CIO Academy

Deciphering the Link Between Big Tech 'Expensive-ism' and 'US Exceptionalism'

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- **Big tech's 'expensive-ism' is on the top of most investors' mind** - rich valuations, concentration of gains in a few mega-cap tech names (the Magnificent-7), and the lack of market breadth are key causes of concern. Investors worry if we're we headed towards a 2000-style tech bubble burst. But big tech companies of 2024 are very different from the tech bubble of 1990s. Our analysis shows that today's tech companies are far more profitable and innovative than those of 1990s. Their superior earnings growth, promising business models and high Return on Equity (RoE) are their key differentiators.

- **For many investors, 'US exceptionalism' has been a head scratcher too**. Despite enduring one of the tightest monetary policy cycles in the last two years, US economic growth, consumption, the labour market, and wage gains – all remain strong. Yet, at the same time, US inflation has declined. **Is this 'economic nirvana' sustainable?** We think it is and here's why: We believe 'US exceptionalism' rests on two pillars: a.) Strong domestic US consumption; and b.) A resounding comeback of US productivity enabled by tech advancements in Generative AI & Robots, Cloud Computing, and Digital Transformation. We discuss in this report why we expect both drivers of US exceptionalism to be strong in 2024.

- **Finally, are 'US exceptionalism' and the big tech 'expensive-ism' interlinked? We believe they are**. There is a virtuous feedback loop between the advancements in technology, the rise in US productivity, corporate earnings growth, and the US stocks' outperformance. Technological advancements generate operational efficiencies, improve corporate margins and earnings, in-turn leading to higher valuation premiums. This structural superiority in US productivity and tech also makes the higher US earnings growth trajectory more durable. Innovation by big US tech companies should also enable other sectors to innovate and this should broaden the rally to other cyclical sectors in 2024. We highlight these cyclical opportunities in our American Resilience and North American Re-industrialisation Investment themes.

Big Tech – Leading the US rally and for the right reasons…

…spurred by AI, Earnings, and Return on Equity

Despite the rigorous recalibration of market expectations for the expected number of Fed rate hikes in 2024 (fewer than the market previously expected) and the ensuing rates volatility, the S&P500 index crossed the psychologically all-important 5000 mark in February 2024. It's almost as if higher rates have no impact on US equities, especially as this stock market bull run has primarily been driven north by a handful of big tech stocks (also referred to as the Magnificent-7) which are traditionally rate sensitive. These stocks have on average rallied over 85% YoY, and they now account for circa 30% of the S&P 500 index.

At their current Price-to-Earnings (P/E) multiple of circa 30x, big tech stocks certainly look optically expensive versus the rest of the S&P 500. But we don't think we're in bubble territory like that of the early 2000s for the following reasons:

1.) **Unlike the dot-com stocks, today's big tech earnings backup their price outperformance:** In the Q4 2023 US earnings season, most big tech companies managed to outpace the already high consensus expectations. Magnificent-7 earnings grew ~ 40% over the last 12 months, much faster than the 1% of the broader index and 6% for the overall Tech sector[1]. Together, they have generated over a quarter of a Trillion dollars in earnings in 2023, contributing to circa two-thirds of the S&P500 performance over the last one year and roughly 40% YTD. Therefore, in complete contrast to the meteoritic gains of the unprofitable dot-com bubble stocks of 1990s, today's big tech earnings show that their price outperformance is very well deserved.

   The total Return on Equity of today's tech companies is also high. As the chart on the right depicts, the RoE of dot-com bubble companies was only 16% on average, far below the 30% RoE of today's world class tech companies[1].

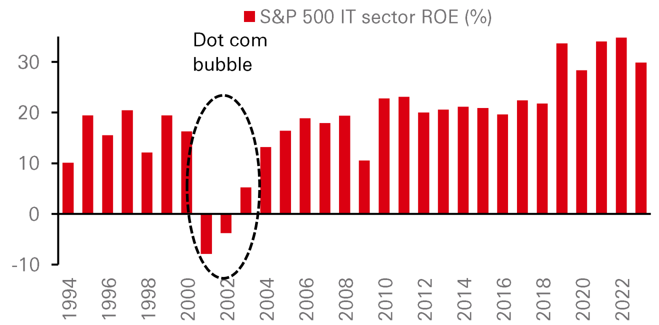
2.) **The quality of the tech companies in the year 2000 was also vastly different from the tech companies of today**. Tech companies of 2024 are large, well-diversified corporates, with solid cash flows generated in well-established parts of businesses, outside of AI. Artificial Intelligence is a new growth area, over and above their already proven, durable business models.

