The unrelenting law of evolution

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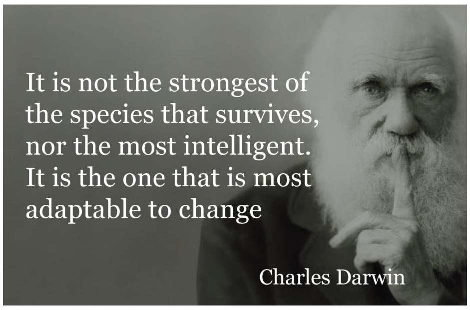
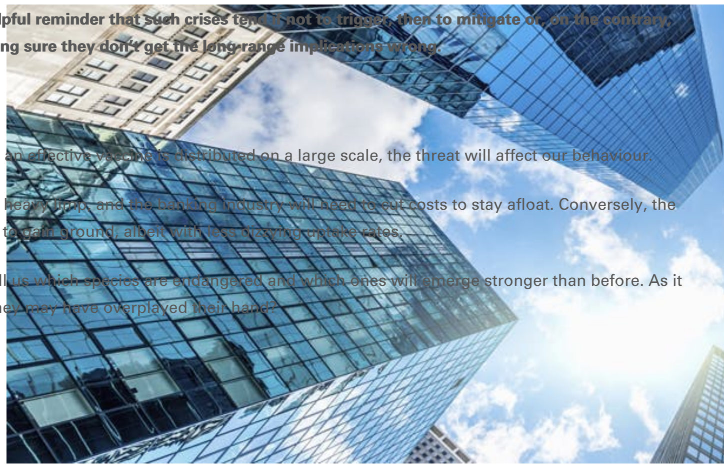
As the summer draws to a close, there is still much uncertainty about how the pandemic will play out, because we know little as yet about the virus behind it. We have all adapted to that uncertainty, and our changed behaviour has reduced the risk of a surge in infections. But it will also hold back the global economic recovery and is already producing stark contrasts in performance between sectors.



As deliberately shutting down 50% of the world economy a second time is no longer an option, we are entering a period of fragile, highly uneven growth whose primary backstop will be widespread fiscal and monetary life support. The successful adaptation of specific companies has provided solutions to issues like mobility, health security and productivity, thereby making them increasingly profitable. In contrast, other sectors are facing the stark choice between overhauling their business models or going under.

The law of evolution can by no means eliminate crises, but it can hopefully provide a helpful reminder that such crises tend if not to trigger, then to mitigate or, on the contrary, accelerate long-term trends. Managing crises is every bit as crucial for investors as making sure they don't get the long-range implications wrong.



The pandemic is no longer the primary risk for financial markets

Today, the world has resigned itself to trying to live with the virus. That means that, until an effective vaccine is distributed on a large scale, the threat will affect our behaviour.

Hotel, restaurant and transportation businesses will make it out of the inferno, but with a heavy limp, and the banking industry will need to cut costs to stay afloat. Conversely, the use of e-commerce, videoconferencing platforms and Web-based solutions will continue to gain ground, albeit with less dizzying uptake rates.

An understanding of how far along the various adaptation strategies have made it can tell us which species are endangered and which ones will emerge stronger than before. As it seems that investors have basically figured this out, is there good reason to worry that they may have overplayed their hand?

Have growth stocks become a source of danger?

Over the past decade at least, the way the aftermath of the 2008 meltdown was dealt with has produced a mediocre global economic recovery and a historic fall in interest rates. As a result, companies able to generate robust earnings growth despite that lacklustre backdrop have done enviably well in the stock market.

That trend has received an automatic boost in 2020 that has worked to the advantage of some corners of the tech industry, enabling them to increase their competitive edge.

Unlike during the dot-com bubble two decades ago, those companies now boast extremely robust balance sheets and vastly superior profitability. This suggests that the striking outperformance achieved since the start of the year by growth stocks – located mainly but not solely in the tech sector – is justified.

Is that outperformance overblown? Not in our view. For example, tech stocks currently enjoy a roughly 30% valuation premium that is barely above the historic average for the past 25 years (a 25% premium) and infinitely lower than the 120% premium at which they traded in 1999–2000.

In view of the present uncertainty, it's hard to arrive at long-range estimates that deserve much confidence. Only in-depth knowledge and analysis of each company, its competitive environment, the disruptive technology affecting its business model and a slew of other factors can make that possible. This has opened up major opportunities for active fund managers.

Given both the nature of the 2020 economic crisis and how it has been dealt with, it would be presumptuous to claim we can predict how it will pan out. This highlights the need to stand ready to act flexibly once again if necessary, because the law of evolution applies to everyone – starting with asset managers. In the meantime, the overriding imperative will be to construct equity portfolios composed, stock after stock, of names reflecting long-term convictions. For overall balance, those portfolios should also include assets with a connection to economic stimulus such as corporate credit and gold miners.

Source : Carmignac, Bloomberg, 31/08/2020