BULL CASE / BEAR CASE

BY BEN CARLSON, CFA
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One of the things I've learned in the investment business is that it's never a good idea to trust someone who is 100% certain about any outcome in the markets.

I've seen enough "best ideas" portfolios over the years to know most portfolio managers have no clue what their best ideas truly are until after the fact. There are simply too many unknowns and outside factors that can impact the economy, markets, sectors, and companies to ever give yourself permission to have complete certainty about the future.

Sure, strong opinions are fine, but they better be weakly held, because the markets are a humbling place if you're not willing to look at both sides of an argument.

The most certain investors are often those who get trapped by recency bias and assume what has worked will continue to do so forever, or the contrarians who assume only that which has performed poorly is worth owning. Both of these camps can be right, depending on their time horizon and market environment, but always thinking in either a momentum or value framework is a sure way to be disappointed eventually.

You could make a compelling bull and bear case for every asset class or market right now. What you believe about these cases depends on how you're positioned or what you believe about investing.

I don't know what the future will hold, so here are the bull and bear cases right now:

S&P 500® INDEX

Bull Case. The United States has been the cleanest dirty shirt in the global laundry hamper for years and the S&P 500® Index has been a huge beneficiary of this.

The S&P 500 is dominated by some of the best and brightest companies in the world, and now includes nearly a one-quarter weighting in the five biggest technology companies which seem to be taking over the world.

Growth stocks also benefit from lower interest rates and it sounds like the Fed is going to keep rates low for a long time.

Bear Case. Sure, the S&P 500 has beaten pretty much every other stock market in the world since the financial crisis, but this may be the biggest reason it won't continue.

How quickly we all forget the precursor to an unbelievable run in the S&P 500 over the past 10+ years was a lost decade from 2000-2009. The S&P 500 lost money over the entire decade of the aughts. There is certainly no guarantee the current U.S. outperformance will last.

Concentration risk works both ways. Yes, it's helped on the way up, but it could hurt investors in the S&P 500 if those companies ever stumble or their lofty expectations aren't met.

NASDAQ-100

Bull Case. The Nasdaq-100® is up 38% in 2020. It's bizarre to think it would probably be up far less this year if there wasn't a global pandemic. The pandemic has pulled forward an enormous amount of adoption in trends like e-commerce.

This has further strengthened the position of incumbent tech firms and helped bring newer companies along much faster than they ever dreamed possible. Technology is now more firmly entrenched in all of our daily lives than ever.

These companies can also borrow at ridiculously low rates to use their equity to go on an acquisition spree. If they start buying up Roku, Sonos, Peloton, Slack, Twitter, or Spotify, an M&A boom is a possibility to keep the party going.

Bear Case. Everything people were predicting in the late 1990s for the Internet happened, and more. But, we still had to go through the tech bust, because by 1999 expectations were far too high and the companies couldn't possibly live up to them.

The Nasdaq fell close to 80% after the huge run-up in prices during the dot-com bubble:

NASDAQ COMPOSITE LEVEL% OFF HIGH

Past performance is not indicative of future results. As of August 28, 2020. Source: YCharts.

The index didn't reach 2000 peak price levels again until 2015. Things were far crazier back then than they are now. Today's tech companies actually have solid businesses, cash flows, and profits, in most cases. They didn't back then. But, there is a case to be made for expectations getting ahead of themselves, and that's probably the biggest risk for tech stocks, other than government regulation.

And, if you think the S&P 500 is concentrated, Apple, Amazon, Microsoft, Google, Facebook, and Tesla make up more than 51% of the Nasdaq-100. This is a huge bet on a handful of companies continuing to knock the cover off the ball.

SMALL CAPS

Bull Case. Since 1926, the Fama-French Small Cap Index has outperformed the S&P 500 by more than 2% annually (12.6% vs. 10.2%). Granted, it was nearly impossible to invest in many of those small-cap names before the 1970s, but here are the annual returns for the S&P 500 vs. the S&P SmallCap 600® Index since its inception in 1994 (through the end of July):

- S&P 500 +9.73%
- S&P 600 +9.66%

Pretty close. Now the annual returns since 2015:

- S&P 500 +10.88%
- S&P 600 +5.52%

Even if we assume there is no such thing as a small-cap premium (which has never been a sure thing), we should eventually see some mean reversion.

Following the dot-com crash, these were the annual returns from 2000-2007:

- S&P 500 +1.66%
- S&P 600 +9.99%

And, in a post-Covid world, we could certainly see a snapback in many of the smaller corporations that have been hurt the most from this crisis.

Bear Case. It's possible we've entered a winner-takes-all stock market where the biggest corporations either have semi-monopolies or simply buy out their competition. There is also competition from private equity buying up smaller corporations.

