STARTING 2017 ON THE RIGHT SIDE OF DISRUPTIVE INNOVATION?

January 09, 2017 | by Catherine D. Wood, CEO and CIO ARK Invest
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I would like to present ARK's perspective on the market last year and our thoughts about the next few years, especially as they relate to our disruptive innovation investment themes. While our predictions early last year on the direction of the US economy and equity markets went against the consensus view - and were correct - our themes sputtered, particularly during the robust fourth quarter. We attribute this unusual divergence to short term cyclical and fiscal policy considerations. In fact, based on our original research, we are increasingly confident that the disruptive innovation captured by our strategies will not only change the way the world works but also create many value traps in traditional investment portfolios.

"2016: THE FLIP SIDE OF 2000"

When the equity market was in free fall during February of 2016, we went on record with a view contrary to consensus thinking at the time:

- the Fed's move toward tightening would not derail the economy;
- the drop in oil prices would not lead to a broad based deflationary bust;
- China was not going to implode; and
- US earnings growth would re-accelerate in 2016.

Those calls were good ones: the six-year-old economic cycle and bull market had not peaked in 2015 after all, and 2016 would not be a replay of 2000.

POST-ELECTION SURPRISE

During the fourth quarter, and even more so after the election, the market began to react to the prospect of a strong economic expansion and higher interest rates. We think the promises of dramatic tax rate reductions and increased spending on infrastructure and defense took investors by surprise. Consequently, they began to reallocate assets from cash and bonds to stocks, flocking to index funds, particularly those in the more cyclically sensitive sectors of the market. In all likelihood, mature companies with high fixed costs would benefit disproportionately, not only from an unexpected acceleration in growth, but also from tax rate cuts and other fiscal stimulus. Earlier stage companies investing heavily in innovation, particularly those with little or no earnings, would not enjoy the same kind of short term benefits.

Value dominated the top performing sectors during the fourth quarter. In the US, for example, financials returned more than 20%, thanks to the unexpected shift in expectations for net interest margins and assumptions about deregulation. Industrials (+7.2%), energy (+7.3%), and materials (+4.7%) also outpaced the total return of the S&P 500 (+3.8%). The laggards were yield oriented stocks (real estate, -4.4% and utilities, +0.1%) along with health care (-4.0%) and technology (+1.2%).

THE REVENGE OF DISRUPTIVE INNOVATION

While the resurgence in cyclically sensitive sectors might make sense in the short term, we think the irony is that innovation will disrupt them during the next few years. Indeed, we would not be surprised to see many mature companies channel much of their windfall tax gains into investments and M&A as they fight disintermediation, obsolescence, and other longer-term pressures on earnings. If they don't, they may not survive in the coming decades.

Financials:

During the late nineteenth century, the last period of innovation as prolific as this one, inverted yield curves were the norm. Now, after being hamstrung by regulation for the past eight years, companies in the traditional financial services sector not only have to compete against new mobile, cloud, machine learning, and blockchain based strategies, but also could be battling surprising pressure on net interest margins. Why? …because the deflationary forces associated with technologically enabled innovation and strong productivity gains, not to mention a fourteen-year high in the US dollar, should be powerful. Consequently, long rates are unlikely to go up much relative to short-term interest rates, certainly not as much as has been the case in the last century, or as much as investors now anticipate.

Industrials:

During the past century, the industrial revolution took root as the internal combustion engine provided the infrastructure upon which the economy thrived. During the next few years, battery technology will upend this existing world order. According to ARK's research, the internal combustion engine soon will give way to battery technology, as electric vehicle prices drop below those of traditional vehicles, and then continue to slide along the declining cost curve that we project for battery pack systems. Industrials may have outperformed during the fourth quarter as the outlook for the economy brightened, but they soon will face a date with destiny.

Energy:

Compounding problems for the energy sector, electric vehicles are four times more energy efficient than traditional automobiles powered by internal combustion engines. Moreover, with the advent of ride sharing and, in the not too distant future, shared autonomous electric vehicles, global auto sales probably have seen their best days, at least for the next five years. The oil price peak probably won't be too far behind. In addition, the recent rise in the US dollar to a 14-year high could curb demand for energy in the broad range of countries that are losing purchasing power.

Materials:

While benefiting from strong global growth, materials also may suffer from the US dollar's appreciation. In turn, as US companies become less competitive, a strong dollar will turbocharge another source of disruptive innovation, the shift to 3D Printing and other new technologies that will lower the weight and costs of manufactured end use parts.

ON THE RIGHT SIDE OF DISRUPTIVE INNOVATION

Certain deflationary forces - those associated with technologically enabled innovation and declining cost curves - will be exceedingly good for growth and profits, in our opinion. Companies just have to be on the right side of disruptive innovation to enjoy them. If not, they probably will become value traps, much like bricks and mortar retail did during the last decade.

Not since the 19th century has the world enjoyed as many general purpose technology platforms as are evolving today: the next generation internet, robotics, energy storage, genomic sequencing, and blockchain technology. Combined, they could lead to a deflationary boom and wealth generation dwarfing that of the computing age. We invite you to learn more about the promise of these disruptive innovation investment themes from the links in this article and, as always, at www.ark-invest.com.

Sincerely,

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