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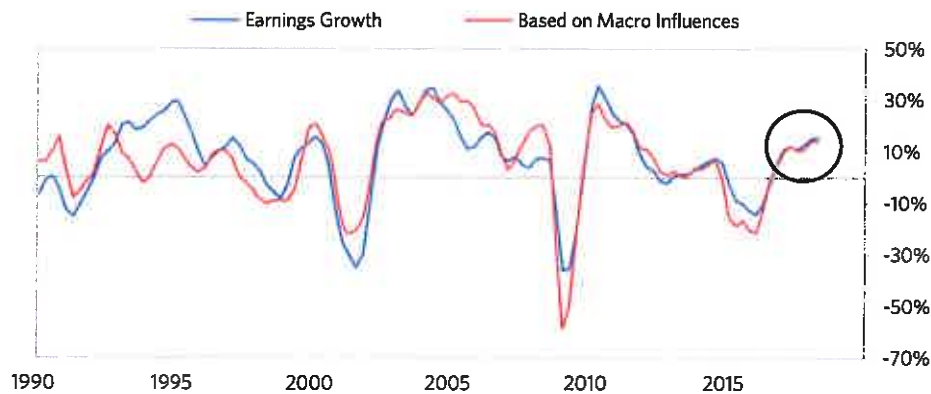
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While Tech Is Creating Big Shifts within the Equity Market, Fundamental Macro Forces Continue to Drive Overall Performance and Those Pressures Are Becoming Less Supportive

Over the past couple of years, as US equities have outperformed the rest of the world, tech has become an increasingly important part of the US equity story, as companies post strong earnings growth and even stronger valuations. The increasing relevance of tech companies has prompted questions of whether something might be different under the hood about the way this cycle is playing out that renders macro assessments of the equity market obsolete. One approach we find helpful is to reconcile the picture coming from the “top-down” lens of the macroeconomic forces driving the market and the “bottom-up” lens of sector and company dynamics. These perspectives are complementary and help us see holistically what is going on, as macro pressures manifest at a company level and micro decisions in aggregate add up to the total macro picture.

- Looking back, the mid-to-late-cycle environment of the past two years has been supportive across the board, but particularly to more cyclical industries—and tech stocks have always been extremely cyclical. It is worth highlighting that these macro pressures are now shifting, with late-cycle pressures intensifying.
- The recent growth rate in tech earnings (which feels so dramatic) is actually consistent with what has occurred late in every cyclical boom over the past fifty years. A few subsectors (e-commerce, online advertising) have seen more explosive growth, but in each case this has come from another company's losses, reflective of a normal cycle of innovation and competition.
- What do look out of line to us are valuations, which are pricing in sustained earnings growth in the US, with tech continuing to outstrip other sectors. This makes US equities vulnerable at a time when cyclical supports look to be appearing in the rearview mirror.

The chart below illustrates that the strength in overall US equity earnings growth continues to be well explained by fundamental macro forces. It shows actual earnings against an estimate based on our read on macro influences on earnings (such as growth, interest rates, wages, currency strength, and so on). Recent strength is consistent with the upswing being predominantly driven by strong growth conditions in the context of still-muted cost pressures.



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This high-level picture permeates down to the sector-level dynamics. As shown in the table below, returns have been strong across sectors, with more cyclical sectors generally outperforming less cyclical sectors and tech on its own contributing close to half of returns. And across sectors, returns have come primarily from earnings growth rather than rising P/Es.

