



14 November 2022

## Weekly Market Analysis: Too Soon to Pivot to Tech

### 3 Things to Know

#### A brutal year for tech investors

The five largest US tech giants have lost over \$3 trillion in market cap since the start of the year. A less aggressive Fed path ultimately benefit technology shares. But the US central bank is far from making a true policy pivot.

#### Cost cuts ramp up

Tech employment and investment growth in 2021 reached its highest levels since the late 1990s. But since late October when most tech firms began to report 3Q profits, the sentiment across the tech landscape shifted toward “hunkering down.”

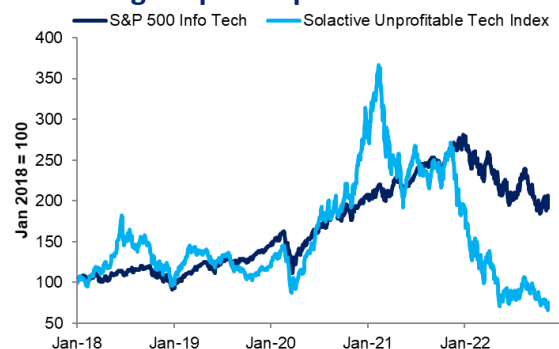
#### Tech valuations have normalized

From a tactical viewpoint, CIO is hesitant to chase sharp moves higher in technology shares until the extent of impending economic weakness becomes clearer. A challenging earnings backdrop is likely to initially offset some modest re-rating toward higher PE tech multiples in 2023.

### Summary

With bearish sentiment at highs, the better-than-expected October headline inflation number caused a huge, highly correlated move higher for all risk assets, one that may extend for a time. While current tech valuations reflect new, higher capital costs and more conservative growth estimates, immediate increases in profits and dividends are unlikely. After this third-quarter US reporting season, it’s clear that tech won’t be immune to economic weakness like it was during the 2020 COVID recession. This does nothing to dissuade CIO from a bullish view on key tech developments for the longer term. The Fed is likely to maintain higher rates until unemployment rises, further adding pressure to tech shares in the coming six months. Until such time as CIO sees a recession unfold and can ascertain its breadth and depth, enthusiasts may get burned. Citi continues to prefer quality tech names with less economic sensitivity.

#### Large cap vs unprofitable tech



Haver Analytics as of Nov. 10, 2022. Past performance is no guarantee of future results. Real Results will vary.

### Portfolio Considerations

CIO continues to prefer a focus on quality names with less economic sensitivity, which in practice means a continued bias toward profitable tech over unprofitable moonshots.

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## A brutal year for tech investors

Tech investors have endured a rough year, even after last Thursday's 8% rally. The five largest US giants have lost over \$3 trillion in market cap since the start of the year. The S&P 100 IT sector has dropped 25% year-to-date, while the Nasdaq is down 28%. A less aggressive Fed path could ultimately benefit technology shares. But the US central bank is far from making a true policy pivot, even though this week's CPI report suggested that inflation was abating in some sectors. In the meantime, slowing economic growth is unlikely to spare these large platforms. Though fintech and ecommerce firms operate with a smaller physical footprint and less capital than banks and big-box retailers, they are likely to see slowing sales in the coming quarters as discretionary consumer spending fades. And for other tech segments, the likely deferment of capital expenditures by some firms could pressure bottom lines. Technology shares benefited from the pandemic environment. With the cost of cash nearly "zero," the ability to "spend to grow revenues" and to take risk for big future payouts was enabled. Now the opposite is true. Risk appetite has faded, and the certainty of growing cash flows is valued.

## Cost cuts ramp up

Tech employment and investment growth in 2021 reached its highest levels since the late 1990s. But since late October when most tech firms began to report third-quarter profits, the sentiment across the tech landscape shifted toward "hunkering down." Dozens of major firms have announced hiring freezes or outright layoffs in recent weeks to preserve free cash flow, maintain margins and appease investors amid an uncertain profits outlook. Management teams also promised cuts to capital expenditures during earnings calls. Initial cost-cutting announcements have in some cases been cheered by markets, as a focus on slimming down operations is probably warranted after a binge in post-pandemic spending. If previous downturns are any guide, outright declines in technology employment and investment next year could materialize, which could have ripple effects on global tech supply chains.

## Tech valuations have normalized

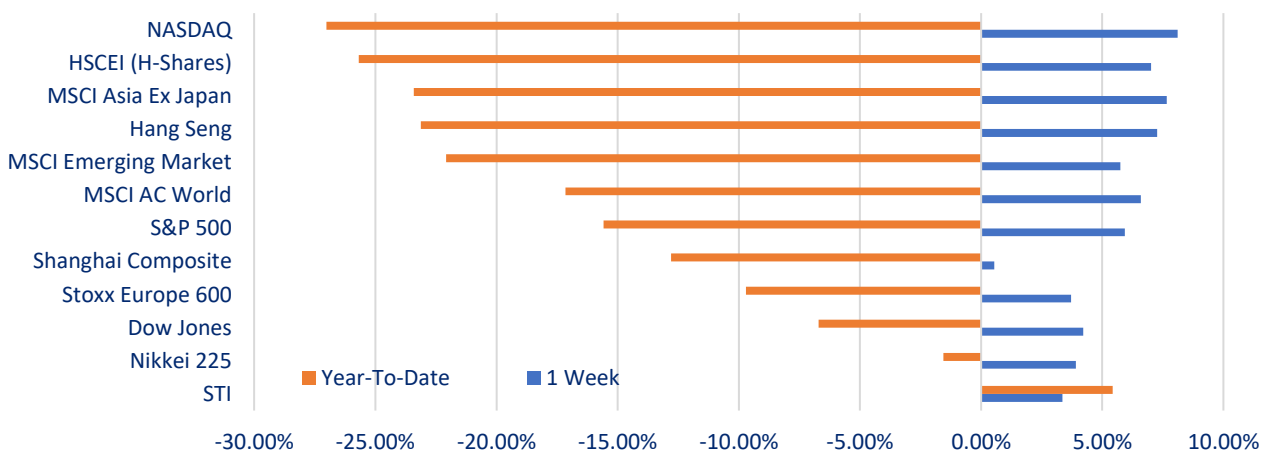
The carnage in the broad technology space this year reflects where we started 2022. Just a year ago, valuations for the US information technology sector were trading at their most expensive levels since the dot-com bubble. Multiples that were acceptable when interest rates were low have had to re-adjust to a sharply rising cost of capital and a rapid shift in preference among investors for near-term cash flows. CIO now sees tech valuations that are much closer to longer-run averages. While we expect interest rates to fall later in 2023, a challenging earnings backdrop is likely to initially offset some modest re-rating toward higher PE tech multiples in 2023.

## Portfolio considerations

CIO continues to focus on quality names with less economic sensitivity. What this means in practice is a continued bias toward profitable tech over unprofitable moonshots. At the sector level, CIO sees software – and especially cyber security – as likely more defensive once rates peak. This is because earnings are less levered to the business cycle than hardware and semiconductors. Differentiation between leaders and laggards could become clearer over the next six months. Those companies able to maintain margins and achieve lofty growth goals could see shareholders rewarded. CIO also expects a re-rating of tech later in 2023 allowing for higher PE ratios when the end of the economic downturn is in sight.

**Note: Past performance is no guarantee of future results. Real results may vary.**

## Market Performance



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