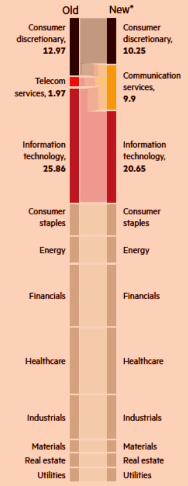
Analysis. Equities

Wall Street shake-up scatters US technology groups

Google, Netflix and Facebook are on the move after sector reclassifications Jason Alden/Bloomberg

Changing face of the S&P 500
Sectors by weight (%)



*Data as of 9/7/2018
Source: S&P Dow Jones Indices

De-Faanging of sector highlights revamp involving big S&P 500 names

MAMTA BADKAR AND NICOLE BULLOCK
NEW YORK

Tech investors are braced for what some have called a "de-Faanging" of the sector — a reference to the handful of big US tech companies that have led Wall Street to record highs in recent years.

From next week, Facebook and Alphabet will move from information technology into communication services, a revamped sector whose creation is the most striking change in a shake-up of the widely tracked classification system that investors use to help navigate the world's biggest stock market.

When the dust has settled, seven tech stocks that represent roughly a fifth of the S&P 500 information technology sector will be reclassified as communication services, according to State Street Global Advisors.

Some 16 stocks, including Netflix, whose combined market cap accounts for about 22 per cent of the consumer discretionary sector, will also join the renamed sector that is home to just three companies including Verizon and AT&T.

Given the explosive rise in passive investing over the past decade, the changes pose a challenge to investors who have used the sector system to gain exposure to the tech sector and the more defensive telecoms sector, as well as the active fund managers who use the sectors as benchmarks. In the short term, some are expecting volatility as portfolios are rebalanced.

"There is no question we will see elevated volumes in most of these stocks," said Rob Nestor, the president of Direxion, an ETF provider. "Whether that is enough to affect prices dramatically, it is hard to tell in advance."

As a rough estimate, he expected that the entire sector reclassification will drive about $20bn in trading volume. The changes mean that the tech sector, which has swelled to account for about a quarter of the total market value of the S&P 500, thanks, in part, to the meteoric rise of the Faangs, will shrink to about a fifth.

What is left in the info tech sector will have a greater weighting towards hardware companies, including Apple, as well as chipmakers and traditional tech stalwarts like Microsoft.

While the overhaul will scatter Facebook, Apple, Amazon, Netflix and Alphabet across more sectors, analysts said that, in other ways, it will sharpen the prominence of the tech behemoths.

Alphabet and Facebook's departure for communication services will see trillion-dollar Apple's sector weight in info tech rise to 22 per cent from 17 per cent, according to analysts at UBS. The weighting in info tech of Microsoft, which is closing in on a $1tn valuation, will rise to 16 per cent, up from 13 per cent at present.

"The new sectors will be more concentrated, but that is the nature of the market, because you have this handful of super-cap names," said Nicholas Colas, cofounder of DataTrek.

The revamp of what is currently called the telecoms services sector will force investors to rethink what has been considered a defensive part of the market with a high dividend yield.

Given that Facebook and Alphabet will account for 16 per cent and 29 per cent, respectively, of the new communications service sector, that perception will be obsolete.

The dividend yield for the renamed sector will drop to just 1.4 per cent, according to UBS, compared with 5.5 per cent for the telecoms sector before.

The proposed changes will also affect valuations. The telecoms sector trades at a low forward price-to-earnings ratio of 10.2 times, according to Jeremy Zirin, strategist at UBS, while he estimated the forward P/E of the communication services to 18.6 times.

"Speaking to clients, the reason they like it [the telecoms sector] is because of the more defensive characteristics and high dividend yield," said Pam Woo, head of US equities at BNP Paribas Asset Management. "So there will be fewer sectors to find that defensiveness."

Some investors said grouping Facebook and Alphabet with highly regulated telecoms companies reflected expectations that the former would soon face heightened regulation, too.

Facebook and Alphabet — along with Twitter, which is joining the communications bucket — have been hit with concerns about privacy and security.

