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FANG-ache? The macro dentist will see you now

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There is a kind of beautiful circular irony about Twitter being both the executed and the executioner of the latest market rout affecting tech stocks. Amidst all the hype and headlines it is perhaps worth taking a step back and having a closer look at how this latest sell-off fits within the broader picture.

FANG sell-off a symptom of current investment climate

In the recent past, we argued that as the macro economic cycle matured, investors should expect a deterioration in risk-adjusted returns mainly due to a rise in volatility. Since we presented this finding to clients in February, the S&P500 has gone on a rollercoaster ride, falling 10%, rising 7% and subsequently falling again by 7%. Over this same period, FANG stocks (an acronym for Facebook, Amazon, Netflix and Google) outperformed 4%, but still suffered severe whiplash, falling 12%, then rising 17% and falling again 10%.

Performance of FANG vs the S&P500

Index, 26 January 2018 = 100

Source: Thomson Reuters Datastream / Fathom Consulting

FANGs: victims of their own success?

The aim of this note is to gauge whether tech stocks might be the trigger for something more than a bout of volatility. Valuations would seem to offer a first piece of evidence. Price-to-earnings ratios are eye-wateringly high, though steady growth in earnings has progressively trimmed these over the past years. For example, at 141 times earnings, the average FANG

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stock is incredibly almost 2.5 times less expensive than it was at the end of 2015, despite price gains of 84% over the same period.

FANG stocks are key for the sustainability of wider market valuations

However, it is undeniable that some of these stocks continue to be priced to perfection, making investors rightly very sensitive to any change in assumptions about their future growth path, Twitter tirades included. As we have previously argued that the whole stock market is also expensive, it would make sense that a change in fortune in these high-growth large tech stocks might reverberate across the wider market.

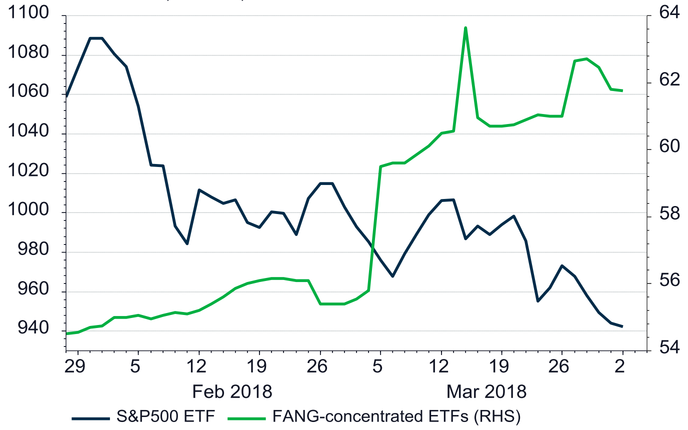
To the test this hypothesis we have run a series of Granger causality tests between FANG stocks and the S&P500 index. We found evidence that the causality over the past three years may indeed run from large tech stocks to the wider market rather than the other way around. In other words, the market seems to need these high-growth stocks to continue to support its own overall lofty valuations. But this appears more of a necessary condition rather than a sufficient one, as a reassessment of growth by investors is quite a different proposition to pulling the rug out from under the market's feet.

Investor appetite remains supportive of tech stocks

More evidence in this direction comes from looking at investor demand. The number of shares issued for two of the most FANG-concentrated exchange-traded funds (ETFs) — FDN and PNQI — has increased since the tech sell-off in mid-March. Conversely, the number of shares issued in the largest S&P500 ETF has fallen in step with equity prices.

Shares issued as a gauge for investors' demand

Number of shares, millions, both axes



Source: Thomson Reuters Datastream / Fathom Consulting

Option prices offer more support to the thesis of broadly unchanged investors' attitudes to risks. For example, market volatility has increased across the board since the FANG sell-off in mid-March, with the biggest increases coming at horizons shorter than three months. At longer horizons, volatility remains below the 20 threshold and the whole-term structure is only slighted inverted.

