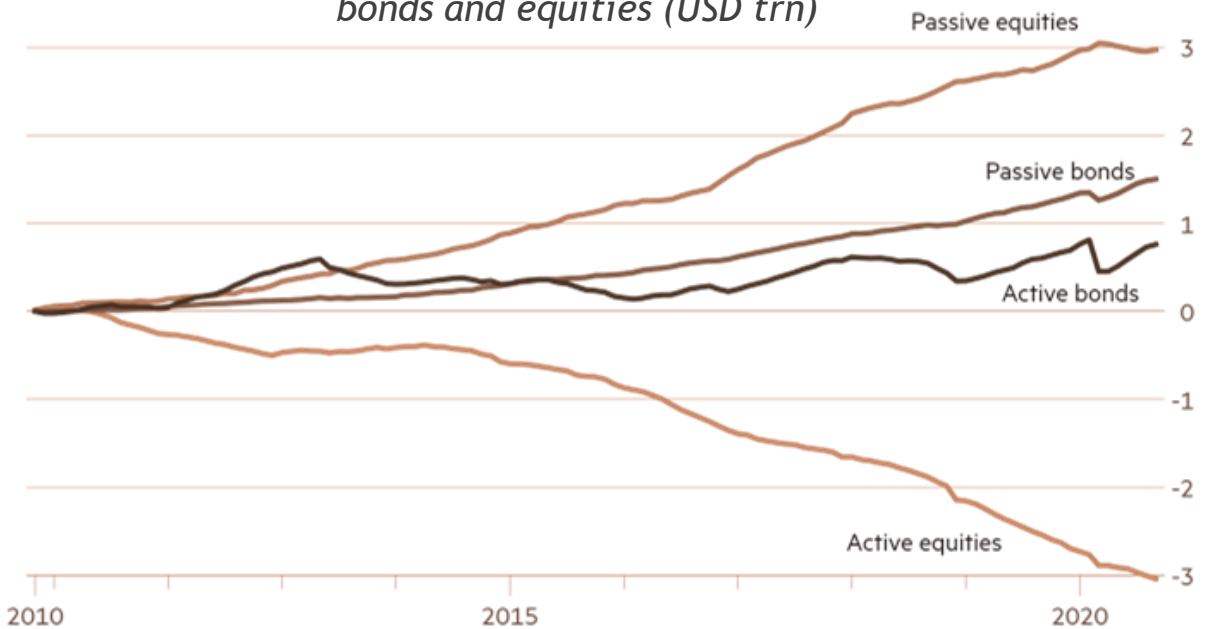


Figure 9. Active outflows, passive inflows, Source: FT.com

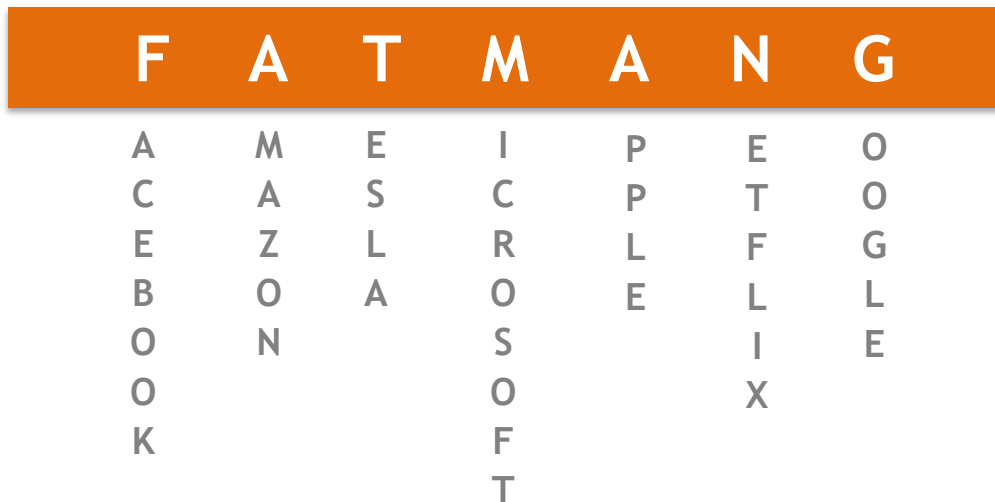


Conclusion

The market has been driven mostly by a very small number of tech giants over the last years, even if it got broader recently. In this viewpoint, we highlighted the risks to a continuation of that trend. This is a risk particularly for passive investors and index huggers.

On top of that, speculative action in markets has increased, and regulatory changes are becoming more likely. Hence, investors need to weigh those risks going forward carefully, keeping in mind the potential rotation away from tech. At HCP, now entering the fifth year of our strategy, we believe that our focus on high free cash flow and good balance sheets is also a measure of risk control.

The digital innovation push triggered by the pandemic may very well lead to an increase in productivity, leading to a new wave of growth out of this crisis and propel the market further up. We are looking forward to a stabilization and healthy recovery of cash flows and earnings in 2021.



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