# AF4 2020/2021
# Asset Classes: shares
# Part 4: The wider market

Besides understanding how the value of shares can be assessed, AF4 will also test your wider knowledge of how equity markets fit into the wider economic system. As with bonds, questions will probably be set against the background of the coronavirus epidemic

The milestones for this part are to understand:

- The difference between cyclical and non-cyclical shares
- The difference between value and growth stocks
- What drives the stock market and does it matter?
- Why markets are currently extremely volatile
- The impact of the coronavirus on the market

There are 2,600 shares from over 60 countries listed on the London Stock Exchange. These range from massive multi nationals such as BP to small start-up businesses listed on the Alternative Investment Market. These can be classified in many different ways but this part will focus on two:

- Cyclical and non-cyclical shares
- Value and growth shares

## Cyclical and non-cyclical shares

It is generally accepted that shares are a leading indicator of economic performance. Prices reflect the market's view of a company's and the economy's future rather than current performance. They will start to fall or ease ahead of an economic downturn and strengthen or rise before the economy picks up.

In practice shares will react in different ways depending whether they are **cyclical or non-cyclical.**

A cyclical share tends to reflect current economic conditions. If the economy is doing well these shares will do well but underperform in times of recession. An example might be a retailer specialising in high end luxury goods. These are seen as aggressive stocks, capable of delivering above average growth

On the other hand tobacco is the classic non-cyclical business as its sales tend to be the same regardless of the state of the economy. Utility companies are another example of a non-cyclical business. These are seen as defensive stocks.

## Value or Growth Stocks

Analysts split stocks into these two categories. They also describe an investment strategy or philosophy and can be applied to collective investments as well as individual shares.

Investors looking for value stocks will select those that trade for less than their "intrinsic value". They believe the current price does not reflect the company's long-term potential and represents good value.

Growth stocks are those whose earnings are expected to grow at an above average rate compared to its sector or industry. The price is not considered to be that relevant in deciding whether or not to buy the share. It is a higher risk strategy as it relies on a strong outperformance of a handful of companies delivering large returns.

**Tesla** is the classic example of a growth stock. Its price rose from just over $1,000 in June 2020 to $1,700 in July 2020 giving it a market capitalisation of $300bn. This makes it the most valuable car maker in the world but Tesla has only made a profit of $104m

Compare this the VW group which in 2019 manufactured 11 million vehicles with sales of £228m, profits of £17bn but a market capitalization of £64bn.

Tesla illustrates one of the classic indicators of a growth stock, a disruptive product. The argument is that oil will be phased out due to environmental issues resulting in a switch to electric vehicles where Tesla will be the market leader. Similarly, the best performing US stocks are known as FAANG: **Facebook, Amazon, Apple, Netflix & Google** (now called Alphabet), all disruptors.

Growth stocks are characterized by:

- A high p/e ratio
- A disruptive company
- High potential growth earnings
- Low dividend yield
- "growth at any price"

The downside to growth stocks is that it is difficult to distinguish whether the rise in its share price is down to its potential growth or to investors piling in due to "Fear of Missing Out (FOMO). It may be that this rise is in fact a bubble and could be followed by a crash.

Value stocks are characterised by:

- Company or sector is "out of fashion"
- Low p/e
- Good dividend yield
- Older established businesses

According to data produced by Brewer Dolphin and Thomson Financial Datastream, funds investing in value stocks have increased by 624% since 1995 while growth funds have returned 1,072% over the same period. The coronavirus epidemic has widened this gap as growth stocks such as the large US tech companies have been the top performers.

Growth stocks benefit from low interest rates and low inflation as the value of future money is higher inflating today's earnings multiple. Conversely higher interest rates and inflation will tend to favour value stocks.

Supporters of investing in value stocks claim that they can benefit from both short and long term growth. In the short term the price may rise as other investors realise they are undervalued and long term growth as the firm's performance recovers.

At present (July 2020) shares in hotels, airlines and travel companies look extremely cheap but it would be a brave investor who bought these in the belief that they will recover.

A few final points on value versus growth.

Warren Buffet has said, "In the short term the market acts as a voting machine, that is investors are following the crowd whereas in the long term it acts like a weighing machine in that it looks at the real value of a company"

Unilever would not be anyone's idea of a growth business. It operates in the fast moving consumer goods sector, with many consumer brands. Nothing very sexy about soap and other household goods but in July 2020 it was in the top 10 of the FTSE 100.

