Nasdaq's tie for fastest-ever Correction since 1928

"Being a value investor in the F.A.N.G. era is no fun at all. - Patrick O'Shaugnessy

Beginning on 6/16/18 this is the 5th time we've shared the above quote. Given how long and often we have warned about Tech, FAANG, and other high flying stocks, "The Boy Who Cried Wolf" has nothing on us. From the front page of today's WSJ:

Swings In Tech Stocks Roil Markets

After two weeks of broad retreats some expect volatility to last into the fall

BY GUNJAN BANERJI AND JOE WALLACE

U.S. stocks capped off a topsy-turvy trading session with a second straight week of declines, continuing a stretch of volatility that many say is a bellwether for the autumn months.

Gyrations in highflying tech stocks have injected volatility into the broader market, a rapid about-face after a summer where U.S. shares marched steadily higher. Shares of Apple, Facebook, Amazon, Microsoft and Alphabet fell 4% or more this week, weighing on the broader market.

The S&P 500 and tech-laden Nasdaq Composite have now lost 4.8% and 7.2%, respectively, over the past two weeks, their worst such stretches since March. The Dow Jones Industrial Average has fallen 3.4% over that time frame, its biggest such decline since June.

The swings in tech stocks have been particularly alarming because of their outsize influence on the market's gains this year. The market's climb over the summer has largely been fueled by a handful of tech companies that are expected to benefit from the stay-at-home economy created by the coronavirus pandemic. Their hefty gains also helped explain a divergence that many people struggled to understand: why the market was rallying when the economy was limping.

Investors abandoned the group this week, leading to big declines in some of the market's favorite trades this year. Amazon shares notched a second straight down week for the first time since February. ... Tesla shares recorded their worst day ever on Tuesday. They fell 11% for the week ....

Though Friday's moves were muted, the moves throughout the week have been jarring and, at times, reminiscent of the intense volatility that roiled markets in the spring, as the U.S. first came to grips with the corona-virus pandemic. On Tuesday, the Nasdaq tumbled into correction territory—a drop of at least 10% from a recent high. It dropped from a record into a correction at the fastest pace ever. The next day, the index logged its biggest point and percentage gain since April.

To some investors, it was also a harbinger of bigger swings to come in the autumn months, which tend to be the rockiest for the stock market. Stocks face challenges from an economic recession, tensions between the U.S. and China, and the prospect of uncertainty after the presidential election. Many investors have already been betting on more volatility around the U.S. presidential election, wary that the outcome may be unknown for weeks.

The political battle over a new round of economic relief also looms. Democrats blocked Senate Republicans' whittled-down aid package from advancing Thursday. ...

The tech-heavy Nasdaq is still up 21% for the year and has rallied 58% from its March low.

From Thursday's WSJ:

STREETWISE | By James Mackintosh

Tech Investors Should Worry About What Happens After Lockdown Ends

The plunge in technology stocks reversed on Wednesday, but Big Tech is still down heavily from the peak earlier this month. Is their incredible run at an end? If not, what could trigger the end?

Things that can break stocks generally divide into three, and each holds dangers for Big Tech and similar growth stocks: a switch in sentiment, a change in the economic outlook and a hit to fundamentals.

The switch in sentiment has been under way for a week now, and hit the best-performing tech stocks (and similar disrupters) hard. At its low on Friday, **Apple,** the largest company by value, was down just shy of 20% from the previous week's high. Electric-car maker **Tesla** has lost almost a third of its value from last week's high, the general tech downdraft worsened by its plan to raise $5 billion from shareholders and failure to join the S& P 500.

There were plenty of warning signs that the market was getting excessive, especially in options, as the last Streetwise column discussed. One example: Tesla was up 74% in August alone.

It shouldn't be a surprise that after such an explosive rise, the most popular stocks should fall back to Earth. So far, at least, the fall has merely taken the froth off; the Nasdaq 100, S& P tech sector and Russell 1000 growth indexes are roughly back to where they were a month ago.

Upward momentum in markets can turn into downward momentum, and Big Tech could fall truly out of favor. But sentiment on its own is unlikely to do more than correct part of the rapid gains.

The economic outlook is a bigger danger, as it has an increasingly strange link to tech stocks. They thrived in lockdown from a triple boost: We all moved our lives online, the collapse of the economy meant their growth had rarity value, and lower Treasury yields mechanically pushed up the valuation of stocks with a decent profit outlook.