Small businesses have been hurt the most from this crisis and it's possible this trend will continue. Bigger companies can borrow more easily and for lower rates too.

And, companies are now staying private much longer than they did in the past and essentially skipping the small-cap phase of being a public company.

EMERGING MARKETS

Bull Case. Emerging markets are becoming more tech and consumer heavy in their sector make-up; a falling dollar would offer a huge boost to developing nations; and the boom-bust nature of emerging markets stocks means you can never count them out for a big run-up in prices.

Plus, there's the fact that emerging markets have lower valuations than the United States. Maybe the bad stuff is already priced in.

Bear Case. The pandemic could hit these countries even harder than developed nations because many of them don't have the infrastructure in place to handle this crisis.

Developing countries also don't treat their shareholders, corporations, or intellectual property as well as we do in the U.S. And, emerging nations don't have mature economics, so they're regularly experiencing currency and economic crises.

FOREIGN DEVELOPED STOCKS

Bull Case. From 1970 through the end of 2007, the annual returns for European (MSCI Europe Index) and U.S. stocks (S&P 500) were basically the same:

- Europe +11.4%
- United States +11.1%

Now here are the returns from 1970 through July of 2020:

- Europe +8.6%
- United States +10.5%

The entirety of the outperformance of U.S. stocks over European stocks has come since 2008. There are sector differences between these markets, but this outperformance is also reflected in the valuations and yields:

Valuation	Europe	U.S.
Price/Earnings	18.0	25.2
Price/Book	1.6	3.5
Price/Sales	1.1	2.4
Price/Cash Flow	8.8	14.6
Dividend Yield	2.4%	1.8%

Past performance is not indicative of future results. Source: Vanguard. Data as of 7/31/20. Proxies: VGK: Vanguard FTSE Europe. SPY: SPDR® S&P 500 ETF Trust Total Return.

If mean reversion still exists and the dollar strength of the past decade-plus relents, international stocks could finally outperform. The fact that European countries have had a much better pandemic response could also play a factor in jump-starting their economies.

Bear Case. Many investors assume low rates are propping up U.S. stocks, but rates have been lower for longer in Europe and Japan, and these countries haven't seen similar stock market performance.

Demographics are poor in many of these countries as well, and they don't have the same exposure to technology stocks.

It's possible this time is different and the U.S. will continue to dominate the rest of the world.

VALUE STOCKS

Bull Case. It can't get any worse for value investors, right? Historically, buying stocks with lower valuations has led to higher returns and, assuming that hasn't changed, value has to come back eventually, right?

An uptick in inflation could also be a catalyst for value to outperform.

Bear Case. It's possible software ate value investing and that premium is gone forever. Intangible assets are a much higher percentage of companies these days, so valuing corporations might be much harder than it was in the past.

And, every hedge fund manager and aspiring long-term investor on the planet has been reading Warren Buffett books since the 1990s. Maybe the cat is out of the bag and value is dead forever.

BONDS

Bull Case. Rates could always go negative. We could see deflation or slower economic growth. And, even if there is inflation, TIPS can hedge that risk as well as any asset.

And, demand for fixed income will likely stay high from retiring baby boomers and the Fed.

Bear Case. Many investors assume rising interest rates are the biggest risk to bonds, but it's actually inflation. An unexpected rise in prices would be harmful to bonds, assuming the Fed doesn't completely control the credit markets at this point.

BITCOIN

Bull Case. My biggest bull case for bitcoin is the fact that it's still here. It survived that massive mania in 2017 and another leg down last year. The fact that it's been so resilient makes me believe it could end up being a store of value in the mold of gold for the Gen Z/millennial crowd.

I think that's actually the best-case scenario.

Bear Case. None of the predictions from the 2017 frenzy have come true yet. It's hard to believe all of the capital that rushed into all of those ICOs hasn't led to anything tangible use cases yet. Where did all of that money go?

Bitcoin is also just made up Internet money that's just a bunch of ones and zeros and the whole Satoshi thing just makes for a good story.

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Treasury Inflation-Protected Security (TIPS) are a type of Treasury security issued by the U.S. government that is indexed to inflation in order to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain its real value.

The **Fama/French US Small Cap Research Index:** Includes NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973) in the lower 50% market equity range of NYSE firms; rebalanced annually in June. Further detail: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_port_form_sz.html. The **MSCI Europe Index (net)** is a free float-adjusted market capitalization-weighted index that measures equity market performance of the developed markets in Europe. The index is calculated on a total return basis with net dividends reinvested. The **Nasdaq-100** Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies. The **S&P SmallCap 600® Index** seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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