Epsilon Theory

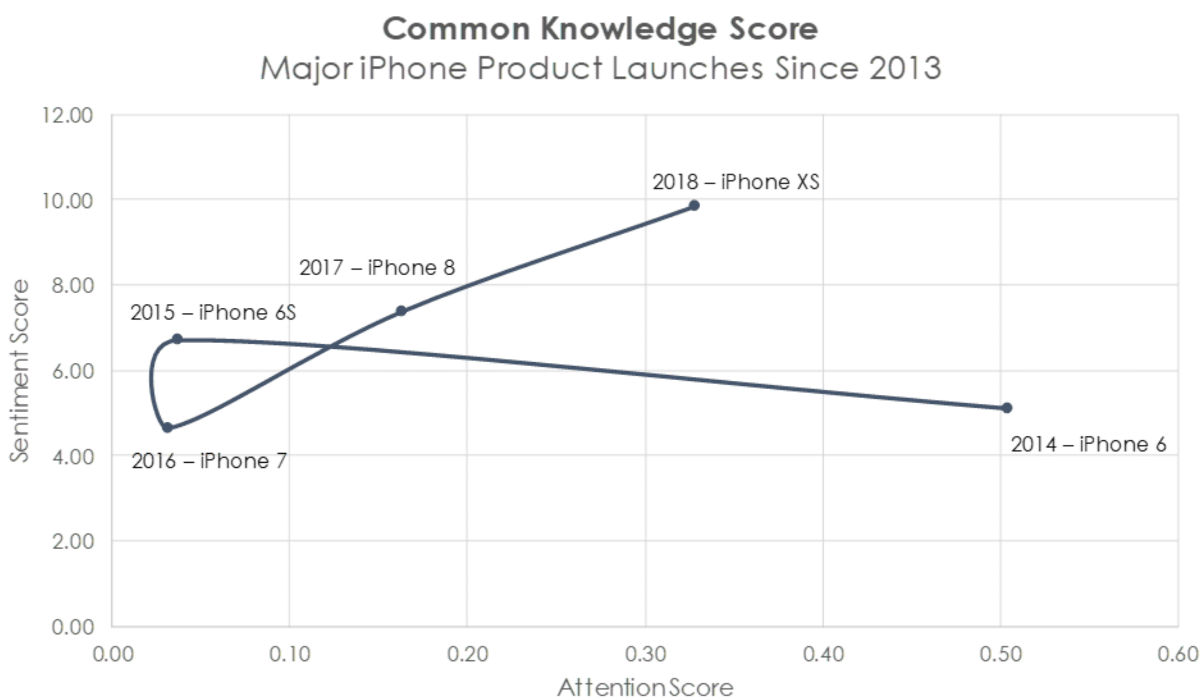
In Focus – Multiple Ways to Lose (AAPL)

January 3, 2019

Sentiment: Very Negative and Stable

Attention: Very Strong and Rising

Leading into Apple's earnings announcement last November, the product-level narratives for Apple were both remarkably positive and reflective of a consistent narrative: 'these new phones are going to be a Big Deal'. We noted at the time that the narrative around this product launch was as positive as any since the iPhone 6, which may be among the best-performing products in Apple's history. Expectations were high.