"It is kind of a clever cluster of the names with some real regulatory risk," Mr Colas said.

Some investors expressed reservations about the new sector's growth prospects.

"I would not call the new sector particularly attractive," said Max Gokhman, head of asset allocation for Pacific Life Fund Advisors, citing second-quarter earnings disappointments for Netflix and Facebook. The latter's shares tumbled after warnings about future growth.

> '[Figuring out] the amount of rebalancing taking place is a bit like walking on the moon'

While the reclassification has been well telegraphed by index providers, volatility before the market close on Friday cannot be ruled out.

"Understanding the amount of rebalancing taking place is a bit like walking on the moon," said Matthew Bartolini, head of SPDR Americas research at State Street Global Advisors. "You can do all of the prep, planning, simulation and analysis, but you won't know the exact experience until you are there."

Explainer

Reclassifying telecoms hits 26 stocks worth $2.8tn

NICOLE BULLOCK AND MAMTA BADKAR

After the close of trading on September 21, index provider S&P Dow Jones Indices will transform the existing telecommunications sector with major implications for the technology and consumer discretionary groups.

MSCI will make similar moves a week later and in November.

The new communication services sector will include AT&T, Verizon and CenturyLink; consumer discretionary names like Comcast, 21st Century Fox, Netflix, and Walt Disney and tech giants like Alphabet and Facebook.

As a result of the switch, the telecoms sector, which currently represents just 2 per cent of the S&P 500, will swell to 10 per cent.

All told, the reorganisation of the communication services sector will affect 26 stocks across the three sectors boasting a market value of about $2.8tn and representing about a tenth of the S&P 500, according to Matthew Bartolini at State Street Global Advisors.

The changes are expected to have a bigger impact on the market thanks to the growth in exchange traded funds and exchange traded products — which had some $5.23tn in assets under management at the end of August.

Many ETFs are "passive" and are designed to track indices. The Global Industry Classification Standard has a four-tiered taxonomy of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries

Mr Bartolini said SSGA will be rebalancing its Technology Select Sector SPDR (XLK), which has $23bn in assets and tracks the S&P 500 information technology sector, "on or around" Friday. That involves selling shares of Alphabet and Facebook, as they exit the index.

SSGA did not have a sector ETF for the telecoms sector, given how small it was and housed those shares in its tech ETF but those will be sold as well.

In March, Vanguard said it would institute custom benchmarks for its funds that track the MSCI sector indices that will change "to minimise trade and market impact costs".

It began rebalancing in line with the new sector weightings in May. Its telecom sector fund will become the communication services fund. Assets of Vanguard-MSCI index funds total $193bn globally.

At BlackRock, $6.6bn of the $60bn in assets invested in sector and industry-focused iShares ETFs follow the Gics methodology.

The rest will not be directly affected because they follow indices provided by Dow Jones and Nasdaq.

The changes come amid an increasing overlap in services provided by telecoms, media and some internet companies. They are also taking place to address concerns over the size of the telecoms sector, which dwindled to just three companies following a wave of consolidation and has been left vulnerable to major swings in its constituents.

Commodities

The drip, drip, drip of Brazil currency and political woes takes toll on coffee

EMIKO TERAZONO

Your daily cup of coffee is becoming cheaper thanks to political uncertainty in Brazil, with prices languishing at 12-year lows, dragged down by the weakness in the Brazilian real.

The Latin American country is the largest producer and exporter of coffee, and selling pressure on the futures price in New York has intensified alongside the real as Brazilians prepare to vote next month in the hotly contested presidential elections.

In addition to the emerging market rout, pessimism over continued fiscal reforms in Brazil by a new government and declining consumer confidence has been depressing the real by more than 20 per cent since the start of the year to R$4.2 against the dollar.

Arabica, the higher-quality bean known for its mild taste, has fallen more than 20 per cent, fluctuating around the $1 a pound level over the past few weeks.

Coffee and the Brazilian real have always been closely correlated because the commodity is traded in the US currency. A lower real encourages Brazil's farmers and exporters to sell more coffee and maximise returns.

The country's coffee producers have harvested a record crop that has been making its way on to the international markets.

