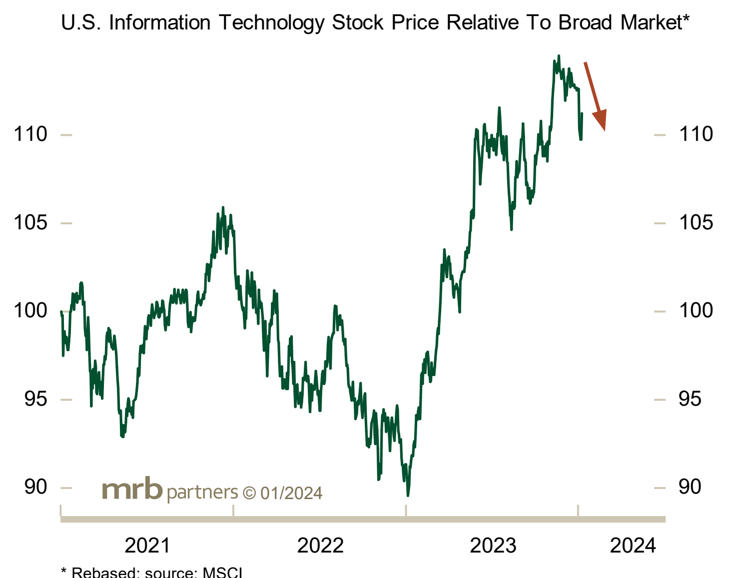
January 10, 2024

U.S. Technology Stocks: Facing More Than Just Rotational Headwinds

- The U.S. technology sector will have to deliver strong earnings in 2024 and beyond to validate the past year's run-up in its share price.
- While the absolute and relative earnings of tech companies should improve this year, consensus forecasts for near- and long-term earnings growth are already very elevated.
- Meeting or exceeding lofty earnings expectations could prove challenging for the tech sector given the bifurcated outlook across semiconductor end-markets and muted tech capex intentions.
- Moreover, any increase in A.I.-related investments in the year ahead will likely crowd out other IT spending given the cautious attitudes of enterprises.
- Given the high bar for positive earnings surprises and valuations that are stretched to the upside, the risk-reward trade-off for tech stocks is unappealing. Accordingly, we remain underweight the sector.

U.S. technology stocks led big gains in the equity market for most of 2023. However, the sector has lagged since late-November as the disinflationary trend in CPI and the Fed's pivot to an easing bias have increased confidence in the durability of the economic expansion (**chart 1**). Optimism about a soft landing has led to a shift in equity market leadership away from richly valued mega-cap growth stocks towards less expensive cyclical and defensive sectors that have a greater sensitivity to interest rate cuts. We expect this rotation to persist in the coming months. Elevated earnings expectations and valuations pose additional downside risks for the relative performance of tech stocks.

Chart 1 Tech Stocks Have Lagged In Recent Months



* Rebased; source: MSCI

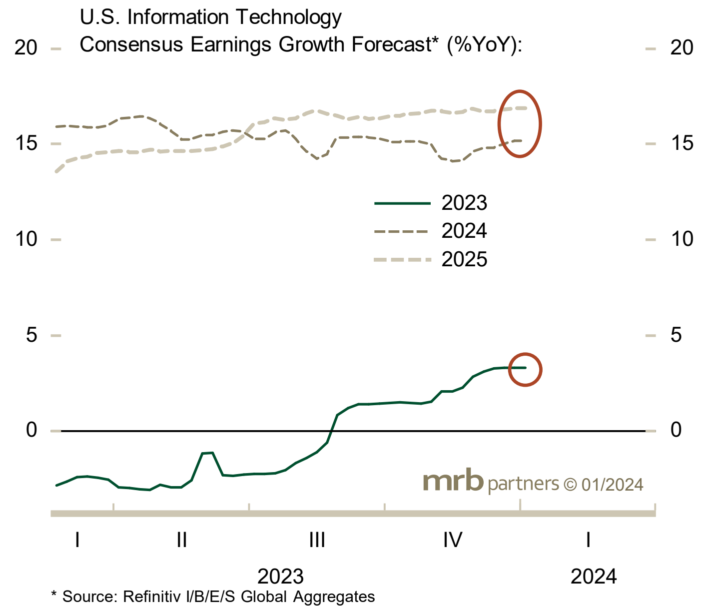
As a result, we remain underweight the sector, preferring cyclicals that have been priced for bad economic outcomes (financials and energy), as well as oversold defensives with growth characteristics (health care)[1].