## What drives the stock market and does it matter?

Share prices are a barometer of a country's economy They rise if key measures such as GDP and personal incomes are increasing. They tend to fall when the reverse happens.

But would a significant fall in say the FTSE 100 affect the UK economy? A fall would reduce the wealth of individuals with significant equity holdings either directly or through funds. That may make them more pessimistic about their own spending but would it impact the "real" economy? The consensus of most analysts is that it wouldn't. In fact commentators in the US have pointed out that there is a growing divide between "Wall Street and Main Street". Whilst the S&P 500 has soared to record levels this has not been reflected in the real economy.

### Is it just supply and demand?

The price of shares, as with any other commodity is set by supply and demand. In equity markets the price reflects the balance between what a seller of a share is prepared to accept and what a buyer is prepared to pay. In the UK this is computerised using the CREST system which matches bids by buyers and offers by sellers. Prices will rise when buyers are prepared to pay prices that persuade other investors to sell.

Pre covid, the rise in share prices was mainly due to:

- Investors' search for yield
- Quantitative easing

**Search for yield**

Where does a saver/investor put their money? Interest rates offered by banks are less than 1%. Some pay as little as 0.1% which means that a £10,000 deposit would produce £10 of income. Bonds offer no respite with UK gilts having yields under 1%. This forces investors into equities, pushing up the price, which could mean the investor is taking on more risk.

**Quantitative Easing**

This is the "big bazooka" employed by central banks. By buying back bonds from banks and financial institutions it has increased liquidity and most of this money has gone back into buying equities. Some economists have conjectured that this could bring in "the new stagflation", that is rising equity prices against the background of a stagnant economy. The term stagflation was coined in the 70's when inflation was high (20% in some years) but the economy was stagnant.

**Why are markets so volatile?**

It is an old saying that markets hate uncertainty. Even before coronavirus hit us there was still many unknowns. In no particular order these are:

- Concerns over trade relations between the US and China
- The full impact of Brexit especially if there was no agreement on a trade deal.
- Political uncertainty affecting investment in China
- Continuing uncertainty over the future of the Eurozone
- Ageing populations in the UK and Europe increasing the cost to governments

Then to this has been added coronavirus.

There has always been uncertainty but the world of 2020 is different to that of 1990 and totally different to say the 1970's.

Historically both individual and institutional investors would tend to be long term investors adopting a buy and hold strategy. They were content to receive a steady rising income through dividends and a rise in the share price as the company's profits increased year by year. Today there is much more short-term trading.

The key development is the wide use of computer-based trading. These trade millions of shares each day using algorithms to seek out minor differences in prices to make gains. Similarly Hedge Funds use shorting techniques and heavy use of derivatives All this increases volatility.

The world is also much more interconnected. Forty years ago, most countries' manufacturing was based entirely in that country. When possible raw materials and parts were sourced inside its territory. Today with globalisation supply chains are spread across the world so any problems in one country will affect many others.

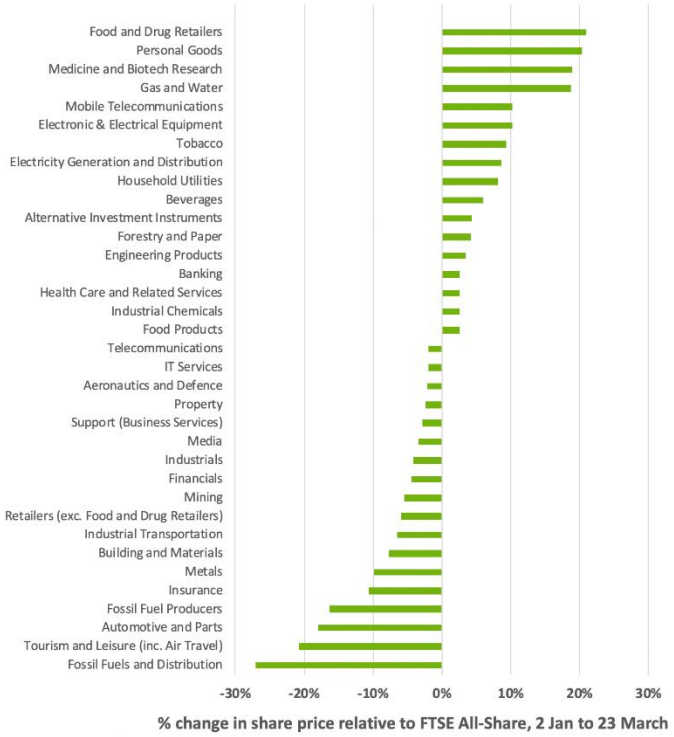
Not that long ago the world's major economies were the US, UK, Germany France and Japan Today there are many more developed countries led by China which by some estimates is the world's second biggest economy.

