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Why Tech Bubble Fears are Overdone

BARINGS INSIGHTS

The tech sector's impressive performance and increasing concentration in indexes has led to concerns of expensive valuations—with some fearing that we could be in bubble territory. In our view, such worries are not justified, and we believe tech's outlook remains healthy.

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The technology sector is undeniably shaping up to be one of the front runners coming out of the current crisis. The sector has been widely covered by the media, with recent headlines drawing attention to tech's market-leading performance, high concentration in benchmark indexes and, by some accounts, expensive valuations—with some market commentators going so far as to claim we could be in bubble territory.

This creates the impression that the market has potentially run too far, and that technology is once again to blame. In our view, this is an oversimplification—indeed, the devil is in the details, and unpacking these statements is key to figuring out what is really going on.

Technology's Outperformance

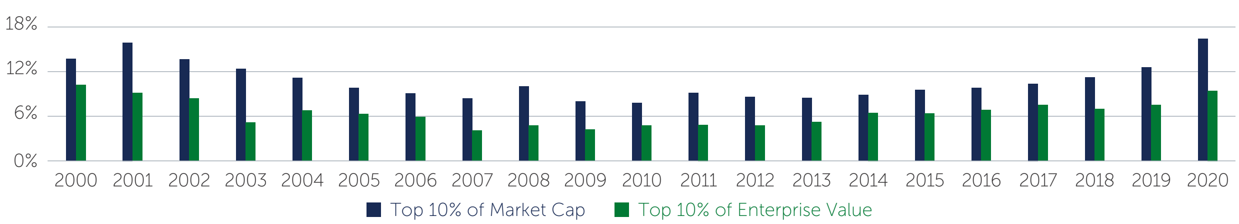
FIGURE 1: MSCI All Countries World Index Performance

	Change 3M %	Change YTD %	Change 1Yr %
MSCI All Countries World Index	6.03	0.78	10.77
Sub-sector			
Technology	9.85	25.45	43.55
Consumer Discretionary	12.95	19.31	30.65
Healthcare	2.41	5.40	20.19
Communications	3.32	6.87	15.45
Materials	8.72	0.90	12.56
Industrials	11.02	-3.51	5.65
Consumer Staples	5.14	-0.50	2.25
Financials	1.51	-22.08	-13.32
Energy	-13.21	-44.07	-39.50

SOURCE: Bloomberg. As of October 7, 2020.

The table above showing the MSCI All Countries World price performance over time, as well as for the constituent sectors, indeed shows that tech has led the market. In fact, the proportion of market cap that is accounted for by the 10 largest companies is now at levels not seen in recent times, and is a source of much angst in the business media given that the list is dominated by technology and internet companies[1].

FIGURE 2: MSCI All Countries World Index Top 10 Constituents



SOURCE: MSCI, Factset, Barings. As of September 30, 2020.

We would note, though, that this analysis stops short of fully understanding what is really happening. The simplest rebuttal is to note that during 2020, the impact of COVID and the subsequent recessionary impact on specific sectors of the market has meant an underperformance of the financials and energy sectors, as well as many smaller companies—which has shifted the index makeup much more toward the larger-cap technology and internet companies. Note also that the concentration of the enterprise values of the top 10 index constituents is far less severe, as their balance sheets are extremely healthy and give comfort that share buybacks can increase if these companies need to support their share prices.

1. September 2020 top 10 constituents of the MSCI ACWI = Apple, Microsoft, Amazon, Facebook, Alibaba, Alphabet, Johnson & Johnson, Tencent, TSMC, Nestle. December 1999 top 10 = General Electric, Exxon Mobil, Pfizer, Cisco, Citigroup, Walmart, Microsoft, AIG, Vodafone, Merck.

Short and Long-Term Growth Drivers

Secondly, there are some compelling fundamental reasons that these technology companies are performing so well. The short-term drivers that provide the simplest and most convenient narratives—and that therefore have also made headlines—stem from the immediate impact of the pandemic. For example, businesses have had to increase IT spending to enable working-from-home, consumers have opted for online shopping instead of brick-and-mortar malls, and bored teenagers have taken to TikTok and Instagram to pass the time at home.

