Tech stocks: Boom or bubble?

Andy Budden, Investment Director of Capital Group, believes that despite elevated prices and the return of market volatility, tech stocks still hold value. This time round, he said, it is no dotcom bubble as companies of the 'knowledge economy' have become global leaders.

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BUDDEN FIRST HIGHLIGHTED the animated discussion about the future of the global economy during 2017 that failed to adequately recognise what he termed the tremendous synchronised strength that has emerged in the global economy.

He said that the strengths were somewhat cloaked by discussion around whether or not the US economy is going to turn less positive at some stage and there was clearly considerable anxiety over market valuations, of US stocks in particular.

"As we then turned to 2018," he noted, "that has come home to roost with a meaningful correction, and there appears expectation that this is going to be the pattern that we will see as we move through 2018 and beyond." In particular, he said, this inevitably focuses attention on the technology stocks, which have had a tremendous run, and which continue to draw a lot of attention with their results and their valuations.

ANDY BUDDEN
Capital Group

Global growth, global returns

The backdrop, Budden explained, is tremendously strong investment results around the globe, but most particularly from the US. He highlighted the S&P 500's performance over 18 months, up 44% from late June 2016 to January 26 and then down 8% from then until February 5.

He noted that had he shown the indices since the pits of the global financial crisis it would show markets up about 300% in the past decade and as he said, "pretty much a straight line".

He explained that since the February 5 levels markets had recovered solidly. "There is expectation that this is going to be a pattern that we see more of this year, and then over the next few years," he reported. "Why? Anxiety over valuations is going to remain and there will be continued anxiety about the US economy. And certainly, anxieties about inflation are starting to emerge."

The end of tech volatility?

He also noted that volatility would normally be led by tech stocks, as was the case in 1999-2002 and again during the GFC. But that has not yet happened during this phase of the markets during the past decade since the GFC.

The lack of volatility in general and of the tech stocks in particular has been predicated by strong macro factors, including the widespread central bank sponsored QE.

"The result is that tech sector volatility has more closely mirrored low volatility sectors such as consumer staples and utilities," he explained.

"Investors have struggled to understand exactly what this means. Does it mean euphoric optimism around the tech stocks? Is it complacency? Is it valuations getting really out of control? Or is it actually some form of tech bubble?"

He then analysed the reasons for this low volatility. He explained that no longer is technology dramatically disconnected from the underlying fundamentals of profit.

Profits booming, cash growing

"What we have seen over the last decade is the emergence of a very different pattern where tech is taking a growing share of profits with the overall market, but that is completely in line with the proportion of market capitalisation, demonstrating that while the valuations may have gone up in technology those are not disproportionate when considered alongside profitability."

He also highlighted the large volumes of cash on tech companies' balance sheets. In the dot-com era investors were bidding up stocks of many companies that were not real businesses but nowadays the tech sector generally has strong balance sheets with plenty of cash.

"Stronger balance sheets of the tech companies are testament to the underlying strength of their business models," he concluded.

A new world of tech supremacy

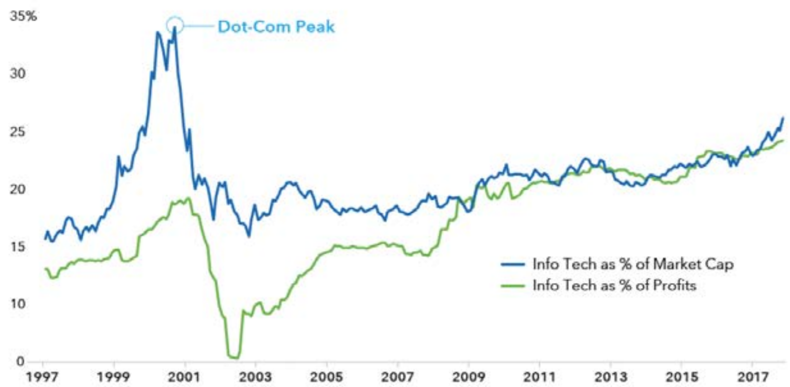
He then referred to leading tech giants such as Apple, Amazon, Alphabet and Facebook, noting that in the past five years net income is up around 64% and sales have more than doubled.

"Tech businesses that have withstood tough competition may be better positioned over the longer term," he stated. "Despite the fact that these companies have to invest so much in improving their technology, and capabilities, a lot of that revenue worth has fallen straight through to the bottom line. Balance sheets are strong, sales growth is strong. Business models are real."

Budden closed by highlighting that eight of the world's top ten companies by market valuation are idea-driven innovators, whereas in 1997 the only tech companies represented were Microsoft and NTT. And six of today's top 10 were not even in the top 10 in 2007. ■

Valuations vs. fundamentals

Unlike the dot-com bubble, profits of tech companies are now in sync with prices



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Past results are not a guarantee of future results.
Sources: FactSet, Standard & Poor's, as of 31 October 2017.