Strong Performance Has Been Supported by Cyclical Boosts to Earnings

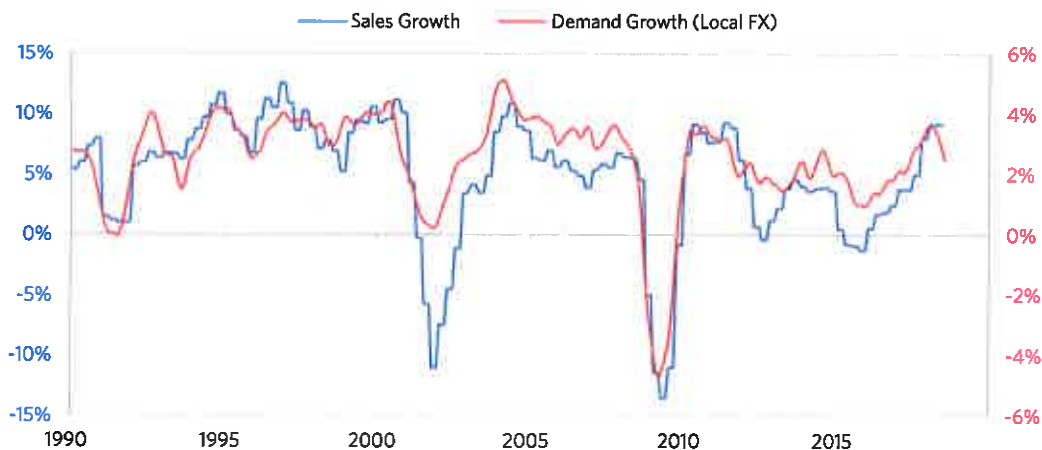
	Sector Breakdown (Past 2 Years, Ann)	Contrib to Total	Price Return	Due to EPS Growth	Due to P/E Changes
Returns have been concentrated in more cyclical sectors, especially tech	Total	16%	16%	16%	-1%
	Cyclical	12%	16%	8%	7%
	Information Technology	7%	22%	21%	7%
	Financials	3%	17%	16%	1%
	Cyclical Services	3%	18%	13%	6%
	Industrials	1%	13%	17%	-4%
	Resources	0%	4%	51%	-49%
	Cyclical Consumer Goods	0%	3%	2%	1%
	Non-Cyclical	4%	8%	8%	1%
	Non-Cyclical Consumer Goods	2%	8%	8%	0%
Non-Cyclical Services	0%	3%	8%	-5%	

Earnings growth has been the main driver of returns

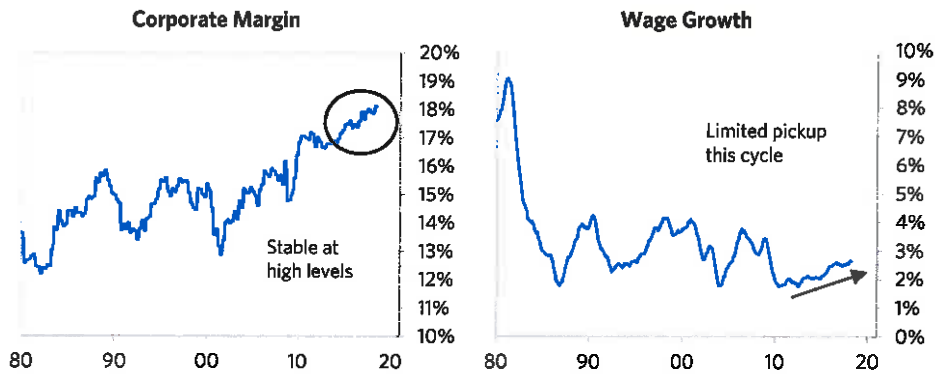
Below, we walk through both the macro and micro pictures, and how they connect, in more depth.

Earnings Growth Aligns with Macro Picture of Cyclical Strength in the US and Still-Limited Cost Pressures

From the macro perspective, companies have benefited as strong global growth has flowed through to strong sales. Growth in the US has been a particular support, as the self-reinforcing expansion of the past few years received a further bump from increased fiscal spending heading into this year. US companies have also benefited from the stability in the dollar over the past couple of years, which had been a significant drag through the translation effect on sales in 2015. Most recently, sales growth has flattened off as demand has moderated a bit, and dollar strength is starting to become a drag. The chart below shows the net effect of these two influences (growth and FX translation) against sales. As shown, they mirror each other through time.

