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US Tech: Dip or blip?

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The US Tech story

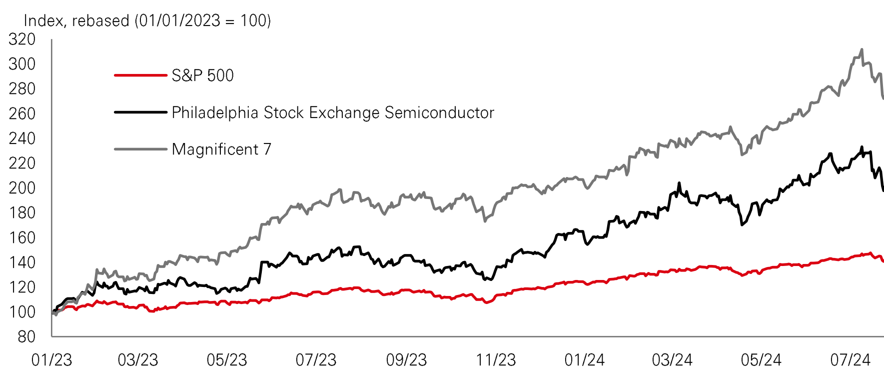
US stock markets have had a very strong run over the past 18 months, outperforming most major regions. The US megacap tech sector has been a key driver of stellar gains, with investor enthusiasm centred on the potential for Artificial Intelligence (AI) to boost company revenues as well as economy-wide productivity growth. Economic resilience despite elevated interest rates, and ongoing disinflation have also boosted broader investor sentiment.

But since hitting an all-time high on 16 July, the S&P 500 has experienced a correction of about 6% at the time of writing. And there has been a much more significant drawdown in the Magnificent Seven (Mag7) tech stocks and basket of semiconductor stocks as represented by the Philadelphia Semiconductor Index (14% and 21% respectively since their peaks on 10 July) (Figure 1). In Asia, tech-sensitive markets such as those in Korea, Taiwan, and Japan have also been hit hard in recent trading sessions.

US stock markets have had a very strong run over the past 18 months. But this has been turbocharged by gains in tech stocks that have recently corrected

There has also been a rotation into left-behind parts of the market such as small caps and value stocks which benefit from interest rate cuts

Figure 1: US stock indices



Source: Bloomberg, HSBC AM as of 2 August 2024. Past performance is not an indication of future returns.

Weakness in US tech and chip stocks matters for the S&P 500. Rapid price gains in these sectors have meant the Mag7 now accounts for nearly a third of the overall market capitalisation of the S&P 500. The Mag7 accounted for just over half S&P 500 gains between 1 January this year and the 16 July peak.

Our view:
Recent market action highlights the vulnerability of the US tech sector to disappointing developments.

As the soft landing is confirmed, we think there is room for left-behind parts of the market such as small cap and value names to outperform

What's behind recent market moves?

The latest selloff comes amid a **valuation backdrop which looks increasingly stretched**. The Mag7 is trading on a 12-month forward price-earnings (PE) ratio of 34x, versus 18x for the rest of the US market. This meant some disappointing earnings results and outlook statements during the Q2 earnings season were received particularly poorly. Investors may also be scrutinising the huge investment outlays on research and development into AI capabilities that are yet to translate into a significant source of fresh revenue generation.

The recent geopolitical news flow has also dented sentiment, with concern over the impact of potential US foreign policy and protectionist measures on the global semiconductor industry.

But this has also occurred amid better news on US inflation, with June's CPI print coming in below expectations, and some evidence of a weakening US consumer and further labour market cooling that **opens the door to a September rate cut**. Markets are now pencilling **five 25bp rate cuts** for 2024, having bottomed out at just one cut expected back in late April, while expectations for the policy rate one year ahead has fallen by around 100 basis points relative to a month ago.

This is a significant development for Japan. The combination of Bank of Japan tightening and prospect of looser Fed policy contributing to a **sharp reversal in the yen that has piled pressure on the country's stock markets**.

An increased chance of Fed rate cuts has fired up investor interest in smaller-cap names that are more sensitive to interest rates due to the structure of their balance sheets and have thus struggled in the post-pandemic world of higher interest rates. Combined with the tech selloff, this has translated into a **sharp rotation out of the tech-heavy Nasdaq into the small-cap Russell 2000** (Figure 2).

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The big questions facing investors

Will big tech continue to selloff? A further drawdown is possible. Valuations still look expensive and the prospect of global central bank easing offers an attractive entry point into many cheaper parts of the investment universe.

But for the time being, broadly robust Mag7 earnings growth combined with moderating EPS growth expectations limits the scope for big disappointments and a further major correction. **We aren't in a 2000 dot-com crash backdrop of very extreme valuations and limited evidence of earnings delivery**.

Figure 2: Russell 2000 versus NASDAQ relative performance

Source: Macrobond HSBC AM as of 2 August 2024. Past performance is not an indication of future returns.

And what keeps the rotation trade alive? Although much good macroeconomic news is now priced in, the delivery of rate cuts and **confirmation of the soft landing could still provide a boost to left-behind parts of the market such as small caps, value, real estate and defensives**. Our analysis points to a less concentrated market performance in H2 amid a broadening out of global profits growth.

And in the event that macro conditions deteriorate more significantly, "defensive value" stocks in sectors such as consumer staples could be the outperformers.

Investment conclusions

Recent market action highlights that **stretched valuations in US big tech stocks have made prices vulnerable to any disappointment on earnings and the general news flow in the sector**. This is a key reason why we hold a cautious view on US stocks in our multi-asset portfolios. Key issues to monitor will be earnings performance in H2, evidence of a pickup in the return on investment on AI expenditure, and how geopolitical tensions affect the semiconductor sector.

While the rotation into small-cap and value names may continue, **we think an alternative Asia-Mag7 could offer a more attractively priced route to investing in the global technology theme**. A basket of seven of Asia's largest and fastest-growing chip makers and IT electronics firms has a 12-month forward PE ratio of around half of the US Mag7, yet with still strong earnings growth expectations.

Finally, after strong returns and low volatility in H1, we think there are plenty of potential developments that could create a more fractious market environment in H2. Although our baseline economic scenario remains for a "softish landing" of below-trend growth and a further decline in inflation, restrictive policy risks a more significant downturn. Recent earnings announcements show evidence that US consumers are showing signs of flagging, with lower-income households in particular feeling the heat from higher borrowing costs.

History also tells us that a gradual **labour market cooling can morph into something more pernicious with little warning**. Indeed, the latest ISM employment reading alongside unexpectedly soft payrolls and 0.2 percentage point jump in the unemployment rate to 4.3% highlight an increasing risk that the US economy hits a tipping point.

And despite the recent good news, the **disinflation path is likely to remain bumpy**.

Geopolitics and politics also matter. The global environment is becoming less predictable. And we know from history that equity market volatility typically rises ahead of US elections. All this is likely to make for a more volatile ride in markets.

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