   In the 1990s, however, the internet was still in its infancy and the world was unbeknown to the power and pervasiveness of the internet of the future. As a result, business models utilising the full reach of internet did not exist, nor did the seamlessness of the world wide web of today. With little revenues and no profits, several internet companies of the 1990s were nothing more than speculative shells. The promise and utility of today's AI, on the other hand, is relatively better understood. Its value proposition in optimising business operations, enhancing output and cost efficiencies is already generating better corporate profitability, as reflected in the Magnificent-7 revenue and earnings.

   Looking beyond the very near term, we think that we are still in the foothills of the AI technology and expect to see continued innovation and evolution. While the AI chips story has been at the front and centre of the AI innovation thus far, it is not the only feather in AI's cap. As the current generation of AI processors and chips become more and more sophisticated with further innovation, new applications should surface.

   We expect the entire **AI tech stack to develop further - from the hardware (AI chips) - to software - and finally to the data layer**. As this materialises, we think several derivatives of AI will play out over the next few years, adding to earnings and profits growth of the big tech. Indeed, it is this evolution of the AI tech stack that's driving the demand for digital infrastructure and datacentres.

IT sector's Return on Equity was much lower in the 1990s vs today



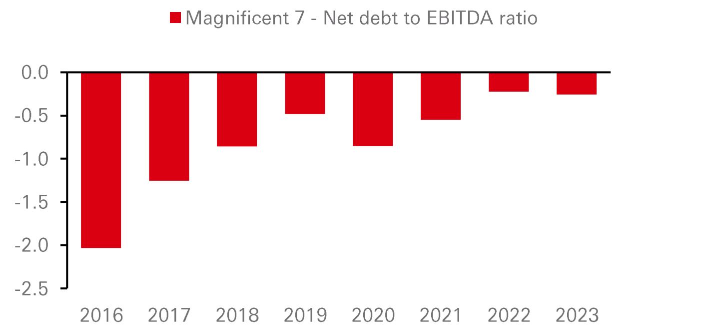
Source: Bloomberg, HSBC Global Research, HSBC Global Private Banking, March 2024

3.) Another key differentiator of the Magnificent-7 from the tech bubble of 2000s is the former's penchant to **reinvest for growth**. The Mag-7 reinvest circa 60% of their cash flow from operations through growth capex and R&D, highlighting their confidence in the continued growth potential. At this rate, they re-invest more than double the 26% of the tech bubble companies and about 3x that of S&P 493[2].

4.) Finally, contrary to expectations, today's **big tech companies have proven to be highly insensitive to the rates volatility,** which has been high. Despite being categorised as "growth stocks", the Magnificent-7 have shown immense resilience to tight monetary policy and rates volatility, especially at the short end of the US rates curve.

That's because these companies **enjoy high Free Cash Flows (FCF) from their operations** which are benefitting from high rates environment. As such, their high-quality earnings, positive net cash positions and low debt-to-EBITDA ratios make them relatively defensive to tight policy and the current higher cost of borrowing. Not only are the big tech companies investing some of their cash piles in further R&D, some of them have also announced **share buybacks in 2024**, which should further aid their price performance.

Magnificent-7 companies have high cash balances low debt to EBITDA ratios



Source: Bloomberg, HSBC Global Research, HSBC Global Private Banking, March 2024

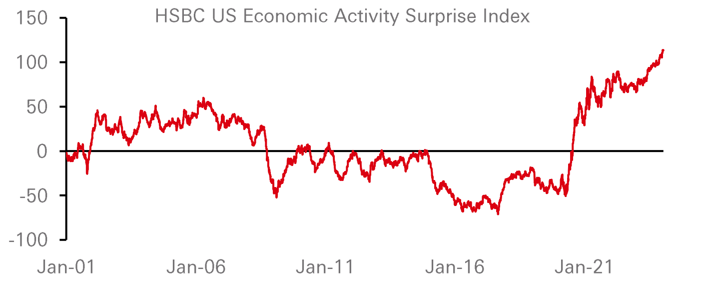
Therefore, we do not expect to see a 2000-style tech sell-off in the US equity market anytime soon. However, as the Fed pivots and economic data remain strong, we expect the rally to spread to the more cyclical sectors of the economy.

But despite high rates, what's underpinning the strong US economic fundamentals, also called the 'US exceptionalism'? We discuss more on this in our next section.