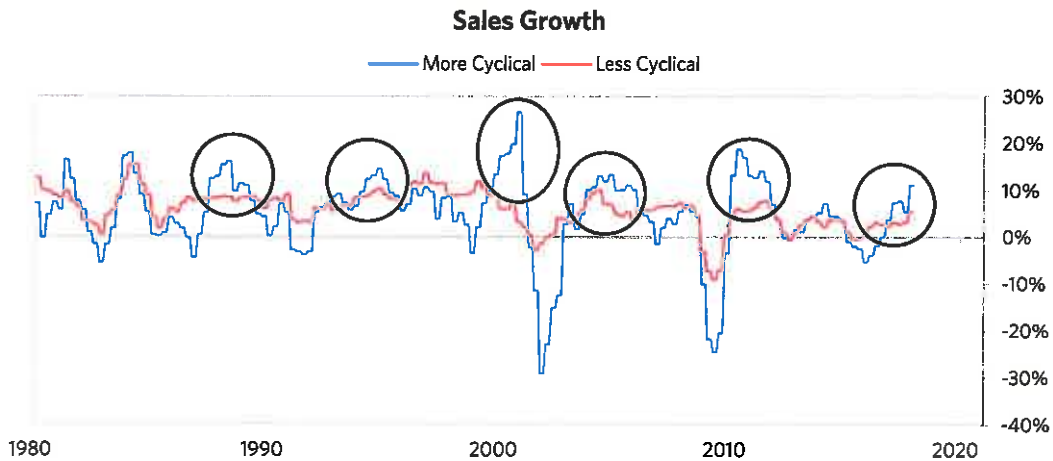


Despite tightening capacity, cost pressures for US companies have remained relatively contained. As shown below, margins have been stable at highs as wage growth has remained relatively weak. This has allowed sales growth to continue to flow through to the bottom line, supporting profits.

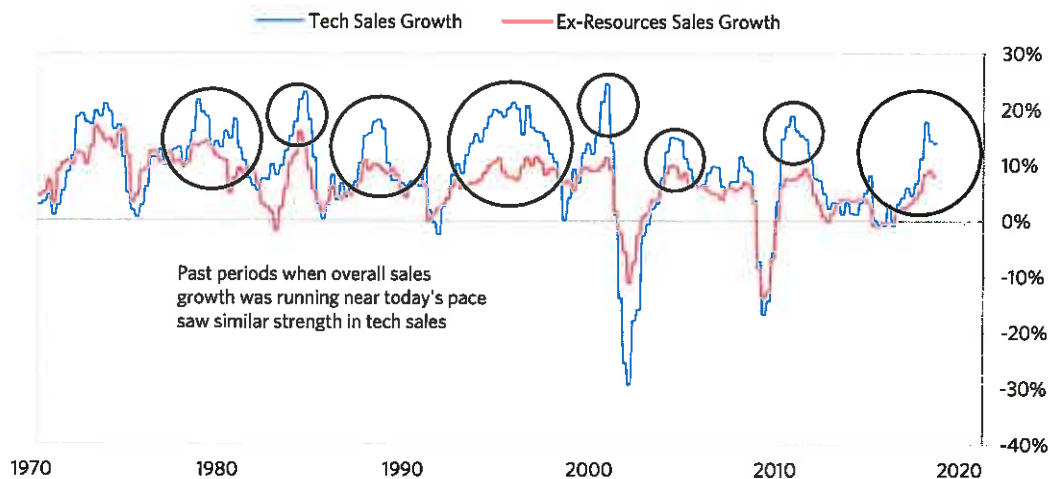


Differences at the Sector Level Largely Mirror Sensitivities to Cyclical Pressures

In a period where strong growth is driving earnings, cyclical sectors generally outperform. This has again been the case today. You can see this in the chart below, which breaks out sales growth of more and less cyclical sectors, highlighting periods of strong cyclical conditions like the one we're currently in.



Zooming in on the tech sector in particular, it makes sense that tech is one of the key sectors to reap the benefits of stronger US growth. Info tech sales are generally closely tied to business fixed investment demand, which tends to be more cyclical (stronger in upturns and weaker in downturns). The recent period of strength in tech sales has been largely in line with the broad pickups in sales growth we have seen in past cycles. It's worth noting that tech sales have also generally run a bit faster than overall sales, reflective of the fact that technology companies have grown in importance and are gradually taking market share from more traditional industries.