Source: Epsilon Theory, Quid

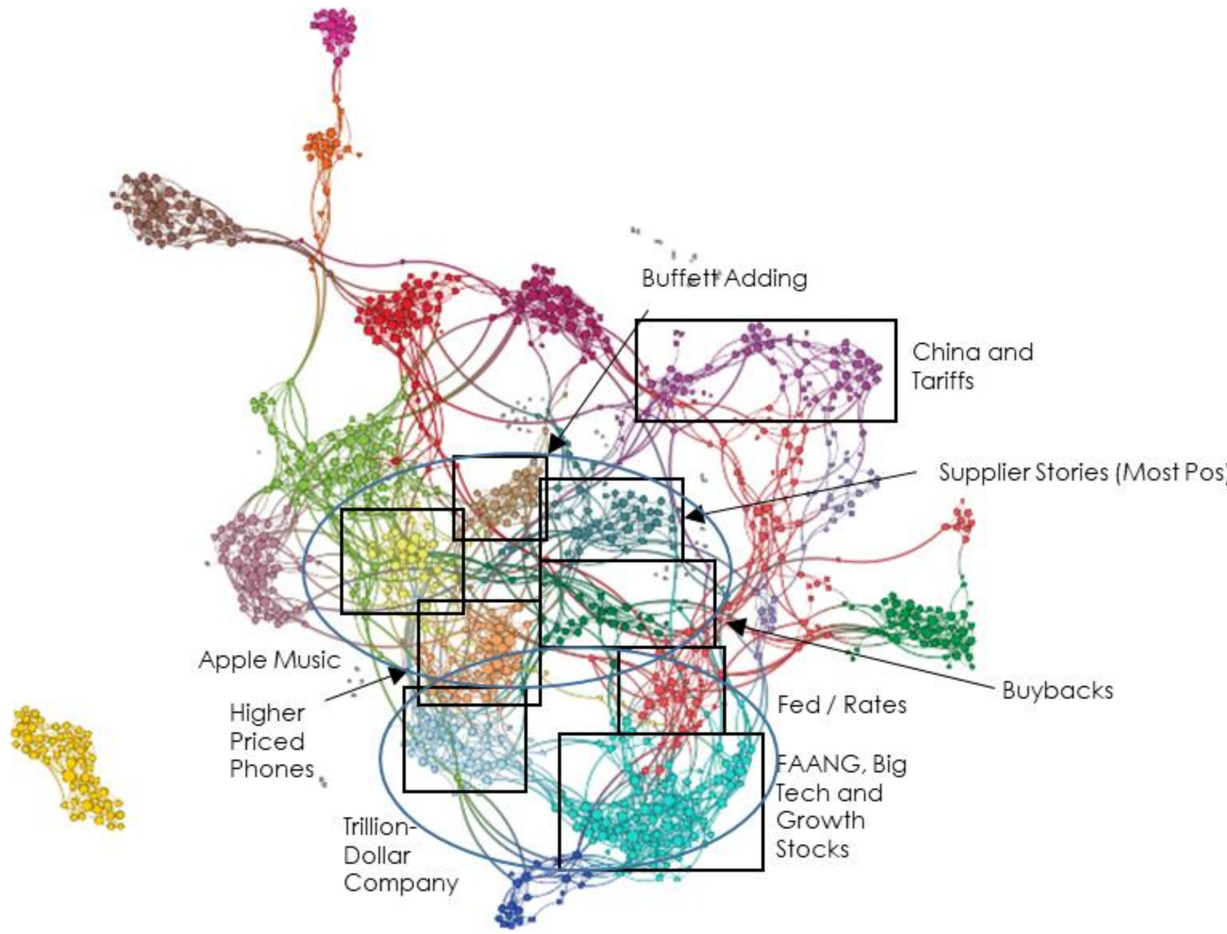
Company-level narratives incorporated a more complete picture of the various forces facing the company, some good and some bad. In the quarter leading up to the November earnings release, we think there were two active narratives about Apple stock (shown below generally within the two oval shapes):

1. As noted above, a product- and business-line narrative that was positive and idiosyncratic to Apple, portraying higher-priced devices in light of Buffett's belief (and double-down) that this was

an underexploited opportunity to expand margins, alongside news of the company's increased success and efficiency in its supplier channels.

2. A market and stock-based narrative (the lower oval) of Apple as part of a growing concern about big technology stocks, the influence of federal reserve policy and interest rates, and Apple's fate as the company that had, to this point, fared the best.