[1] MRB ***2024 U.S. Sector Outlook***: "*Laggards Will Get The Limelight*", December 19, 2023

The Bar For Positive Earnings Surprises Is Very High

One of the biggest challenges facing tech stocks in 2024 will be living up to the lofty earnings growth expectations that have built up as a result of the optimism surrounding A.I. Last year's huge rally in the sector was mostly driven by multiple expansion. Underlying earnings and revenue growth were lackluster. This year, tech companies will have to deliver much better financial performance to avoid profit-taking in their shares. The tech sector will also need to show tangible evidence of A.I. monetization, with the benefits broadening beyond a small handful of companies such as NVIDIA and Microsoft.

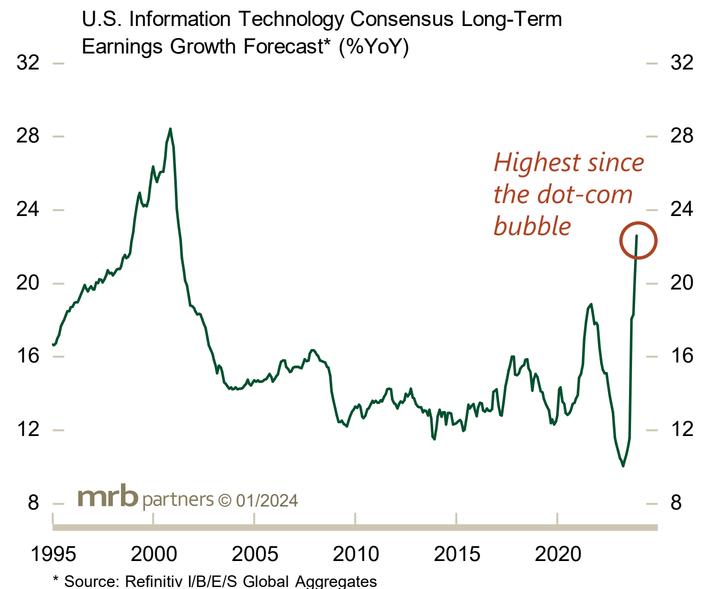
Chart 2 Tech Earnings Growth Is Expected To Markedly Increase In The Next Two Years



* Source: Refinitiv I/B/E/S Global Aggregates

Expectations are very high, implying that the bar for positive surprises has been substantially raised. According to data from Refinitiv I/B/E/S, analysts are forecasting that the tech sector will generate earnings growth of 15% and 17% in 2024 and 2025, respectively (**chart 2**). Furthermore, consensus expectations for long-term earnings growth have surged since mid-2023, led by the semiconductor sub-group where profit estimates have soared for companies such as NVIDIA. Analysts are projecting earnings growth of more than 20% per annum for the broader tech sector over the next 5 years (**chart 3**). Long-term earnings growth forecasts for tech companies have only been higher during the dot-com bubble years in the late-1990s/early-2000s, when they ultimately proved to be overly optimistic despite the revolutionary nature of the internet. The result was a prolonged period of underperformance for tech stocks. The earnings level of the tech sector is much higher today such that growing as rapidly as in the late-1990s will be more difficult.

