Mega Cap Tech as Safe Haven?

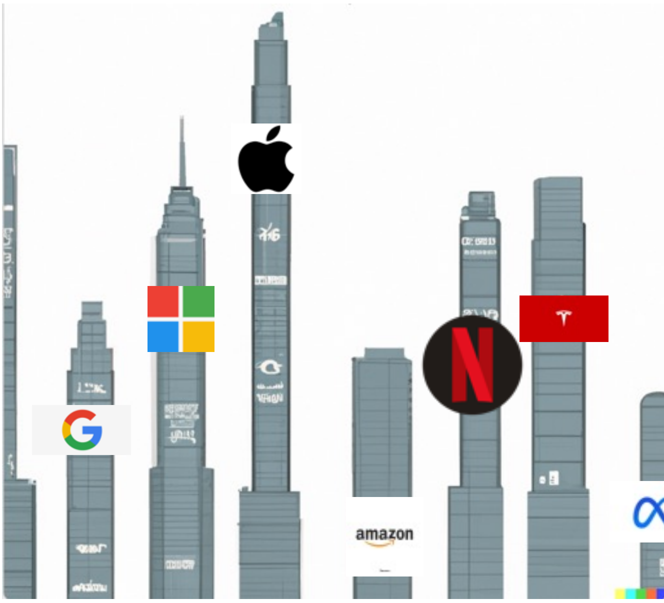

Image: Dall-e

Mega Start to 2023 for Large Techs

At the start of 2023, the advance of equity markets was primarily driven by the largest US tech stocks (see chart 1): MAMATAN, or Microsoft, Apple, Meta, Alphabet, Tesla, Amazon and Netflix. After the miserable year 2022, in which all of them lost more than the market - some of them even more than 50 % - the question arises, is the recent move more than a bounce back from lower levels?

The outperformance of those technology stocks – including Tesla and Netflix in this group – accelerated after the mid-March banking crisis. Technology earnings were seen supported by easy cost-cutting following years of partially reckless expansion. Investors considered tech stocks safe as their healthy balance sheets enabled large buybacks. As recession fears blew through markets, investors fled to MAMATAN.

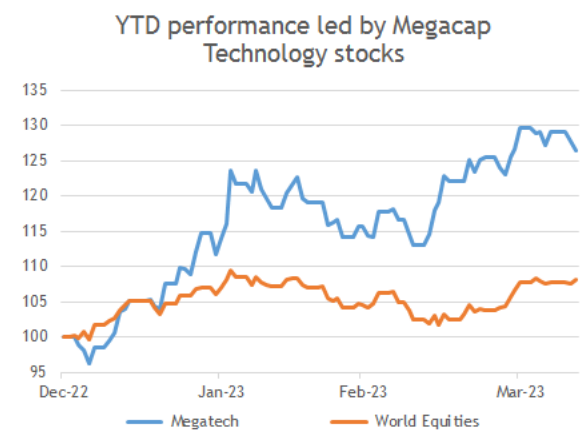

Chart 1:
Mega cap tech the place to be so far in 2023. Megatech as defined in the text by the acronym MAMATAN.

Source: Bloomberg

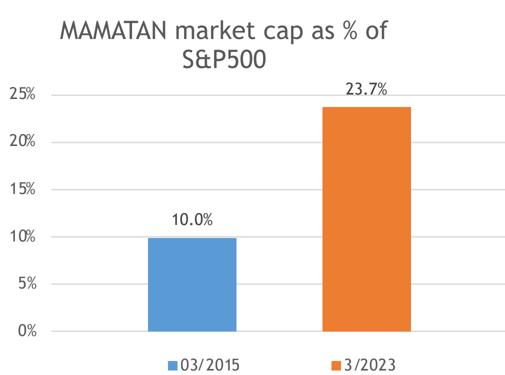

Chart 2: Mega cap tech a quarter of S&P 500.
Source: Bloomberg

Large influence on indices

With rising prices for many mega tech companies, their proportion in equity indices has been growing over the years. For the US, this proportion has surpassed 23 %, and for global markets, 14 %. This calculation does not even include Nvidia, Salesforce, AMD and Broadcom, four companies that have surpassed the smallest MAMATAN member, Netflix, in terms of market cap. Adding those four would bring the numbers to 27 % (versus S&P 500) and 16 % (versus MSCI World), respectively. It is time to rewrite the MAMATAN acronym !