US exceptionalism continues, but is the economic nirvana sustainable?

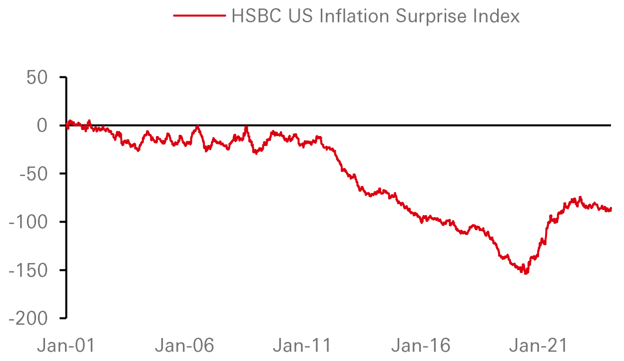
Despite enduring one of the tightest monetary policy cycles in the last two years, the most anticipated US recession of the recent history never showed up in 2023. It remains elusive even now! Data continue to show that US economic growth, domestic consumption, the labour market, and wage gains – all remain strong amid tight US monetary policy. Yet, at the same time, US inflation has continued to decline, notwithstanding some recent bumps, as it approaches the Fed's 2% inflation target. **How is this possible? And can this economic nirvana, also dubbed at 'US exceptionalism' continue?**

Despite a tight monetary policy, US economic activity continues to surprise to the upside…



Source: HSBC Global Private Banking, Bloomberg, March 2024.

…while US inflation has been declining



Source: HSBC Global Private Banking, Bloomberg, March 2024.

What is driving this 'US Exceptionalism'?

We think there are two key factors underpinning 'US exceptionalism':

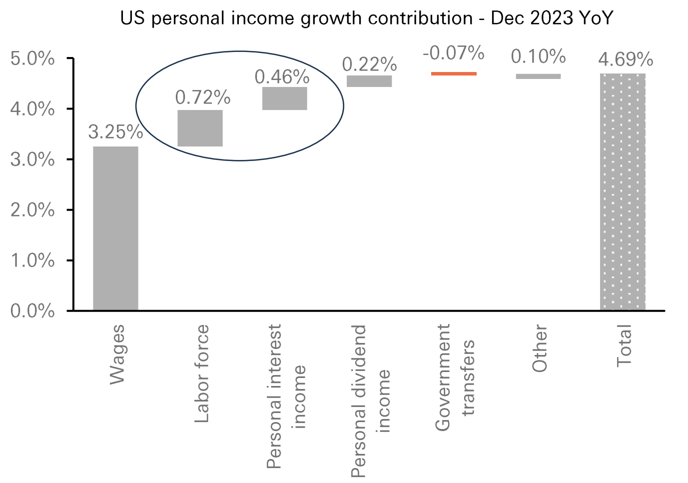
- **Persistent resilience of the US consumer:** Two-thirds of the US economy is led by domestic consumption, and we expect this resilience to prevail in 2024, despite some concerns over higher credit card debt and auto loan delinquencies, which have risen from a low base and remain historically low.

US unemployment remains under 4% and real consumer spending reached a two year high in December 2023, growing 3.2% YoY. As the next chart shows, personal income growth has not only accelerated due to higher wages (3% contribution, YoY) but also due to a growing labour force (0.7%) and interest income (0.5%, mainly due to higher interest on bank deposits and savings).

Another key factor which the consensus consistently discounts is the fact that the **US consumers are also benefitting from the 'Wealth Effect'** of higher US markets**.** According to a study, recent stock market gains have fuelled a significant rise in the number of retirement savers who've reached the milestone of a $1 million 401(k) balance. There was a 20% rise in the number of 401(k) millionaires in Q4 2023, compared to Q3 2023. Year over year, the number of 401(k) millionaires rose 11.5%[3].

As long as the employment picture remains strong in 2024, we think the consensus is underestimating the US consumers' ability to withstand higher interest rates, especially as the potency of the transmission mechanism of tighter monetary policy to the consumer has been diluted because of the shift towards 30-year fixed rate mortgages. We discuss this US consumer investment opportunity in our **American Resilience High Conviction Investment theme**.

