TrendMacrolytics

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Is There a Tech Valuation Headwind?

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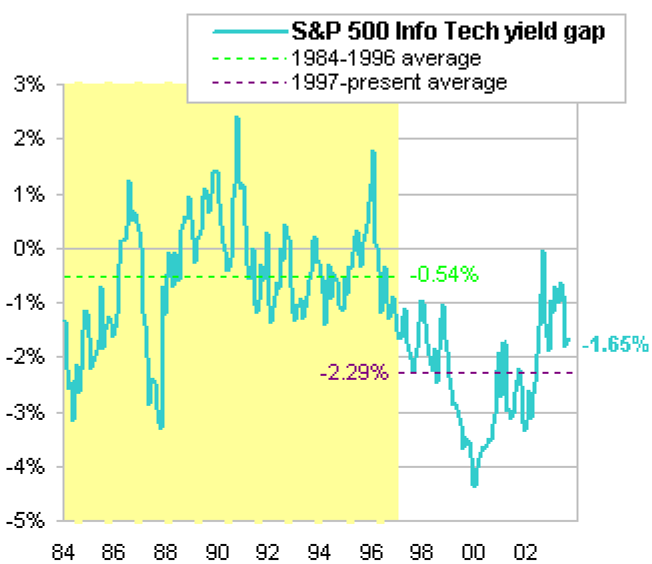
Tech is no bargain, but it's at the center of an investment-led recovery.

In conversations with investors all year we have always been faintly embarrassed to admit that we were bullish on technology stocks. It is as though speaking kindly of an always richly valued sector were to confess one's lack of sophistication, or unwillingness to learn history's painful lessons. Yet right after it was announced in early January that this year's tax bill would include some version of a capital gains tax cut, we reversed our short call on tech and began forecasting that it would be this year's best-performing equity sector. Persistently either the most overvalued or the least undervalued sector, we have been skeptical that tech would offer the best *risk adjusted* return, but our confidence that it would deliver the best *absolute* return has been strongly borne out.

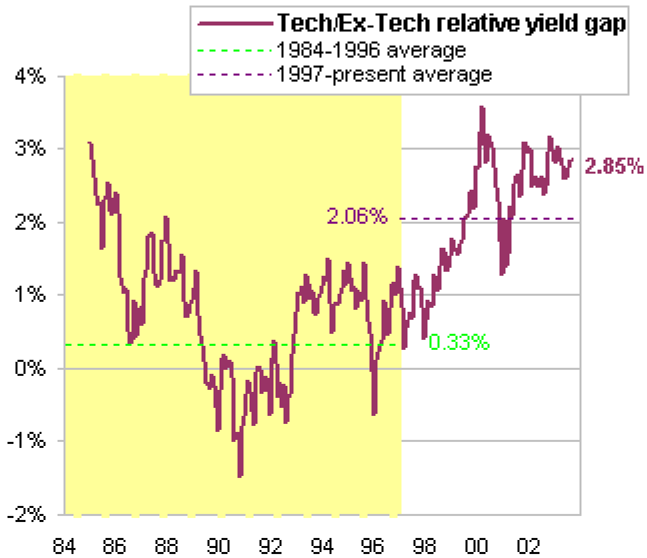
Now with the NASDAQ up 38% year-to-date, valuation concerns loom larger than ever. On the one hand, we can't deny that, by traditional norms at least, the tech sector is richly valued. Even in the bear-market convulsions of the last three years it never became truly, deeply, washed-out cheap. But on the other hand, our macro analysis tends to minimize these concerns. We believe that the present acceleration of economic growth, being triggered both by relief of deflationary pressures and tax incentives favoring capital formation and risk-taking, is of a type that ought to be especially favorable to the investment-sensitive and innovation-driven tech sector.

So the question is: *how bad is the valuation headwind?* As with all matters of valuation -- which are inevitably matters of norms and expectations -- it depends on which norms you use and what your expectations are.



