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MARKET CALLS

# The Tech Recovery -- But...

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**Is the NASDAQ saying that tech is back, or that investors are now more risk tolerant?**

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It was less than two months ago that **Intel** lowered revenue guidance for the fourth quarter, and we argued then that this should come as no surprise, and said that "we're not at all convinced that Intel has derailed an overall equity markets recovery" (see "Until Intel" October 16, 2002). Indeed, the markets have never traded lower since we wrote those words.

Now Intel is guiding *higher* for the fourth quarter, saying that revenues will come in at or above the high end of the previously lowered guidance. And *that* should come as no surprise either, because nothing Intel said in their conference call last night suggests that this signals the long-hoped-for IT spending turnaround. In fact, it may reflect nothing more than that Intel was too pessimistic in October -- their forecasting department may have been as spasmodically risk averse as the rest of the economy was then. As **CFO Andy Bryant** blandly put it, the quarter is simply coming in "more in line with seasonal patterns than we anticipated in October... Everything is just a little better than we thought it would be." And for next year? "Think about a seasonal first quarter."

A recovery of sorts *is* underway in the tech sector, but it is as uninspiring as Intel's upward guidance. As of month-end November, of the 77 companies in the S&P 500 Information Technology sector, 46 can boast trailing 3-month earnings that beat the comparable year-ago period. And it's a non-trivial beat -- $3.3 billion, or 57.8%.

That's the good news. But -- and there's always a but...

- The other 31 companies turned in worse-than-comparable performance, missing the year-ago period by $3.0 billion, or 256.4%.
- Net the winners and the losers together, and the gain over the year-ago period is only $308 million dollars, or 4.6%.
- The net beat of $308 million is more than entirely explained by the earnings improvement of a single company -- **Cisco Systems** -- whose $366 million beat was the best in the sector.
- The net beat of $308 million is more than entirely explained by $522.1 billion in improvement in 9 companies who are running at a loss in the most recent trailing 3 months, but a *smaller loss* than the year-ago period.
- That said, a single company -- **Lucent Technologies** -- was responsible for about half the losses. It's not fair to arbitrarily ignore a data-point just because it's unpleasant -- but

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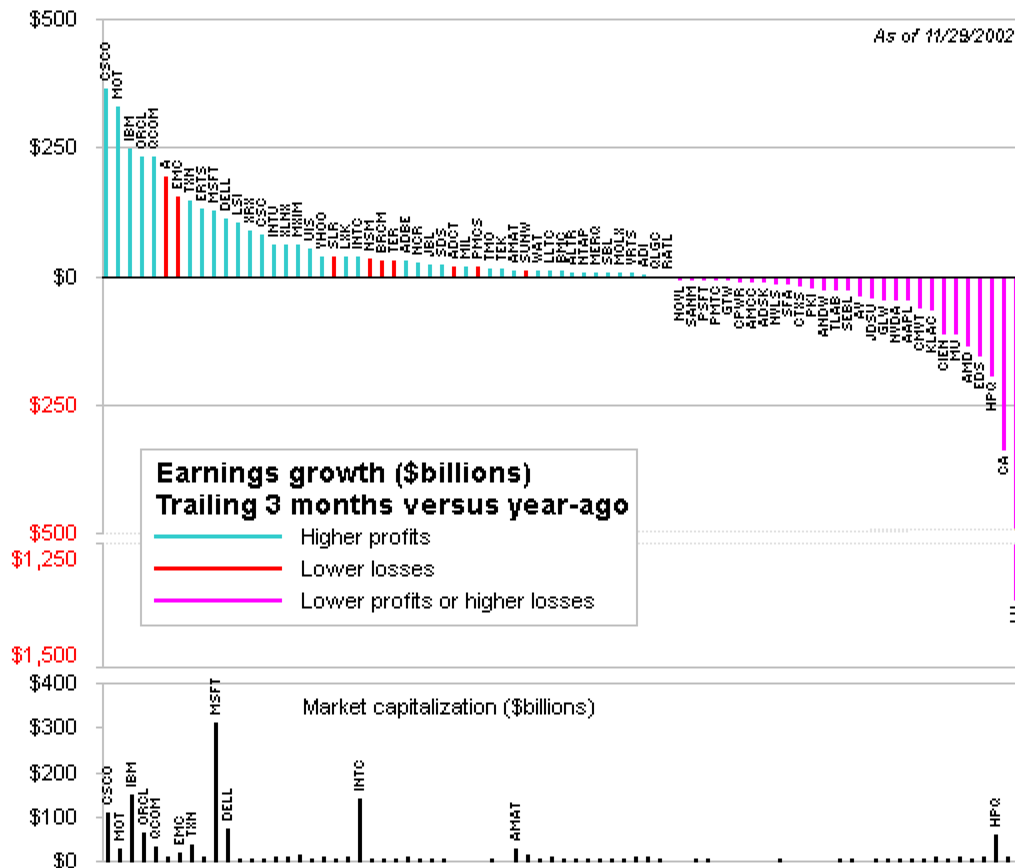
if we *were* to ignore Lucent, the net beat would have been $1.7 billion, or 22.7% over the year-ago period.