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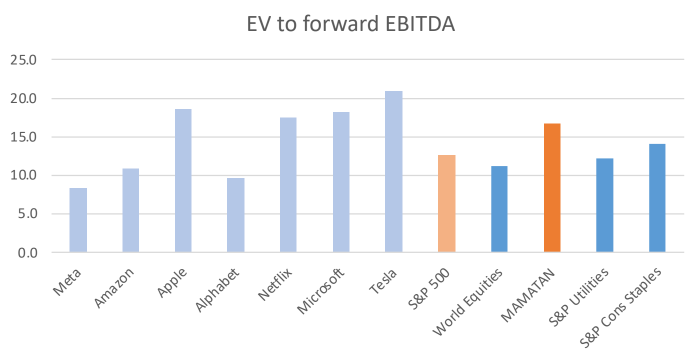
Chart 3: Mega cap tech not cheap with some exceptions.
Source: Bloomberg



Not a cheap safe haven - on average

Analysing the valuations against other traditional safe havens such as utilities or consumer staples, we must conclude that the average mega tech stock is expensive. However, Alphabet, Amazon, and Meta are trading well below the market level as investors doubt the business model for two of these names, and Amazon is seen as recession-exposed.

Earnings growth in mega cap tech has been outstanding

So far, we have yet to look at growth rates in our valuation analysis. Chart 4 details earnings per share growth rates for MAMATAN versus world equities for the past and the current market forecasts (note that the market includes those stocks, hence market ex large-cap tech earnings growth is even lower than indicated; the usage of EPS also provides for the effect of share buybacks).

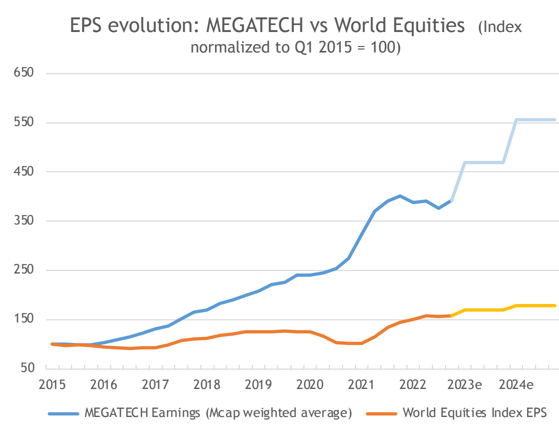


Chart 4:
Earnings growth for MAMATAN is exceptional. 2023 + 2024 are annual market forecasts.

Source:
Bloomberg

After a 2022 pause, MAMATAN EPS growth should outgrow market again

Analysts estimate mega tech to outgrow the rest of the market again in the next two years after a pause in 2022. For 2023, earnings per share growth forecasts for MAMATAN are +21 %, three times what is expected from the rest of the market (+6.9 %). For 2024, the current numbers stand at +18.5 % versus +5.6 % for the MSCI World ex-MAMATAN. Expectations have come down for the group except for the two most minor constituents, Meta and Netflix, where other effects, such as cost-cutting and depressed expectations, led to upgrades. We still challenge the view that tech earnings are resilient in any recessionary downturn. Ultimately, IT spending is part of capex and hence depends on budgets. Consumers will rethink spending on expensive iPhones or other goods in such a scenario, also hurting advertising-driven models such as Meta.

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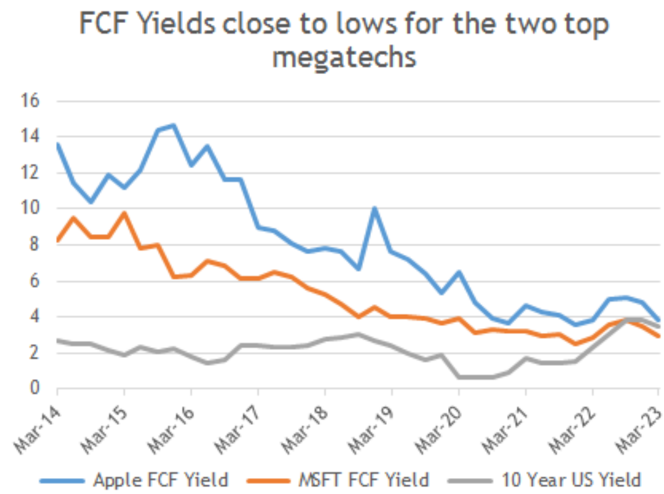
Apple and Microsoft, more than 50 % of MAMATAN's market cap

As a value investor, we look at FCF yields. As measured by market cap, the two largest companies in mega tech make up more than half of this group—one more reason to analyse them more closely. Chart 5 shows that despite higher interest rates than ten years ago, both companies are significantly more expensive than back then. Hence, it is difficult to see them at current levels (below 4 % FCF Yield) as a value investment, in stark contrast to ten years ago.

