WILSONS

Dissecting the US Tech Sell-Off

Our weekly macroeconomic view.

14 September 2020

A Sign of a Bubble or a Healthy Correction?

Over the past week, we have witnessed a sharp pullback in the US tech sector.

The NASDAQ index corrected 10% over the course of one week. This is a small correction in the context of the rally with the index still 33% higher than 12 months ago. Is the sharp correction a sign of a bubble about to pop, or just a healthy correction within an uptrend?

As we foreshadowed 2 weeks ago, the tech sector was looking overheated with accelerating performance alongside narrowing market leadership – a warning sign that a correction was likely.

> Read our report on
> The Global Equities Revival.

Stepping back a little, we can point to strong fundamentals behind much of the outperformance of US tech over both recent quarters and recent years. Most fundamentally, tech earnings have been much stronger than the broader market when assessed on either a short-term (6 month) or long-term (3-5 year) view.

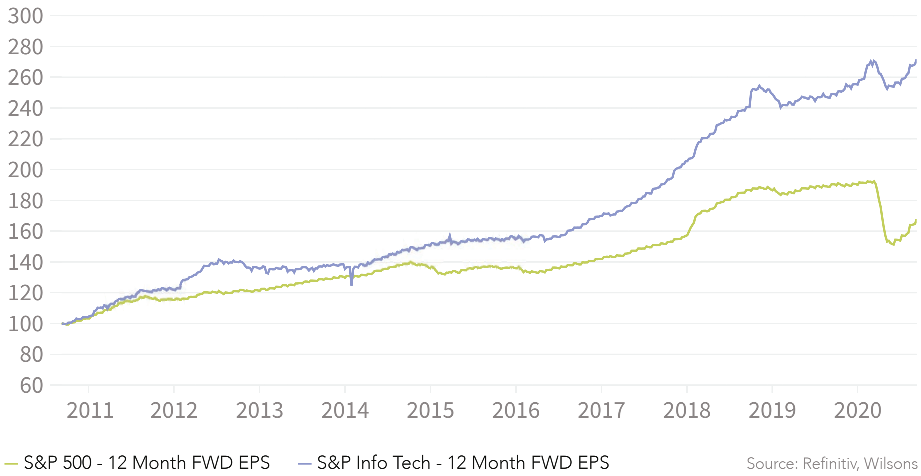
The market (helped by retail flows) may have become over-enthused in chasing the recent COVID-19 acceleration in tech earnings. The superior earnings performance of tech was, to a large extent, in place before the COVID-19 pandemic, as were the earnings struggles plaguing many traditional businesses in a highly competitive, low-growth world.

US mega-cap tech companies have built strong global market positions with powerful network effects. This is likely to give them a growth advantage over the next 5 years, or indeed longer, notwithstanding the possibility of a cyclical earnings bounce-back from sectors impacted by COVID-19.

Exhibit 1: The 6 big US tech stocks have rocketed - a correction is not surprising

Source: Refinitiv, Wilsons

Exhibit 2: US tech sector earnings versus S&P500 earnings



Source: Refinitiv, Wilsons

A Shift or a Pause in Market Leadership?

What is interesting about the large c35% correction in global equities earlier in the year is it didn't trigger a shift of market leadership as most bear markets do.

This could be because the correction was so brief and the circumstances so unique. The sell-off (once it bottomed out) actually intensified tech leadership because the sector proved to be relatively insulated from the economic shutdown with many tech companies proving to be substantial winners from the shift in consumer and business behaviours.

A leadership shift may come when the world begins to genuinely normalise. Structural trends have been front-loaded and normal behaviour disrupted, and it is likely old-world businesses will make a strong cyclical comeback, at least for a period. This may not lead to an aggressive sell-down in tech, but the sector may lag in a recovery rally. This does not necessarily mean the structural leadership of tech is over, but it may pause.

Exhibit 3: S&P Tech Sector 12 Month Forward PE Ratio

Source: Refinitiv, Wilsons

Valuation: No Bargain but No Bubble

The other consideration is that large-cap US tech multiples (on average) have risen but certainly not to the same extent as the year 2000 peak (see Exhibit 3), and not relative to the extensive decline in interest rates.

Stocks that can grow at a double-digit rate over multiple years are very valuable given the scarcity of growth globally and the very low level of long-term discount rates (see Exhibit 4). So we don't see a clear case that big cap US tech is overvalued, particularly post the recent pullback.

Exhibit 4: US mega-cap tech stocks

	Price	Mcap (US$b)	1 Year Fwd PE	EPS CAGR (FY16-19)	EPS CAGR (FY19-22)
Apple Inc	112.82	2,006.47	29.4	12%	13%
Microsoft Corp	202.66	1,598.97	30.2	20%	17%
Amazon.com Inc	3,149.84	1,637.21	76.3	63%	45%
Facebook Inc	271.16	779.78	28.1	16%	25%
Alphabet Inc	1,532.39	1,055.62	28.7	10%	14%
Tesla Inc	330.21	341.30	120.0	N/A	N/A

Structural Risks for US Tech

1

Lower forever?

A more significant structural threat could come from a considerable rise in interest rates. This would hit the long duration cash flows of tech harder than shorter duration cash flows of traditional businesses. While a risk, we think a very significant shift in rates is a long way off – it may take several years to generate inflation and to see central banks lose their resolve to keep rates anchored. However, we can see the potential for pressure on both inflation and real interest rates on a 3-5 year view. There is no guarantee rates will lift substantially with many structural headwinds for both growth and inflation, though the eventual interest rate implications of ultra-easy monetary policy and massive debt issuance make it worth contemplating.

> Read our report on the US Fed's Experimental Policy, Inflation Risk and Investment Markets.

2

Geopolitics and regulation

The underlying bull case for US mega-cap tech is centered on the fact that these businesses have established dominant global market positions (monopolies in some cases), which may attract the attention of governments/ regulators both inside and outside the US. The US has a history of breaking up powerful monopolies, national governments will undoubtedly be seeking to collect more tax revenue across the globe, and China increasingly has its own national champions to preference, making this another potential structural risk worth monitoring.

Correction not a Pop

We think the pullback in US tech is likely to be a bull market correction rather than a bubble pop. We are a long way from seeing central banks tightening policy, and we think the near-term risk of a substantial shift in either policy rates or bond rates is low. Valuations generally do not look outrageous versus proven track records or expectations. While a rotation to recovery trade stocks over the coming year is certainly worth contemplating from a portfolio positioning perspective, it may not be an indication that secular dominance of US tech is over.

Disclaimer and disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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Source: Refinitiv, Wilsons