Not only is the world more physically connected but the internet has made transfer of data and information instantaneous. Neither are there any barriers as to the flow of capital. The UK had what were called **Exchange Controls** from the war to 1979. This limited access to foreign currency which made it difficult to invest overseas. If you bought foreign currency to go on holiday you had to take your passport to the bank who would record how much you bought. Back in the late 60's and early 70's you were limited to £50 plus you could take £15 sterling with you!

## Covid, the economy and the market

Covid has been described as the biggest hit to the world economy since 1945. It has drastically cut the GDP of all the major economies but its impact on markets has been selective

On March 23 the FTSE 100 fell by 34% but even at that stage not all sectors fell as can be seen from this chart Source (IFS)




The market recognised that the travel business would be hit together with fossil fuels as it was apparent even at this stage that these businesses would take a large hit.

As the crisis developed and more analysis was done, this initial view was confirmed.

The following is sourced from the Guardian on July 24 2020.

Following the drop of 34% in the FTSE 100 on March 23 some shares have fully recovered their losses but others are well below their initial value.

Among the most resilient are pharmaceutical companies **Astra Zeneca, Reckitt Benkiser and Glaxo Smith Kline.** These are

worth more than they were on January 2 which reflects both an increased demand for their products and the possibility that they could develop an effective vaccine.

The star performer was **Ocado** which on June 24 was 70% higher than at the beginning of the year. Its rise being due to the increased demand for home deliveries during the lockdown.

Among the stragglers were the oil firms **Shell and BP**, hit by both the drop in demand and a fall in the world oil price.

The biggest fallers were all related to tourism and air travel: **Tui, Easyjet, IAG (British Airways)**, together with firms involved with aircraft manufacture, **Rolls Royce** and **Melrose**.

This pattern has been repeated in other markets with tech related stocks and pharma stocks prospering whilst oil and airline firms suffer

Yet even in individual sectors the performance of companies has varied. Whilst covid has been a boost for most pharma companies, on July 28 it was reported that Smith and Nephew had made a loss of $5 million and revenues had dropped by 1/3 between April and July. The reason was they make replacement knee and hip joints but elective surgery ground to a halt as health services around the world suspended elective surgery.

In a "normal" recession, investors would expect the share price of cruise and travel companies to fall as consumers cut back on discretionary spending. What makes covid different is that it is likely to result in structural changes to the world economy. This could mean that certain sectors will take many years to recover and may disappear completely.

The sectors likely to suffer long term adverse effect include:

- Aviation/airline companies
- Cruise companies
- Travel and holiday companies
- Property companies
- "Bricks and mortar" retailers

What can be deduced from all this?

- "It's an ill wind ….." It's possible to select stocks that prosper even in an economy that's shrinking
- Whilst this is easy with hindsight it is extremely difficult to select the winners.
- Nothing lasts forever. Twelve months ago, a strong case could be made for investing in Carnival. An ageing demographic with disposable income resulted in an increased demand for cruises. Covid not only hit current demand but the sector may have suffered reputational damage with customers unwilling to book in the future.
- Conversely investors piling into Ocado might find that demand falls away when things return to something like normalcy.
- It demonstrates why diversification is the key to managing risk.

## So what happens next?

This is being written in July 2020 and if I could give a definitive answer I wouldn't be writing this.

To use an analogy, the UK and most over governments put their economies into an induced coma. Complete collapse is being avoided by use of government support and Quantitative Easing.

The first problem is that as lockdown measures are reduced will the economy recover and how quick will this be? At the same time it has to decide if it can start to start shutting off its support without slowing down or even collapsing the economy.

As far as share (and bond) prices are concerned the biggest impact will be ending QE or even reversing it. This would reduce gilt prices and increase yields. The effect on the equity market would also be severe. It would reduce liquidity and prices would fall, at least in the short term.

An even more frightening possibility is that inflation starts to rise. Many economists argue this is unlikely but if it did then the UK government might find the Bond market would demand higher interest rates which in turn could stifle off any growth.

