TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Tech's Top Line is Back

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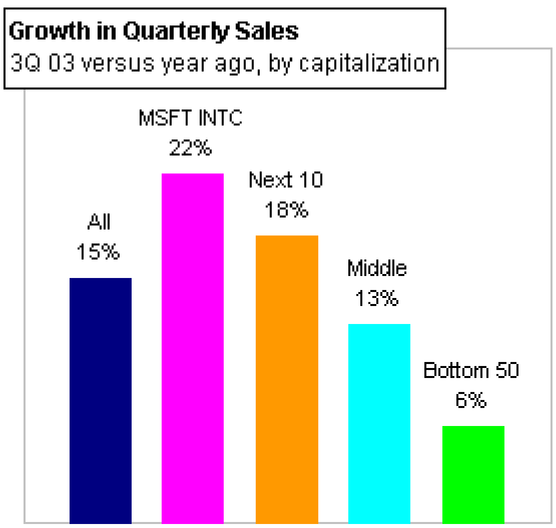
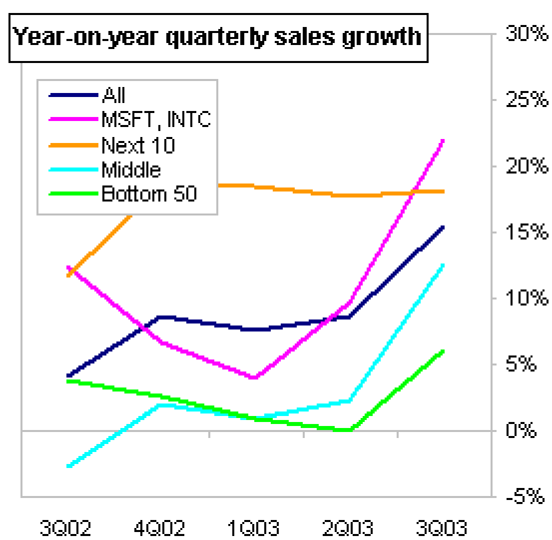
Donald Luskin

Tech has moved beyond the "sales-less recovery."

We expect the recovery in technology sector earnings to be well documented this earnings season, and for tech to continue to lead the equity market. We estimate that trailing 12-month earnings for the S&P 500 Information Technology sector have now recovered 30% through the September quarter, since their bottom eleven months ago in October 2002. And the consensus is now calling for 49% earnings growth in the coming 12 months. In the early days of this recovery, it was the case that rebounding profits were, to a large extent, the product of cost-cutting. It seems now to have entered the conventional wisdom that, just as the economy's recovery is supposedly jobless, the tech earnings recovery is "sales-less." But the numbers indicate that this is simply not true. Across the board, the top-line in tech is coming back.



Over the 279 tech companies in the S&P 1500 super-composite for which complete data is available, sales for the just-completed third quarter are 15% higher than the trough quarter a year ago. Within that, sales growth is monotonically correlated to market capitalization. This is consistent with the process we described a year ago -- leading companies in each category would emerge from the tech-wreck with renewed competitive dominance (see "Let's Play Survivor" September 24, 2002). Note that this look at only 279 well-researched companies ignores over 1000 smaller ones that make up the true bottom end of the tech sector.



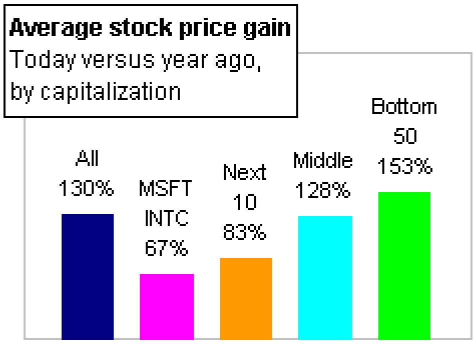
No question about it -- a big part of the profits resurgence is productivity, with earnings growth coming in at twice sales growth. But sales growth has hardly been paltry, and it is accelerating. Note that sales growth for the top ten tech companies excluding *de facto* monopolies **Microsoft** and **Intel** has been strongly in evidence now for four quarters. These are the #1 and #2 companies in categories in which there was market share to be gained, and these companies have consistently gained it at the expense of their #3-and-lower competition. Now, as the overall economy's growth is accelerating, we're beginning to see sales growth ramping up all across the spectrum of companies, from the monopolies all the way down to the smaller niche players (where sales growth has

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

been consistently declining until this just-completed quarter.



Over the last twelve months, investment gains in tech have been negatively correlated to capitalization -- the smaller the company, the bigger the returns. This presents the paradox that the stocks of the slowest growing companies have turned in the best performance. And it's led some commentators to object that we are seeing the resurgence of tech speculation. But it's no paradox, and the fact that confidence in riskier companies has come back into the market is not the same thing as mindless speculation. The fact is that these companies have had near-death experiences, and have pulled through. A year ago their very survival was threatened by a liquidity scarcity that was choking off their capital lifelines -- and now, just a year later, we find ourselves in an investment-led recovery. Yes, the panic premiums are out of these stocks. But we continue to expect that tech will set the pace in this recovery. And we continue to believe that the best *risk-adjusted* gains will come from the #1 and #2 companies -- with continued dominant *absolute* performance coming from small niche players whose sales growth is just now beginning to materialize.

It's so politically incorrect to think well of the tech sector, investors we talk to always insist that we give them a "what can go wrong" scenario. That's simple -- the risk to the tech recovery continues to be the possibility of an inflationary outbreak triggered by **Fed** policy that targets job growth to the exclusion of all other indicators, seeking to meddle in non-monetary matters using monetary tools. The Fed's jobs tunnel-vision has become especially dangerous now, with currency turmoil adding new volatility to the global demand for the dollar.

An inflationary outbreak would be especially damaging to tech, as it would effectively undo this year's capital gains tax cut (capgains is an unindexed tax, so inflation effectively causes the investor to pay taxes on illusory gains). We are encouraged by the pullback in gold, which signifies that the market is willing to bet that this risk will be abated by improving jobs statistics (see "Back From the Inflationary Brink" October 6, 2003). But gold remains our inflationary smoke-detector, and we frequently check to make sure that the batteries are fresh. TM