Chart 5:

Investors pay up for mega cap tech leaders.

Source:
HCP, Bloomberg. As of 11.4.2023.



From a growth perspective, we highlighted the superior earnings growth large-cap tech shows versus the overall market. Interestingly, long-term growth rates, i.e., expected growth over the business cycle, have gone up for Microsoft while they have been dropping for Apple over the last ten years (even if, recently, expectations started to rise again). Apple is still expected to outgrow Microsoft.

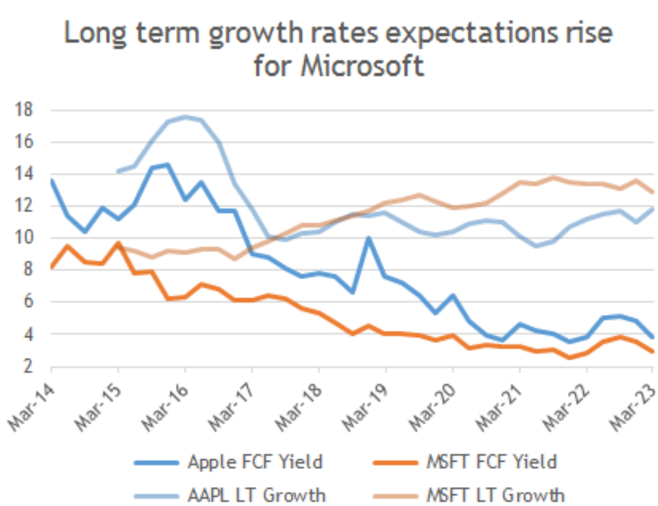


Chart 6:

Growth expectations differ

Source:
HCP, Bloomberg (S&P 500)

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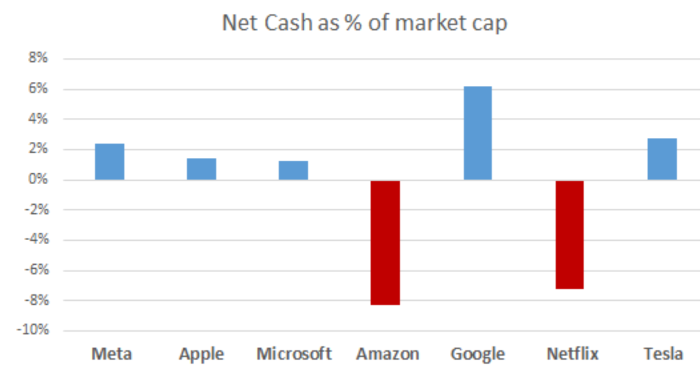
Healthy balance sheets giving support

Focusing on companies with healthy balance sheets makes sense in an economy likely facing a credit crunch from the aftermath of a banking crisis. Chart 7 shows that most large-cap tech companies still run positive net cash balances. Numbers have come down over the years but still look healthy, supporting the group. Large is beautiful in this sense!

Chart 7:

Mega cap Tech balance sheets still strong.

Source: Bloomberg



Conclusion: Highly valued large cap tech group with superior fundamentals

After a solid start to the year, tech companies are likely to consolidate their gains. This is especially true as earnings season is approaching, and a slowing economy tends to depress tech demand. However, cost-cutting may provide a cushion in the short run. Longer term, it is all about growth rates and which companies can hold up in the game of innovation. We have seen Meta struggling with its vision and Alphabet coming under pressure as new AI technologies threaten to disrupt its core search business. Will the reshoring trend impact Apple's margins as the founder of Taiwan Semiconductor warns that a US-based production will potentially double chip cost? Will Microsoft profit from incorporating technology from Open AI into its productivity tool, or will new companies come up with superior technology - as often has been the case in history when incumbents struggle to survive technology shifts?

Those questions make it clear that each company has to be looked at case by case, and fundamentals may turn fast in one way or the other. Valuation is not yet at depressed levels for most of the MAMATANs.

What is still underappreciated in our view is that all large tech companies profit tremendously from their ability to gather data via AI from all types of companies. Large is also beautiful, as huge economies of scale exist. New insights will lead to new applications and use cases yet to be thought of. This optionality has value – for growth investors. Importantly, if one talks about the US market, much of it is driven by these mega-cap tech stocks. We will dive deeper into more aspects over time.

HCP Asset Management, April 2023