ENVESTNET PMC

What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Michael Manning, CFA

How Do Investors Justify Tesla's Current Valuation?

They cannot unless they make bold predictions. Tesla's ascension has been driven largely by the perception that the shift from internal combustible engines to electric vehicles (EVs) will intensify, and Tesla will become the dominant player. And although it is undeniable that demand for EVs will grow, it is tough to claim that Tesla's valuation is justified in what will be a competitive industry, as many automakers ramp up their line of EVs.

To put things into perspective, Tesla's current market cap per vehicle sold is about $1.5 million. Meanwhile, that figure is under $10,000 for Ford and GM. Furthermore, Tesla's market cap is currently greater than the nine largest car manufacturers in the world, and represents two-thirds of global car production. This follows the stock rallying in 2020 from about $88 a share to about $800 at the end of January 2021. So to get close to Tesla's high valuation, one must believe that Tesla will not only one day possess the highest margins in the EV business, but also the greatest market share in the industry, and sell about 100x as many cars as it does today.

On the flip side, maybe investors have reasons to be optimistic. The company has a dynamic leader, Elon Musk, who has a history of creating disruptive companies. Also, Tesla's gross margins are high, and hover around 20%-25% (5%-10% ahead of most big car makers). Margins are likely to increase as Tesla rolls out self-driving packages. The company also is rapidly increasing production, and it is a safe bet that its roughly 20% share of the EV market today will continue to grow. One can argue that Tesla should not be compared with traditional auto makers, since it also produces solar panels, solar roof tiles, and battery-energy storage, as well as other related products that are large sources of revenue for the company. However, now that it is included in the S&P 500 Index, index providers are forced to buy company shares. All of these facts no doubt underwrite the astounding valuation.

Investors with either a bear or bull thesis on Tesla can agree the company has a unique brand with dynamic technology in a rapidly growing market. And although the EV industry is likely to become more competitive, Tesla will probably remain at the forefront of innovation and has the opportunity to live up to today's lofty expectations.

Monica Sengelmann, CFA

Will the US Delist Chinese ADRs?

This is just another piece of the US/China relations puzzle, proving that investing in China can carry significant and unanticipated risks. On December 2, 2020, Congress passed the 'Holding Foreign Companies Accountable Act' (HFCAA). This act states that foreign companies listed on a US exchange (ADRs) must allow the Public Company Accounting Oversight Board (PCAOB) to review their audits. This applies to countries where the government has placed restrictions on the PCAOB's ability to inspect foreign auditing firms' audit paperwork. Most companies either already allow this or will allow it, so the issue mainly rests with China, who has resisted calls for oversight by the PCAOB. Foreign companies have three years to comply, or they will be forced to delist from the US stock exchange. PMC Research, alongside our managers, is monitoring the situation, as it is both fluid and has many uncertainties.

Most of our asset managers believe this three-year lead time will allow for the US and China to come to a resolution over this issue. With more than $2 trillion in US-listed Chinese companies, an incentive exists to find a solution and not disrupt this enormous source of capital. The three-year period also should allow ample time for companies to create a secondary listing in another market if they have not already done so. This will make it easier for holders of these ADRs (the primary vehicle used to list Chinese stocks in the US) to exit their ADR vehicle in the US and buy the same underlying company on another exchange, as in Hong Kong, for example.

However, some asset managers believe the threat of delisting is more serious. It will force Chinese firms to comply with the US's high standards of accounting under GAAP. Will higher-quality Chinese firms comply, whereas smaller, lower-quality companies will be delisted? It remains to be seen. But with the ability to list on alternate exchanges, as many companies have already done, the situation should not materially limit a company's ability to attract capital. Nor should it limit an asset manager's ability to own shares of one of these companies in its mutual fund vehicles. However, it still would be an issue for ADR-only portfolios, like the Separately Managed Accounts available on the Envestnet platform. Therefore, we will be keeping an eye on future developments around the HFCAA and provide updates as we have them.

Navaneeth Krishnan

US High Yield—Attractive, But No Free Lunch For Income Investors In 2021

Like most other risk assets, US high yield (HY) markets had an incredible year in 2020. Although the 5%-6% total return generated during the year by major US HY indices may sound ordinary, what makes 2020 'incredible' is the V-shaped recovery the HY market made after a deep sell-off in the first quarter. Credit spreads, which widened to 1400 levels in March, retraced to prepandemic levels at a time when default rates more than doubled (from 2019 levels) to around 6%. The recovery was triggered by the Federal Reserve's direct support through a buyback of "fallen angels" and junk bond ETFs, gaining momentum as the economy began to reopen, vaccines rolled out, political uncertainty diminished, and expectations for a sharper economic recovery started to solidify.