Narrative Structure of Apple Stock - July 2018 - October 2018

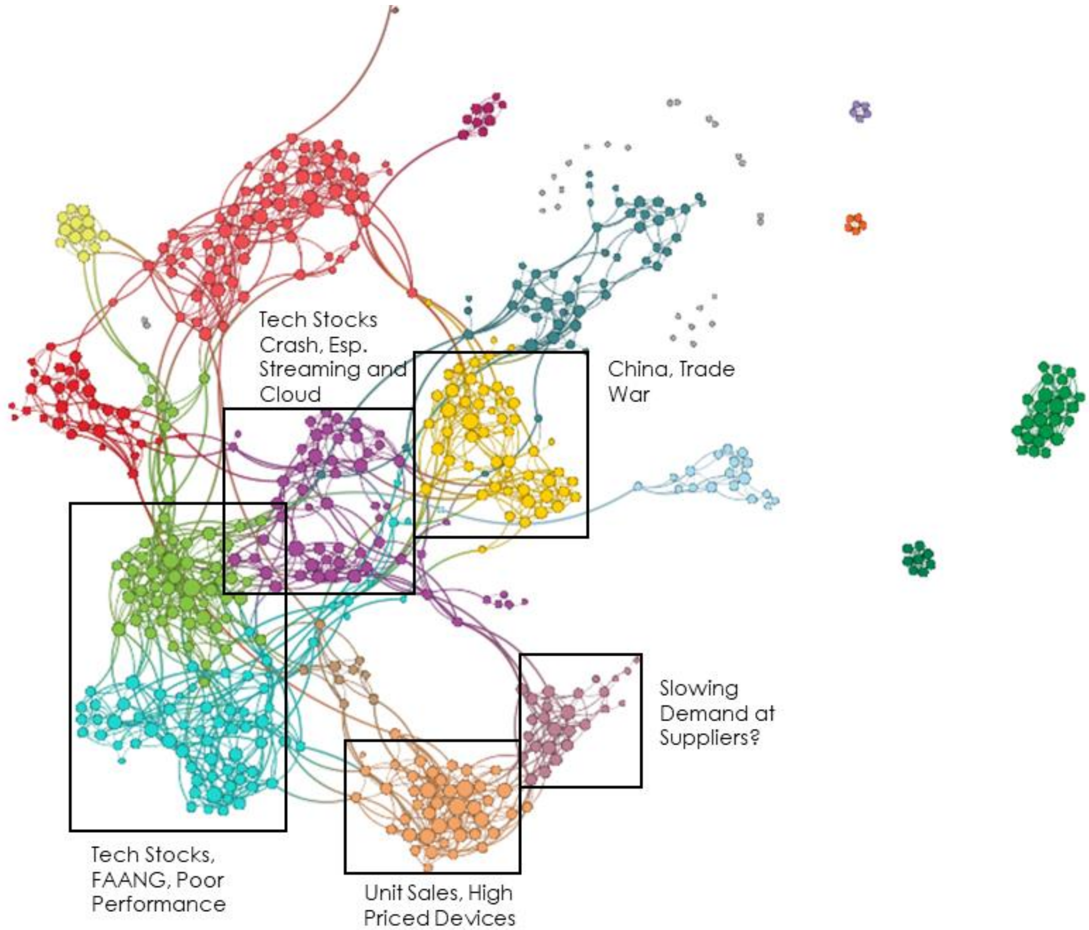


Source: Epsilon Theory, Quid

Immediately following Apple's earnings release – and more importantly, its announcement that it would no longer release unit sales figures for its flagship products, two things happened. First, the stock performed very poorly. In short, the company's announcement flipped the surprisingly positive lens with which the market was taking in unit price information into a decidedly negative one. **In this, Apple executives discovered one of two ways to lose the narrative game – to flip a positive, high attention component of the core narrative to a negative one.**

The second effect, of course, is that the narrative structure shifted - quickly. The market narratives attached to concerns about technology stocks became central to all of the stories written about Apple. When authors, sell-side analysts, strategists and buy side investor letter writers wrote about Apple, they were also writing about the rest of the wreckage in technology stocks. More importantly, the only two clusters of Apple-specific topics connected to this central narrative about the stock's performance were (1) fears about China and the trade deal and (2) concerns about the unit sales reporting policy and what that might imply about Apple's expectations for sales. Both were decidedly negative topics in their treatment of Apple.