When bad news on the economy makes a stock outperform, good news probably means it will underperform. So far we haven't had much good news, but if we do we should expect the three boosts to turn into a major drag for Big Tech. The work-from-home impulse will fade, even if fewer of us go into the office than before. Old industries will offer great—if temporary—growth in a recovery. And stronger economic growth means higher Treasury yields (even with the Federal Reserve's dovishness), which typically hits the highest-valued stocks hardest.

Even the fundamentals of the big tech stocks aren't as great as they were. The China trade war has morphed into a technology war, which leaves many of the leaders (especially Apple and the chip makers) exposed. Antitrust regulators have finally waked from their slumber, while tax authorities in Europe are trying their hardest to grab some of the profits of the tech multinationals. The software company behind popular game Fortnite has opened up another front, using the courts to try to break Apple's control of apps.

The tech disrupters are also increasingly competing with each other. So far this hasn't done significant damage to earnings, because the markets for video and music streaming, cloud services and online advertising have been expanding so quickly. But one day they will either compete away each other's fat profit margins, or we will enter a technology dystopia with strictly defined monopolies. The first is good for customers but hurts shareholders, while the second is terrible for society—and while every investor wants to buy a business protected

by what Warren Buffett memorably called a "moat," history is full of monopolies that grew fat and lazy. Finally, the old industries might eventually get their act together. The video-streaming wars are part of a fightback by Disney and the cable companies against Netflix and Amazon, and while it isn't obvious that Netflix has lost ground, it is at least a risk. The car giants are finally pushing back against Tesla with decent electric models, too, with General Motors on Tuesday inking a deal with newcomer Nikola. Traditional publishers have been lobbying governments to force **Alphabet's** Google to pay for news, with some success in Australia and parts of Europe.

The economic and fundamental threats are for the future, though. The immediate risk is that sentiment gets a lot worse. I suspect we're almost done with blowing froth off the tech stocks, even though valuations remain very high. But I am hopeful that the economy will keep improving, making the longer-run outlook better for the rest of the market than for Apple and its peers.

From Friday's Global Investment Strategy:

The Correction Is Not Over, But We Are Sticking With Our Bullish 12-Month View On Stocks

After recouping some of their losses on Wednesday, stocks stumbled again on Thursday. Since reaching new highs last week, global equities have dropped by 5.3%. US equities have taken the brunt of the beating. They are down 7% from last week's top, compared to 3% for non-US stocks (**Chart 1**). The tech-heavy Nasdaq remains 9.4% off its record high.

We continue to see near-term downside risks to global stocks, particularly US equities. It has now been six weeks since emergency US federal unemployment benefits lapsed. The US economy is set to rebound at a brisk pace in the third quarter – the Atlanta Fed's GDP Now model projects that output will grow 30% at an annualized pace – but GDP is rising from a very low base. In the absence of a new fiscal package, US growth could slow sharply in the fourth quarter and beyond, causing more workers to become permanently unemployed.

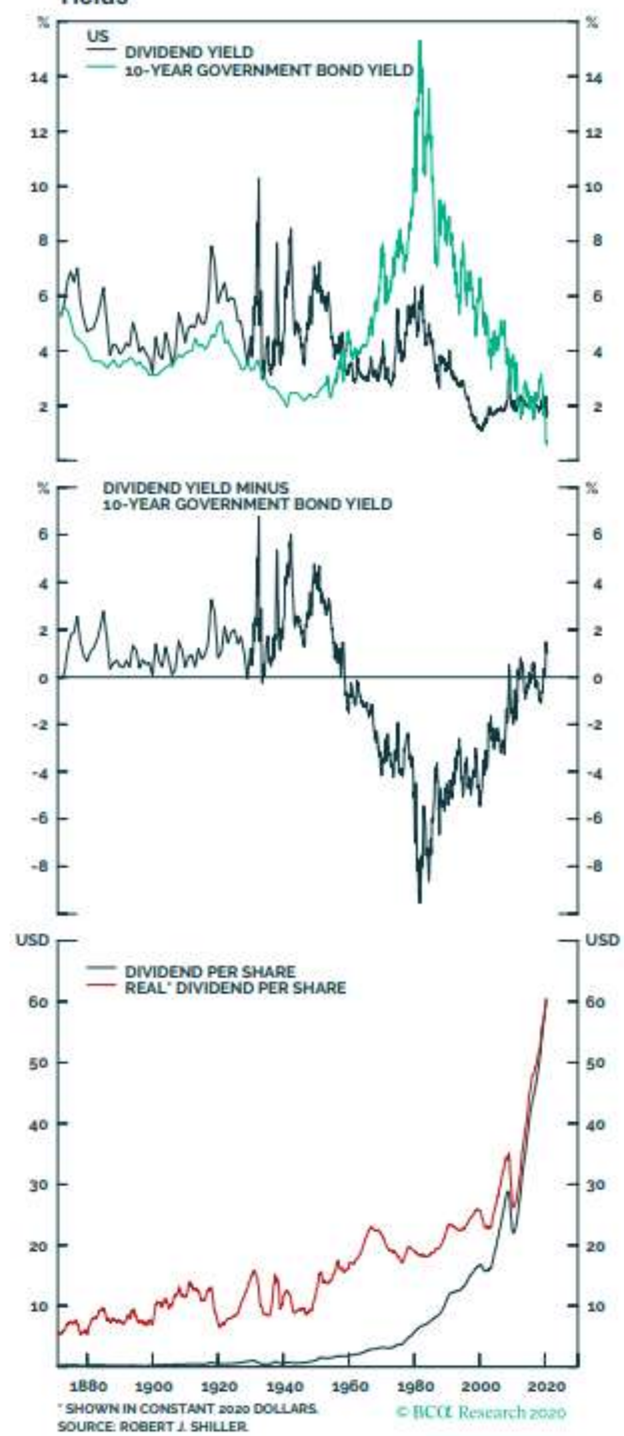
Concern over the safety of the vaccines being developed to fight Covid-19 could also unsettle investors. On Wednesday, AstraZeneca announced that it had temporarily paused the

