Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Warning Sign: Unprofitable Companies' Shares Soaring

We have been noticing a trend not unlike the one we saw during the late 1990's market run-up: an increasing number of publicly-traded companies reporting losses quarter after quarter, while their stock prices soar. This disconnect of losing money – while enjoying strong stock appreciation – should have investors treading carefully in the 11th year of this bull market, in my view.

Here are some of the eyebrow-raising statistics that investors should be aware of:[1]

• Nearly 40% of listed companies in the U.S. reported losing money over the last 12 months. This is the highest percentage of loss-makers we've seen since the late 1990's (and excluding recessions like 2001 and 2008).
• Of the largest 100 companies that reported losses, approximately 75% of them saw their shares go up over the last 12 months.
• Of all the money-losing companies in the U.S., 41% of them saw their shares go up last year. (Takeaway: smaller companies are not getting the same treatment as large-caps)
• Categorically, the largest percentage (42%) of companies losing money are in the healthcare sector, mostly in biotech. 17% of them are tech stocks, mainly the flashy IPOs like Uber and Pinterest.

Investors are placing a huge premium on disruptors and future growth, but the question remains – *is it too much of a valuation premium?*

Then There Are the IPOs

About 75% of IPOs last year were by loss-making companies, but I was encouraged to see that investors proceeded with a bit more caution in this space. In 2019, the class of IPOs underperformed the S&P 500 by more than 50% – a sign that investors aren't getting too exuberant over the flashy new players in the market. It's been this way for the entirety of the bull market for IPOs – over the last 10 years, the class of new companies that have listed are trading on average about 70% above their IPO price, trailing the S&P's 190% rise over the same period.[2]

Investors can look at this market scenario in a couple of ways. On the one hand, we have investors skittish about flashy, high-growth but no-profit IPOs – a good sign that we are not seeing the type of exuberance that led to the tech bubble in the late 1990's. On the other hand, we have an unusually large percentage of listed companies in the U.S. that are currently losing money, while the broad stock market continues to reach new all-time highs. Losing money while delivering rapidly growing sales and revenues is certainly an acceptable proposition, but the question is how long can it last and how high of a premium are investors willing to continue paying?

Bottom Line for Investors

Investors should proceed with caution and be mindful of the premium you might be paying for loss-making companies. Rising share prices have given many of these loss-making companies the ability to finance even more losses, which is a slippery slope particularly if we start to see a marked slowdown in economic growth. In the current environment, keep these two principles in mind:

• Statistically, over historical periods of time, we find that stocks that are expected to report positive earnings per share have generated higher returns than stocks that are expected to report negative earnings per share.
• In my view, the market is pricing many loss-making stocks on the expectation of future earnings growth. What we're often left with are major assumptions about the business prospects of a company, as opposed to whether quarterly earnings are evolving (and growing) relative to expectations.

At Zacks Investment Management, earnings remain our core focus in portfolio management and investment decision-making. We have a long history of earnings forecasting with proprietary processes in place that help us monitor earnings and earnings estimates – which in turn drive our decision-making. With the bull market now in its 11th year, these processes will become ever-important, in our view.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, January 9, 2020. https://www.wsj.com/articles/money-losing-companies-mushroom-even-as-stocks-hit-new-highs-11578608209?mod=djemDailyShot&mod=djemDailyShot

[2] Los Angeles Times, December 30, 2019. https://www.latimes.com/business/story/2019-12-30/ipos-underperform-for-investors

IN FOCUS THIS WEEK

- How will impeachment trials affect the markets?
- Is this a new front for the Trade War?
- Job openings in the U.S. on the decline
- What do we know about the Coronavirus Outbreak?

Markets Largely Ignore Impeachment Trial

As the impeachment trial got underway in the Senate this week, the equity market continued to tick higher. The market's ambivalence to the impeachment proceedings comes as little surprise – during Bill Clinton's presidency, from the start of Congress' impeachment inquiry to actual impeachment, the S&P 500 went up +23%. In the twelve months that followed the Senate's acquittal of Clinton, the S&P 500 went up an additional +19%.[1] A similar pattern has emerged during President Trump's impeachment, with the market rallying through the House proceedings and now remaining largely stable as the Senate takes up the matter. The conclusion for investors, in our view, is not necessarily that impeachments are meaningless for markets – political outcomes do matter. But once the information is known and the equity market can "price-in" the outcome (in this case, near-certain acquittal for President Trump), then there is not much room for positive or negative surprises – which are ultimately what move markets in the short term, in our view.

Coronavirus Outbreak Continues to Grow

Headlines were jittery this week, with growing reports of patients affected with the coronavirus. The virus originated in the highly-populated city of Wuhan, China, which also serves as a major travel hub for Southeast Asia. As of this writing, there are over 500 confirmed cases of the virus with 17 reported deaths, numbers that are likely to grow in the coming days and weeks. The spread of the virus comes at a very inopportune time, in that many Chinese nationals are set to travel for the Lunar New Year holiday, which spans from seven days to up to an entire month. Many market-watchers were reminded of the SARS outbreak back in 2002, which also overlapped with the Lunar New Year holiday and killed 774 globally after it first appeared in southern China.[2] The global health system is more sophisticated today than it was in 2002, so we should expect to see more effective containment of the virus's spread. Though time will tell. In the meantime, China has halted outbound flights and trains in Wuhan, as well as shutting down public transportation and putting the city on lockdown. But we expect the problem to get worse before it gets better.

New Front for the Trade War?

Just days after the US signed a Phase 1 trade deal with China, the Trump Administration hinted that it may have a new front for the trade war: Europe. The root of the budding trade dispute with Europe centers around a "digital tax," a 3% levy on American tech companies earning revenue in France. The issue had taken broader appeal once the European commission had unveiled a proposal for taxing US tech companies across the 28-nation European Union, a move that the Trump administration warned would result in tariffs on European goods.[3] A trade war with Europe would bring a far wider range of goods into play, since the US exports three times more to the European Union than it does to China. With the European Union already posting feeble growth amid rising political uncertainty, however, US tariffs would surely sting at a vulnerable time.

Job Openings in the U.S. on the Decline

The US economy continues to add new jobs at a steady pace, but many employers are citing labor shortages as a reason for waning demand to fill new positions. According to the Labor Department, job openings fell 10.8% in November from a year earlier, which marks the 6th consecutive month of annual declines.[4] To be sure, the number of available jobs in the US still outnumbers the unemployed workers in America, so anyone who wants a job in the US can get one. But declining job openings could be a precursor to slower business investment and growth.

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[1] Inquirer, December 20, 2019. https://www.inquirer.com/business/impeachment-donald-trump-bill-clinton-richard-nixon-stock-prices-20191203.html?outputType=amp

[2] The Wall Street Journal, January 22, 2020. https://www.wsj.com/articles/china-virus-cases-pass-400-11579670877?mod=hp_lead_pos5

[3] The New York Times, January 22, 2020. https://www.nytimes.com/2020/01/22/business/france-us-digital-tax.html

[4] The Wall Street Journal, January 17, 2020. https://www.wsj.com/articles/u-s-industrial-production-fell-0-3-in-december-11579270662

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