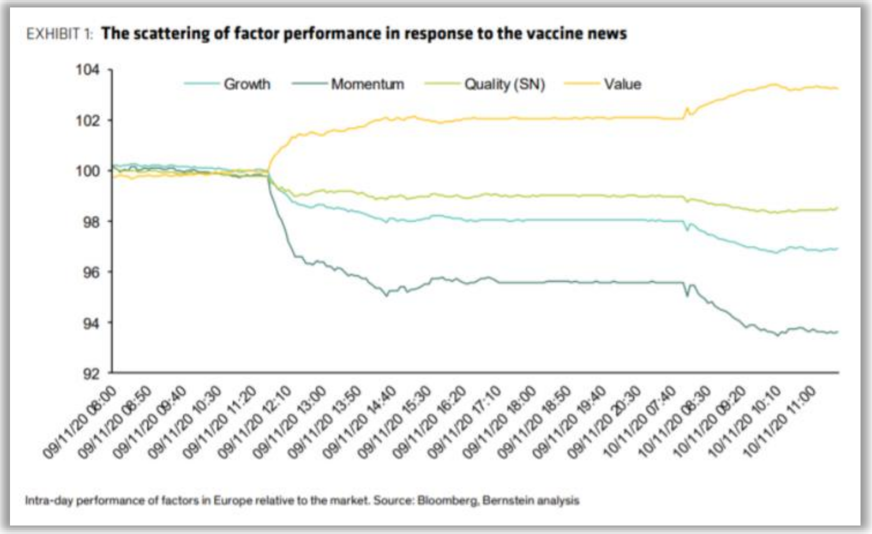
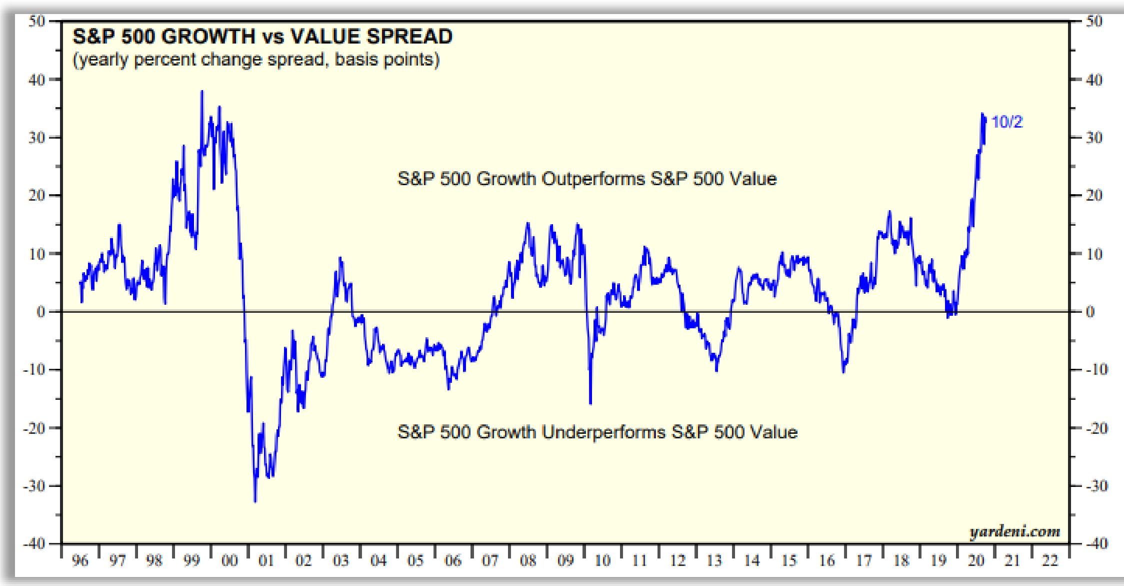
BROOKMONT CAPITAL MANAGEMENT

The Great Value Rotation Has Begun

The work from home displacement caused by the Covid-19 pandemic has led to a peak in the Price to Earnings ratio of the Russell 1000 Growth (40 as of 11/18). The announcement of the viable vaccine has created a timeline for herd immunity and a return to normal economic conditions. The graph on the right shows the performance of the stock categories in response to the vaccine news. This was just one day's worth of positive vaccine news on November 11th, we believe this is an indication of what is to come.