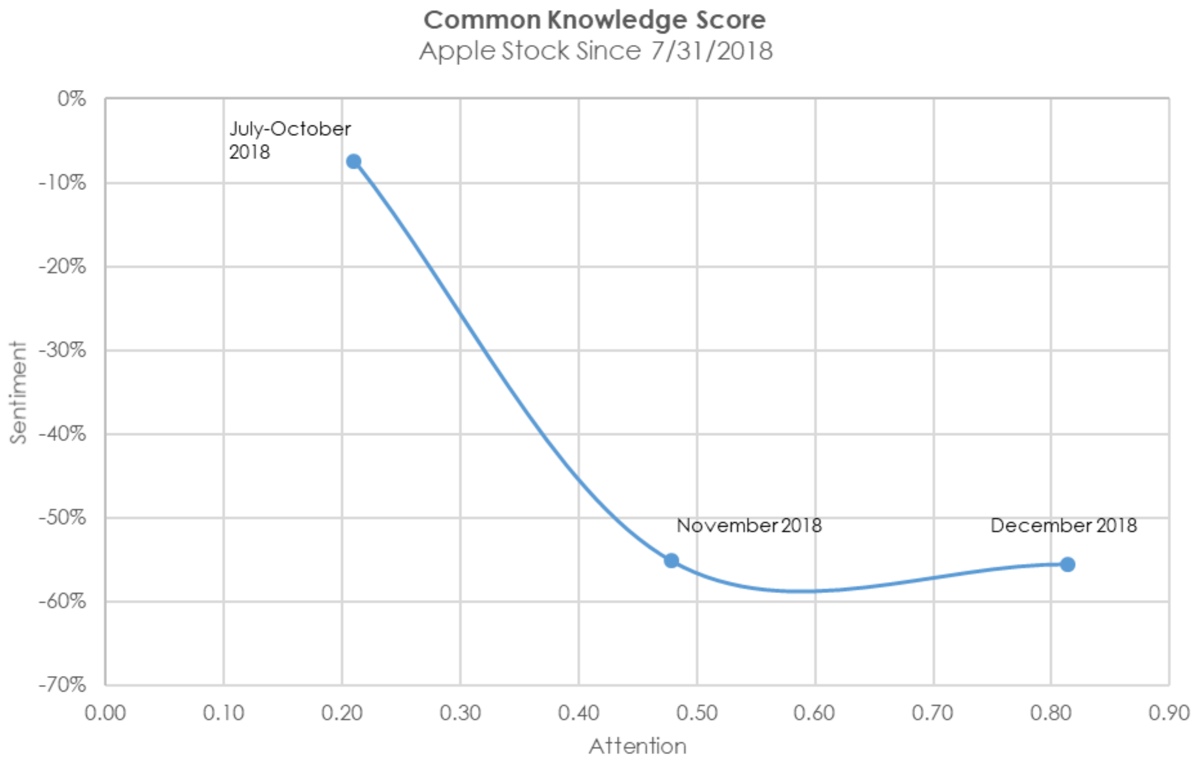
Narrative Structure of Apple Stock - November 2018



Source: *Epsilon Theory*, *Quid*

With this narrative structure in place, in early January 2019, Apple executives discovered the second way to lose on narrative: confirm a negative peripheral component of a high attention narrative, bringing it into the core.

When Apple guided lower on sales and pointed to China in the process, they confirmed the two only high attention, highly connected components of the narrative to the stories being told about Apple, both of which happened to be negative. What's more, the narrative became more concentrated and more interconnected as the calendar approached 2019. As shown in the over-time chart of attention and sentiment below, our attention measure here reached near-peak levels in December 2018.



Source: *Epsilon Theory*, *Quid*

What now?

Our view at this time would depend heavily on our time horizon and strategy, but this narrative structure does lead us to a few conclusions:

- For better or worse, Apple is now a stock whose narrative is tied up in the China Trade War narrative. If they aren't already, we think that traders and investors who are attempting to trade this idea creatively (or do so reflexively) will now be using Apple as part of their thematic "trade war" baskets. As we have written elsewhere, we believe this is a classic game of chicken whose odds cannot be predicted. For shorter-term investors and traders, that means that we think active positions in AAPL are likely to have more or less random outcomes with significant volatility while this broader narrative dominates market attention. Shrink your book.
- For cross-sectional trend-followers, we think that the narrative environment of a strong core narrative and consistent sentiment is more conducive than usual to trend formation over the medium term. We would still be mindful of the higher volatility and potential randomness of the issue highlighted in the first bullet above.
- For longer-term investors less sensitive to short-term volatility, especially long-biased investors or financial advisers, we view the realization of the two highest attention, negative-sentiment topics to Apple's narrative at once as a *positive* for active positioning. While any decision should be subject to your own fundamental analysis of potential emerging issues of concern for the company (on which we have no view), barring any such concerns, the major narrative threats to the perception of the company are (for the time being) very much in the open and being discounted to some extent.

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