Chart 3 Expectations For Long-Term Earnings Growth Have Soared

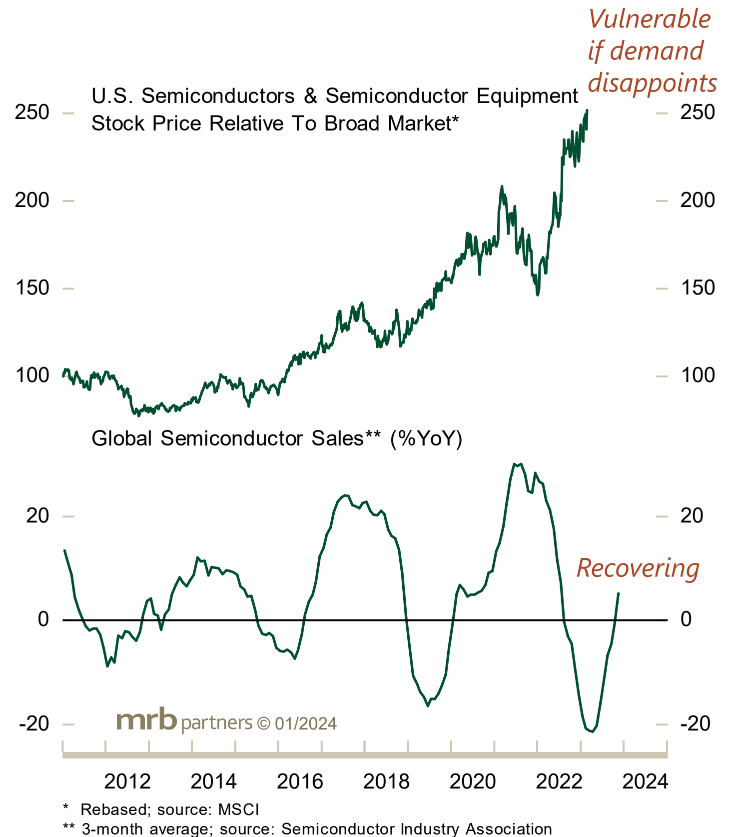


* Source: Refinitiv I/B/E/S Global Aggregates

To be clear, we expect the earnings growth of the broad tech sector to improve in 2024 as global semiconductor sales recover, the PC market exits its post-COVID

hangover, and tailwinds from digital transformation persist. Parts of the sector should also benefit from positive operating leverage as revenues pick up due to cost-cutting in the past year. However, in order for tech stocks to deliver the type of earnings growth projected by the Wall Street consensus, two outcomes must materialize, neither of which is assured:

Chart 4 Chip Stocks Have Already Discounted A Material Rebound In Semiconductor Sales



* Rebased; source: MSCI
** 3-month average; source: Semiconductor Industry Association

1) Global semiconductor sales will have to validate the strong upswing in demand that has been anticipated by chip stocks (**chart 4**). The conditions for such an outcome are not in place. While demand for processing units to support A.I. workloads is very strong and will remain robust, thus benefiting the likes of NVIDIA and a small handful of other chip companies, the outlook across other semiconductor end-markets is bifurcated. End-markets where inventory corrections are well advanced such as PCs and smartphones should see a rebound in revenue growth in the year ahead. However, those which have been more resilient, such as industrial and automotive, have started to stumble of late, and are likely to face further de-stocking headwinds before troughing.

Given the asynchronous nature of the semiconductor cycle some skepticism about the achievability of the high earnings growth expected for the semiconductor sub-group is warranted. It is also important to recognize that there has been considerable guesswork that has gone into anticipating how A.I. will impact the chip industry and at some point down the road the sales of NVIDIA are bound to hit an air pocket when demand for its processing units inevitably moderates.

