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Large Tech Sector Outlook: Dense Fog Late April 2023

The tech sector, especially the largest caps, has had a surprise rebound based on the hope that the Fed will soon reverse its fight against inflation. That is a big risk to bet on.

While nothing is assured, I suggest diversification, including allocations to historically less risky investments. I have specific value and other "participate yet protect" recommendations for clients based on their objectives, risk tolerance, and personal outlook - especially as investors get closer to or are at retirement age.

Why the sudden growth-tech sector sprint?

While the "after-inflation" long-term outlook may be good for many large-cap tech stocks, high valuations, massive layoffs, declining revenues, and continued high-interest rates could result in another reversal in market values. Since valuations assume future growth, this is discounted to present value based on the interest rate outlook.

Barron's 4/24/2023 discusses the recent drop in interest rates and the lowered S&P500 VIX "fear index" vs. the Fed's latest FMOC meeting outlook. The article quotes Harley Bassman, creator of a different volatility index: "The rates market has bet the ranch that inflation will soon collapse and the Fed will jump one more time to 5%, and then cut (rates) twice by December and five times by May 2024. I don't buy that."

Bassman doubts that inflation will break, as implied by the market's [stock and bond] expectation of rate cuts, given a continued tight jobs market because of baby-boomer retirements and curtailed immigration. Deutsche Bank economists write that core services inflation remains high, even with housing costs starting to cool. They add that healthcare costs will probably boost the personal consumption deflator, the Fed's favored inflation measure, which will feed into labor costs. Barron's concludes that the two worlds of bond and stock investors may collide in the months ahead.

FT London 4/23/2023 Excerpts: The economy still shows signs of rude health (British meaning: strong and healthy). Most Fed officials characterise the labour market as "tight" even as monthly job growth has ebbed. Wage growth, while slower, remains far above a level consistent with inflation trending back to the Fed's 2 percent target. While the annual pace of inflation has declined significantly, monthly measures of underlying price pressures remain worryingly elevated.

Christopher Waller, an influential Fed governor, said that the recent data indicate "we haven't made much progress on our inflation goal."

Opinions have diverged, however, about how significantly regional banks have pulled back from lending in the wake of Silicon Valley Bank's failure last month and the extent to which credit availability around the economy is now hamstrung. Less lending could also result in less inflation pressure.

"At this point, I don't see why we would just continue to go up, up, up and then go, 'oops'" and rapidly cut rates, said Patrick Harker, president of the Philadelphia Fed. Austan Goolsbee, the new president of the Chicago Fed, has also called for "prudence and patience" following the most aggressive campaign to tighten monetary policy in decades.

Tim Duy, chief US economist at SGH Macro Advisors, said: "It's very hard for an inflation-targeting central bank to walk away from rate hikes when underlying inflation has not shown persistent progress towards its target."

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Morningstar excerpts 4/20/2023: The companies leading this year's stock market rebound are mainly high-growth technology stocks and communication services sector stocks. These stocks tend to be sensitive to changes in interest rates, and the building expectations that the Federal Reserve will be cutting rates in the second half of this year have helped buoy the group.

The recent bounce in these mega-cap names marks a big reversal from 2022, when the same stocks got clobbered amid the fastest interest-rate hike cycle in decades, dragging the rest of the market into bear territory. But what happens now is unclear, partly because valuations look less attractive for many than at the bear-market lows.

The article includes a chart showing that relative to the Morningstar (MS) Growth or Blend sectors, the Value sector has the lowest price to MS's "fair value" estimates ratio, which continues to make the value sector attractive on a relative valuation basis. MS also shows the smaller-cap value stocks at more favorable valuations than the mid-cap or the large-value sector.

Related News The current decline in bond interest rates may be temporary. After last month's sudden collapse of Silicon Valley Bank and Signature Bank, the bond market began adjusting for potential rate cuts even as the cost of living remained elevated. The bank crisis was mainly due to the plunge in the value of "safe" longer-term Treasury debt as interest rates rose.

Bank of England expected to raise interest rates again after UK inflation only dips to 10.1%. Food prices soared over 19% - their fastest rate in over 45 years last month, adding to the inflation pain suffered by households. The Guardian 4/19/2023

Good for the economy/Bad for inflation: The regional Fed's "Empire State" index on current business conditions jumped notably to a reading of +10.8 this month. Economists polled by Reuters had forecast the index at -18.0. A reading above zero signals the New York manufacturing sector is growing. The rebound is an encouraging sign for national manufacturing activity, which had been undermined by higher interest rates and the rotation of spending from goods back to services. Reuters 4/17/2023

Summary

The market is forward looking, typically with valuations based on expected earnings looking forward 6-12 months or more. The key is the impact of higher-for-longer rates on economic growth and corporate profits. And, of course, this is the big unknown. I recommend a balanced portfolio for those with a moderate growth/moderate risk long-term outlook that includes our specific value, growth, and "participate yet protect" investment recommendations.

Annuity rates have been so low I have not recommended any for a few years. However, their current higher rates may make sense for the most conservative part of a portfolio.

I continue to recommend from previous pdf reports on hutchisonria.com:

Reasons to Stay Invested in Volatile Times https://dhutch.news/StayInvested

Include Value and Growth in Portfolios: https://dhutch.news/ValvevsGrowth

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Investors cannot invest directly in indexes. The performance of any index is not indicative of the performance of any investment and does not take into account the effects of inflation and the fees and expenses associated with investing.

Small-cap equities may be subject to higher market risk than large-cap funds or more established companies' securities. Furthermore, the small-cap market's illiquidity may affect an investment's value so that, when redeemed, shares may be worth more or less than their original cost.

All guarantees associated with annuities are backed by the claims-paying ability of the issuing insurance company.

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