Eerie Similarities To Those Before 2000 "Dotcom" Bear Market

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Overview

In the period leading up to the recession and bear market of late 2000-2002, the stock market was led by four large tech stocks: Microsoft, Dell, Cisco and Intel – the so-called *“Four Horsemen.”* These stocks continued to surge in 1999 and early 2000 even though much of the rest of the market was underperforming or moving lower. A severe bear market followed.

A similar situation exists today with the market being led, once again, by four large tech companies: Facebook, Amazon, Netflix and Google – the so-called *“FANG Quartet.”* These stocks continue to grind higher while much of the rest of the market is struggling.

The question is whether the market is headed for the same fate as in 2000-2002? The answer may be yes. While the talking heads on financial shows try to paint an optimistic outlook for equities, the fact is the market has gone nowhere this year – unless you consider the ugly plunge in late August as going somewhere.

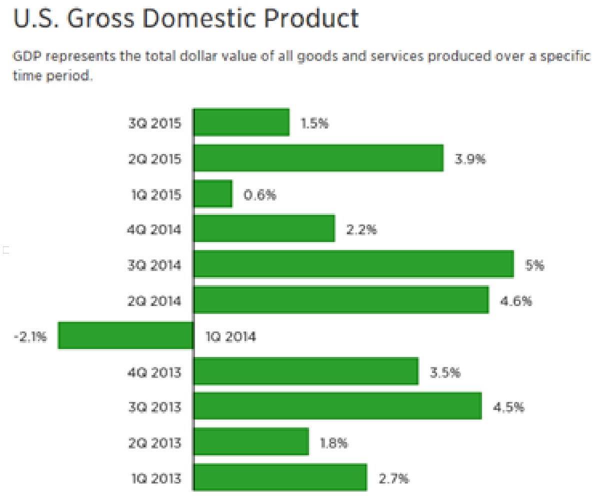
As I have said in recent weeks, a collapse such as we saw in late August should *not* happen in a healthy bull market. As I will discuss as we go along today, there are increasing signs that the stock market is rolling over to the downside.

Yet before we get to that discussion, let’s take a look at the latest economic reports. We’ll look at last week’s 3Q GDP report which was disappointing and consumer confidence which took a big hit in October and softened even more in November. We will also look at retail sales and manufacturing which are both struggling.

3Q GDP Rises as Expected But Well Below 2Q

The Commerce Department reported last week that GDP rose at an annual rate of **2.1%** in the 3Q, up from only 1.5% in the initial estimate released in late October and well off the 3.9% pace in the 2Q. The report said the improvement was due largely to consumer spending, non-residential fixed investment and state and local spending.

The latest estimate was also boosted by businesses spending more on equipment and growth in new home construction. Most economists believe the third-quarter’s respectable(?) expansion means the economy should achieve at least 2% growth in the second half of the year, which is around what is now considered its long-run potential.



While consumer spending increased by a solid 3% in the 3Q, that was down from the initial estimate of 3.2% and well below 3.6% in the 2Q.

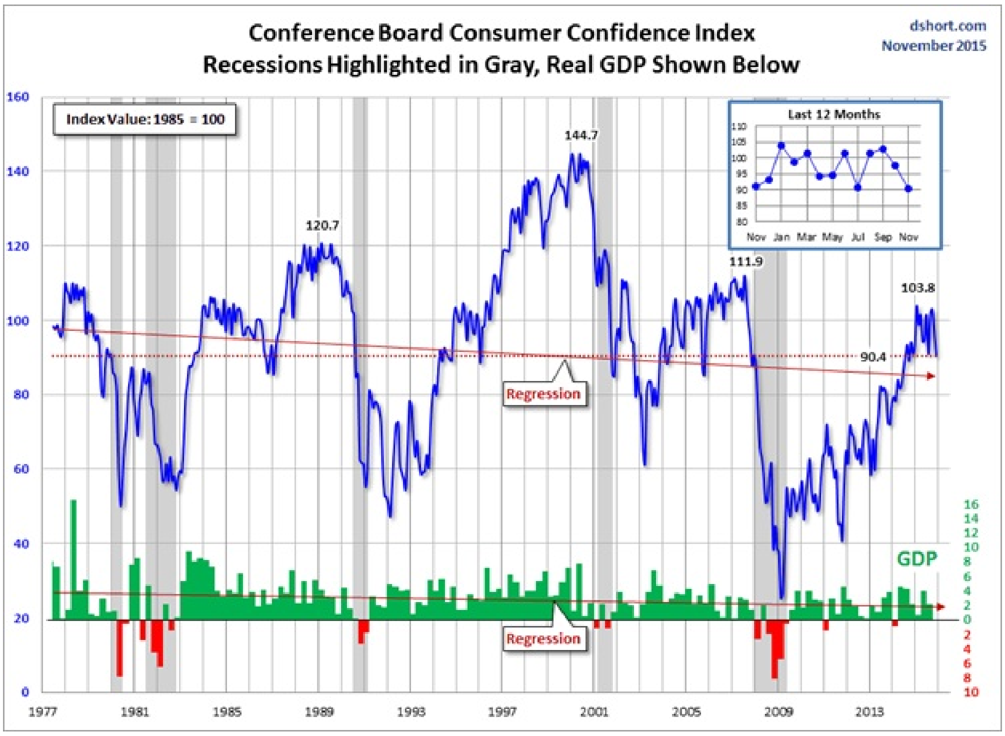
The report noted that corporate profits dropped 1.1% in the July-to-September period and were down**4.7%** from a year earlier, the weakest annual reading since the final months of the recession.