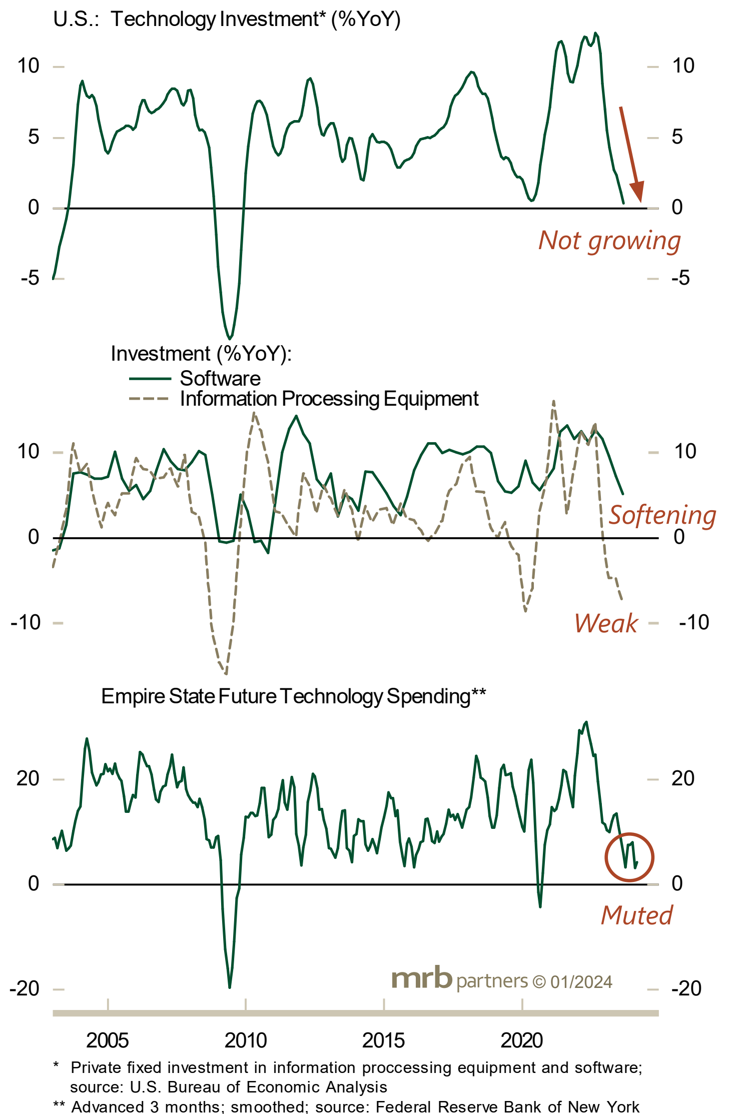
Tech capex intentions are muted and not pointing to an imminent rebound in IT spending

2) Business investment in technology will have to significantly accelerate from its pace of flat annual growth in Q3 2023, the last period for which data is available (**chart 5**). The hope is that A.I. will unleash a flurry of spending for software and tech hardware equipment, but so far, there is no evidence that this is occurring. Moreover, tech capex intentions are muted and not pointing to an imminent rebound in IT spending. If anything, enterprises have been keeping a tight rein on IT budgets, reflecting uncertainties about the economic outlook amid higher interest rates.

Tech spending should see some improvement if corporate confidence in a soft landing continues to build, but policy uncertainty ahead of the U.S. presidential elections

could still keep IT budgets from materially expanding. While A.I. adoption is expected to grow, it is likely to remain largely experimental in the year ahead given the still limited use cases for the technology. As such, it is probably premature to expect A.I. to provide a big lift to tech spending. Moreover, given the high upfront costs involved in building and training large language models, any A.I.-related increases in IT spending will likely crowd out other tech investments, thus reducing the net benefit to overall tech capex.

Chart 5 Tech Capex Growth Has Been Soggy



* Private fixed investment in information proccessing equipment and software; source: U.S. Bureau of Economic Analysis
** Advanced 3 months; smoothed; source: Federal Reserve Bank of New York

The bottom line is that there are enough uncertainties about the breadth of the semiconductor recovery and the strength of the overall tech spending outlook to be circumspect about the tech sector's ability to measure up to very optimistic consensus earnings forecasts.

Valuations Provide No Margin Of Safety

High valuations add to our caution towards tech stocks and underscore the importance of earnings follow-through in driving the sector's future performance. The aggregate tech sector trades at a forward P/E ratio of 27 or a hefty 35% premium to the broad equity market (**chart 6**). The valuation premium has nearly doubled in the past year and is larger than at the end of 2021 following the pandemic-driven surge in tech spending. Tech stocks are also expensive based on other valuation metrics. For example, the sector's forward price/sales (P/S) ratio of 6.3 has increased significantly from 4.7 at the beginning of 2023. The premium based on the P/S ratio is at a 20-year high and has materially expanded since the period immediately preceding the pandemic, highlighting that expectations for future sales growth are extremely high.