Let's start with norms. One dimension in the choice of norms is *time* -- to what period should today's values be compared? Equity valuations have been in a distinct new regime since the beginning of 1997 -- as it happens, shortly following **Alan Greenspan's** famous ["irrational exuberance" speech] in December, 1996. Our "yield gap" valuation analysis of the S&P 500 Information Technology sector illustrates this, with the pre-"irrational exuberance" regime set against the light yellow background. As a reminder, the "yield gap" is the forecasted earnings yield of the tech sector, minus the long-term Treasury yield. It can be understood either as a stock/bond risk premium, or (holding Treasury yields as given) an equity valuation measurement. The higher the yield gap reading -- i.e., the more toward the top of the chart -- the more relative value is being offered by equities.

According to this metric, today the tech sector is significantly *over*valued relative to the norms that prevailed in the pre-"irrational exuberance" regime. In fact, the sector has never been *under*valued relative to the pre-1997 average except for in a single month -- September 2002. Measured against the norms of the *new* regime, however, the sector is somewhat *under*valued.



Another dimension in the choice of norms is *universe* -- should technology stocks be compared to stocks overall? The chart at left compares the tech sector yield gap to that of the rest of the S&P 500. Compared to the previous chart, it has to be interpreted "upside down" in relation to tech sector valuation. The larger the number, the more technology stocks are *over*valued relative to non-technology stocks.

Here, too, there is a strong distinction between the norms of the two time regimes. But by this way of looking at valuation, the tech sector today is significantly *over*valued relative to non-tech against the norms *of both time regimes.* This is so because today the S&P 500 ex-technology is significantly *under*valued in both regimes. This suggests the intuition that the difference between the two time regimes is not an attribute of stocks in general, but an attribute primarily of technology stocks only. *Why would this be?*

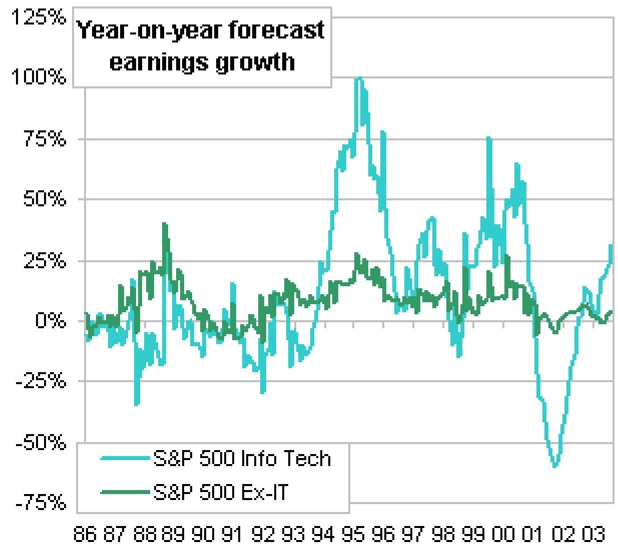
A compelling explanation is that new regime has been characterized by two capital gains tax reductions, one in mid-1997 and another in mid-2003. Changes in capgains taxes perturb expected after-tax returns more meaningfully for technology stocks, all else equal, both because tech stocks are expected to deliver a larger fraction of their returns in the form of capital gains rather than dividends, and also because they tend to be traded more frequently (so the incidence and cumulative value of capgains realizations is greater).

