Investment Strategy Note

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Tech sector wobble likely to remain just that

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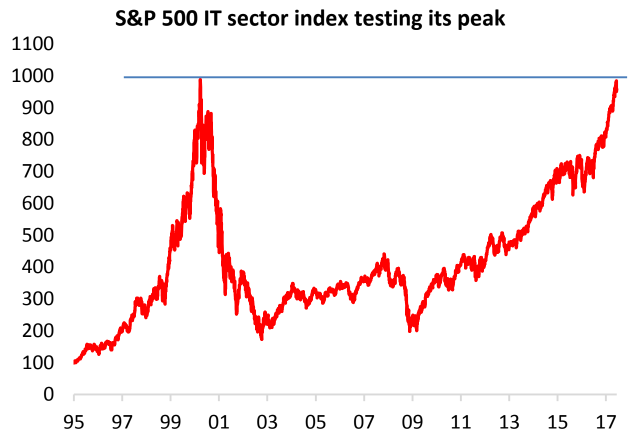
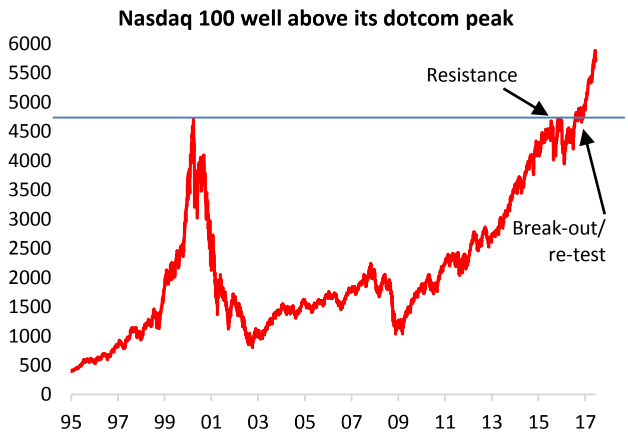
- **The mini sell-off among US tech stocks recently has sparked concerns that it might lead to broader equity market weakness. We do not expect this to be the case**
- **The reasons for the Tech sell-off are likely to have been a combination of resistance levels (the S&P 500 IT sector has hit its dotcom peak), valuation concerns and simple profit taking**
- **The fundamental outlook for equities remains healthy. In this environment investors will be quick to buy any dips**

Tech sector spill-over unlikely

There has been concern that the recent sell-off in the so-called FAAMG stocks (Facebook, Apple, Amazon, Microsoft and Google, now Alphabet) will lead to more broad-based pressure on US (or indeed global) equities. Tuesday's close suggests this pressure is already abating. Nevertheless, it is worth recapping why we believe a sell-off in the largest US sector will remain contained.

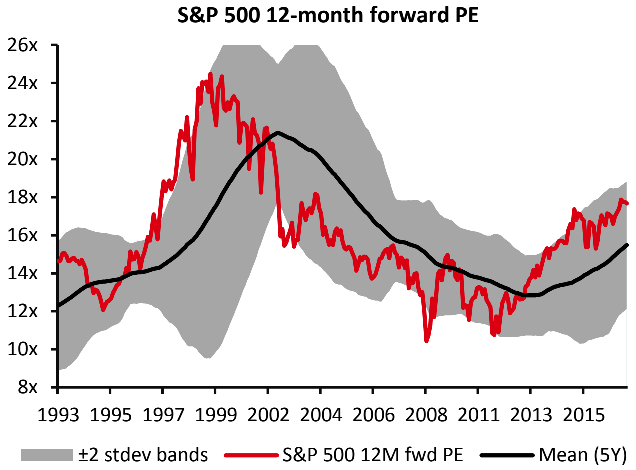
Firstly, there does not appear an easily identifiable reason for the sell-off. It could be that technical factors, such as the fact that the IT sector in the S&P 500 had approached its all-time high from the dotcom days. **Previous peaks are often strong technical resistance levels.** Perhaps this is not the most persuasive argument for the sell-off purely for the fact that the Nasdaq is already significantly above its dotcom peak. However, on closer inspection **the Nasdaq also struggled to surpass its dotcom highs in 2015/2016, needing several attempts before succeeding in breaking out.** Therefore, we believe resistance levels have played a part.