The valuation premium of the tech sector has nearly doubled in the past year

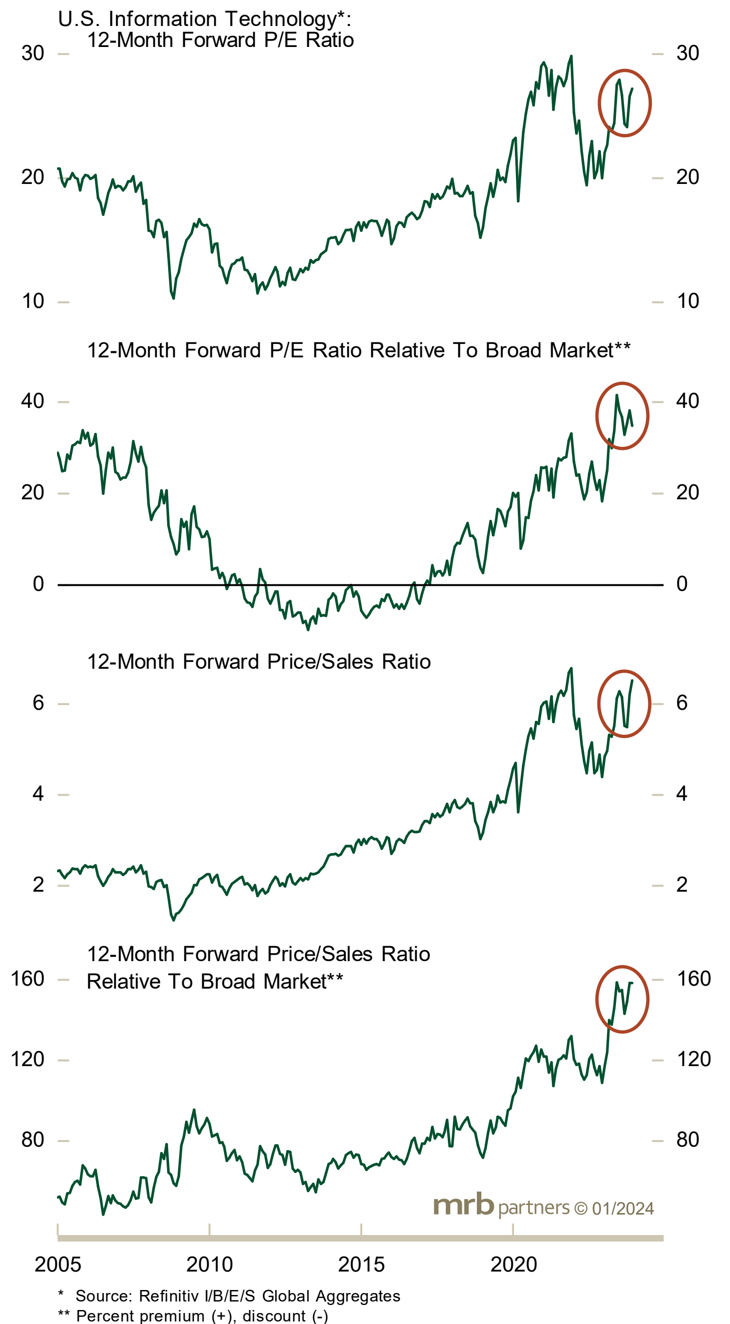
Elevated valuations imply limited room for multiple expansion, while providing little cushion against adverse developments or earnings disappointments. They also leave tech stocks vulnerable to de-rating pressures if expectations for aggressive Fed rate cuts are unwound in 2024, as we anticipate will occur.

