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Monthly Market Review

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DÉJÀ VU ALL OVER AGAIN

Shades of 2000's tech craze and hanging chads

September lived up to its reputation as the cruelest month for stocks. The S&P 500 Index had its first down month since March, losing 3.9%. Big Tech stocks started the market swoon after having gone parabolic in August. Value stocks held their ground during the first half of the month, but then succumbed to the selling pressure as the political battle to fill late Justice Ruth Bader Ginsburg's seat was believed to have deepened the political divide and diminished the odds of a bi-partisan stimulus bill before year-end. However, stocks mounted a rally in the final days of the month as both sides in Washington attempted to give the Heroes Act 2.0 one more shot so they would have political cover with voters. At the time of this writing, House Speaker Pelosi and Treasury Secretary Mnuchin are still trying to work out a deal that appears to be $800 billion apart (House's $2.3 trillion vs. Mnuchin's $1.5 trillion). There is also the question of whether the Senate would go along with it. On the pandemic front, warning flags were raised across Europe as new cases had doubled in more than half of the European Union's member states over the last few weeks. The U.K. re-imposed some lockdown measures through next March as it confronted what Prime Minister Johnson called a "perilous turning point."

The risk-off mood led to a decline in U.S. Treasury yields and widened corporate bond spreads. Prices pulled back among commodities from crude oil and copper to lumber. A bout of profit-taking also dragged down precious metals, with gold falling 4%. The U.S. Dollar Index (DXY) mounted a rally as diminishing odds of a major stimulus bill meant less U.S. deficit spending in the near term.

The highly anticipated first presidential debate turned out to be an unproductive shouting match that will likely become future textbook material on what not to do at a debate. Biden continues to have a sizeable lead in the polls and at the betting market, which makes the battle for control of the Senate even more important. One controversy from the debate was Biden's refusal to swear off "packing" the Supreme Court with additional justices, which implies that a Democrat-controlled Senate might do away with filibuster. Such a development will have far-reaching implications in swinging the policy pendulum to the left.

On the good news front, Johnson & Johnson has entered Phase 3 trial of its single-dose COVID-19 vaccine. Unlike other vaccines, this one can be more easily distributed as it requires only basic refrigeration rather than deep freeze for storage. If all goes well, it could be available in early 2021, and the company could produce one billion doses next year. Lastly, please do not forget to get the flu shot.

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A STAR-STUDDED INVENTION

She is probably the most under-appreciated actress of all time; under-appreciated not for her 28-year acting career, but for the far-reaching impact of her inventions.

Born in Vienna in 1914, Hedwig Eva Maria Kiesler had shown an interest in acting and invention since childhood. Her father would pique her curiosity with tales of technological discoveries as they took walks together. At the tender age of 16, she managed to get herself hired at the Sascha-Film production company. Two years later, under her maiden name Hedy Kiesler, she starred in the controversial film *Ecstasy*, a passion-filled drama featuring brief nude scenes. The film was banned in several countries but propelled Hedy to stardom and won her many admirers. One of them was Friedrich Mandl, an arms merchant 14 years her senior and reputedly the third-richest man in Austria. She married Mandl just a few months after the release of Ecstasy.

Her marriage to Mandl turned out to be a nightmare as he forbade her from acting and kept her as a virtual prisoner in his lavish castle. She eventually disguised herself as a maid and fled to Paris and then London in 1937. She was introduced to Louis B. Mayer, the head of MGM, while he was in London scouting for talent. Mayer was so impressed with Hedy that he brought her to Hollywood in 1938 and promoted her, now with the stage name Hedy Lamarr, as the "world's most beautiful woman."

While Hedy was enjoying a successful Hollywood career, she was also tinkering on the side as an amateur inventor. The legendary Howard Hughes was so convinced of Hedy's inventiveness that he reportedly put a team of scientists and engineers at her disposal. Hedy wound up improving on the aerodynamics of his aircrafts by proposing a swept-wing design modelled after birds.

During WWII, Hedy learned that the Allied's radio-guided torpedoes were being jammed by the Axis powers. She ruminated that, rather than transmitting the signal on one carrier frequency which could be easily jammed, there must be a way to spread the signal over multiple frequencies at different intervals to avoid interference. She brought the idea to her friend George Antheil, an avant-garde composer and pianist, to implement her scheme since the piano has 88 keys, each generating a note of unique frequency. Together they developed a frequency hopping system for which a U.S. patent (number 2,292,387) was granted in 1942.

The U.S. Navy did not adopt Hedy's "secret communication system" during WWII as it was deemed too difficult to implement. However, in the late 1950s, the advent of lightweight transistors enabled military contractors to start exploring this frequency hopping scheme. By the time of the Cuban Missile Crisis in 1962, or three years after the patent's expiry, U.S. ships deployed to blockade Cuba were armed with torpedoes guided by this new system.

