Are we at the end of the 'Big Tech' sell off?

Cormac Weldon, manager of the Artemis US Select Fund, looks at recent earnings releases from the Big Tech companies and assesses their prospects following the sell off.

Cormac Weldon

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For much of 2020-2021 the 'Big Tech' companies (Apple, Microsoft, Google/Alphabet, Amazon and Facebook/Meta) drove the US market's rally as they benefited from the pandemic boom in online advertising or online retail. In 2022, the situation has reversed as, in the face of economic slowdown, consumer companies started to pull back on advertising and expenditure on cloud computing (a major growth driver) was reduced. More broadly, rising interest rates put growth companies' valuations under scrutiny. The result was a dramatic sell off, exacerbated by some surprises and disappointments in recent earnings announcements from the Big Tech companies.

Have we reached the end of the sell off? And can Big tech companies regain their status as all-weather growth companies? Recently announced Q3 results offer an opportunity for us to step back and assess.

Although the companies are grappling with different dynamics, we saw some common themes in their recent results. The first was that the strength of the US dollar had a much bigger impact than had been anticipated when Q2 results were reported in July. However, excluding the effect of currency, the underlying growth of each company seemed fairly robust, despite difficult year on year comparators. And this was despite weakness in advertising spend and growth in cloud.

Secondly, reported costs provided negative surprises. Investors expected overall cost bases to look more positive as there had been a lot of talk about hiring freezes and redundancies. These did not materialise in the Q3 results (although some have been announced since). The companies have continued to invest in staff this year and it was still going on at the beginning of the summer. Although growth in costs will now stop or at least slow, year on year comparators will hold back profitability for the next few quarters.

Amazon's update was probably the least surprising. The company downgraded its expectations on the retail side for the key holiday season, given consumers' uncertainty around rising interest rates and the slowing economy. It also disappointed on revenues in its cloud business, which has been compensating for a slowdown in the retail

business after the pandemic boom. Of more concern was the slowness in reducing costs in the cloud business. We think there is still a lack of valuation support for Amazon and it is likely to derate further.

Apple beat expectations for revenue and earnings per share. It has held up relatively well this year thanks to new product launches and as a result we think it looks expensive. It has also benefited from consumer spending being more robust than corporate spending so far in the slowing economic environment. This dynamic could switch early next year as higher interest rates start to affect consumer confidence. Delays to shipments of the iPhone 14 pro because of Covid-related factory shutdowns in China could also put the stock's premium valuation under pressure. As with Amazon, we think it could derate further.

For **Microsoft**, we think the stock sold off so much because while investors expected the Azure public cloud business to slow, operating expenses rose more than expected because the company continued to add new employees. The company has committed to not increasing the cost base with more hires, so there should not be further surprises there. But investors will still worry about the cloud business slowing. Although the short term may be difficult, we still believe in the long-term story for cloud growth.

For **Google**/**Alphabet**, on a currency adjusted basis Q3 revenues were better than the headlines would suggest. Costs were more of a problem, as there was record hiring during the quarter and not clear enough guidance on future operating costs. There are obviously concerns about advertising revenues continuing to slow as the economy deteriorates. But following the share price falls Google's valuation looks undemanding. We also think the management will be more disciplined on costs than currently expected. We would still need more clarity of cuts to advertising expenditure before taking a more positive view of the stock.

Meta/**Facebook** provided the real shock in the Q3 results. Mark Zuckerberg's plan to invest in artificial intelligence and the Metaverse led to a 25% fall in its share price in one day. Capital spending is set to more than double to $39 billion at a time of stagnating revenue growth. While it's clear the company is investing heavily during a down cycle to gain a long-term advantage, it's far too early to tell if this is the right move to make.

The above is a snapshot of our views on the individual Big Tech stocks. As to when we think the rout in their share prices will end – the market will need to see through the current decline in advertising expenditure. According to Standard Media Index, September 2022 marked the fourth consecutive month in which overall expenditure had declined on the previous year (-5%). This could still turn around. As the effect of higher interest rates and the scale of economic slowdown become clearer, the next few months are likely to be key. In the meantime we retain a cautious stance.

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Manages:
US equity strategy

Cormac has managed Artemis' US equity strategies since launch.

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