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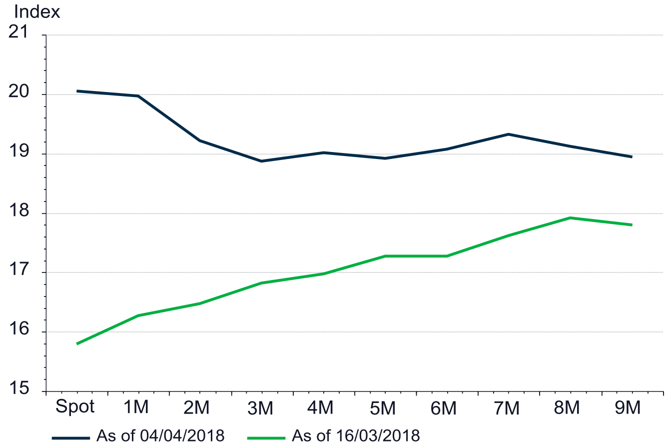
S&P500 volatility curves



Source: Thomson Reuters Datastream / Fathom Consulting

Investors are not running for the hills

Moreover, there has been little shift in the relative upside and downside risks of tech stocks at longer horizons, while the market-wide measure has actually fallen. In other words, investors' risk attitudes to upside and downside risks for FANG stocks appear broadly balanced and no higher than usual at longer-term horizons. From a market-wide standpoint, the attitude to risk has become less skewed towards downside risks than prior to the FANG sell-off.

Are investors swapping domestic for foreign growth?

International flows offer an interesting and persuasive perspective too. Over the last month, investors appear to have reallocated equity assets away from the US and Europe and more aggressively towards Asia and emerging markets more broadly. This move alone would not be consistent with jittery investors worried about an impending global recession and bear market. Rather, it seems to highlight the possibility that the market is in the midst of a reallocation towards more attractively priced foreign growth companies and away from relatively more expensive domestic ones. On a forward price-to-earnings basis, there is clear evidence that the US remains the more expensive market with further scope for the valuation gap with the rest of the world to narrow if the macro picture remains broadly supportive as happened in the previous cycle.

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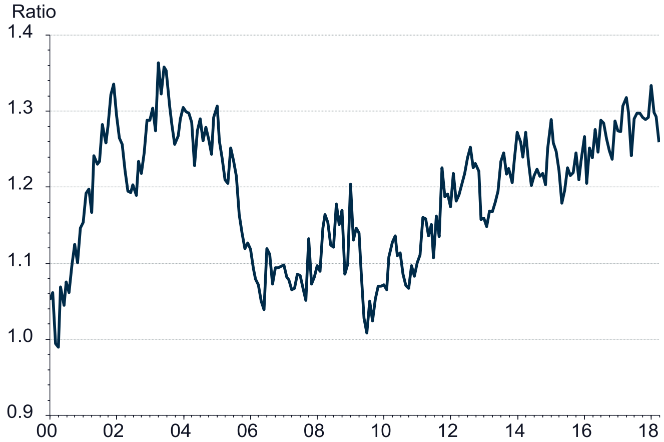
US equity 12m forward PE relative to RoW



Source: Thomson Reuters Datastream / Fathom Consulting

Overall, we think that the FANG-ache of the past week fits well with our template of richly priced and more volatile markets within a maturing macro cycle. In such an environment, stock-specific risks, including a Twitterstorm from the Commander in Chief, can be the trigger for a partial unwinding of crowded positions in large and expensive stocks and can drive up market-wide volatility. This dynamic, in turn, has the potential to feed on itself by prompting a broader sector or geographic reallocation. However, investors are unlikely to feel any protracted pain from the current FANG-ache so long as the macro anaesthetic has not run out and attitudes to risk remain intact.

Investors' attitude to risk unlikely to change without a deterioration in the macro environment

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