Many speculators and hedge funds, aware of coffee's link with the Brazilian real, buy or sell coffee when the currency moves. Sugar, another commodity where Brazil is a leading exporter, is also correlated to the currency.

The weak real and increased production in other leading producers such as India has pushed the commodity down 27 per cent from the start of the year.

Carlos Mera, analyst at Rabobank, said: "[Hedge funds] have been selling the commodity as the real has fallen."

Hedge funds have continued to bet against coffee as the real has been sliding. The "net shorts", or the difference between speculative bullish and bearish bets, have continued to rise over the past year and are at record highs.

Arabica is down 20% as gloom over fiscal reform leaves the real bruised

Investors in the coffee market will need to monitor the outcome of the presidential elections, which will determine which way the currency goes.

Until Brazilians go to the polls, the real is expected to remain volatile and could experience further weakening, said Ilya Gofshteyn, forex and global macro strategist at Standard Chartered.

The real might fall to as much as R$4.40-4.50 against the dollar if leftist candidate Fernando Haddad — the anointed successor to former president Luiz Inácio Lula da Silva — or another leftist, Ciro Gomes, won, said Mr Gofshteyn.

Should far-right politician Jair Bolsonaro maintain his lead, the real might strengthen, he said.

"It's binary," said Alberto Ramos, head of Latin American economics at Goldman Sachs.

The uncertainty around the poll's impact on the currency was double-layered because there was little visibility over who would win and how much appetite for fiscal reform he or she had and could implement.

Cross asset

Economic optimism hits lowest for nearly seven years in BoAML survey

KATE ALLEN

Investor optimism about the global economic outlook has hit its lowest level for nearly seven years, according to a widely watched survey that found the decoupling between the US and the rest of the world is expected to continue.

Some 24 per cent of investors expect global growth to decelerate in the next 12 months, the Bank of America Merrill Lynch monthly fund manager survey found, the worst outlook on the global economy since December 2011.

A net 16 per cent of survey respondents thought that corporate earnings would not improve by 10 per cent or more in the next 12 months, a significant swing from six months ago when a net 35 per cent thought they would.

But expectations of the outlook for US earnings are at a 17-year high with bets on US equities at a four-year peak. Bets that the dollar will rise are one of the three most crowded trades.

Combined with investors' portfolio weightings of investment-grade bonds, which have hit a 10-year low, this suggests that the markets are bracing for a hawkish monetary policy tightening cycle from the US Federal Reserve, BoAML said. Meanwhile, the outlook for the rest of the world is becoming cloudier.

In an illustration of the extent to which investor preference for the US is proving negative for other regions, one of the other top-three most crowded trades among those surveyed by BoAML was to short — or bet against — emerging markets.

Investors' cash holdings climbed to an 18-month high of 5.1 per cent of their portfolios. Other popular shorts were UK assets and resources and commodities.

> 'Investors are holding on to more cash, telling us they are bearish growth and bullish US decoupling'

Investors continue to rate a global trade war as the biggest potential tail risk for global markets, although those concerns have receded somewhat over the past two months.

The risk of a China slowdown is a growing concern, however, along with the consequences that quantitative tightening could have on the markets.

Month on month, investors have rotated out of EMs, banks and materials and into Japanese assets, healthcare and industrials.

Allocations to commodities slipped in September, ending a six-month streak of investors being overweight the sector.

The findings reflect the extent to which the recent sell-off in EMs has reinforced investor expectations that the divergence between the US and the rest of the world will continue.

"Investors are holding on to more cash, telling us they are bearish growth and bullish US decoupling," said Michael Hartnett, BofAML chief investment strategist.

"Fund managers are signalling that they are starting to price in a hawkish Fed," he added.

As much as 48 per cent of the investors surveyed said that they expected the economic decoupling trend to end when US growth slows; just over a quarter thought it would end when growth in Asia and Europe accelerates to catch up with America.

The most crowded trade, for the eighth straight month, was in the FAANG and BAT stocks (Facebook, Amazon, Apple, Netflix, Google; and Baidu, Alibaba, Tencent).

BofAML surveyed 244 investors with $742bn assets under management.