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Is big tech back?

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Recorded: May 2, 2023

Allison Nathan: Is big tech back? After sharply disappointing performance in 2022, tech stocks are roaring back. But is the latest revival just a short-term blip, or is a new growth phase ahead for the tech sector?

Ben Snider: If you look at the tech sector, of companies that have reported so far, over 75% of them have beaten earnings. If we continue with this rate through the rest of this quarter, this will be one of the strongest quarters of tech results in the 20-plus years of data history that we have.

Allison Nathan: I'm Allison Nathan, and this is Goldman

Sachs Exchanges.

To help break down the sector's performance and outlook, I'm sitting down with Ben Snider, a senior strategist in Goldman Sachs Research, and Peter Callahan, who covers the tech sector for global banking and markets. Ben, Peter, welcome back to the program.

Ben Snider: Good to be here.

Peter Callahan: Thanks for having us.

Allison Nathan: So let's first talk about the tech sector's performance this year. Where are we now compared to last year in terms of performance? Ben, maybe you start us off?

Ben Snider: It's amazing. This year has been almost a mirror image reversal of last year. Last year, the S&P was down 18% for the year. Tech was down 28%. So one of the worst sectors in the market, lagging the market by more than 10 percentage points. This year, it's been a volatile market, but the S&P is up roughly 8-9%. And the tech sector is up more than 20%. And it's one of the best sectors in the market.

And then of course if you look at one of the biggest tech stocks, the ones that everyone focuses on all the time, it's the same mirror image, just even more extreme. At the largest tech stocks in the market were down more than 40% last year on average. And this year they're up more than 40%.

Allison Nathan: So what's driving that performance?

Ben Snider: There's a lot of factors, and we could spend a long time talking about them. But I like to boil it down into really two categories. There's micro and macro. And from a micro perspective, much of the last year was characterized by a real degradation of earnings in growth expectations, right? After a very strong 2020 and 2021, last year, we saw consensus earnings estimates for tech fall by more than 15%. And that led to a series of cost cuts, changes in company strategy, and now it looks like we are moving out of the woods and expectations are starting to improve. And part of that is as a result of those cost cuts. Part of that is due to optimism about AI. But generally speaking, the earnings picture is improving for these companies.

From a macro perspective, we've basically been in the ideal environment for tech, and we've seen this repeatedly over the last decade. Which is that the sweet spot for the tech sector from a macro perspective is pretty weak growth, not recession but weak growth that increases the scarcity value of these companies that can generate their own idiosyncratic growth without relying on the economy.

Allison Nathan: And so we've talked in the past about this sector being bifurcated, though, between profitable and unprofitable. Are we still seeing that type of bifurcation?

Ben Snider: Absolutely. Maybe even to a larger degree than you've seen over the last few years because, really, if you look at the tech sector or you take a step back and you look at the whole S&P 500, almost the entire market return this year has been driven by just a handful of the largest stocks. And part of the reason those stocks have outperformed so much is their extraordinary profitability in an environment, as I mentioned, where growth is slowing across the economy and investors are extremely anxious about the prospect of a recession.

Peter Callahan: Yeah, Allison, if you can look at the numbers here as well would back that up. So if we look at tools that we have like a nonprofit tech index that we have here is flat on the year. And the Russell 2000 Technology Index, the world's smallest tech companies, that's flat on the year as well. And by comparison, the mega cap tech stocks are up anywhere from 30 to 100%. So it's really showing up in performance as well, any way you want to cut it. Big over small is absolutely the theme this year.

Allison Nathan: And Peter, where is this demand coming from? Earlier this year, hedge funds were the big buyers of the sector, so are they still buying today?

Peter Callahan: Yeah, so it's a good question. I think this story, everyone likes to measure snapshots as a start of the year and an end of the year. And I think it's really important to think about where we ended last year as a measurement stick for what's happened this year, right?