Equity Markets Indices[1]	8/31/20 Price	9/30/20 Price	MTD Change	YTD Change
MSCI All Country World	585	565	-3.4%	0.0%
S&P 500	3500	3363	-3.9%	4.1%
MSCI EAFE	1910	1855	-2.9%	-8.9%
Russell 2000®[2]	1562	1508	-3.5%	-9.6%
NASDAQ	11775	11168	-5.2%	24.5%
TOPIX	1618	1625	0.5%	-5.6%
KOSPI	2326	2328	0.1%	5.9%
Emerging Markets	1102	1082	-1.8%	-2.9%
Fixed Income				
2-Year US Treasury Note	0.13%	0.13%	0	-144
10-Year US Treasury Note	0.71%	0.69%	-2	-123
BarCap US Agg Corp Sprd	1.29%	1.36%	7	43
BarCap US Corp HY Sprd	4.77%	5.17%	40	181
Currencies				
Chinese Renminbi (CNY/$)	6.85	6.79	-0.8%	-2.5%
Brazilian Real (Real)	5.49	5.61	2.1%	39.2%
British Pound ($/GBP)	1.34	1.29	3.4%	2.6%
Euro ($/Euro)	1.19	1.17	1.8%	-4.3%
Japanese Yen (Yen/$)	105.91	105.48	-0.4%	-2.9%
Korean Won (KRW/$)	1187.85	1169.60	-1.5%	1.2%
U.S. Dollar Index (DXY)	92.14	93.89	1.9%	-2.6%
Commodities				
Gold	1968	1886	-4.2%	24.3%
Oil	42.6	40.2	-5.6%	-34.1%
Natural Gas, Henry Hub	2.63	2.53	-3.9%	15.4%
Copper (cents/lb)	304	303	-0.3%	8.4%
CRB Index	153	149	-3.1%	-20.1%
Baltic Dry Index	1488	1725	15.9%	58.3%

Source: Bloomberg

In 1985, seven entrepreneurs founded a company named Qualcomm for "quality communications." It was contracted by Hughes Aircraft for a satellite network proposal, and the project led to its first patent on the CDMA wireless technology. Qualcomm bet the farm on CDMA and eventually made it the global standard for the third-generation (3G) wireless networks. On its website, the company paid tribute to Hedy Lamarr and George Antheil by tracing the origin of CDMA, or its "star-studded beginning," to their 1942 patent. Their frequency hopping design also laid the foundation for today's GPS and WiFi.

In recognition of their contribution to the wireless industry,

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the Electronic Frontier Foundation bestowed the Pioneer Award to Hedy Lamarr and George Antheil in 1997. Upon hearing of the award, Hedy merely said, "It's about time."

By the time Hedy Lamarr passed away as a recluse in 2000, she had long faded from most of her fans' memory. However, wireless communication networks were being rolled out globally and her invention had far more lasting impact than any of Hollywood's leading ladies.

CHASING GROWTH

Technology stocks led the market into a correction after a blistering surge that peaked in early September. It turned out that the huge run-up in the prior month had to do with Japanese conglomerate SoftBank's big derivative bets. The nominal value of call options traded in the second half of August was more than triple the average of the prior three years. It turned out that SoftBank was gobbling up several billion dollars of call options on a basket of already expensive tech stocks. As share prices moved up, market makers were forced to buy more shares to hedge their books. However, as these bets were unwound, the reversal also created a downward spiral. It felt like markets were being hijacked by excessive wagers among scheming traders and a legion of fearless "Robinhood bros."

Despite the pullback in tech shares, the tech IPO market remained sizzling hot. To wit, software company Snowflake set a new IPO record on September 16th when it became the largest company by market capitalization ever to double its share price in a market debut. On its first day of trading, its share price surged to as high as $319 from the $120 IPO price and closed at $253, which gave the company a market value of $70 billion. To put this number into perspective, it is more than 5 times the $12.4 billion private market value that it fetched in February, 174 times the company's trailing four-quarter sales, and roughly the entirety of its projected total available market in 2022.

This phenomenon of investors rushing to outbid each other to own a slice of companies supposedly well-positioned for big new markets is nothing new. During the dot-com bubble twenty-plus years ago, investors were excited by not only start-ups with a ".com" attached to their names, but also technology companies that would blanket the globe with Internet and wireless networks. Indeed, the latter was clearly the "sure thing" as the infrastructure buildout was for real regardless of which Internet portals or online stores won out. As a case in point, the aforementioned Qualcomm was one of the most popular stocks as investors realized that the company would be minting money with its patent portfolio should its CDMA technology become the standard for the 3G wireless networks to be rolled out in the 2000's.

In March 1999, Qualcomm and rival Ericsson settled their patent dispute and made CDMA the standard for 3G. It triggered a buying frenzy that propelled the stock up an amazing *2,619%* for the year. The most memorable part of the run-up was in the final days of the year. On December 29, 1999, an analyst at PaineWebber initiated coverage of Qualcomm with a target of $1,000, doubling the previous day's closing price of $503. The analyst forecasted that the royalty business alone would generate $20 billion of sales in 2010, as 85% of his projected 3 billion handsets to be sold in 2010 would license Qualcomm's CDMA technology. The stock gapped up at the open and closed the session at $659, up 31% for the day. A few days later, on January 3, 2000, it hit a closing high of $717.

