Conversations with Commerce Trust podcast
March Episode: How Technology is Re-shaping the S&P 500 Index
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David Hagee: Hello and welcome to *Conversations with Commerce Trust,* our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're discussing equity markets and the influence of the technology sector, with Senior Investment Strategist and Director of Equity Research, Don McArthur. Welcome to the podcast, Don.

Don McArthur: Thanks for having me, David. Looking forward to the conversation.

David: Great to have you on here. It's really timely to talk about the tech sector. As we've discussed on this podcast and certainly in a lot of different materials that we published, 2023 was a fantastic year, but it was mostly driven by the tech sector. 2024 has been off to a good start here. Again, tech sector dominance inside that space. It would be helpful for our listeners to go through a quick recap of what happened in 2023 with regard to the tech sector.

Don: Yes, David. 2023 was good for all equity markets, but it depended on where you were. The S&P 500 (Index) was up 26%. The Dow (Jones) Industrial Average trailed, only up 16%. The leader was the NASDAQ, up 45%. International developed (as measured by the MSCI EAFE Index) had good returns, but still trailed it, up 18%. Emerging markets (measured by the MSCI Emerging Markets Index) were up 10%. It really mattered where you were invested with these major markets because you had a fairly wide dispersion of returns.

Within the S&P 500, it was very concentrated into what is noted as the "Magnificent Seven." These are the large technology companies. We have Apple, Microsoft, Alphabet, which is Google, Amazon, NVIDIA, Meta, formerly known as Facebook, and Tesla. These seven companies were up 76% last year. The rest of the market was only up 14% when you exclude those.

Some of the performance was due to a rebound of these companies having poor performance in 2022. They were generally pandemic beneficiaries, so they ramped up expenses to fulfill increasing need. Then as things slowed down, they had bloated cost structures that they need to get in order. We had some improving profitability as they cut costs, but we also had innovation such as artificial intelligence (AI) contribute to the performance.

David: As we look back, you mentioned 2022, a very rough year for these Magnificent Seven at that point. 2023 was a fabulous year, up 76%, as you mentioned. Net-net, I think on a two-year basis, they're up about 3%, 4% if you're looking at just the Magnificent Seven there. What do we think about 2024? Are there earnings there? Are the valuations stretched? What's that looking like?

Don: Through February, much of the trends of 2023 are in place in 2024. We have the S&P (500) up 7%, developed international markets are up 2%, and emerging markets are roughly flat on the year. Earnings are coming in better than expected, which is driving performance. Also, investors priced in a less aggressive Fed (Federal Reserve.) The end of last year, investors were looking for six rate cuts by the Fed. Now we're looking for three, as investors switch from looking for a recession to a view of continued economic growth in 2024.

Technology is still a driving force of recent returns. Valuations due to this increased profitability don't appear stretched broadly. Sure, there's some areas, but overall, look forward to good returns in the year.

David: As we start to dissect the tech sector, let's walk through a little bit of history here. We had the "Nifty Fifty" in the early '70s. We had the Dot-com era in the late '90s. It seems like now the tech sector is on a much better footing than they were when the previous run-ups inside the tech space. What's going on in tech? Why is it doing so well?

Don: Yes, David, good point. Simply put, technology is taking profit dollars from other areas of the economy and the stock market. We have Amazon.com, leader in e-commerce, taking profits away from other retailers that we had in the past. You speak of the Nifty Fifty, one of them was Eastman-Kodak in the '70s. Now, we take pictures with our iPhones, so that goes to Apple. We used to get our entertainment through television, through newspapers, and now it's Netflix, social media, YouTube, which is owned by Alphabet.

Profit dollars are shifting from other areas of the economy to technologies. If you actually look at technology sector itself, it's just at 30% of the S&P. If you add in some of these other large-cap companies that are not classified as technology companies—Amazon, Meta, Alphabet, etc., you get to nearly half of the S&P is technology-related. Now, these businesses have evolved, and they're very "asset light": they get higher returns, which argue for higher multiples than our economy of the past, where it's very cyclical, industrial-based.

If you go back to the '70s, roughly two-thirds of the S&P 500 was industrial companies, and now nearly half is technology, innovation-related. Again, much more profitable. They just add a new server when they get new businesses, new business, or new revenue. They don't have to build a new plant, buy a piece of equipment, because when the economy does start to turn down, you have a lot of fixed costs in those industrial bases. The market's really shifted towards these higher returns.

David: That's a great point, that not only are they stealing sort of market share from their sort of old-line competitors. Maybe you could talk a little bit about how they're driving profits inside their own companies.