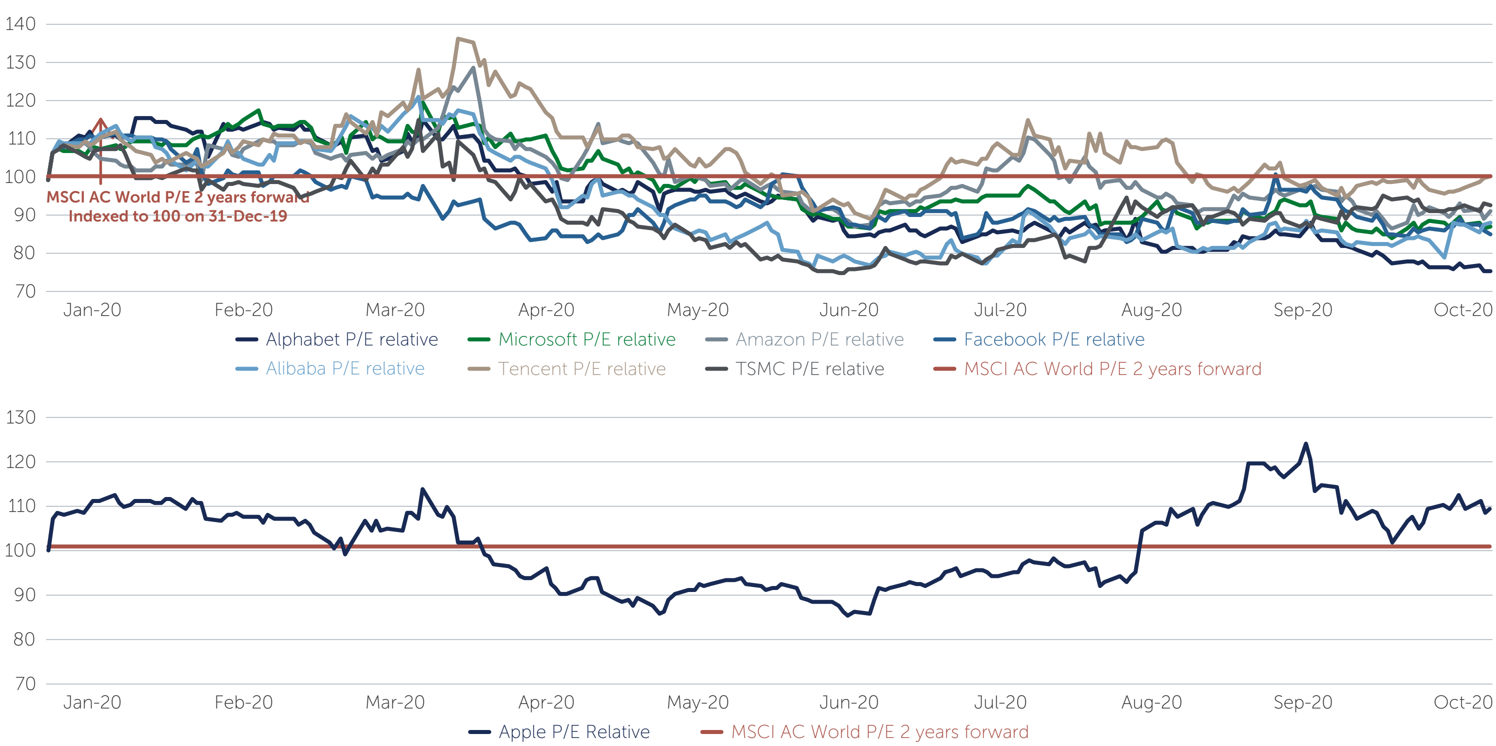
However, these short-term effects are born out of far more powerful changes occurring in how technology is applied to everyday life and, in particular, how businesses are starting to use it to grow and become more efficient. History has shown that when the penetration of a new technology reaches a level of around 15%, the rate of adoption accelerates. This is because once the early adopters have helped prove that the technology works, the mass market begins to follow suit. In 2020, public cloud services are forecast to reach just over 8% of global IT spending, out of the total $3.5 trillion Enterprise IT market[2]—the implication being that, in the not too distant future, we may see a tipping point for growth in demand for these services.

The longevity of this growth is dependent on the business models adopted by the cloud. Their sheer scale and efficiency drives significant cost advantages to customers, but also lowers the costs of innovation. Internet companies such as Airbnb and Software-as-a-Service (SaaS) companies, like recent IPO 'darling' Snowflake, were established on top of such infrastructure—with many more added every year. This step-change in the ability to innovate and take risks with new ideas for business solutions is seismic in proportion, and it is only just beginning to permeate beyond technology companies into the wider economy. In other words, the big players are getting bigger in a market poised to accelerate.

