FUND MANAGEMENT DIARY
Meeting held on 15th May 2018

IT sector to struggle when the S&P 500 slumps

- United States economy expected to slow next year
- The valuation of the information technology sector isn't as high as it was during the dot com bubble, so it is unlikely to underperform as dramatically when the economy turns
- Nonetheless, a deteriorating business climate will add to the problems facing the sector in coming years and it could fare particularly badly among cyclical sectors when the S&P 500 falls

The S&P 500 has struggled since mid-March and, as of the end of last week, its level was barely changed since the start of the year at around 2,730. This has been mainly due to worries about protectionism, regulation and geopolitics offsetting positive economic developments. But even if these fears recede, the index could face challenges late in 2019 as the United States economy, which is already running into capacity constraints, could slow next year as the fiscal stimulus fades and tighter monetary policy bites.

The economic consultancy firm Capital Economics thinks that real gross domestic product growth in the United States will fall from 2.8 per cent in 2018, to 2.0 per cent in 2019 and only 1.5 per cent in 2020. Although the forecast does not assume a recession during the next few years, a mild one in late 2019 or 2020 is certainly a possibility. Not surprisingly, the S&P 500 has tended to perform poorly in the run-up to, and during, recessions, as expectations for earnings have fallen and risk aversion has increased.

The information technology sector has fared the worst around the last three recessions

On average, the sector that has held up the best around the last three recessions was consumer staples, with an average fall of just under ten per cent. This finding is not surprising, given that consumer staples is routinely considered to be a defensive sector – a sector whose performance tends to be countercyclical. Indeed, the sector actually rose during the overall bear market that began in 2000.

At the other end of spectrum, the sector that fared worse around the last three recessions was information technology, with an average drop of more than 60 per cent. This might seem more surprising, as some other sectors are often thought of as being even more cyclical than information technology. However, the average drop in the information technology sector is particularly large owing to a very deep

downturn during the bear market that began in 2000, when it fell by more than 80 per cent. As a result of the surge in the information technology sector prior to 2000, its valuation was extremely high, both in absolute terms and relative to the valuations of other sectors, when the bear market began.

But the current bull market doesn't suggest that information technology is the most overvalued

The past performance of different sectors, especially if it has been stellar, may conceivably influence their future performance. This was the case for the information technology sector around the recession before last (March 2001 to November 2001), where its high valuation set the stage for the sector to plummet once the dot com bubble burst.

Not surprisingly, the sectors that have delivered the highest total returns after the current bull market began (9 March 2009) are typically the most cyclical. This includes the consumer discretionary, information technology, financials and industrials sectors. The sectors that have underperformed the whole market are typically defensive. These are the health care, consumer staples, utilities, telecommunication services and energy.

Most of the total return from each sector of the stock market since 2009 has been provided from capital gain rather than income. In the majority of cases, the capital gain has been fuelled by an increase in earnings. Exceptions include the industrials, utilities and energy sectors, where the capital gain has been driven by an increase in the price-to-earnings ratio.

Looking at how current price-to-earnings ratios compare with their average before the last three recession-led downturns, the picture is mixed. The valuations of three sectors are lower now than their averages. These sectors are information technology, health care, and telecommunication services. Although the average for information technology is inflated by the dot com bubble, the valuation of the sector is below its level in 2007.

The analysis of performance and valuation does not suggest that any sector of the S&P 500 is likely to fare particularly badly, or indeed to hold up especially well, when the next slump in the stock market occurs. For example, the valuation of the information technology sector is much lower now than it was at the peak of the dot com bubble.

But the sector could still fare particularly badly when the stock market falls
Although the usual pattern, whereby defensive sectors fare better than cyclical sectors, should hold when the market does fall, it is also worth considering what might be different this time around. With this in mind, there are a couple of key developments that could have implications for different sectors: (i) a lurch towards protectionism; and (ii) greater regulatory scrutiny.

While more protectionism probably wouldn't darken the outlook for the United States economy that much, it might have a greater impact on equity prices. If increased protectionism drove the stock market down significantly it would presumably reinforce the underperformance of cyclical sectors. The information technology sector could be hit particularly hard by growing protectionism, because many firms in the cyclical sector depend on global supply chains or access to overseas markets.