That concludes this part so you should now understand:

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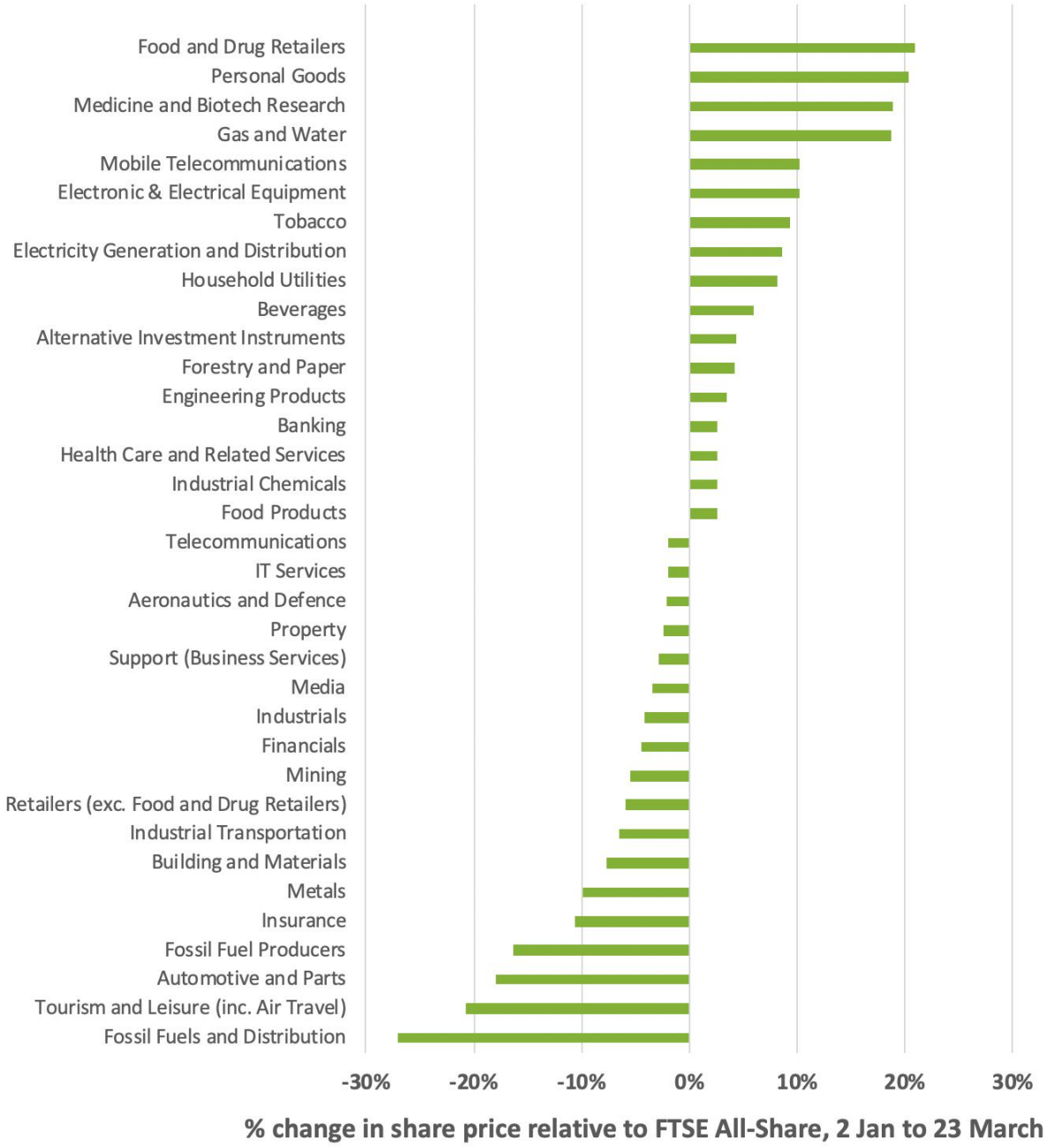
Food and Drug Retailers
Personal Goods
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Mobile Telecommunications
Electronic & Electrical Equipment
Tobacco
Electricity Generation and Distribution
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Beverages
Alternative Investment Instruments
Forestry and Paper
Engineering Products
Banking
Health Care and Related Services
Industrial Chemicals
Food Products
Telecommunications
IT Services
Aeronautics and Defence
Property
Support (Business Services)
Media
Industrials
Financials
Mining
Retailers (exc. Food and Drug Retailers)
Industrial Transportation
Building and Materials
Metals
Insurance
Fossil Fuel Producers
Automotive and Parts
Tourism and Leisure (inc. Air Travel)
Fossil Fuels and Distribution
-30%
-20%
-10%
0%
10%
20%
30%
% change in share price relative to FTSE All-Share, 2 Jan to 23 March