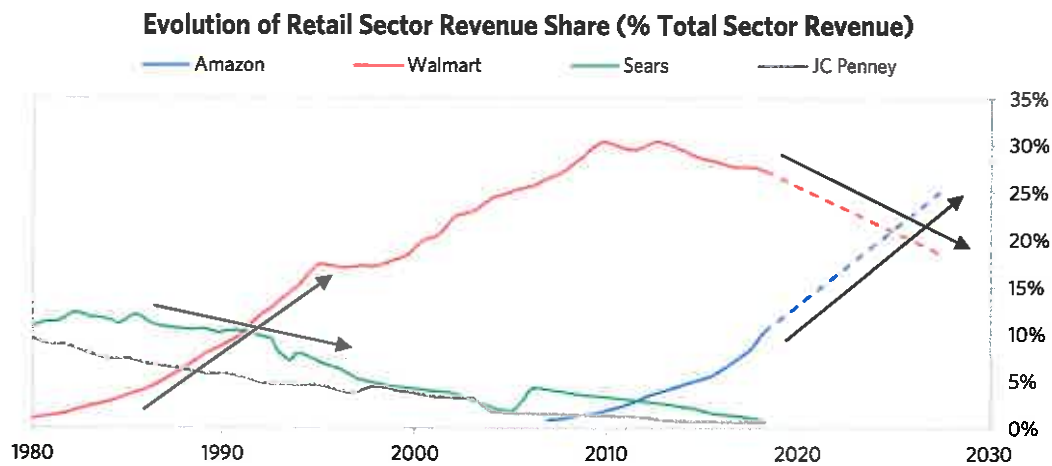


Over time, tech companies have also been able to make ongoing market share gains relative to more traditional listed companies. The table below breaks out sales growth across different business lines within technology, highlighting the places where we have seen this dynamic playing out in the recent period. As shown, the subsectors experiencing the fastest growth are the disruptive product lines. E-commerce and advertising (which are the two areas explicitly replacing existing and traditional industries) are growing much faster than the rest of the tech sector.

Info Tech Sector Sales Growth by Product Line

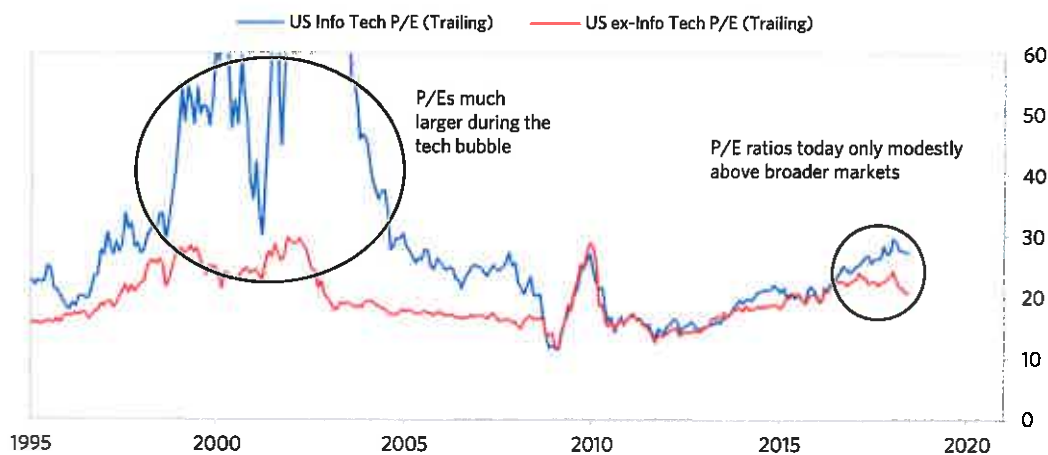
Sector	Sales Growth (Ann)		
	Since 2010	Since 2017	
More "traditional" tech products	Telecom	4%	2%
	Hardware	13%	5%
	Cloud Computing	9%	13%
	Services & Software	5%	11%
"Disruptive" product lines	E-Commerce	27%	28%
	Advertising	27%	26%

Shifts of this nature are always going on among different companies, reflective of ongoing innovation and competition. The chart below shows the example of the shifts occurring in retail over time. Through the '90s, we saw the boom in Walmart stealing share from existing retailers like Sears and JC Penney. More recently, Amazon has begun to steal share from Walmart. Looking ahead, what's priced in reflects a shift akin to that we saw in the early '90s. Each successive wave has reflected new innovations (e.g., successively lower distribution costs and increased convenience), with the innovators reaping the rewards.



Discounting Is Extrapolating Sustained Strong Earnings Growth, with Tech Continuing to Outperform

Currently, P/Es for both tech and the broader market reflect an extrapolation of recent trends, pricing in sustained strong earnings growth in the US, with tech continuing to outstrip other sectors. While tech sector valuations remain somewhat higher than the rest of the market, this divergence is significantly smaller than what we have seen in the past, and certainly nothing like the tech bubble. For the whole market, we think that this extrapolation as underlying macro conditions begin to shift makes US equities more likely to disappoint.



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