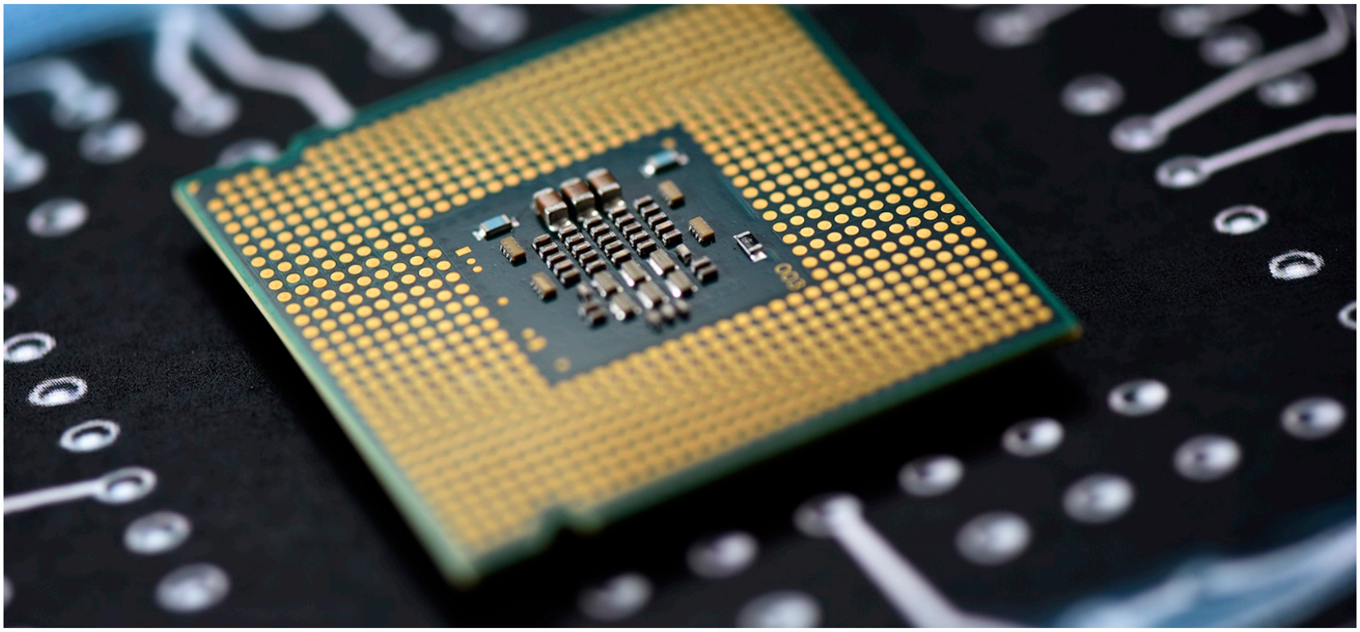

Investors should continue to build long-term exposure to high-growth themes in the tech sector. (ddp)

Opportunities remain in tech despite industry headwinds

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Mega-cap US technology stocks were a bright spot in an otherwise lackluster trading session on Thursday. The FANG+ index, which tracks the top 10 most traded tech companies, rose 0.9% to a fresh one-year high and a gain of 44.5% so far in 2023.

That was on a day when the S&P 500 fell 0.2%, for a year-to-date gain of 7.6%. An equal-weighted variation of the S&P 500, which dilutes the impact of the large tech companies, has risen just 0.1% so far this year.

Despite these positive trends, we remain least preferred on the global information technology sector. First-quarter sector earnings—though lower—were better than analyst had feared, but elevated valuations are our main concern. The global sector now trades at more than 22 times 12-month forward earnings, a 22% premium to the past decade. On a price-to-book basis, the MSCI World tech sector is trading in the 90th percentile of the past 20 years.

But we would urge investors to put this constrained outlook in context, and not to neglect opportunities in the sector:

Tech is the largest single component in the MSCI All Country World Index, and we recommend an exposure only marginally below benchmark, rather than aggressively selling down the sector. The tech industry's weighting of 22.5% puts it well ahead of the second largest sector in the index—financials at 13.9%. Before adjusting tech positions, it is therefore important for investors to evaluate their current allocations. For many investors who have exposure well below their strategic benchmark, we think it could still be prudent to add selectively to exposure. Investors who are well above their benchmark on tech, by contrast, can consider capital protection strategies, along with rebalancing toward more defensive sectors, such as consumer staples and utilities.

In the near term, investors can consider rotating into less richly-valued, more defensive parts of the sector. Notably, we see risks around industries which are expensive after the recent rally and highly cyclical, such as global ex-Asia semiconductors. We believe it is prudent to trim exposure in key stocks that have rallied strongly year-to-date. In terms of defensive parts of the industry that are less affected by the economic slowdown, we see greater safety in software.

On a tactical basis, investors can also consider stocks in our tech "self-help" theme—which focuses on companies that have been particularly effective at trimming costs, upgrading products, or delivering strong distributions to shareholders. Having expanded employee numbers by around 860% in the decade to 2022, versus just 24% for S&P 500 companies, the mega-cap tech firms have been slimming down. Although such restructuring is common in many industries, it is the first such drive for the tech industry in more than a decade. There has also been a focus on distribution to shareholders from several top tech companies.

Investors should continue to build long-term exposure to high-growth themes in the tech sector. For example, the first-quarter earnings season underlined the growth potential of artificial intelligence. Alphabet and Microsoft mentioned AI more than 50 times each during their first-quarter earnings conference calls. This underlines our view that the broad AI hardware market is likely to achieve a 20% compound annual growth rate to reach USD 90bn by 2025. We see artificial intelligence as a horizontal technology that will likely have important use cases across various applications and industries.

From a broader perspective, AI, big data and cybersecurity form what we call the ABCs of technology. We believe these three major foundational technologies are at inflection points and should see faster adoption over the next few years as enterprises and governments increase their focus and investments in these areas. We also see rapid growth potential from other tech themes, including the metaverse and smart automation.

So, while we are least preferred on tech, we are not recommending investors to aggressively sell down exposure to the sector.

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