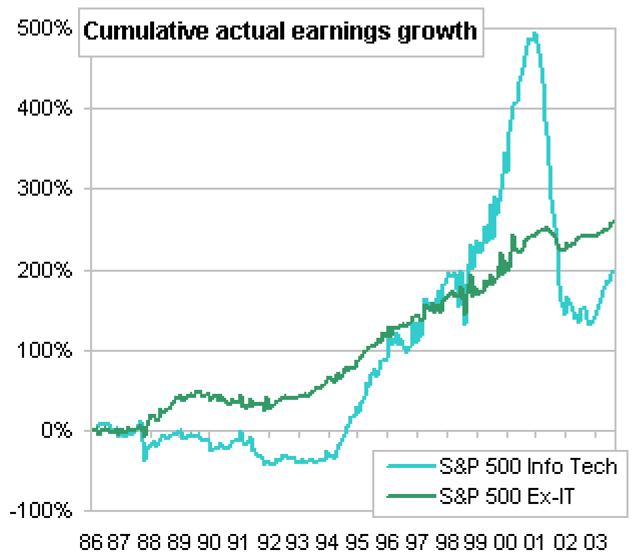
Furthermore, capgains tax reductions lead to greater economy-wide capital investment and risk-taking, both of which could drive significant upgrades in *long-term* earnings growth expectations for tech companies. Such expectations would not be fully picked up in the one-year-forward earnings estimates used in the "yield gap" model.

As a reality-check on this proposition, we can figure out how much higher today's earnings estimates would have to be in order to justify tech sector valuations based on historical norms. Today's consensus estimate for the sector is $57.7 billion, which represents 42.8% growth over today's trailing 12-month earnings of $39.5 billion (a growth rate, by the way, which we see as entirely attainable in the context of the present investment-led recovery). The consensus would have to be revised upward to $75.6 billion, representing a 91.4% growth rate, to explain today's prices against the pre-"irrational exuberance" valuation norm. Against the norm combining both the pre- and post-"irrational exuberance" regimes, the consensus would have to be revised upward to $66.0 billion, for a growth rate of 67.1%.

If those growth rates sound entirely unattainable, remember that in this reality-check they are only a one-year's proxy for longer-term growth rates which would not have to be sustained at anywhere near those lofty levels. But that said, growth rates of 91.4% or 67.1% are rare, but not entirely without precedent, as the chart on the following page illustrates.

The chart also suggests another element of tech sector valuation in the post-1996 regime. It has been a time of both greater earnings growth *and* earnings volatility. But as the bottom chart shows, that has translated into *less* actual percentage cumulative earnings growth for the technology sector than for the rest of the economy. So much of the astonishing earnings growth run from 1995 to 2000 has been given back in the last recession that, at the moment at least, it's definitely a case of the slow-and-steady tortoise having won the race. Yet in terms of valuation, in the new regime the market seems to consistently prefer the hare.





One explanation is that the market is crazy. But another is that the market is betting that the technology sector as it is today -- a vast complex of computation and communications device and service companies touching the entire business and consumer economy, far evolved beyond the limited computer-only paradigm of just a decade ago -- still has a higher enough mean expected return to justify the all-too-evident risks. Or, to dust off a "new economy" rationale from several years back, it could be that risk itself is now seen as a kind of virtue. Perhaps the technology sector is viewed as a portfolio of risk-seeking options, not risk-averse stocks. Setting aside all those regime-level explanations, it could simply be that the market -- at this moment in time -- is betting on a strong bounce-back recovery in the sector that took the worst pain during the bust.

Putting it all together, we continue to believe that technology will be among the best performing *economic* sectors in our present investment-led recovery. Technology *stocks* are not *wildly* overvalued, even relative to the pre-"irrational exuberance" norms, so there's no *strong* headwind that would keep them from reflecting their sector's underlying performance. But there is definitely no tailwind unless you fully accept the norms of the new regime. So with no value case for technology stocks, what they gain from here will be on the growth merits, not because they're cheap. We don't think they're in a "bubble," but it's hard to argue they are cheap.

On another level, we continue to be intrigued by the very wide value differential between technology and non-technology stocks. The undervaluation in non-technology stocks is not as great as it was at the bottoms of last October and March, but it is still notable. So while technology stocks must make it from here strictly on a growth case, non-technology stocks could benefit from the same growth case as well as from at least some valuation tailwind. We're not there yet, but if the value differential continues to expand, we will initiate a model position long non-tech and short tech in risk-adjusted weights. TM