So if you just zoomed out and said let's look at Q4 of 2022, huge draw downs across mega cap tech stocks, right?

Think about the Amazons and Teslas and Metas down anywhere from 20 to 50% in Q4. So you saw a big reduction in length from investors coming into calendar '23. At that time, this was a hire-for-longer, reflationary, China reopening type of narrative, right? That was the playbook to start the year. And so investors were admittedly a little bit off sides. As we measured from our hedge fund client base or if you just looked at public mutual fund filings, we saw tech exposure kind of near the lows coming into calendar '23. And so I think that capitulation to some degree in Q4, plus this sort of fertile ground of low positioning across our hedge fund client base and mutual funds, really is the grounding for the start that we've seen this year.

Allison Nathan: And so you're focused on hedge funds. What about retail?

Peter Callahan: Yeah, the retail story has really taken a backseat in calendar '23. For multiple different parts of the last couple of years, it has been what's retail doing? What's the meme stock community doing? Whether you looked at crypto's barometer for retail excitement in the investment markets. It's really taken a backseat this year. And if you look at aggregate, researchers put up pieces around aggregate single-stock flows within tech for retail investors which would have actually shown outflows to start the year. So the story is not really been that of the retail investors, so to speak. It's been more of the institutional investor re-leveraging and getting into position back on sides across the tech landscape.

Allison Nathan: And so we are coming off a big week of tech earnings. Ben, what did you learn from earnings?

Ben Snider: We learned that the fundamental picture across the market and specifically for tech is a lot better than most investors have feared. Just to give you some stats, if you look at the tech sector of companies who have reported so far, over 75% of them have beaten earnings. And when I say "beat," I mean by at least a standard deviation of analyst estimate. So a really substantial beat. This number may not mean anything, but, if you look historically, the average is about 50% of companies beating.

And in fact, if we continue with this rate through the rest of this quarter, this will be one of the strongest quarters of tech results in the 20-plus years of data history that we have. And so it's very clear that, as much as expectations have been reduced over the last 12 months, the picture now is starting to look a little better. In fact, if you look at analyst earnings estimates, over the last week or two, they've actually started to rise for the tech sector.

Allison Nathan: What is driving the underlying strength? Is it the consumer demand? Is it cost tightening? You mentioned some of these factors, but from a micro perspective, what's driving that outperformance relative to expectations?

Ben Snider: It's everything you'd want to see. Companies have beaten on both sales, both on revenues and demand, but also on margins, which is telling us that the cost cutting that has taken place over the last year is bearing fruit.

Peter Callahan: Maybe I'll jump in on that point, too. If you think about tech specifically, a lot of the headwinds that showed up last year, anything from dollar to higher electricity costs, higher fuel costs, supply chain shortages, all that stuff was pressuring margins. So you have that starting to reverse back out. You have cost cuts showing up. There's a lot of headcount reduction showing up across the tech sector. That's had an impact as well on lower OpEx pieces. And then the reality is some of these largest companies are what we would call platform players, right? They have lots of product, lots of scale, lots of breadth that, if a certain vertical, a certain customer base, a certain product is a little bit slower, they are so diverse in their reach that they could often find times to offshoot to that.

So I think you had a negative revision cycle encountered in '22. Some of that macro, some of that micro. We're starting to come back off of this. And then stabilizing revenue met on a lower cost base is driving a lot of that earnings upside. And so Microsoft, Google, Meta all delivered 10% earnings beats in 1Q. The biggest beats in over two years for those stocks.

Allison Nathan: So the performance of the companies has backed up the performance of the stocks, but the stocks have run up so dramatically. How would you engage investor sentiment at this point? Are people getting nervous that returns are really front loaded this year?

Peter Callahan: People always are worried about something, and I would say that is certainly a concern that is coming up in the marking right now. This stock's now up anywhere from, again, 20 to 100% on the year. If you look at that index of mega cap tech stocks, including names like Nvidia and Tesla and things like that. So people are always going to be worried about something.