This is the game of "survivor" that we've been talking about for over a year -- where the larger companies eat the smaller ones to get through the hard times, and emerge on the other side stronger than ever and with fewer competitors (see ["Let's Play Survivor"]() September 24, 2002). It's reflected in the fact that the tech recovery of the last three months has been mostly a large-cap phenomenon. The average capitalization of 46 companies showing year-on-year earnings improvement is $25.6 billion -- for the 31 companies showing earnings deterioration, it's only $5.6 billion. Only one large-cap techstock -- **Hewlett Packard** -- is in the loser's circle.



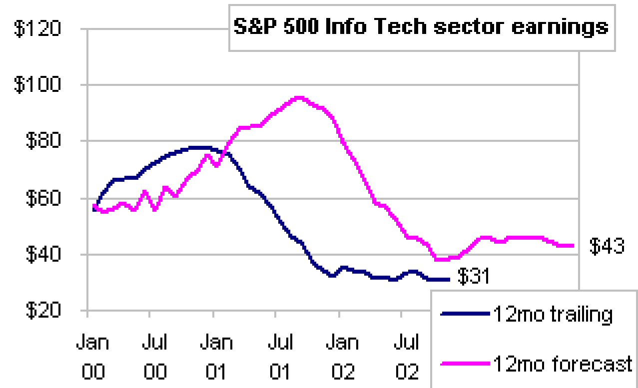

While perennial tech bulls may find sustenance in some of the headlines of the last couple weeks, the news background has done nothing but confirm the decidedly mixed prospects for a tech recovery. A small sample of the tech cross-talk this week:

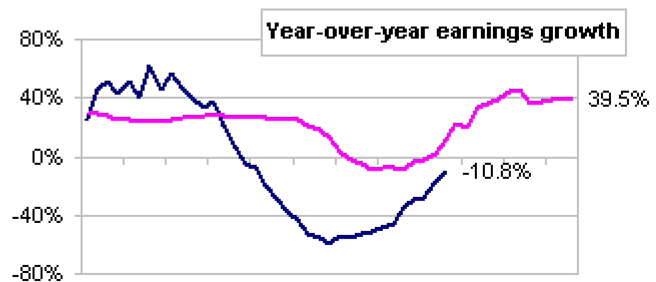
- **Advanced Micro Devices** raised revenue guidance yesterday morning, citing signs of improvement in PC processor orders. But just two weeks ago **CEO Hector Ruiz** [announced a new strategy]() that effectively abandons the high-end PC market to Intel.

- Hewlett Packard announced on Tuesday that it expects to squeeze $500 million more than expected out of merger synergies from the Compaq deal. But at the same time lowered revenue guidance, proving that you can't shrink your way to greatness in the tech game.

- **Siebel Systems CEO Tom Siebel** said on Tuesday that he saw the IT market firming, and saw more robust demand in the 4th quarter. But on Wednesday rival **PeopleSoft CEO Craig Conway** said that IT spending won't increase next year.

- On Monday **Texas Instruments** guided revenues higher -- to a smaller decline, that is -- citing strong demand for wireless products. **Merrill Lynch's** wireless analyst raised his estimates for cell-phone handset growth to 20%. But the next day **Nokia** reaffirmed its forecast for only 10% growth in handsets.




With the NASDAQ Composite having risen as much as 33.6% from its October bottom -- and today still 26.6% above it, even after the pullback of the last two weeks -- it's tempting to say that the market is signaling a bigger tech recovery than these statistics and the news background suggest. But if it is, then it's the same old tech recovery that the market's been expecting for the last year -- or even less than that. The consensus 12-month forward forecast for the S&P Information Technology sector is now $43.0 billion, *down* from $46.2 billion just 6 months ago.

No, the run-up in technology stocks is probably more a reflection of relaxed risk-aversion than it is of higher expected returns (see "Monetary Progress, Fiscal Stasis" November 25, 2002). Some evidence of this is the fact that the average return over the last 12 weeks for the 46 companies showing year-on-year earnings improvement is 21.0% -- while for the 31 companies showing earnings deterioration, it's a substantially identical 20.1%. We can safely conclude that the market may well not be focusing on earnings performance. The only alternative explanation that can justify the substantial move of the last two months is a profound shift in risk preferences.

When markets are moved by shifts in risk preferences, valuation anomalies can arise -- and that is the case today. As we pointed out two weeks ago, the S&P 500 Information Technology sector has become more overvalued relative to the rest of the S&P 500 than it has been at any time other than in the first quarter of 2000 (see "Tech Out of Whack, Once Again" November 25, 2002).

Today's tech sector valuations are high *even granting* the $43.0 billion forward earnings consensus for the tech sector. That consensus implies 39.5% growth over trailing 12 months actual earnings, in the absence of unambiguous signs of a true IT turnaround and in the face of today's sector-wide trailing 3-months year-on-year earnings growth of only 4.6%. But according

to our model, to justify today's high valuations, earnings growth would have to turn out to be even higher -- 55.0%. That's not going to happen.

This is far from the most overvalued the tech sector has been over the last several years. Today's valuation anomaly lies in the fact that this technology overvaluation is occurring at the same time as a deep *undervaluation* in the rest of the S&P 500. For the rest of the S&P 500, the consensus for forward earnings growth is a relatively modest 12.1%. On top of that, to justify today's low valuations, earnings growth would have to turn out to be a *decline* of 13.1%. That's not going to happen, either. TM

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The author, a principal of Trend Macrolytics LLC, owns shares of Cisco Systems.