Phase 3 trial of its vaccine co-developed with the University of Oxford after a patient suffered a severe reaction. Such delays are normal in the conduct of vaccine testing, but they do raise memories of the 1976 debacle with the Swine flu vaccine, which caused 450 Americans to come down with Guillain-Barré syndrome, a life-threatening neurological disorder.

These worries come on the heels of a six-month rally in tech stocks – one that was dangerously amplified by speculative call option purchases by retail investors. The preference among retail investors for short-dated calls allowed them to gain control of large swathes of shares at relatively little cost. Market makers and other counterparties who sold the calls were forced to buy the underlying stock to hedge their exposure. This created a self-reinforcing feedback loop where rising call option prices generated more purchases of the underlying stock, leading to even higher call prices. Starting last week, the process began to go in reverse. It is noteworthy that Nasdaq implied volatility actually fell on both Monday and Wednesday as tech stocks imploded, a possible sign that nervous investors were liquidating their call positions. It is difficult to know how much further this process has to run, but our guess is that a capitulation point has not yet been reached. This suggests that the correction is not yet over.

CHART 4

Bond Yields Have Fallen Below Dividend Yields



TINA's Siren Song

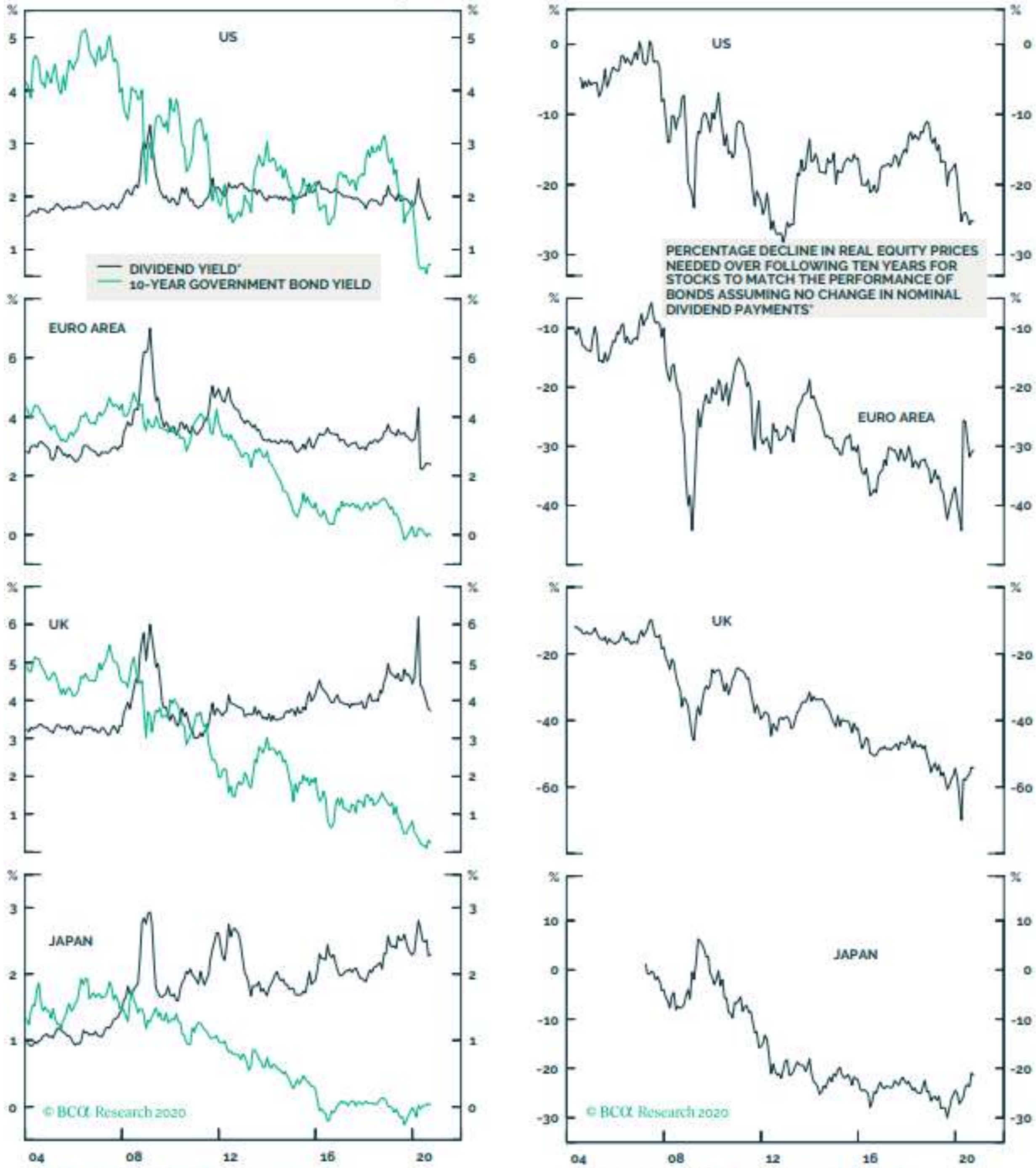
Despite our near-term concerns, we expect global equities to be higher in 12 months' time. At least one of the nine vaccine candidates currently in Phase 3 trials is likely to produce a viable formula. Policymakers are also liable to heed the will of voters and maintain generous fiscal stimulus measures. (As noted above, further Fiscal stimulus is looking less likely.) All this should allow global growth to pick up. Stocks usually do well when global growth is accelerating.