The good news -- and you highlighted this -- is the fundamentals have backed the stock moves. So you are moving into a cycle of positive earnings revisions. Does it last more than a quarter or two? I do think you need the macro to cooperate to some degree, but there's a lot of really good idiosyncratic stuff going on that has been driving these results. So investors are nervous about this slowing down.

We've seen continued demand for these large cap tech stocks. We hear a lot of “best house in a mediocre neighborhood” when you're referencing the rest of the market right now. The liquidity, the cap return profiles, the balance sheets checks a lot of boxes for investors right now. And so, while people will always worry about what's next and the sustainability, we get the sense that investors are still, at least as of now, comfortable in these stocks relative to what else is out there.

Allison Nathan: And Ben, Goldman Sachs Research recently published a survey of CIOs' spending priorities. And so is there any read on the demand for spending on technology that also could provide more legs to this performance?

Ben Snider: This is maybe one of the less positive parts of the outlook. As you said, our analysts just published the survey, and the survey showed a real degradation in expectations in terms of what companies are reporting about their spending plans. And in particular, if you look at their capital investment plan -- so spending on business equipment and software -- we saw actually the lowest reading in the 20-year history of that survey outside of the recessions in 2008 and 2020. So a major step down there.

And if you want to be a pessimist, you'll say that this is going to flow through to revenues and to earnings of these companies in coming quarters. I'm a little less concerned. I think this is pretty well choreographed. And in fact, our macro forecasts show a major slowdown in CapEx this year. They have for a while. All the drivers of CapEx, things like slowing cash flow growth, high interest rates, declining cash balance, all point to this trend. So I don't think it's going to be a shock, and I don't think it's going to be a disaster either because, if we continue with the rate that we expect, by the end of this year and into next year, we should be seeing a lot of these factors reverse and CapEx plans starting to improve again.

So I think it's potentially a near-term headwind, but not as bad as you might think if you just look at that survey by itself.

Peter Callahan: And like everything, we're finding a little bit of nuance in the results, right? So we're halfway through 1Q earnings season so far. And there's definitely companies that are talking about disruptions and slowdowns in spending, particularly late in the quarter where the regional bank episode has played out. Companies like F5 or Tenable talking about this sharp slowdown later in the quarter. Deal pushouts. More approvals being needed for things to get across the line.

But that's counterbalanced by the companies like Service Now or Microsoft or SAP who are putting up really solid results and showing that, if you are a scaled player with true value that you're adding to your customers, there will be demand for this digital transformation narrative. So it's harder than it was a year ago, but it's not impossible to deliver results in this environment.

Allison Nathan: And one of the key areas we're spending for tech companies themselves is clearly artificial intelligence. How could that drive growth for revenues, for margin improvement, all of the above for these companies?

Ben Snider: You know, very fitting you asked these questions back to back because, while CapEx, capital investment plans, look like a potential cyclical headwind, AI is pretty clearly going to be a really long-term secular tailwind. We have to be humble enough to understand that, at the beginning of these kinds of huge shifts, it's very hard to know who the winners will be 5, 10, 20 years down the road. But I think we can all agree that tech will at least accrue part of the gains of artificial intelligence. And when you look at our forecast, either from an economic perspective where we're forecasting that AI is going to generate $7 trillion of global GDP growth over the next decade, or from a micro perspective, where our software analysts think AI is going to increase software TAM, total addressable market, by roughly 20% over the next decade, it's pretty clear there's some pretty strong tailwinds coming around the corner.

Peter Callahan: And to give you a little bit of a real-time sound bite, I think investors would agree profit pools will be disrupted, profit pools will be created by this AI technology. But, like Ben said, it's a little bit early for everyone to have the same view on the winners and losers. And so earnings season, it's coming up a lot. I think I counted Google and Microsoft using the word "AI" over 80 times on their earnings calls last week. Google talked about upward pressure on its CapEx this year specifically driven by AI investment. So this is real. I don't think there's much debate about that.

