MARKET *view*

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On your marks

"The question now, is whether we are facing a long cycle of underperformance or whether tech stocks are becoming attractive again"

2022 : TECH'S ANNU HORRIBILIS

-39.8% for the IGV (US Software sector ETF), -39.2% for the SOX (Philadelphia Semiconductor Index), -42.4 % for the Hong Kong Tech Index.

2022 can already be described as an annus horribilis for the global tech sector, after several years of relentless performance.

Each segment of the industry has gone through a long and throbbing downward phase in 2022 that ended in violent retreat. First, Chinese technology stocks. Then, Semiconductors followed by GAFAM. And finally, the Software segment which collapsed on the 4th of November 2022.

This historic decline is part of a broader sector rotation movement. Flows are moving out of tech (and in particular GAFAM) into two types of sectors:

- Cyclicals (Energy, Financials and Industrials)
- Defensive: sectors with relatively stable earnings expectations during a recession (Pharmaceuticals and Food)

The question now, is whether we are facing a long cycle of underperformance or whether tech stocks are becoming attractive again.

We see reasons to be more constructive from now on:

1. The segments that capitulated first (Chinese tech and Semiconductors) are rebounding
2. Some semiconductor companies have already revised their forecasts three times and are now presenting a more de-risked level of expectations
3. Valuations have returned to attractive levels for long-term investors. For example, it is not uncommon to find companies with double-digit growth rates along with valuations close to those of the Telecoms sector
4. The sector's fundamentals remain excellent and there are no leading indicators that the semiconductor super-cycle is about to turn around

In the long-term, tech stocks remain attractive. The main question is about when we should reposition.

To answer that, several prior questions need to be addressed first.

➢ **How high will US interest rates go?**

The Fed is adapting its strategy by reducing the magnitude of future rate hikes while remaining adamant to raise the terminal rate ever higher. It is therefore data-dependant, including on how the labour market will perform a key parameter to avoid a price-wage spiral.

However, we believe a pivot of the Fed has begun and that most of the monetary tightening is behind us. The Fed will want to measure the impact of its monetary policy on the economy and is rightly concerned about a possible dip in the housing market. The rise in short rates is certainly not over, but the rise in long-term rates may well be...

Our scenario: stabilisation of long-term rates

- **Should we expect further downward revisions to the 2023 earnings?**

We think so because analysts' forecasts lag during recessions and some companies tend to model in their guidance only the level of deterioration already experienced (and not the one yet to come).

Our scenario: a decline in EPS at this point in the cycle

- **Is further multiple compression to be expected?**

We do not think so. On the contrary, future disappointments will be offset by an expansion of valuation multiples; this is what previous crises exits have shown, especially if rates stabilise and even more so if they fall.

Our scenario: No multiple compression with stable rates and normalisation of the supply shock

- **Have we witnessed the beginning of the end of GAFAM (Google, Amazon, Facebook, Apple and Microsoft)?**

The index market cap weight of these 5 companies is so large (around 25% of the S&P) that an "idiosyncratic" analysis of these stocks must be carried out. The history of the tech sector is made up of the rise and fall of big names that end up being disrupted and replaced by new generation, more innovative players. The considerable loss of value of these five stocks in October and November could lead us down this path. Yet, we will not be drawing such a conclusion.

We remain very constructive on Microsoft for its ability to grow sustainably on key segments such as Teams, Cybersecurity, or the Power Platform. We also remain positive on Google for the resilience of its core business and its investments in AI (Waymo, Calico, Verily). This is less the case for other companies whose EPS outlooks have recently been divided by 4, with the outlook for advertising revenues in particular revised downwards. Apple's Smartphone segment is also turning negative and will impact the valuation of the stock, according to our analysis.

Our scenario: a natural selection will happen and break the “GAFAM” theme

- **Can we expect the US-China tech war to ease?**

We do not think so. The interests around artificial intelligence, the interweaving of supply chains in semiconductors and hardware, and therefore Taiwan, are too antagonistic to hope for a halt or a slowdown in the pace of restrictions.

Our scenario: a status quo would be the most optimistic scenario

- **Should we expect other tech areas to break down as well?**

Infrastructure software such as ERP (SAP, Oracle, Workday) is clearly at risk if the recession intensifies, as is a larger share of semiconductors that service the manufacturing sector.

Our scenario: in this context, we recommend favouring sectors that have already collapsed

In conclusion, which catalysts will fuel a recovery in the sector?

1. A pause in rate hikes
2. An end to earnings downgrades (some segments are even recovering six to nine months before the earnings low)
3. The resumption of the M&A cycle
4. The arrival of opportunistic and activist investors in undervalued stocks

If these criteria were met (we are getting close), we would focus first on emerging market technology, then on semiconductors, and finally on software. In other words, the end of China's zero-covid policy could be the catalyst for a shift to “risk-on” mode in the portfolio, which would undoubtedly benefit the technology sector. On your marks...

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