Drivers of US personal Income Growth



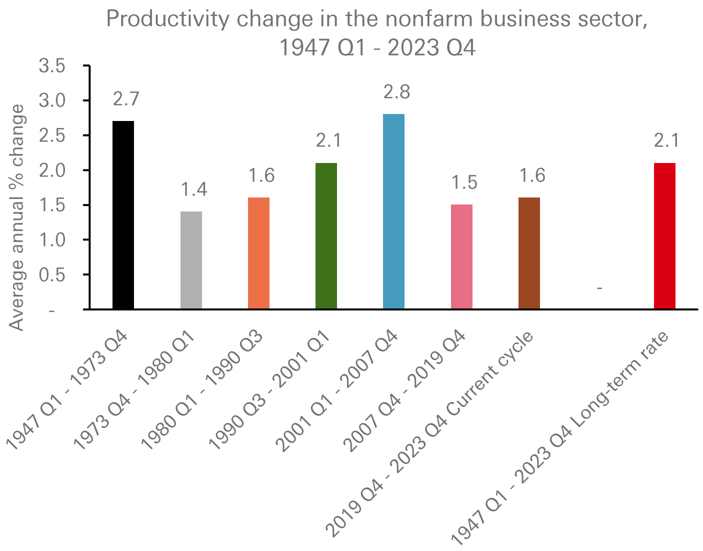
Source: HSBC Global Research, HSBC Global Private Banking, Bloomberg, March 2024.

◆ **A resounding comeback of US productivity enabled by tech**: In a key reversal of long-term trends, US labour productivity has seen a sharp uptick over the last few quarters. As the chart on the right shows, the historical average for US labour productivity has been 2.1% since 1947, and the average for this cycle, so far, has been mere 1.6%. However, US labour productivity rose to 3.2% annualised rate in Q4 2023, after surging by 4.9% in the prior three-months period, bringing the overall YoY increase to 2.7% in 2023, which outpaces the 25-year average.

This emphatic comeback in US labour productivity has been made possible by increased technological advancements like **Generative AI and Robots**, cloud computing and investments in digital transformation which have collectively improved the operational effectiveness of corporate America. Higher productivity reduces the unit labour cost of workers, and despite higher wages, generates higher profits for businesses. Consequently, US margins have been rising in contrast to those in Europe, for example. These well-paid employees in-turn spend in the domestic economy as US consumers, creating a virous cycle of resilient US consumption and higher earnings. This partly explains why the US economy has continued to see strong growth, yet a steady decline in inflation.

From an industry perspective, McKinsey predicts that Technology companies could see productivity impact of between 4.8% - 9.3% of revenue; Banking (2.8- 4.7%) and Pharma (2.6% - 4.5%) from generative AI use cases, focused mainly on productivity improvements across customer operations, marketing and sales, software engineering, and R&D.

US productivity has sharply rebounded in 2023



Source: BLS, HSBC Global Private Banking, Bloomberg, February 2024

So, are 'US exceptionalism' and big tech 'expensive-ism' interlinked?

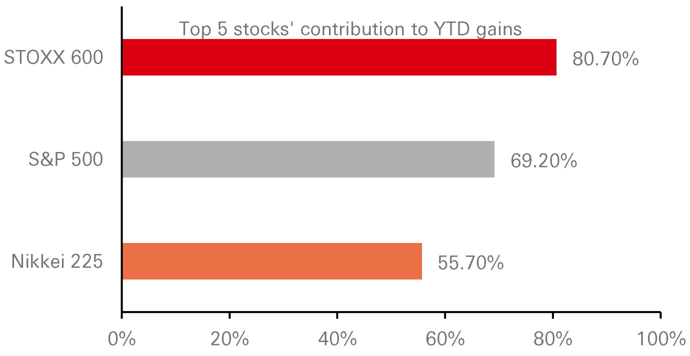
We think they are!

We believe there is a virtuous feedback loop between advancements in US technology, the rise in US productivity, higher corporate earnings, and the US valuations premium, especially, in big tech.

The US remains the global epicentre of technological innovation, with continued investments in R&D. These technological advancements generate greater operational efficiencies and lower costs, which improve corporate margins, and lead to better earnings growth.

And it is these superior US corporate earnings which ultimately underpin higher US equity valuations, versus other developed markets, like Europe for example, where productivity remains low given fewer technological advancements and the absence of a formidable European Tech sector in the overall Stoxx600 index. Interestingly, contrary to popular belief, the concentration of recent equity gains is far higher in the European Stoxx600 index than S&P500, with over 80% of the YTD gains in Europe coming from the top five stocks in the benchmark European index.