But the particular profit pools and opportunity sets, it is something we're talking about with our clients every single day. And you're starting to see it shape stock performance as well. Think about names like Nvidia, a name like Chagon [sp?] in the education space this week. It is definitely starting to show up. And it feels like a lot of discovery value here and a lot of research going on by institutional clients on this topic.

Allison Nathan: And tech companies have also been making headlines because they've seen a lot of layoffs. What are the broader sector but also economic implications of those layoffs?

Ben Snider: You're right. I remember last year, early this year it felt like every day we were sending around an update of a new big layoff announcement. You had a tracker, I think, at one point.

Peter Callahan: That's right, yeah.

Ben Snider: And it really is extraordinary. The good news is, from a macro perspective, this is much smaller an issue than most people think. As equity investors, we tend to overweight the tech sector relative to the economy because more than 25% of S&P 500 market cap is in tech. As humans, we tend to overweight tech because we're all using technology all the time, right? Probably people on the other side listening to this are listening through their phones or computers, right?

But if you think about overall US economic employment or growth, the US labor force is over 150 million people. And if you look at tech and tech-related industries, it's less than 5% of that employment. So even though you have seen this increase in layoffs across tech, it really is much more about cost cutting in that sector than any big macro picture issue.

Peter Callahan: And I'd just say the early read, there hasn't been a discernible impact yet on revenues and on the top line that we're seeing from our companies yet that have gone through this. There's still a lot of talk about efficiencies out there right now, but that is something investors are focused on. If you do start to see layoffs in the tech sector, could impact spending, could impact headcount type of sale cycles like licenses and seat-based models. So it's something people are watching, but right now the conversation is efficiency and margin expansion. It's not yet revenue impact, and it's something people are monitoring.

Allison Nathan: Let's talk a bit about valuation for the sector. We've talked about how much the sector has run up. So where does valuation stand at this point? Is there value left?

Peter Callahan: I'm sure Ben will have a view on this, and maybe we'll even have a little [UNINTEL] debate here in the studio. But listen, if you just look at NASDAQ overall, it trades at about 25 times earnings. The 7-year average is slightly below that in kind of the low 20s range, so it's a little bit rich to its recent history. But if you went back and we did this podcast a year and a half ago, we'd be talking about 30, 35, 40 times earnings in multiples for the NASDAQ. It is off the lows. It is no longer a, quote/unquote, bargain relate to its history, but we have certainly seen episodes where the index can trade -- and this is the NASDAQ index traded a richer multiple than it does.

I also think there's going to be just continuing to be conversation around the spread within the sector. The largest, most profitable companies relative to the smaller companies where you don't have that gap profitability, that true free cash flow backstop. So like everything, there's some level of nuance, but we are off the lows. I think we entered the year with the NASDAQ at 22 times, so we've seen a fair bit of multiple expansion, which I think is driven by some of the easing concern around interest rates and inflation and some of the good top-line trends that we've seen to start the year. But Ben, feel free to keep me in check if I'm off.

Ben Snider: Of course we're looking at the same data. The point I would make is that the whole equity market screens as pretty expensive relative to history, right? 80 or 85th percentile versus the last few decades. If you adjust the tech sector for the level of the market and you look at the relative valuation, we're actually pretty close to the long-term average.

Now to your point, ten years ago, tech was trading at an unusually large discount. And I think a lot of investors under appreciate how much that starting point of valuation contributed to the strength of tech over the last decade. You don't get that if you're buying the sector today, but nor does it look extraordinarily expensive when you adjust for the overall equity market or macro environment.

Allison Nathan: Peter just mentioned easing inflation, the Fed, all eyes have been trained on it this week. If we put it, again, in the context of the interest rate environment, the broader macro environment, what are the sector implications as we look ahead, Ben?