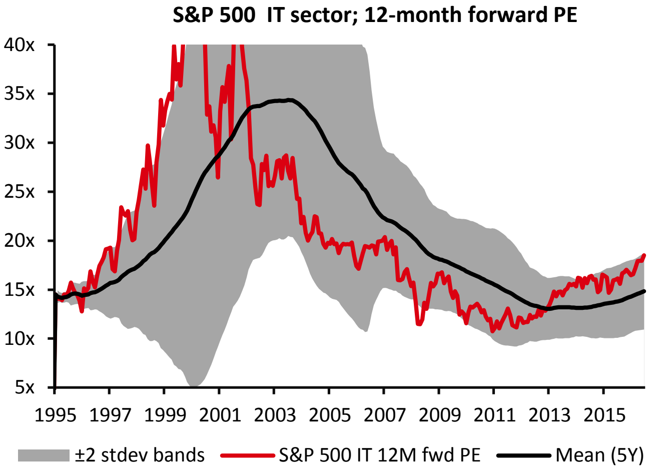




Source: ADCB, Thomson Reuters

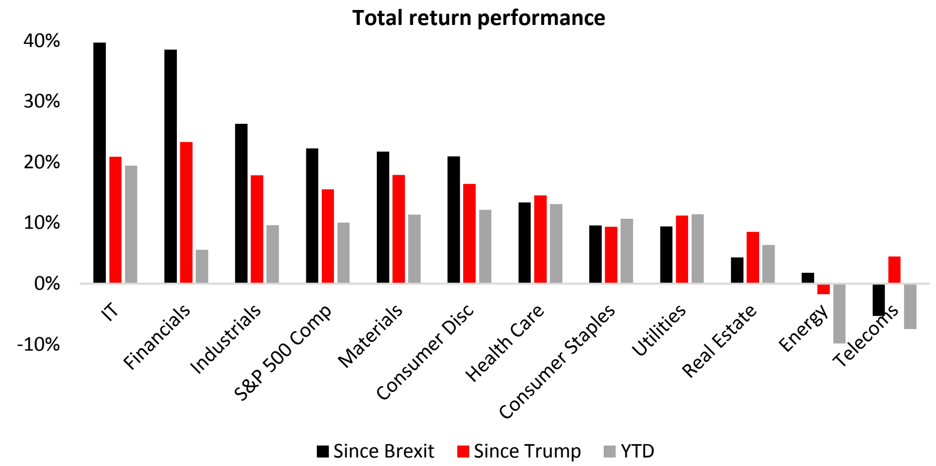
Secondly, valuations. The chart below shows consensus forward valuations for the S&P 500. When valuations reach the top of the band (2 standard deviations expensive), markets tend to correct regardless of fundamentals. For the broader market we are not yet at those levels, largely because earnings have been so strong of late. However, if you look at the right hand chart, the IT sector is clearly much closer to the top of its band, which is where the risks lie. However, **valuations are very poor tools for gauging inflection points.** Equities can remain expensive and hug the +2 standard deviation line for quite some time. This is especially true when earnings growth is beating expectations, as we witnessed during Q1 earnings season. Therefore, stretched valuations will also have played a role in the recent pull-back. A major caveat to add here, is that valuations can be looked at in a number of ways. For example, although using the below methodology tech stocks look expensive today, compared to the dotcom bubble they are extremely cheap. **The largest five tech stocks at the peak of the market in 2000 (Microsoft, Cisco, Intel, Oracle and Lucent) traded around an aggregate 58x forward PE. This compares to FAAMG stocks today around 22x. At the same time the combined weight of the main five tech companies in the S&P 500 back then was c16% compared to FAAMG stocks today around 13%.**





Source: ADCB, Thomson Reuters, IBES

Thirdly, Friday's and Monday's sell-off is likely to have been driven by simple profit taking, quite natural after the stellar run the sector has enjoyed since the Brexit referendum almost 12 months ago. In this time the S&P 500 IT sector is up c40% in total return terms, outpacing the broader market by c17%. Year-to-date the sector has outperformed the S&P 500 by 9.4%.



Source: ADCB, Thomson Reuters

Conclusion, the combination of strong outperformance, the fact that the sector (within the S&P 500) is hovering around its dotcom peak as well as stretched valuations (in certain lights) are likely to have led to the pull-back. However, we do not believe that these factors justify a larger sell-off in the sector, nor do we believe they should drag the overall market meaningfully lower. As we discussed in our recent note **(link)**, the combination of a synchronized pick-up in global economic growth and very strong Q1 corporate earnings along with still accommodative global central banks means that the fundamental backdrop for equities remains healthy. Having said so, we expect a period of consolidation during the seasonally weaker summer months rather than strong new upward momentum.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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