The growth in demand for services from such internet companies could also directly lead to a rise in the need for server and storage capacity. Semiconductors are the key infrastructure components of the internet and public cloud and, as such, will feed into demand for memory chips, graphics processing units (GPUs), central processing units (CPUs) and application-specific integrated circuits (ASICs). Companies that offer services around securing websites and managing traffic flows, like cyber security businesses, could also stand to benefit from this longer-term growth.

Since the start of the year and the emergence of COVID, the price/earnings multiples paid for the largest technology businesses in the MSCI World Index, with the exception of Apple, have actually fallen relative to the multiple paid for the broader MSCI World Index **(FIGURE 3)**. Of note, this has occurred in a period where these companies have demonstrated their resilience of profit growth in the face of a global pandemic.

FIGURE 3: Technology P/E Relative to MSCI ACWI P/E (2-year Forwards)



SOURCE: Bloomberg. As of October 7, 2020.

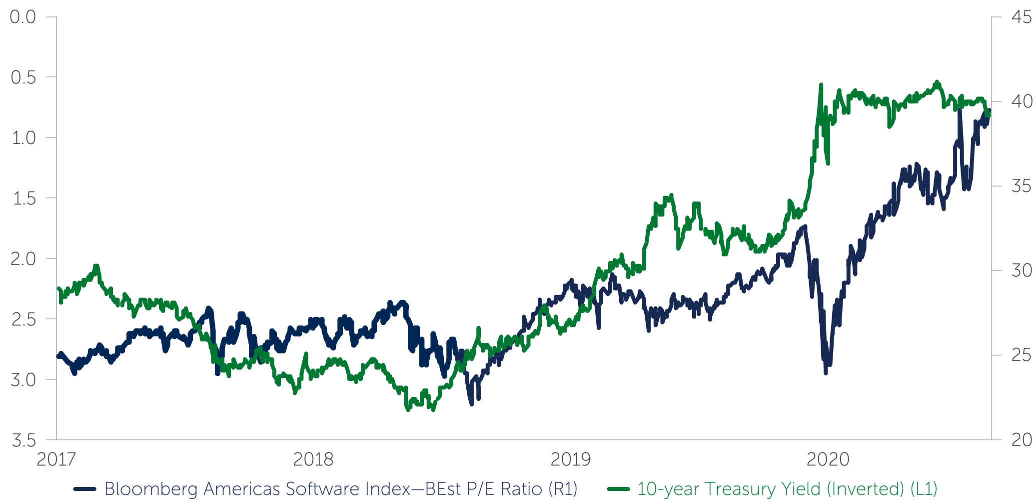
2. Source: Gartner, Inc. As of September 18, 2020.

The companies within the technology universe commanding the highest multiples tend to be the high-growth SaaS companies. The software sector as a whole, despite strong share price performance from these SaaS companies, has not seen valuations expand this year relative to the broader market. The missing piece here is the stronger earnings revisions.

Further, the successful SaaS companies typically sell using a subscription revenue model and as such tend to have very stable, predictable and growing cash flows. The absolute valuations for these companies look less alarming when you realize that the cash generated by these businesses often significantly exceeds the accounting profit.

Finally, given that the best of these SaaS companies will see growth over the long term, the importance of the long-term discount rates used to value such companies also rises. It should therefore come as no surprise that the fall in the U.S. 10-year Treasury yield has coincided with investors' increased willingness to pay rising earnings multiples for what are deemed to be attractive growth businesses **(FIGURE 4)**.

FIGURE 4: U.S. 10-Year Treasury Yield vs. Software Valuations



SOURCE: Bloomberg. As of October 7, 2020.

Key Takeaway

COVID has been a catalyst for our generation's technological revolution, advancing many of the most important secular trends that were already in place prior to the pandemic. The response from central banks and governments, to dramatically increase borrowing to fund the economic support packages, will likely leave us in a low-rate, slow-growth environment for years to come—which should be supportive of valuations for companies with strong prospects for long-term secular growth.

The assumption that the technology sector must be expensive due to its strong share price performance and higher concentration in indexes does not hold up, in our opinion. Valuations for the largest companies have lagged the rest of the market, even as the impact of technology on companies from all sectors speaks to a far greater growth opportunity than was ever assumed at the peak of the dot-com bubble. Given the lower-for-longer interest rate environment, rising share of investment, and accelerating innovation from the adoption of next generation technologies, we believe the outlook for the sector will remain healthy in the coming years.

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