Technology stocks used to grow pretty dependably. But in a year difficult for equities, tech’s decline has outpaced the broader market’s fall. In his article for finews.first, Stéphane Monier examines why investors might expect a turnaround in 2023.

Between 2009 and 2021, the Nasdaq Composite index only posted one annual decline, in 2018, of 1 percent. 2022 has been brutal in most asset classes, but especially in tech stocks. Year to date, the broad Dow Jones Industrial Average benchmark has declined 8 percent and the S&P 500 index by 17 percent.

Over the same period, the Nasdaq dropped 29 percent, continuing a fall from a record November 2021 high. Several factors explain the disparity. Half of the Nasdaq’s market
capitalization consists of technology firms, with no energy stocks and few healthcare names to cushion the index’s fall.

«The outlook for the industry’s earnings has clouded»

The Nasdaq has a bias toward growth stocks that are more affected by the rising cost of capital. At the stock level, many large tech stocks such as Meta, Amazon.com, Netflix and Google’s parent, Alphabet, posted disappointing performance and lowered earnings expectations. Finally, the dollar’s strength has also affected large tech companies, who on aggregate depend more on international sales than the American market.

The pandemic boost behind sectors linked to working from home and domestic entertainment that supported stock values from Alphabet to Amazon and made Zoom a household name has faded. The outlook for the industry’s earnings has clouded. In response, business models are adapting. Meta is looking to diversify away from social media, Netflix is offering a cheaper, advert-funded subscription and Amazon has cut its third-quarter sales outlook and staff.

The tech industry story dominating the news in recent weeks is Elon Musk’s management of Twitter. While uncertainties over Twitter’s future attract much attention, there are probably few lessons to be learned from the forced acquisition, and it should not detract from the broader tech industry’s fundamentals.

«Since mid-October, the tech sector has started to recover»

Valuations in the sector were high at the start of 2022, and they have adjusted to reflect rising borrowing costs and investor preferences for value stocks. As tech companies adjust to weakening revenues, especially in those segments most dependent on consumer sales, investors are recalibrating their growth expectations for 2023. Many stocks are now trading at prices below pre-Covid levels and their longer-term averages. Still, since mid-October, the tech sector has started to recover, and once confidence in the earnings outlook improves, valuations should start to expand.
One way to see this coming is to look at semiconductors. Computer chips drive everything from kitchen toasters to car navigation systems and offer a bellwether for the industry because chips are critical to every technological appliance. As a result, the sector reflects wider economic demand, and so can signal turning points in the market as much as nine months in advance. The segment’s shortages and disrupted supply chains of the past two years are improving, and inventories are building as demand for personal computers, gaming, and handsets slow. Demand from data centers and carmakers remains relatively resilient thanks to rising demand for cloud-based data storage and analysis, as well as consumers’ interest in electric cars.

«Not every asset class linked to tech looks sound»

Earlier this month Berkshire Hathaway Inc. took a $4.1 billion stake in TSMC (Taiwan Semiconductor Manufacturing Co.), as part of its $350 billion equity portfolio. The investment by Warren Buffett was interpreted as a vote of confidence in a more stable US/China relationship, and recognition that the global economy depends on Taiwan’s semiconductor supplies. Linked to that news, Apple, TSMC’s largest customer, said last week that it is preparing to begin sourcing chips from a plant being built in Arizona, and likely owned by TSMC.

There are currently multiple projects to relocate some semiconductor manufacturing capacity in the US, supported by the $52.7 billion infrastructure package approved by the US administration in August. The beneficiaries of this package must agree not to expand their capacity in China for ten years. That stipulation follows the US Department of Commerce’s 7 October restrictions on chip exports to China.

«Yet FTX’s story illustrates failures in corporate governance and counterparty risk»

Not every asset class linked to tech looks sound. Cryptocurrencies have mirrored tech companies’ decline in 2022. While rising interest rates have curbed investor appetite for growth-focused tech firms, cryptocurrencies have suffered more from rising risk aversion. The total market capitalization of all cryptocurrencies reached more than $3 trillion a year ago and now amounts to less than one-third of that peak. Rather than offer diversification, crypto assets have tended to decline in line with falling markets, and proven very volatile, with two high-profile
disasters; the collapse of ‘stablecoin’ TerraUSD in May, and crypto-exchange FTX’s bankruptcy, valued at $32 billion before its default. These have damaged the valuations of both crypto coins and crypto companies, undermining traditional financial firms’ appetite to work with crypto. It will probably translate to less venture capital funding for the sector, and eventually greater regulation.

Yet FTX’s story illustrates failures in corporate governance and counterparty risk, not flaws in the underlying blockchain architecture. Cryptocurrencies are not the only application for this decentralized, dependable technology. The shared, transparent data recording system can create tamper-proof procurement or insurance contracts, trade finance reconciliation, and non-fungible tokens (NFTs) that guarantee digital ownership. In the furor over FTX, the potential for such useful applications should not be lost.

«The cryptocurrency universe will continue to face specific challenges as it develops»

Clearly, the cryptocurrency universe will continue to face specific challenges as it develops. At this stage of the economic cycle, we remain cautious about equities in general and continue to favor quality and value names. In particular, we like the healthcare and energy sectors. Within technology, we see opportunities in equipment suppliers with large order backlogs, semiconductor makers, and firms exposed to electrification and connectivity trends. In segment terms, the software is seeing corporate investment rise and may account for around one-quarter of companies’ technology budget by 2025.

A selective approach to technology stocks, which often have little in common, remains key to any investment in the sector. As economic activity slows, we focus on firms supplying businesses with cybersecurity, cloud data and productivity tools, who benefit from more stable revenues and an ability to pass on higher costs. Technology that depends on consumer or advertising spending will become more attractive once economies begin to recover later in 2023.

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Previous contributions: Rudi Bogni, Peter Kurer, Rolf Banz, Dieter Ruloff, Werner Vogt, Walter Wittmann, Alfred Mettler, Robert Holzach, Craig Murray, David Zollinger, Arthur Bolliger, Beat Kappeler, Chris Rowe, Stefan Gerlach