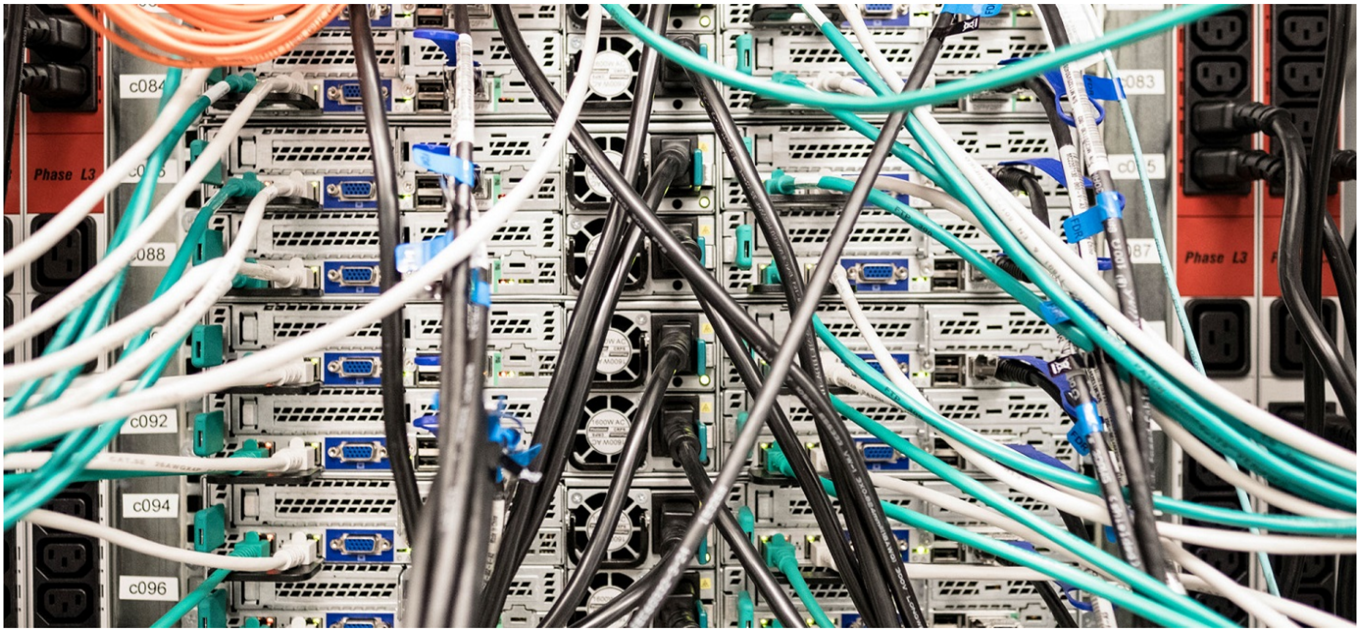
CIO expect techs to remain in favor unless we see either a reacceleration in growth that would favor cheaper cyclicals, which we view as unlikely, or a hard landing for the economy. (UBS)

Upgrading the technology sector to most preferred

14 November 2023, 6:37 pm CET, written by UBS Editorial Team

At this point, we think it's safe to say that no recession transpired in 2023. Indeed, the more macro data we receive, the more conviction we have that our base case of a soft landing will take place over the coming quarters. This is also resonating among policymakers, who appear more confident that the US economy could successfully navigate higher rates without too much pain. At the same time, we still expect growth to slow into next year as headwinds facing the US consumer continue to build.

Our overarching theme for investors in a late-cycle environment, where the yield curve remains inverted, is to focus on quality. In equities, this means companies with a strong return on invested capital (ROIC), resilient operating margins, and low debt balances. In fact, looking at data since 1999, of the 1,000 largest companies, whenever the yield curve has turned flat or become inverted, high ROIC companies outperform low ROIC ones by 750 basis points on average over the next 12 months.

Upgrading the technology sector to most preferred
When it comes to quality, the tech sector is the gold standard, and we have now upgraded it to most preferred. Technology offers the highest ROIC of the 11 US equity sectors—19% over the last 12 months (compared with just 4% for utilities or real estate). Tech sector balance sheets are also the strongest, with a net debt-to-EBITDA ratio of just 0.5x. Furthermore, the recurring nature of many software companies' revenue makes cash flows for these businesses somewhat annuity-like. In a sense, many of these firms are "enterprise staples."

Tech also has one of the strongest earnings growth outlooks among US equity sectors. US tech earnings are on pace to grow 11% in the third quarter, better than market expectations of 4% before the start of earnings season, and we expect the sector to sustain low-double-digit growth in 2024. We also believe the bottoming of end-markets like smartphone and PC will be beneficial moving forward.

Finally, while it's true that valuations are still not cheap, they have improved alongside some cooling of AI enthusiasm, and valuations alone are not typically a good predictor of near-term returns. We also believe investors will be willing to pay a premium to gain exposure to the high-quality nature of many companies within the sector. The bottom line: We expect tech to remain in favor unless we see either a reacceleration in growth that would favor cheaper cyclicals, which we view as unlikely, or a hard landing for the economy.

Balancing our tech exposure

While a "hard landing" is not our base case for the economy, we still believe investors should keep a balanced portfolio that provides good hedges against tail risks. As such, within equity sector allocations, we balance our tech position with most preferred views on consumer staples and energy stocks.

Consumer staples stocks have lagged somewhat in recent quarters, and the sector is trading at a discount to the market, which we find attractive given staples' defensive growth profile. Meanwhile, our expectation that oil prices should reverse their recent slide is a key driver of our positive view of the energy sector. Energy stocks are also a good hedge for any unexpected increase in inflation or geopolitical tensions. Positions in consumer staples and energy are also consistent with our focus on quality, as these two sectors have the highest ROIC outside of tech.

This month we did also make two changes in our sector strategy on the other side of our tech upgrade. First, we downgraded materials from neutral to least preferred as large supply additions in chemicals are a cause for concern, as is the ongoing headwind of sluggish activity in China. We also downgraded industrials from to neutral to least preferred. The industrials sector is very diversified across defensive, short-cycle, and longer-cycle companies, such as aerospace. Given our expectation that the economy will slow in the fourth quarter, we don't believe an outright sector position is the best approach as the more cyclical areas, like short-cycle, will be impacted. Therefore, we would rather invest selectively in stocks within the sector.

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