Weighing the Pros and Cons of the Technology Sector

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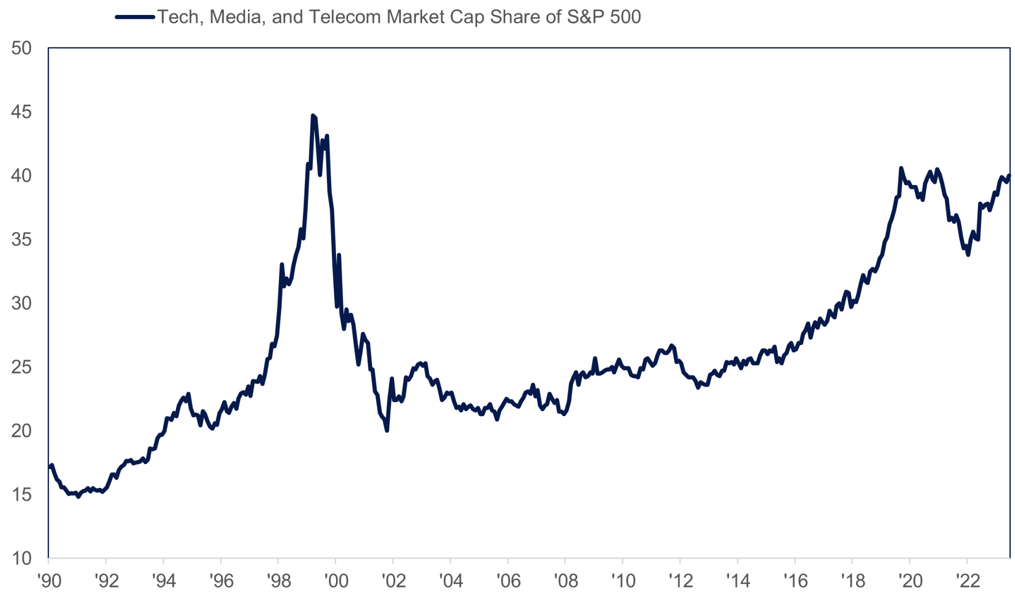
The technology sector was all the rage last week thanks to strong results from artificial intelligence (AI) darling NVIDIA (NDVA). Generally, a top-performing sector over the past decade, it's hard to overstate technology's importance to the market. While the official S&P classification results in a roughly 30% weight for the technology sector in the S&P 500 Index, adding tech-focused powerhouses such as Alphabet (GOOG/L), Amazon (AMZN), Meta (META), Netflix (NFLX), Tesla (TSLA), and others, pushes that weighting to around 40%.

Market Concentration of Big Tech Nearing "Dot-Com" Levels

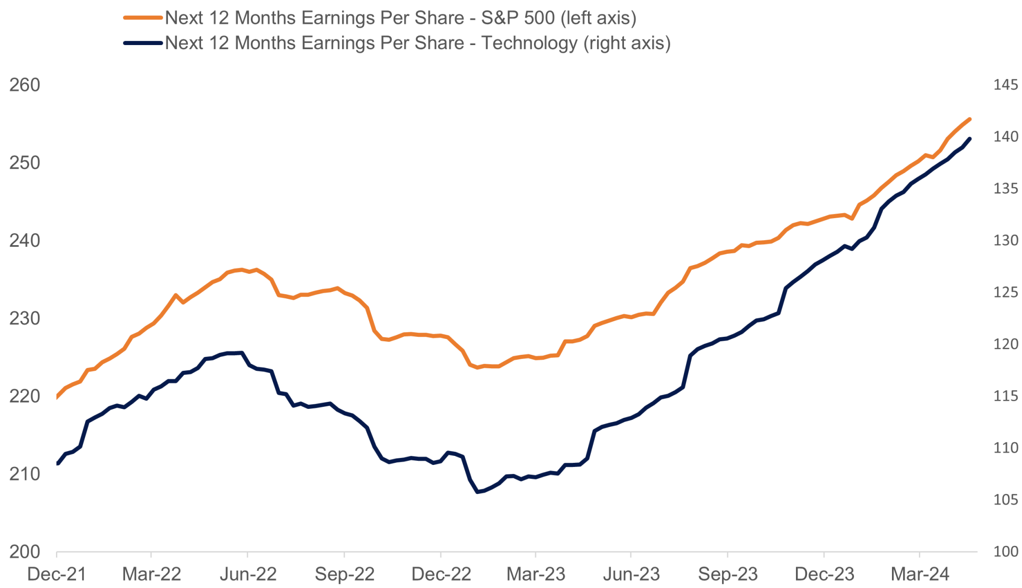


Source: LPL Research, Bloomberg 05/24/24

Technology's importance is also evident when analyzing earnings. First quarter S&P 500 earnings growth would be more than cut in half (from near 8% to around 3%) if the technology sector was excluded. If the definition of technology is expanded to include the biggest tech-adjacent names, including those mentioned above, then technology accounted for all of the S&P 500's earnings growth in the first quarter.

Not only did technology report solid results last quarter, with growing earnings north of 25%, but estimates for the sector have also risen in recent months.

Technology Earnings Estimates on the Rise



Source: LPL Research, FactSet 05/23/24
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

The sector continues to grow both revenue and profits at a solid pace, driven by advancements in AI. Companies in this space have significantly outperformed broader markets over the past two years as they, particularly NVDA, have showcased their ability to scale rapidly and take advantage of the market opportunity. AI has successfully boosted not just technology but everything it requires. Utilities and some segments of the energy sector, which are needed to power AI data centers, have also experienced a performance boost recently. Industrials have even caught a whiff of the wave, with companies that build data centers and provide equipment to cool servers getting a boost from the AI halo effect.

Favorable Technical Backdrop

Technical indicators for the tech sector are favorable, reflecting strong momentum and positive investor sentiment. The sector has remained in a solid uptrend since the current bull market began in October 2022 and has solidly outpaced the S&P 500 during that time. Technical analysis suggests that this positive momentum is likely to continue, at least in the short term.

Technology Sector Enjoying Strong Momentum and Relative

Strength

Source: LPL Research, Bloomberg 05/28/24
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Perhaps the biggest concern for investors in tech is lofty valuations, which raise worries about the potential for a correction. While growth prospects remain strong, the sector's elevated price-to-earnings ratio (P/E), approximately 30%higher than the S&P 500, suggests that widespread earnings shortfalls, or macroeconomic disruption, could potentially trigger outsized price declines relative to the index. Expectations for future profits are currently high, leaving little margin for error. Technology has commanded high valuations in the past for disruptive innovations, as was the case in the 1990s, and it can be hard to value such a massive future opportunity. What appears certain is the investments in AI are significant and the benefits, over time, are likely to be as well.

Technology Valuations Are Elevated, But Well Short of Tech Bubble Levels

Source: LPL Research, FactSet 05/23/24
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With strong earnings, booming AI growth, and technical momentum, technology is a sector we believe it is prudent to maintain sizable exposure to (it is the largest sector in the S&P 500). But elevated valuations and the concentration of a few mega cap leaders heighten the potential for volatility and the potential for market rotation. Given this mix of pros and cons, LPL Research's Strategic and Tactical Asset Allocation Committee (STAAC) currently recommends a neutral allocation to technology, though it is one of our favorite neutral sectors, along with industrials, and one we would potentially upgrade on weakness depending on the macro environment.

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