Current Market News - Equity Research

Technology stock update: Still winning at mid-year, but are risks rising?

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The arrival of COVID-19 caused a significant economic shift compared to the beginning of the year which featured generally positive investor expectations regarding the economy and stock market along with talk of animal spirits reviving. Global PMIs were bottoming and the outlook for 2020 was improving. The COVID-19 pandemic resulted in global lockdowns which had a devastating economic impact.

One thing that didn't change was the continued outperformance for the Information Technology (IT) sector which outpaced the S&P 500 by almost 5% for the month of June and by wider margins for the quarter and year to date. Relative to other sectors, IT is benefitting from the work-from-home environment and the acceleration of trends such as cloud computing and digital transformation which were already in place.

If you add in the giant internet players, "Big Tech" as represented by the "FAAMG" stocks (a derivative of "FANG" consisting of Facebook, Apple, Amazon, Microsoft and Google—now the five largest constituents of the S&P 500) has been driving an outsized portion of the market's return over the past several years ***(see Chart 1)***. During the February – March bear market their stock prices held up better than the broader S&P 500 which is unusual since tech stocks haven't historically been considered defensive, but it reflects the outsized influence these companies now hold in the economy.

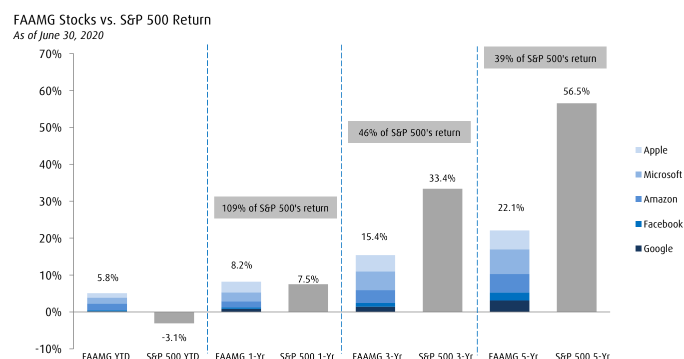
After the recent run, tech stocks are on the expensive side relative to their historical norms. That's especially true of the mid-cap software names that have been in hypergrowth mode and generating interest from momentum traders--both institutional investors and a new crop of millennials day-trading on Robinhood. A basket of software-as-a-service names was recently trading at 13x estimated EV / Sales versus an average of 10x over the past year and 7x at the bear-market bottom in March. Some of the COVID-19 winners such as DocuSign and Zoom Video with high valuations represent a risk but expectations don't seem as unrealistic as was the case during the 2000 internet bubble.

One thing that has changed is that the business models for the big tech companies are evolving. They are no longer driven by new products (Apple might be the exception) as much as in the past. As described by Marshall Van Alstyne, a professor at Boston University who is an expert on the digital economy, they have become giant "multi-sided platforms" which benefit from powerful network effects that can result in "winner-take-all" outcomes. The platforms become more valuable as the number of users increases. In the case of Google and Facebook, the more consumers they attract, the more advertisers are willing to pay for online ads. For Amazon and Microsoft, their sheer scale, technology leadership in important new areas (e.g. cloud computing, artificial intelligence) and growing end-user reliance create tremendous advantages for continued expansion.

As these companies have become more powerful, efforts to rein them in have been growing. European regulators have already slapped multi-billion-dollar fines on Google and Facebook, and a number of countries in Europe (and elsewhere) are planning to enact a "digital tax" on tech company revenues (not profits) that will primarily be a hit to these U.S. digital behemoths. In the U.S., politicians on both sides of the aisle have stepped up their attacks (for different reasons) and anti-trust investigations have been launched at both the federal and state level. Given their massive cash balances, the Tech titans have the wherewithal to pay the fines that are levied against them and efforts to break them up will not be easy or create obvious benefits for consumers. However, there is near-term headline risk and long-term regulatory risks are certainly greater than before.

Despite these concerns, we expect that large cap tech will remain favorably positioned going forward. Our recommendation of a generally balanced approach leans toward U.S. large caps based in part on the expectation that the trends driving "Big tech" will persist.

Chart 1: The FAAMG stocks have contributed at least 40% of the S&P 500's return



Source: Factset, BMO Wealth Management, FAAMG is an acronym used to describe a group of stocks made up of Facebook, Amazon, Apple, Microsoft and Google (Alphabet). Both share classes of Alphabet stock are included. **Past Performance is not a guarantee of future results, investment cannot be made in an Index.**

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