Philequity Corner (April 7, 2014)
By Valentino Sy

Momentum Stocks Drag Down US Stock Market

After reaching intraday all-time highs, the Dow and the S&P 500 both closed in the red last Friday. US stocks were dragged down by the sharp fall in momentum stocks. Most of these are tech and biotech stocks listed in the NASDAQ, which fell 2.6% last Friday. After experiencing a huge run-up in 2013, these stocks have been heavily sold down recently. As momentum stocks faltered and pulled the whole US market down, it remains to be seen whether last Friday's move is a normal pullback or the start of a possibly savage correction. Nonetheless, we continue to monitor movements in US stocks as these may probably affect the direction of global stocks.

From High-Fliers to Falling Knives

Momentum stocks are high-flying stocks that have moved up sharply. Traders are drawn into these stocks with the belief that the steep uptrend will likely continue. As US indices hit new highs, return-seeking hedge funds who aim to outperform the broad market flocked into these high-fliers. Most of these stocks are in the biotech industry, as well as tech companies engaged in social media and cloud computing. These companies are highly touted by Wall Street for their potential for explosive growth. After defying gravity in 2013 and in the early part of 2014, these stocks have been heavily sold down in recent weeks. The table below shows this.

Performance of Momentum Stocks in the US					
Company	Ticker	2013 Return	2014 YTD at the Peak	% Change in 4/4/14	Peak to Present
Amazon	AMZN	59.0%	2.3%	-3.2%	-20.8%
Facebook	FB	105.3%	32.8%	-4.6%	-21.8%
iShares Biotech ETF	IBB	65.5%	21.3%	-4.0%	-18.2%
Netflix	NFLX	297.6%	24.4%	-4.9%	-26.4%
Tesla	TSLA	344.1%	64.5%	-5.8%	-14.3%

Sources: Stockcharts.com, Wealth Securities

Avalanche of Shares

As stocks from the tech and biotech sectors surged last year, the demand for shares from these sectors likewise snowballed. This growing demand was gladly met by more initial public offerings (IPOs) from similar companies. In 1Q14, 64 companies listed in the US, raising $10.6b in capital from share issuances. This is more than double what was raised in 1Q13.

Most of these recent IPOs are understandably from the tech and biotech sectors. Almost every day this year, there were new IPOs in the market. And last Friday, there were 5 IPOs. Aside from these, there are still more IPOs in the pipeline, as budding companies and underwriters move to replicate the success of high-flying momentum stocks. Aggressive hedge funds and momentum traders have been shifting money away from momentum stocks into these IPOs in order to earn a quick buck. This caused the sharp correction that has so far been seen in these stocks.

A Torrent of Shares, Similar to Philippine Experience

What is now happening in the US is something that our local stock market also experienced in the last 2 years. We saw the negative effects of too many placements and IPOs on the stock market. We wrote articles about it when our market experienced a barrage of placements and share issuances in 2012 (*An Avalanche of Overnight Secondary Placements*, July 23, 2012) and 2013 (*A Torrent of Share Issuances and Placements*, November 11, 2013). This phenomenon usually happens when companies take advantage of the strong performance of the stock market by raising capital through share issuances. Though the money raised would usually fund corporate expansion, the supply of shares from the frequent share issuances causes indigestion in the stock market in general. Big investors would usually be seen shifting money away from their usual holdings into these placements. This weakens the demand in the stock market and precipitates a correction. The market usually needs time to digest and recover from the barrage of share placements and issuances that are done one after the other.

When Valuations Go Haywire

Another concern about US momentum stocks and recent IPOs is valuation. Much like the boom-bust companies in the 2000 US tech bubble, these high-flying stocks and recent IPOs are not valued using traditional valuation metrics. Some of them do not even have earnings yet and are valued based on price to sales or 'presumed growth.' Consequently, these stocks would look unreasonably expensive if they are valued based on earnings. Nonetheless, the hype and excitement about these stocks and the greed for a quick return carry share prices higher. The hope is that the fundamentals down the road will catch up with the valuation and the price.

"Basura" Stocks Signal Correction

Again, we draw from our experiences locally to understand what is now happening in the US. Although we do not have tech and biotech stocks, local *tsupiteros* (short-term traders) are fond of trading "basura" stocks. These are stocks which do not have solid fundamentals and go up or down for no apparent reason, other than rumors. Like momentum stocks and recent IPOs in the US, most of these "basura" stocks do not have earnings yet. The earnings of these stocks may catch up with the price after many years, or in some cases may not even come at all. Instead of the usual fundamental research reports, buy recommendations on these stocks are often passed on as tips from one *tsupitero* to another. When too many of these "basura" stocks go up, it usually signals that investors and traders are starting to become lax and overconfident about the stock market. Often times, this suggests that the market is topping and that a painful correction is probably forthcoming.

From momentum to value

We note that that in the past month, fund managers have been shifting away from momentum stocks into value stocks. Moreover, they have been shifting away from those with high multiples to laggard plays that are either cheap or have not moved for a while.

These value plays are stocks with reasonable valuations, solid fundamentals, measurable earnings and clearer growth prospects. Though these stocks are less exciting than the high-flying tech and biotech stocks, they are easier to understand and are less susceptible to meltdowns. Moreover, it will be easier for investors to predict the direction of the stocks if they understand the underlying businesses of the companies that they are buying.

From momentum to EM

Similar to the shift from momentum to value, we are witnessing a shift from momentum stocks into emerging market (EM) stocks. After being clobbered last year and in the early part of this year, EM indices are continuing to show signs of recovery. Given the run-up that DM stocks, especially momentum stocks experienced last year, EM indices have started to look cheap considering their growth prospects. With this, investors have been shifting away from US momentum stocks and other high-fliers into EM countries including the Philippines.

Despite what happened last Friday, MSCI Emerging Markets (EEM) was only down by 0.27%. Moreover, EEM has bounced more than 11% from the lows that it saw in February 2014. However, it remains to be seen whether the scare last Friday is a normal pullback or the start of a severe correction. If the correction is severe, EM stocks would likely get affected too.

Correction in momentum stocks is healthy

The correction in high-flying US stocks may cause a pause or even a correction in global stocks. Nonetheless, we believe that the correction in momentum stocks is healthy, as it brings valuations back to more reasonable levels after rising too much.

Moreover, we view the rotation from momentum stocks into value plays and EM stocks as something positive for the global stock market. This comes at a time when EM stocks have started to look cheap, as many EM stocks continue to deliver impressive growth rates.

While last Friday's move may result to a correction in Philippine stocks, we view a possible correction as healthy. Note that the PSE Index is up 14.9% from its post-Yolanda low and is up 11.4% year-to-date. Ultimately, we see the shift from momentum stocks to EM stocks as beneficial to the local stock market, as there is value to be found in many Philippine stocks.

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