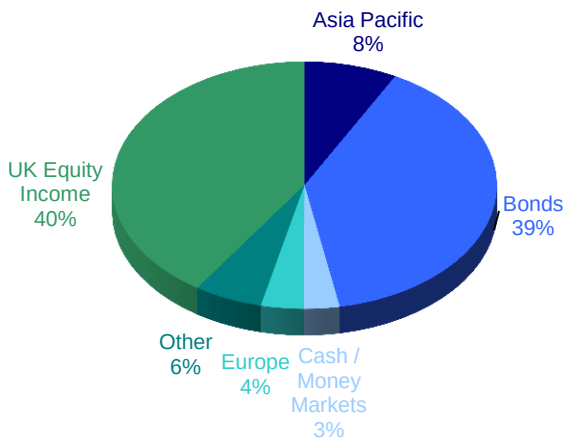
When it comes to greater regulatory scrutiny, this seems mainly to be a risk for the information technology sector following recent allegations about the misuse of data in election campaigns. Firms focussed on software and social media would probably have the most to lose from stricter rules relating to the handling of customer data.
Overall, the cyclical information technology sector could fare particularly badly during 2019 and 2020. A cyclical slowdown in the United States economy will exert a squeeze on earnings, which could be exacerbated if there is a further lurch towards protectionism or greater regulatory oversight of the handling of customer data. Tougher times may lie ahead for the sector, despite its price-to-earnings ratio being nowhere near as stretched as it was during the dot com bubble of the late 1990s.

Strategy
Future Money believes that the US is relatively overvalued, and that other regions currently offer more attractive investment opportunities. Across the fund range, we are underweight compared to the long term target for US equities.

US equities have performed strongly for some time, particularly the 'tech giants' known as the FAANGs – Facebook, Amazon, Apple, Netflix and Google. We believe the technology sector could struggle if US markets experience a correction. The elevated valuations of these companies means that they could possibly experience higher losses if the market experiences a mean reversion.

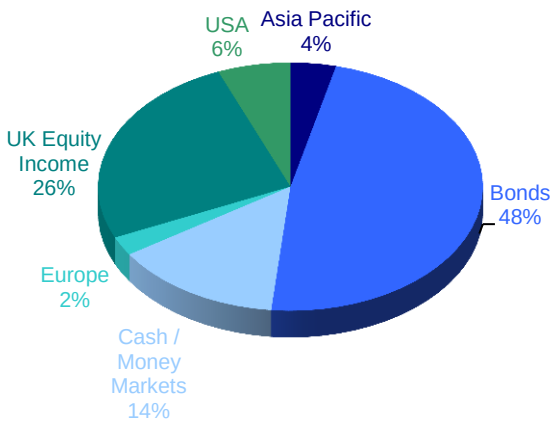
Income

An investment diary was not published last week, as is customary on the weeks of bank holidays. During the preceding week, however, the equity target was reduced by 0.5%, removing the increase made in February. As markets fell in February, greater value was created and a recovery was expected. Following a strong performance by stock markets over recent weeks, markets have now recovered to their mid-January peaks and therefore the Future Money Income has benefitted from the increased equity exposure over this time. While we remain of the view that equity markets offer the opportunity of good returns over the medium term, the decision was taken to restore target levels to the pre-February levels to take profits and to reduce risk exposure slightly.



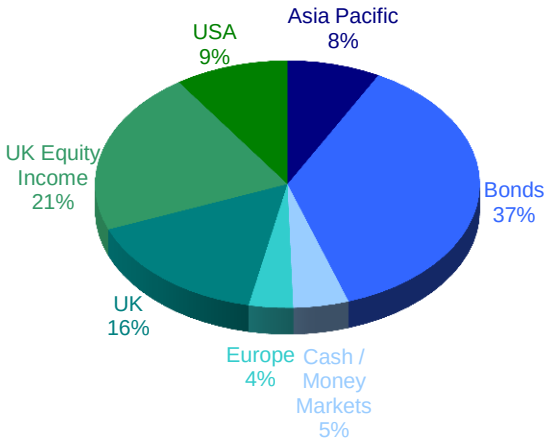
Real Value

For the same reason described for Future Money Income, the equity target was recently reduced by 0.25% in Real Value, following the strong performance of stock markets in recent weeks, particularly amongst the UK, where the fund has a significant allocation.



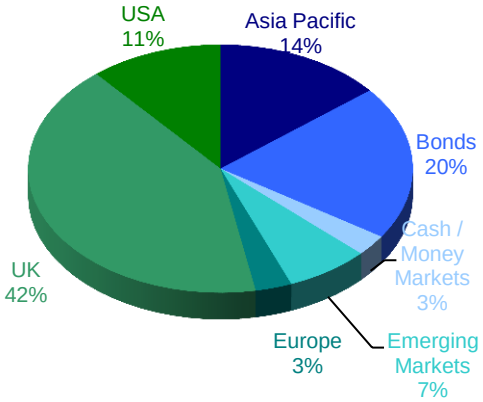
Real Growth

Real Growth's equity allocation has recently reduced by 0.5% following strong stock market gains. As with the other Future Money funds, however, Real Growth maintains a reasonable overweight to the broad asset class. While we are cautious on the medium term prospects for the US, as discussed in this week's article, we feel there are compelling opportunities in the UK as well as in the Asia Pacific ex Japan region.



Dynamic Growth

Dynamic Growth's equity target has been reduced by 0.75%. Following recent gains the portfolio was already above target and therefore significnat sales have been made from across the portfolio's equity positions. No further changes are currently being considered.



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Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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