Growth and Value strategies have performed equally well over the last twenty-five years. Since 1996 Value has averaged outperformance for a duration of 2.2 years while growth has averaged outperformance for a duration of 2.8 years. As you can see in the graph below, the current growth outperformance is nearly 4 years old. The last time Growth has had a duration of outperformance for 4 years was also its biggest fall from grace during the dot-com bubble (1996 – 2001).

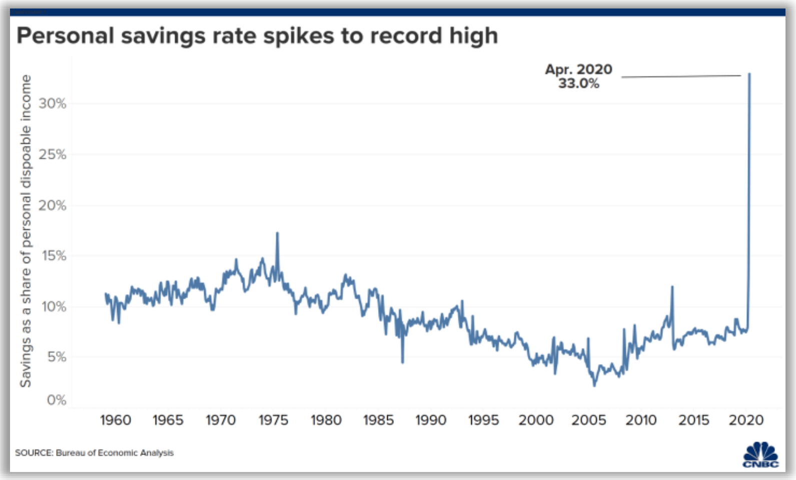


Regulatory and Inflation Risks Loom Large for Big Tech

The increased scrutiny of anti-competitive business practices of Apple, Amazon, Facebook, and Alphabet (which comprise 17% of the S&P 500), will create headwinds for the technology sector. Both US political parties and global regulators have expressed their discontent and intentions to limit the influence of these four tech giants specifically. The recent anti-trust cases against Alphabet in both the United States and Europe shows the contempt of global regulators and a precedent being set that could cause valuation concerns in other large tech firms such as Apple that make up a large portion of growth strategies. The Biden Administration is also pushing for an increase in capital gains taxes. This tax increase will incentivize investors to realize those gains before the end of the year and deploy the cash back into value names.

Lack of Balance Between Consumer and Government Spending

The US Consumer makes up two thirds of the US Economy and the global pandemic has limited the ability of the US Consumer to spend money at the normalized rate. This led to an all time high in personal savings rate of 33%. To counteract this loss in revenue from US consumers, the Federal Reserve and the US Congress Acted swiftly to provide stimulus to US businesses and consumers.



As the economy recovers and US Consumer Spending goes back to its normal rate, public sector spending will need to be reduced by a proportionate amount or consumer inflationary pressures could rise. This is likely to happen given the current political backdrop. The Biden Administration plans on passing a new stimulus bill and a large infrastructure bill after the January 20th inauguration. A stimulus bill (estimated between $1 trillion and $3 trillion) and an infrastructure bill (estimated $2.4 trillion) could result in a majority of that money flowing into the real economy resulting in consumer price inflation in the long term as the programs are carried out over time. These inflationary pressures could result in increased nominal rates and pressure the Fed into acting.