Final Word: *U.S. technology shares saw huge gains in 2023, driven mostly by multiple expansion on the back of excitement over A.I. As a result, the sector will have to deliver strong earnings in 2024 and beyond to validate the past year's run-up in its share price. While the absolute and relative earnings of tech companies should improve this year, consensus forecasts for near- and long-term profit growth are already very elevated, and meeting or exceeding these lofty expectations could prove challenging for a couple of reasons. First, the recovery in the semiconductor sales cycle is likely to unfold in an asynchronous manner across end-markets. Second, sluggish growth in tech capex shows no signs of an imminent upturn and any increase in A.I.-related investments in the year ahead is likely to crowd out other IT spending given the cautious attitudes of enterprises.*

Given the high bar for positive earnings surprises and valuations that are stretched to the upside, we view the risk-reward trade-off in tech stocks as unfavorable, and accordingly remain underweight the sector.

Salvatore Ruscitti
Strategist, U.S. Equities

Chart 6 Tech Stocks Are Priced For Perfection



Please see the following page for a full summary of our U.S. sector and industry sub-group recommendations.

MRB U.S. Equity Sector And Industry Sub-Group Recommendations

Sector	– N +	Industry Ratings* Underweight	Neutral	Overweight
Consumer Discretionary	–	Automobiles Consumer Discretionary Retail Household Durables	Auto Components Hotels, Restaurants & Leisure Textile, Apparel & Luxury Goods	
Communication Services	N		Media & Entertainment Telecom Services	
Consumer Staples	N	Tobacco	Consumer Staples Retail Food Products Household & Personal Products	Beverages
Energy	+			Energy Equipment & Services Oil, Gas & Consumable Fuels
Financials	+		Capital Markets Consumer Finance Financial Services Insurance	Banks
Health Care	+		Health Care Providers & Services	Biotechnology Health Care Equipment & Supplies Pharmaceuticals
Industrials	N	Machinery	Electrical Equipment Ground Transportation Industrial Conglomerates	Aerospace & Defense Air Freight & Logistics
Information Technology	–	IT Services Semiconductor & Semi Equipment Technology Hardware & Equipment	Software	
Materials	N		Chemicals Metals & Mining	
Real Estate	N		Real Estate	
Utilities	N		Utilities	

* 6-12 month horizon; relative to the U.S. equity benchmark
Note: + = overweight, N = neutral, – = underweight

mrb partners © 01/2024

MacroResearchBoard

mrb partners

Independent Investment Strategy

MRB - Macro Research Board is an independent top-down research firm that provides integrated, global, multi-asset investment strategy as well as actionable absolute and relative return ideas. Our views incorporate a long-term outlook based on in-depth thematic research, together with a rigorous set of frameworks and forecasting models/indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to form one cohesive house view and ensure that investment strategy is articulated in a client-friendly manner.

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

MRB Research Coverage

- Weekly Macro Strategy
- Global Macro & Investment Themes
- Global Asset Allocation
- Absolute Return Strategy
- U.S. & Developed Market Strategy
- China & Emerging Market Strategy
- Regional Equity Strategy
- U.S. Equity Sectors Strategy
- Global Fixed Income Strategy
- Foreign Exchange Strategy
- Commodity Strategy
- Webcasts & Live Events

Copyright 2023©, MRB Partners Inc. All rights reserved.

The information, recommendations and other materials presented in this document are provided for information purposes only and should not be considered as an offer or solicitation to sell or buy securities or other financial instruments or products, nor to constitute any advice or recommendation with respect to such securities or financial instruments or products. This document is produced for general circulation and as such represents the general views of MRB Partners Inc., and does not constitute recommendations or advice for any specific person or entity receiving it.

This document is the property of MRB Partners Inc. and should not be circulated without the express authorization of MRB Partners Inc. Any use of graphs, text or other material from this report by the recipient must acknowledge MRB Partners Inc. as the source and requires advance authorization.

MRB Partners Inc. relies on a variety of data providers for economic and financial market information. The data used in this report are judged to be reliable, but MRB Partners Inc. cannot be held accountable for the accuracy of data used herein.