And then there is TINA. TINA — There Is No Alternative — has become a popular adage on Wall Street. As the argument goes, no matter how expensive stocks seem to get, bonds and cash are even less attractive.

There is some logic to this view. Today, the dividend yield on the S&P 500 stands at 1.6%. While this dividend yield is well below its historic average of 4.3%, it is still higher than the 0.68% yield on the 10-year Treasury note (**Chart 4**).

Granted, stocks are riskier than bonds. However, based on a comparison of dividend yields with bond yields, stocks today are significantly cheaper than usual (**Chart 5**). ..

CHART 5
Stocks Would Need To Fall A Lot For Equities To Underperform Bonds



* SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).

* CALCULATIONS ARE BASED ON THE DIFFERENCE BETWEEN INTEREST AND DIVIDEND INCOME OVER 10 YEARS (DEFLATED BY THE 10-YEAR INFLATION SWAP RATE). ASSUMES THAT NOMINAL DIVIDENDS DO NOT CHANGE DURING THE 10-YEAR HORIZON. BASED ON MSCI INC. DATA (SEE COPYRIGHT DECLARATION).

Our thoughts

At the end of last week we received a call from one of our DIYers. He was concerned about MTUM, our favorite Momentum Factor fund, which is chock full of the very stocks we have been warning about, and yet is held by all but one of our clients (whose primary focus is Income), including those for whom we buy individual stocks. This Morningstar 4 star Silver rated ETF's chart since inception compared to the S&P 500 is shown below, followed by their analyst's summary:

This is a cost-efficient momentum strategy.

Summary | Alex Bryan | Mar 10, 2020

IShares Edge MSCI USA Momentum Factor MTUM is one of the best momentum funds available and one of the better options within the large-growth category. It offers cost-efficient exposure to stocks with strong recent performance, which should allow it to beat the Russell 1000 Growth Index and the broad market over the long run. It earns a Morningstar Analyst Rating of Silver.