New Government Precedent

Direct stimulus checks were sent out to millions of Americans as opposed to previous stimulus packages where money was administered through government programs, tax incentives, and corporations. Consumer prices rose 0.6% in June and July which was more double than what was expected and has leveled off to 0.0% in October. This is a result from the direct stimulus checks and unemployment benefits that were administered in late April. This precedent increases the long term inflation risk as congress and elected officials now have more power over the money supply in the US Economy than ever before and the incentives of elected officials is very different than the incentives of the United States Federal Reserve.

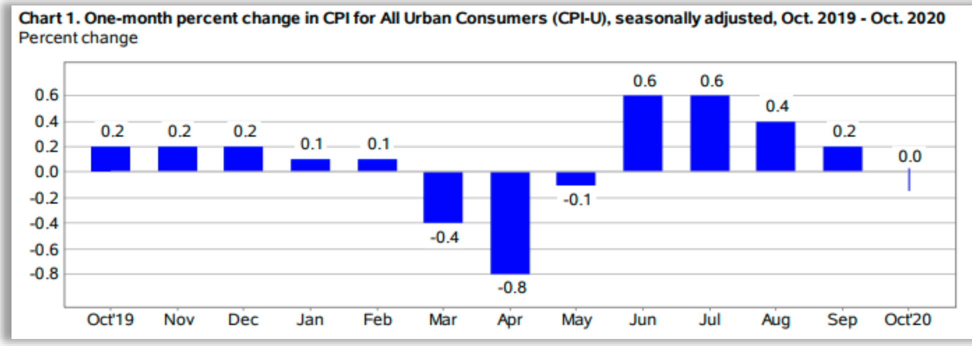


Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, Oct. 2019 - Oct. 2020

Inflation Risks for Mega Cap Tech

The Growth P/E ratio is at 40 as defined by the Russell 1000 Growth Index and the Value P/E Ratio is at 17 as defined by the Russell 1000 Value Index (as of 11/17). P/E ratios decline during rising inflation and with growth P/E ratios historically high and value P/E ratios historically low we expect the Growth P/E ratios to be affected disproportionately.

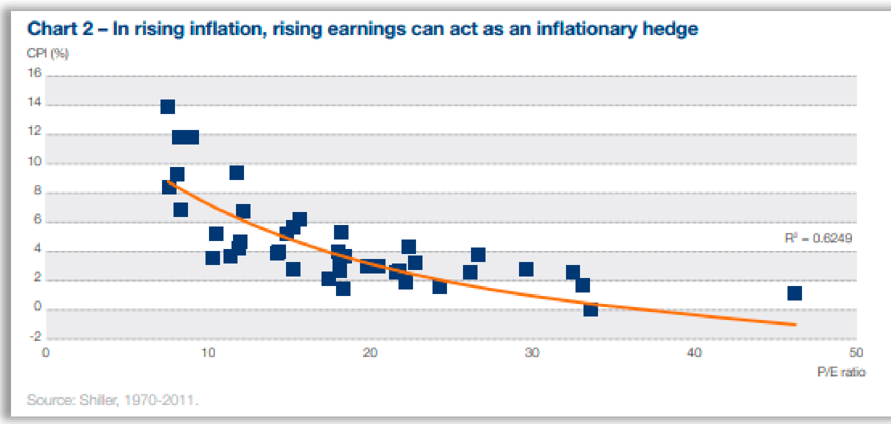


Chart 2 – In rising inflation, rising earnings can act as an inflationary hedge

Large cap tech stocks are similarly priced to long duration bonds as investors are buying the long-term earnings. With the lofty expectations and extended time frame priced into these assets and combined with a low rate environment, these assets have become extremely sensitive to changes in interest rates and inflation. Inflationary pressures on rates could lead to the earnings and profits being less valuable than they are today.

Whenever there are inflationary pressures rising in the market, the best hedge are companies that have increasing earnings. Earnings resiliency is one of the major attributes that Brookmont looks for in its analysis and is the first component of the Brookmont Dividend Score. Brookmont Capital invests in companies that are labeled as value but have strong growth prospects.