Qualcomm indeed wound up as one of the greatest technology companies of all times. However, as was often the case, it was not easy for a business in the real world to top analysts' rosy projections at the peak of the bubble. In 2010, 1.4 billion units of cellphones were shipped worldwide, far below the PaineWebber analyst's 3 billion-unit forecast. Qualcomm's $11 billion of total revenues for that year also fell way short of his $20 billion from royalties alone. As for Qualcomm's stock performance, it fell as much as 87% from the early 2000's high of $717 to $95 in mid-2002 during the dot-com bubble implosion. On a stock-split-adjusted basis, it did not climb back to the $717 peak (or $89.66 post stock splits) until November 2019, nearly *20* years later. The moral of the story is that valuation matters in the long run, and it should not be lost on those who want to own a slice of today's great growth stories with stratospheric valuations.

DÉJÀ VU

Speaking of the dot-com bubble from two decades ago, we see many similarities between that era and today's market. Both have narrowing market leadership with a handful of growth stocks capturing a big chunk of market indices. The valuation gaps between the winners and losers were reaching historic highs, and retail investors were feeling invincible. The demand environment was also weakening during both periods. With venture funding drying up after the March 2000 peak, spending by start-ups was declining rapidly. Weakness in technology demand subsequently spread to corporations and consumers in late 2000. I still recall that Hewlett-Packard's CEO Carly Fiorina lamented that it was as if someone had just switched the light off in December. Here in 2020, corporate spending has been hurt by the pandemic and many tech companies are actually seeing sales declines in spite of the run-up in their share prices. Consumer spending has so far been buoyed by generous fiscal stimulus. However, holiday sales may turn out to be rather lackluster given the twin issues of the absence of continued fiscal stimulus, and the potential for another wave of COVID-19 outbreak, as is the case in Europe.

There is, however, one glaring difference between 2000

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and today: whereas the Fed was withdrawing liquidity and raising rates in 2000, it is printing money today. That said, tech stocks did not bottom until October 2002 despite multiple Fed rate cuts that started on January 3, 2001 – it showed that monetary easing did not always prop up stocks when fundamentals were collapsing.

HANGING CHADS REDUX?

Another similarity between 2000 and 2020 is the election calendar; both are presidential election years. Remember the "hanging chads" cliffhanger that threw the 2000 presidential election into a 36-day political crisis? That race came down to Florida's 25 electoral votes, and George W. Bush was leading Al Gore by merely 537 votes out of six million cast. Gore sued for a recount and the case reached the Supreme Court. On December 12th, in a 5-4 ruling along ideological lines, the Supreme Court ended the recount and Al Gore gave a poignant yet gracious concession speech on the following evening.

Some political observers cautioned that we could see another contested presidential election this year. Unless a candidate wins by a sizeable electoral margin on November 3rd, the contest could drag on due to larger shares of mail-in ballots in various states. The validity of some of these ballots could be challenged in a close race as both sides have armies of lawyers ready to mount legal battles. Assuming the Republican-controlled Senate does not have sufficient time to confirm Amy Coney Barrett to the Supreme Court before the election, there is the possibility of a 4-4 decision on a challenge that would then ratify the lower court's ruling. The control of the Senate may also be up in the air for days or even months as Georgia's special election to fill Senator Isakson's seat may not be settled until a run-off on January 5, 2021, if no candidate receives more than 50% of the vote in the first round. In short, the November general election could turn into a nail-biting, market-moving event.

A TIME FOR CAUTION

The epic equity rally from April through August was driven by positive catalysts such as exceedingly accommodative monetary policy, massive fiscal stimulus, prospect of a V-shaped recovery, and progress in therapeutics and vaccines. By now, most of these catalysts are in the rearview mirror. The Fed has fired most of its bullets for now and is urging more fiscal stimulus to lift the economy. Unfortunately, partisan politics has so far failed to deliver on the badly needed phase 4 stimulus bill. The West's haphazard approach to contain COVID-19 has let new daily case counts rise dangerously high in several countries, prompting re-imposition of some containment measures that will impede economic recovery. Investors also appeared to be waking up to the depth of America's social and political divide, electoral uncertainty, and a potential "blue sweep" that will lead to a major policy shift to the left. While corporate earnings for the third quarter may surprise on the upside, forward guidance might be cautious as the economic recovery appears to have lost momentum. We still expect good news on the vaccine front, but it will take time to get much of the population vaccinated to create herd immunity.

While the market will likely rally if a stimulus deal is reached, we would still be cautious ahead of an election that could have far-reaching impact for years. We suspect markets will mount a relief rally if President Trump manages to win a second term. A divided government with a Biden Administration and a Republican senate majority will be spun as a positive, although Republican senators will likely morph into fiscal hawks to make the passage of Biden's stimulus programs more difficult. Lastly, a "blue sweep" will likely lead to significant fiscal stimulus in 2021, but the subsequent tax hikes and more heavy-handed regulations might weigh on the market down the road. In short, elections have consequences, and markets will adjust accordingly.

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