Context is key: Contrary to belief, concentration risk appears to be higher in Europe vs the US



Source: Bloomberg, HSBC Global Private Banking, March 2024

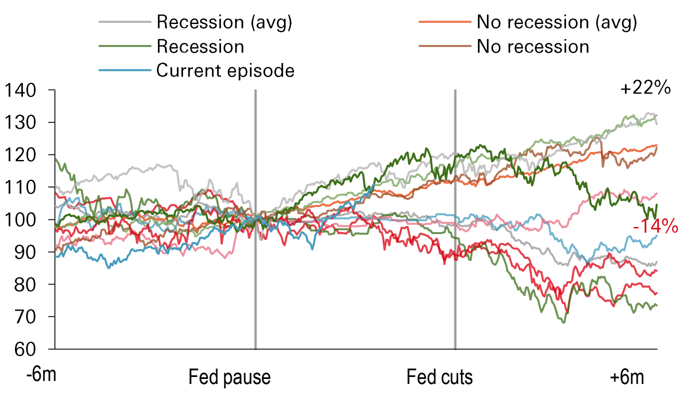
We think that the dominance of tech names in S&P500 index (which are not just early **adopters** but also the **enablers** of tech in other sectors) has not only delivered S&P500's outperformance, but it should also help broaden the rally to other cyclical sectors in 2024 like financials and industrials, in the backdrop of a Fed pivot and persistent strong economic data.

We expect superior US economic growth to underpin the overall US earnings growth in 2024. With a firmly entrenched disinflationary trend in place, lower costs should lead to higher margins in 2024. Plus, Fed rate cuts in 2024 should be another macro tailwind to US equities.

While the debate between a 'soft landing' and a 'no landing' remains hot, as the below chart shows, the current trajectory of the S&P500 is consistent with the historical performance of a Fed-engineered soft landing.

S&P 500 performance around Fed cuts

A soft-landing implies an upside of another 5% between now and when the Fed begins to cut rates.



Source: HSBC Global Research, HSBC Global Private Banking, Bloomberg, March 2024.

To Summarise

While the leadership in the current US equity rally has been rather concentrated in the big tech names - and like all rallies, this one may not be infallible either - we don't think this bull run has been a fluke or can be compared to the tech bubble of 1990s.

Why? Because unlike the unprofitable dot-come stocks of 1990s, the price gains in today's big tech are backed up by formidable earnings. Their promising business models driven by AI, defensive earnings and high RoE are their key differentiators that exude quality. These are reasons enough to justify their relative '**expensive-ism'**, in our view.

At the same time, '**US exceptionalism'** underpinned by a superior growth-inflation mix continues, resting on two key pillars – the resilient US consumer and a roaring comeback of US productivity, aided by technology.

We think there is a virtuous feedback loop between 'US exceptionalism' and big tech 'expensive-ism'. Advancements in technology have aided the rise in US productivity, which is boosting corporate earnings growth, and the US stocks' outperformance.

The dominance of tech names in S&P500 index is its key differentiator from the rest of the world. It has not only delivered S&P500's outperformance, but it should also help broaden the current rally to other cyclical sectors in 2024, in the backdrop of a Fed pivot and persistent strong economic data.

Finally, there's a lot of cash sitting on the sidelines which will look for a home in risk assets. **Once the Fed starts cutting rates in 2024 and the Money Market Funds' yield is no longer as attractive as it was in 2023**, we expect some of the ~ $1trn incremental cash that flowed into these Money Market Funds in 2023 to flow out and get reallocated to US equities. Therefore, any pullbacks may be short lived, as they are likely to be used by investors to allocate their cash holdings to equities.

This implies that although now is not the time to call the top of the ongoing tech rally, we think it's certainly time to diversify into other cyclical sectors of the US market which should benefit from impending Fed rate cuts and/or a rotation of market leadership from big tech to other cyclical parts of the economy. We highlight these investment opportunities the US market in our **American Resilience** and **North American Re-industrialisation High Conviction investment themes**.

Sources:

1.) **HSBC Gblobal Research, February 2024**
2.) **FT, Goldman Sachs, Feb 2024**
3.) **Fidelity Investments, Nasdaq, Feb 2024**

Risk Disclosures

Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk
Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments
High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
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Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or cancelled. Investors may face uncertainties over when and how much they can receive such payments.
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Contingent convertible securities (CoCos) or bail-in debentures are highly complex, high risk hybrid capital instruments with unusual loss-absorbency features written into their contractual terms. Investors should note that their capital is at risk and they may lose some or all of their capital.

Changes in legislation and/or regulation
Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk
The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalisation.

Reinvestment risk
A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may have a negative effect on the prices, mark-to-market valuations and your overall investment.

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Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government. Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond. There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk. Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

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