The drop largely reflects pressure on US corporations' overseas operations due to a stronger dollar and weak global demand. The pullback underscores the challenges US corporations will face as short-term interest rates and labor costs start to rise.

November Consumer Confidence Hits 14-Month Low

US consumers were feeling less optimistic about the economy in November, according to the latest report last week. The Conference Board's Consumer Confidence Index fell to **90.4** in November, badly missing the pre-report consensus of 99.5. It was also lower than October's reading of 99.1. In fact, it was the lowest reading since September 2014.

The share of Americans surveyed by the Conference Board who anticipate more jobs in the coming months fell. Fewer people also expect to see their incomes increase. The percentage describing jobs as *"plentiful"* declined to **19.9%** from 22.7% in October.



The decline in the confidence index comes after a robust month of hiring in October. Employers added 271,000 jobs in October as the unemployment rate settled at a healthy 5.0%. Yet consumers remain concerned about job security.

"Heading into 2016, consumers are cautious about the labor market and expect little change in business conditions," Lynn Franco, director of economic indicators at the Conference Board, said in a statement.

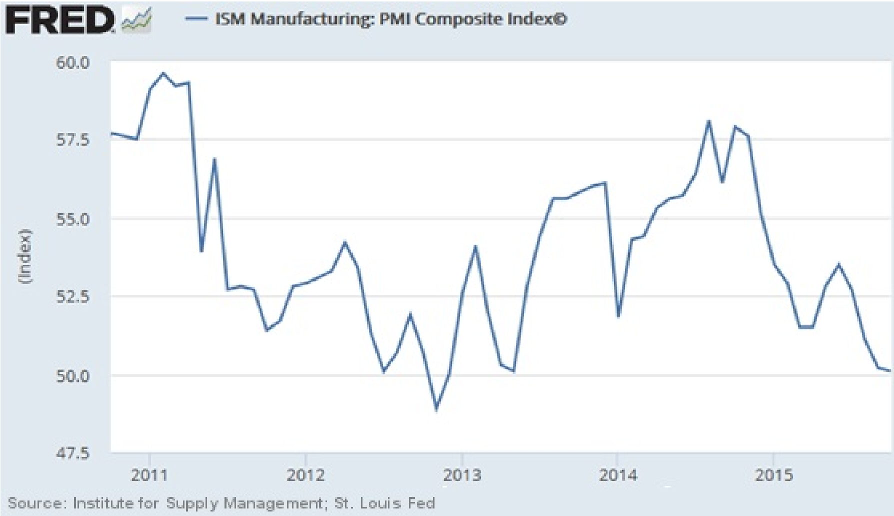
The University of Michigan's Consumer Sentiment Index shows a similar pattern to the Consumer Confidence Index in the chart above. It also has been trending lower since the first of the year and unexpectedly fell to **91.3** in November.

The sudden drop in consumer confidence in November raised questions about Americans' plans for spending during the holiday season which is now upon us. The latest report on retail sales showed an increase of only 0.1% (annual rate) in October, following zero growth in September. Retail sales have been basically flat since July.

I continue to read predictions that this will be a disappointing holiday shopping season.

Manufacturing Sector Continues to Flirt With Recession

The Institute for Supply Management (ISM) manufacturing index fell to a reading of **50.1** in October from 50.2 in September. This key index has been falling all year. Manufacturers are smarting from a combination of the strong dollar and slower demand for their products.



A reading above 50 in the ISM Index indicates an economy which is expanding, whereas a reading below 50 indicates the economy is contracting. With the Index hovering only fractionally above 50 for the last three months, that raises the odds of a recession before long.

Eerie Similarities to Those Before 2000 "Dotcom" Bear Market

I have been warning about the increasing risks in the equity markets since back in March and April when I recommended reducing exposure to long-only (buy-and-hold) strategies. Risks remain elevated as this is written, in my opinion, so my advice remains the same.

The current market environment has become eerily similar to that of late 1999-2000 in the following sense. In the late stages of the bull market back in 1999-2000, most of upside momentum was generated by four exploding tech companies: **Microsoft, Dell, Cisco** and **Intel**, the so-called ***"Four Horsemen."***

While these four tech giants and many dotcom companies were surging, much of the rest of the market was losing momentum or had turned lower. While most market analysts knew that underlying conditions were deteriorating, there was a feeling on Wall Street that ***"maybe this time is different."*** Well, we all know how that turned out – **the S&P 500 plunged almost 45%** by August 2002.

