TrendMacrolytics

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MARKET CALLS

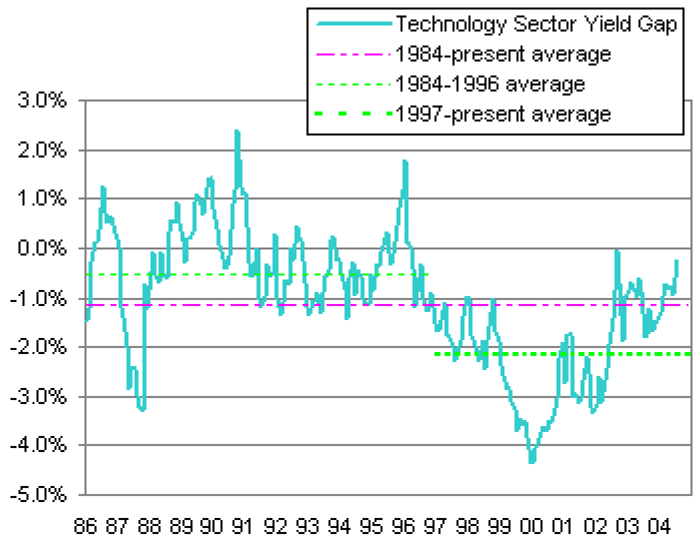
# Tech: A Trading Value Play

Tuesday, July 20, 2004

**Donald Luskin**

**Back at the bottom of the trading range, the Technology Sector looks cheap in relative and absolute terms.**

As of yesterday, the S&P 500 has rallied 37.5% from the bottom on March 11, 2003. The high-beta Technology Sector of the S&P 500 has returned only slightly more, at 39.4%. Technology has not earned an excess return sufficient to justify its risk. Yet at the same time, technology earnings have recovered explosively. From the trough in October 2002 at $30 billion trailing 12-month earnings (which coincided perfectly with the bottom in the NASDAQ), sector earnings have now nearly doubled to $59 billion. Over the same period, S&P 500 earnings have grown by 19%. Put it all together and there is a story to tell that technology could be seen as a value play, both in sector-relative and overall terms.




Our "yield gap" valuation model (which compares forward earnings yields of the equity market or specific equity sectors to the yield of long term Treasuries) shows the Technology Sector now to be more undervalued than it was at the March 2003 bottom, and *more undervalued than at any time since March 1996* with the sole exception of the October 2002 bottom. By the standards of the post-1996 "irrational exuberance" era, tech is stone cheap. By the standards of the last two decades, it is still reasonably cheap (about 0.7 standard deviations from the mean). Even by the tough standards of the pre-1997 era, it is at least a little bit undervalued. So at this point we're talking about degrees.

Tech is also undervalued versus the rest of the equity market on a sector-relative basis, but not as convincingly. The chart on the following page shows the difference in forward earnings yield (forward consensus earnings divided by market capitalization) for the Technology Sector minus that of the S&P 500 Ex-Tech. The more positive the difference, the more technology is relatively undervalued. Today the Technology Sector is still relatively overvalued compared to historical norms -- it is only slightly undervalued even compared to the norms of the post-1996 era. That said, it is more relatively undervalued today than at any time since the sector washout in the spring of 2001, which set the stage for a 41% rally in just seven weeks. Also, note that in October 2002, when the Technology Sector was so deeply undervalued in absolute terms, in

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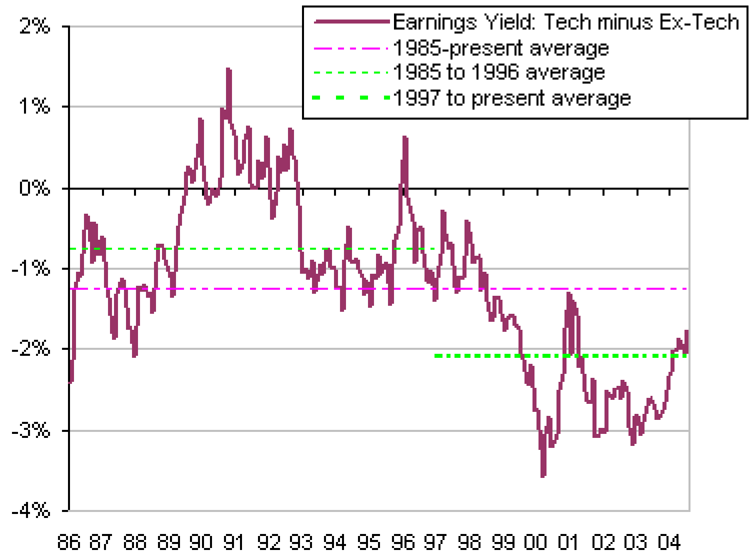
sector-relative terms it was not -- then the *whole market* was extremely undervalued. Yet that bottom, too, was an excellent buying opportunity in tech -- it was followed by a 33% rally in seven weeks (with *much* sharper gains to be had in smaller names).




With the overall market nearing the bottom of the year's trading range, we come back to the philosophy that has guided us in that range all year -- buy the dips and sell the bounces. Who knows if we've reached the absolute bottom of the range at this exact moment. But if not, we're probably close to it. And while we don't see markets -- and especially tech -- breaking out to new highs with so much uncertainty about the election and monetary policy, it's probably time to get prepared for moving back up through the trading range, and the combination of absolute and sector-relative value makes tech the way to play it. Yes, this earnings season so far has been generally treated as being a big disappointment for the Technology Sector. Indeed, we've already noted that the annualized rate of earnings forecast revisions has been falling sharply, and we'll have more on tech earnings dynamics in a subsequent report. But our valuation metrics take all that into account -- and they suggest that the market has *more* than taken all that into account.