Momentum investing is based on the well-documented observation that recent performance tends to persist in the short run. This effect may arise because investors might underreact to new information, causing prices to adjust more slowly than they should. Once a trend is established, investors may pile into a trade, further accentuating these moves and potentially pushing prices away from fair value. This strategy should benefit from these behavioral biases.

The fund doesn’t just go after the highest-returning stocks; instead, it targets large- and mid-cap stocks with strong recent risk-adjusted performance. This focus on risk-adjusted performance should reduce volatility and improve performance when market volatility picks up, as riskier stocks with strong momentum tend to struggle in those environments. Still, this strategy will likely underperform during periods of high market volatility, as volatility often disrupts trends.

Stocks that make the cut are weighted according to both their market capitalization and momentum. This can lead to some large positions in individual names, but the fund caps these weightings at 5%. The resulting portfolio lands squarely in the large-growth Morningstar Category. It should effectively complement value-oriented holdings because momentum tends to work well when value doesn't, and vice versa.

To mitigate turnover, this strategy reconstitutes only twice a year and applies a wide buffer around the stocks it targets. These adjustments reduce the portfolio's style purity, as momentum can shift from month to month. But they also improve cost efficiency. This is still a high-turnover strategy: Turnover here exceeded 100% in each of the past six years. However, it has not yet distributed a capital gain, thanks to the tax advantages of the exchange-traded-fund structure.

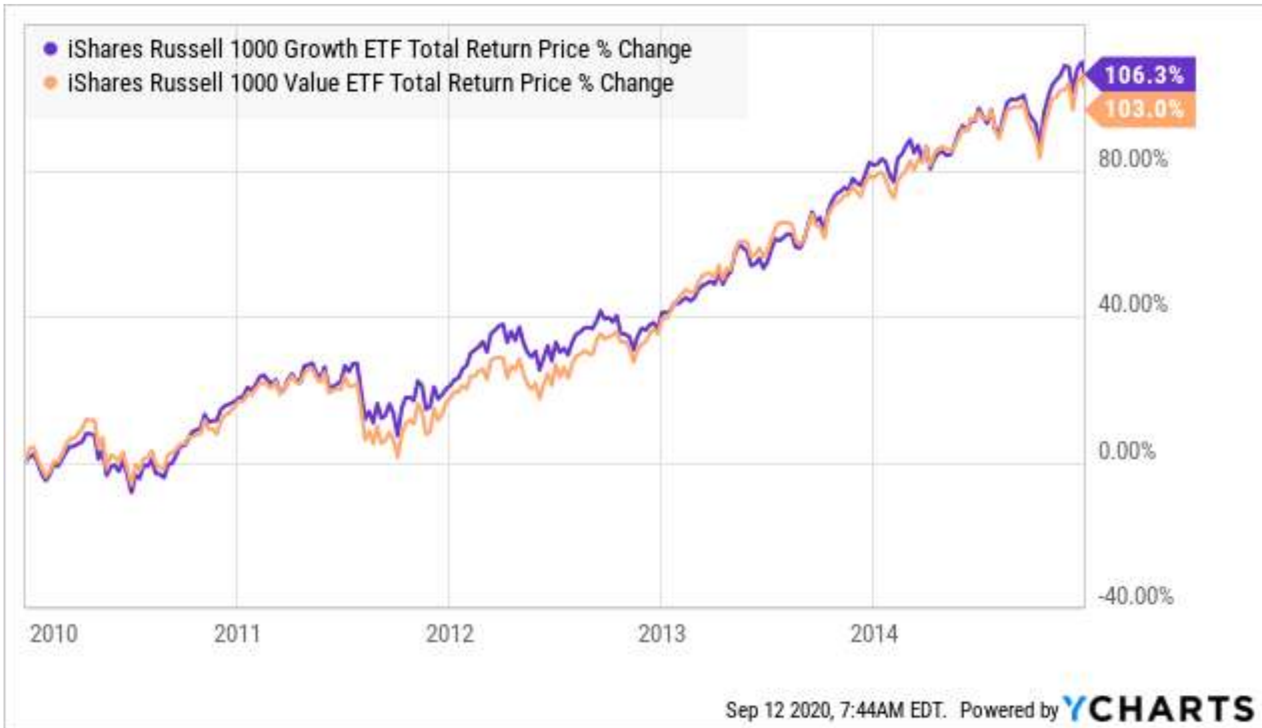
What it boils down to is that the importance of diversification across academically proven Factors far outweighs our ability to time the markets or Factor exposures, an academic debate we have previously addressed. Our clients are well positioned for when the Value Factor once again leads the way. From High Dividend Opportunities today:

How To Prepare For The Rise Of The Value Stocks

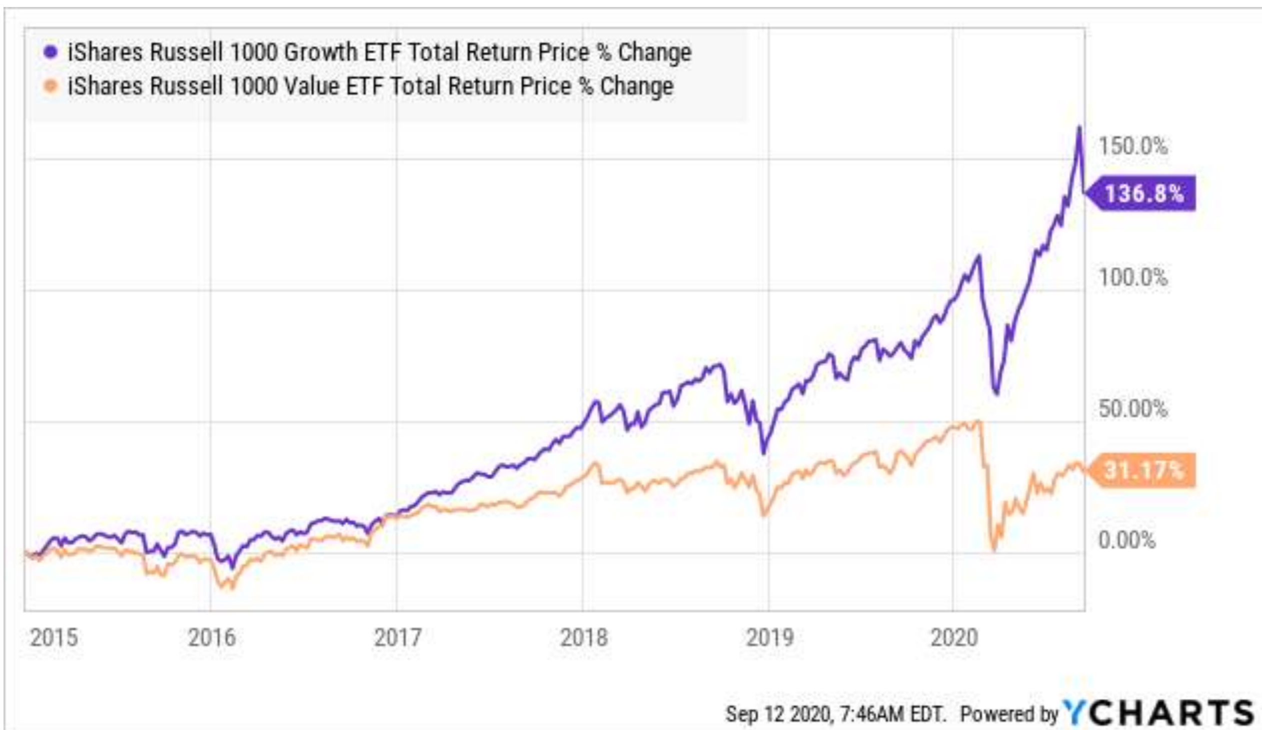
After March, we have seen a major division in the stock market. Growth stocks have not only rebounded, but are actually having very good performance year-to-date. Looking at just growth stocks, one might believe that COVID had no economic impact on the US. Value stocks are a different story, while they have recovered substantially from their March/April lows, most are still down.

Looking at the Russell 1000 indexes, growth is up 20% year-to-date, while value is down 12%. ...

The valuation difference between growth and value stocks has grown to extremes, and most of it has occurred over the past 5 years. From 2010 to 2015, growth and value grew almost in lockstep.



Then from 2015 until today, growth stocks have taken off, leaving value stocks in the dust.



The result is that growth stocks are more richly valued than they have been at any time since before the dot-com bust. While value stocks are more **undervalued** than they have ever been relative to growth stocks.

As investors, we have a few options. We could try to buy into growth stocks, hoping that their valuations will continue to stretch. Which is great if growth stocks are able to continue their epic rally. On the other hand, the first week of September should be a reminder of just how precarious capital gains can be as **Apple Inc** (AAPL) shed 15% of its market cap in just two days before rebounding to be down about 10% for the week. That was two days where there wasn't any particularly bad news for AAPL.