Latest attributions show that the bulk of the return was driven by lower-quality (near distressed) credits within the pandemic-affected cyclical sectors. Most of these issuers may not yet be completely out of the woods. Moreover, as most "fallen angels" currently fall into the BB-rated segment, BBs now form more than half of US HY benchmarks. Although "fallen angels" potentially becoming "rising stars" improves the prospects of generating long-term returns within the BB segment, their higher duration adds to the interest rate sensitivity of the overall portfolio. With the economic recovery being nascent and vaccine dependent, and valuations not being cheap, any negative surprises may prompt markets to differentiate stronger balance sheets from weaker ones.

Although the broader expectations in the market are for the prevailing positive momentum to continue into 2021, we believe that investing through managers with proven credit selection ability and strong risk management practices is increasingly important this year.

Ramasubramaniam, CFA

Emerging Markets Outlook: Poised For Outperformance

Buoyed by vaccine approvals and the reopening of the economy, the MSCI Emerging Markets Index returned nearly 20% in the fourth quarter, outperforming the MSCI World Index by 600 basis points. Emerging markets equities also outperformed for the year, returning 18.3% versus 15.9% for the developed markets. Furthermore, the International Monetary Fund has projected that emerging markets economies will grow 6.3% in 2021 and 5.0% in 2022 compared with 5.5% and 4.2% for developed economies, respectively. The projections are even better for emerging-Asia, which is projected to grow 8.3% in 2021 and 5.9% in 2022. However, these projected growth rates must be viewed in the shadow of the severe global contraction in 2020 (estimated at negative 3.5%).

Asset managers are observing and acting upon several trends in emerging markets . China remains key, but continuing tensions with the US increase the risk for Chinese equities. It remains to be seen whether the change in US government leadership improves this situation. Commodity-focused countries like Mexico and Russia could do well, buoyed by resurgence in global trade and nonenergy commodity prices, which are at their highest levels since mid-2014 and are rising at their fastest rate since mid-2011.

Value stocks may be poised for a continued rally. The pandemic also has accelerated the need for businesses to adopt new technologies, like artificial intelligence, digital payments, and 5G. Companies in these businesses are expected to perform well. Continued weakening of the US dollar as the global economy begins to expand also should help emerging markets equities outperform developed markets.

Ryan Knisely

The Relative Value Play—High Yield Versus Investment Grade Credit

The high yield market experienced a roller coaster of a ride in 2020. The throes of March brought on by the pandemic blew high yield spreads out to more than 1,000 basis points. This was shortly followed by a rally in credit markets throughout most of the remainder of the year amid massive stimulus, Fed interest rate policy, economies reopening, and positive news on COVID-19 vaccines. This all led to high yield spreads finishing the year at 360 basis points. Although some asset managers might look at the asset class and wonder how much more upside can there be, others see opportunity in high yield relative to investment grade (IG) credit. Why is this?

Some high yield managers have reminded investors that even though the duration of IG credit has extended, US high yield market's duration has shortened. This becomes important, as asset managers note that markets are placing duration as the primary risk in fixed income. With interest rate forwards pointing to higher yields, greater interest rate risk exists. Despite the lower high yield credit-quality rating, asset managers see more relative value in the space, as longer-duration IG holdings can be riskier investments.

Credit quality is another talking point for managers. The notional amount of IG credit comprises BBB-rated issues (the lowest-quality tier within IG), whereas the credit quality within US high yield has improved. The technical backdrop points toward further improvement. As the pandemic accelerated, downgrades and forced selling by IG investors led to an increased supply of fallen angels. One manager noted 90% of fallen angels are currently rated Ba, the highest-quality tier within the high yield category. As defaults slow, some managers expect a reversal of the trend earlier in the year, potentially turning the fallen angels into rising stars, and boosting returns. To put defaults in context, as of December 31, 2020, the trailing 12-month speculative default rate sat at 6.2%, per JP Morgan data. This is well below the historical 10%-15% peaks exhibited in prior default cycles in recessions over the last 30 years, suggesting a stronger recovery for the asset class.

Investors have a few reasons to take a hard look at the high yield-versus-IG space. Although there is no guarantee, the high yield market posted positive returns in 17 of 18 one-, two-, and three-year observed periods since 2000, following instances where the high yield spreads crossed 800 basis points.

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