Ben Snider: This is one of the bullish arguments I get from tech investors every day now, which is let's look historically. When the Fed stops hiking, the equity market goes up. And in particular, if you look at the last two times the Fed did this -- 2006 and 2018 -- after the end of the Fed hiking cycle, the best sector in the market was tech. And so a lot of investors say to me, "Shouldn't we be following that playbook? Shouldn't this be the start or the middle maybe of a great tech rally over the next several months?"

And I think you can make that argument, but I would add maybe a small dose of skepticism, which is, if you look at more than just the last two episodes, it's much more of a mixed picture. In fact, over the last six Fed hiking cycles, tech has about a 50-50 hit rate of outperforming when the Fed is done.

And on top of that, there's considerable macro uncertainty today about whether the Fed actually is done, about the path of the economy going forward, and about the valuation and expectations already embedded both in the tech stocks and in the interest rate curve, which is actually pricing Fed cuts coming up soon. So I think you can make a bullish argument. It's not as clear to me as what I hear from some of our investors.

Allison Nathan: Peter, anything to add to that?

Peter Callahan: No, I agree. I think Ben nailed it, which is it looks like the tech sector's sniffing out the end of this Fed hiking cycle potentially. So if you had a reason to believe that was not the case, it may be a slightly less favorable backdrop for tech moving forward, but of course this is the multi million dollar question or trillion dollar question moving forward is can we stay in this sort of easing, slowing, less worrisome inflation environment with interest rates above where they were the last two years but no longer climbing like they were in 2022? And as long as tech investors don't have to feel like they're pocket macro economists and Fed whisperers like we did in 2022, it's probably going to be a better investment landscape.

Allison Nathan: So what are the risks you're focused on?

Peter Callahan: Yeah, I think that a year ago we would have said, oh, well, it's positioning, it's valuation, it's regulation, it's over earning. I think a lot of those risks wed be lower down the priority stack right now. And candidly, I do think the number one risk would be Fed and inflation. And if we get back into a runaway inflation environment where it feels like the Fed has to keep hiking to keep up, it's just going to be a difficult environment for tech as we learned in calendar '22. So I really think that's the biggest story for this sector right now.

Outside of that, I think there'll be a growing focus on how long can tech rise above the macro conversation right now? And by that, I mean a lot of the forecasts for the largest tech companies are embedding some revenue reacceleration into calendar '24. I think it's too early to say whether that's right or wrong. But at some point over the course of this year, investors will say do I believe that acceleration and growth or not? And if the rest of the economy looks like it's slowing down, it may be harder to underwrite.

So I think that kind of calendar '24 debate is out there. I candidly think that's a second half conversation. And between now and then, it's really going to probably come down to the Fed and a few CPI prints between now and then.

Ben Snider: I broadly agree. I think most tech investors or most generalist investors I talk to are keenly focused on the risk of inflation in the Fed, particularly because that's been such a key driver of the sector over the last year. I would add to that recession and growth risk. It's not very controversial to say that's a big risk out there, but I do get the sense, talking to a lot of investors, that there is the view that, if the economy slows further and we dip into recession, tech is still going to keep outperforming because it's less cyclical. And I'm very skeptical.

We've seen this many times in the past. At the end of the day, there is still some cyclicality to these companies' revenues and earnings. We talked earlier about capital investment. And I think positioning is also a factor. These tend to be very popular investment positions for many large institutional investors who will inevitably sell if the economy really does dip into recession.

So I would agree with you, Peter. I think if we stay in the middle where we are today, that's a great environment for tech. If things heat up and inflation and growth pick up, I don't think that's great for this sector. But also, if we turn down and dip into recession, I think I'd probably rather own something like a utility or a consumer staple or even cash rather than tech stocks.

Allison Nathan: Ben, Peter, thanks for joining us.

Peter Callahan: Thanks for having us.

Ben Snider: You, too.

Allison Nathan: And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called The Markets. Each week, in just 10 minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Search for Exchanges, The Markets on all podcasting platforms.

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