So what about the current market? Like in late 1999-2000, today's market is dominated by four large tech companies: **Facebook, Amazon, Netflix** and **Google** – the so-called "***FANG Quartet"*** (first letter of each company name) **–** which are sucking up all the oxygen left in the room. And like in late 1999-2000, much of the rest of the market is deteriorating.

At the beginning of this year, the *FANG* stocks had a combined market cap of **$740 billion** and combined 2014 earnings of **$17.5 billion**. So a valuation multiple of 42X PE ratio might not have seemed outlandish for this team of hot performers, but what has happened since then surely is.

At the end of last week, the *FANG* stocks were valued at just under **$1.2 trillion**, meaning they have gained $450 billion of market cap (or 60%) during the last 11 months – even as their combined earnings for the 12 months ended in September were up by only 13%.

What this tells us is that investors and traders alike continue to pile into these stocks despite the disappointing earnings – willing to accept the higher risk in the hopes that their momentum will continue to carry share prices even higher. The same thing happened to the *Four Horsemen* in late 1999 and 2000. Kinda scary, isn't it – especially with a likely Fed rate hike on December 16?

More Signs the Stock Market is Rolling Over to Downside

Some talking heads on CNBC and elsewhere suggested that last week's 3% gain in the S&P 500 was the best week of the year. They further suggested that it was particularly impressive given that consumer confidence fell sharply in October, the onset of the fifth recession in seven years in Japan and more credit problems in China.

While the talking heads were spinning last week's modest gain as big news, the fact is that the stock market has **gone nowhere** this year. An old Wall Street adage holds that market tops are a process, not an event, meaning that a topping out process can take a while. As I pointed out last week, a drop of the magnitude we saw in late August should <u>not</u> happen in a healthy bull market.

Not to get too wonkish here, but at the end of last year the total market cap of the S&P 500, excluding the *FANG* stocks, was $17.70 trillion. By contrast, it was **$17.26 trillion** at the end of last week, reflecting a 2.5% or nearly half trillion dollar loss of value. And this is not at an opportune time since the world economy is visibly drifting into stall speed or worse, and corporate earnings are already in an undeniable downswing.

It's clear now that the smart money has been unloading stocks since mid-year by selling underperforming shares on the numerous mini rallies shown in the chart above, while climbing onboard the *FANG* momentum train despite the higher risks. The problem is, this process rarely ends well.

As noted above, it didn't end well in 2000 when the *Four Horseman* of Microsoft, Dell, Cisco and Intel continued to rise despite a cratering broad market. At its peak in late March 2000, for example, Cisco was valued at $540 billion, representing a $340 billion or 170% gain from the prior year.

The same story was true with the other three members of the group. During the previous 24 months, Microsoft's market cap had exploded from $200 billion to $550 billion, where it traded at 62X reported earnings. In even less time, Intel's market cap had soared from $200 billion to $440 billion, where it traded at 76X. Dell's market cap had nearly tripled during this period, and it was trading at 70X.

Altogether, the *Four Horsemen* levitated the stock market by the stunning sum of $800 billion in the 12 months before the 2000 peak. Yet in a manner not dissimilar to the *FANG Quartet* during the past year, the *Four Horsemen's* market cap had soared from $850 billion, where it was already generously valued, to **$1.65 trillion** or by 94% at the time of the bubble peak.

There was absolutely no reason for this market cap explosion except that in the final phases of the technology and dotcom bull market, speculators had piled onto the last momentum trains leaving the station.

But it was a short and unpleasant ride. By September of 2002, the combined market cap of the *Four Horseman* had crashed to just **$450 billion**. Apprx. $1.2 trillion of market cap had evaporated from the entire market in a crushing decline.

Could it happen again just ahead? No one knows for sure, of course, but the absurdly inflated values of the *Four Horseman* in the spring of 2000 **looked very similar to the *FANG Quartet* today.** This is just another risk that I have not pointed out before, in addition to all the elevated risks I have warned about since last March.

Facebook reported $2.8 billion of net income in the most recent period, thereby weighing in with an incredible 107X PE multiple. Amazon is trading at a ridiculous 950X. Netflix currently trades at a lofty 307X. And even Google, which has now smacked into the law of large numbers with revenue growth of just 13% in the last year, is valued at 32X.

Moreover, despite its overflowing creativity and competitive prowess, Google is not a technology company which has unlimited potential. For example, nearly 90% of its $72 billion in revenues over the last 12 months came from advertising, which can change very quickly.

The bottom line: The *FANG Quartet* is about all that is keeping today's stock market afloat; each of the *FANGs* have serious vulnerabilities; each has been driven higher by large-scale speculative buying; each could reverse lower at any time, sparking a wave of selling; and **this could lead to the next bear market.**

If that happens, look out below!

Very best regards,

Gary D. Halbert