Don: How they're driving profits are a lot of leverage just to technology and to new users, and it's not that expensive to facilitate that new user. If you think about social media platforms, if they get more eyeballs, then they can sell more advertising ads. Then they create value for their customers, and it's a lot more measurable. There's just not a lot of investment to get that incremental user for these technology companies.

Now, if we look, bigger picture, at even the whole world, why we prefer domestic stocks over international stocks are just that composition of the market and the composition of the economy, whereas the U.S. (has) nearly half of the market is technology-related, only 8% of international developed stock market is technology-related. It's even less for emerging markets.

As these companies, which are primarily U.S.-based, even though they're global, are doing well, they're taking profit dollars from other areas of the economy and of the world. Now, I'm not saying that this trend is going to last forever in a straight-up manner. However, we're going to get pullbacks from time to time. They'll get extended, as we've seen cycles in the past. We'll just have to go through those. Just for that long-term, where the market's going to go, if you look at the Wayne Gretzky "Where the puck's moving," is we want to be in these areas that are going to be increasing profitability over time.

David: We have been inundated with AI-related items, especially as we're looking at earnings. You hear AI, AI, AI. As we talk about AI, where is that positioning inside the tech sector, and how is that playing through inside the markets?

Don: Yes, I think in the last earnings season calls, nearly two-thirds or 75% of all companies mentioned AI in their transcripts. It's definitely very big in the media, and we're hearing about it from various places. Artificial intelligence really gained steam with the release of ChatGPT in November of '22, but various levels of AI have been around for years, it's just improving.

I think now we're really in the early innings of the artificial intelligence age. This is-- think about a big stage of technology. We had the internet, we had mobile, we have artificial intelligence going to drive growth in the future. Right now, we're seeing it in what I would call the infrastructure layer. We have semiconductor companies that run these large artificial intelligence programs. We have networking companies that move data around. We have data companies which are organizing the data. We have servers which run the computations on them.

We're really getting that infrastructure in place right now. We're also seeing cloud computing companies such as Amazon Web Services, which is AWS, (and) Microsoft Azure, which run these artificial intelligence programs, either for other people or applications which run on them. They're really seeing a benefit as we move right now.

David: As we look at AI inside businesses, now is this going to drive the profitability of the business or is this going to draw new customers into a business?

Don: Yes, great question. A little bit of both, and a lot of efficiency. Right now, we're seeing AI in daily life through generating content. This is especially true from a creative standpoint, advertising firms, et cetera. There (are) also several large software companies ingraining AI into their existing capabilities to make life just more efficient for users. They're noting-- a lot of companies are noting 25% to 40% improvement in efficiencies by using AI.

That increases their profitability, increases returns, etc. Matters where you are, but we're going to see this evolution continue for many years. Part of it will just drive more economic growth, but greater profitability, which generally means good things for the stock market.

David: With AI as a backdrop for 2024, how are we thinking about the tech sector and technology companies from a portfolio management perspective?

Don: We're still very bullish on technology, especially for the long term with increased profitability, increased returns, and in just better business models going forward, taking those profits from other areas. Again, we'll get overextended from time to time. But right now, things are looking good for technology companies. Again, that's why we prefer domestic over international because of that technology waiting.

David: As we look forward, again, this is a situation where we think it's fairly sustainable from an earnings point of view, that we're not over our skis in terms of valuations, we haven't gotten too far ahead of ourselves. I'm struck by the fact that, as you mentioned earlier, that these seven companies are about 28% of the S&P 500, and tech or tech-adjacent companies are about 50% of the S&P 500.

Historically, when companies have gotten to be that big a weighting in the S&P 500, that's led to some issues. Any thoughts on whether we're facing valuation problems or whether we're facing any sort of headwinds inside the tech sector that historically this big a weighting has caused?

Don: Yes, great point, David. When you look at individual companies, there are some that do look very extended from a valuation perspective. If you look at it from a whole, a lot of the earnings growth for the S&P 500 in general is from technology companies. I think, in the last quarter, technology plus areas were up over 20% on earnings, whereas the rest were zero, to give us about 10% earnings growth in the fourth quarter of '23.

It's really an earnings-driven story, which makes those valuations not as stretched as we saw in 1999, when we're valuing companies off of eyeballs or pets.com that everybody was going to buy four or five dogs and order everything online, that didn't actually happen. We're not to those areas. Sure, there's some companies that are overextended. A lot of these companies, even within the Magnificent Seven, are just very profitable and their valuations are very similar. Actually, some had a discount to that of the S&P 500. If we look broadly, we don't see valuation as a hindrance right now for the market.

David: Don, thanks for the interesting discussion today. For more information on this topic, please download our companion piece at www.commercetrustcompany.com.

If you've enjoyed what you've heard today, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from. Thank you for joining us today on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

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