With tech fundamentals staying robust, in particular from big tech in the first quarter, CIO continues to highlight the recent correction has provided interesting entry points for tech and AI-related stocks. (UBS)

Return of tech optimism helps offset macro worries

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Strong results from Microsoft and Alphabet have helped restore optimism over the outlook for artificial intelligence and the tech sector.

Revenues and earnings at both companies topped expectations in the first quarter, with executives citing strong demand for cloud-computing and AI-related services.

The results, which were released after the end of trading, helped offset concerns over the US economic outlook. The Federal Reserve's favorite measure of inflation showed core prices, excluding volatile food and energy prices, rising at an annualized 3.7% in the first quarter, higher than the consensus expectations for 3.4%.

The announcements from Microsoft and Alphabet have also helped restore confidence in the growth outlook for AI and tech, which was shaken last week by fears of slowing demand for semiconductor chips and chipmaking equipment. These worries contributed to a roughly 7% decline in the Magnificent 7—the largest US growth and tech stocks—from their peak on 11 April. But this group of stocks is still up 20% so far in 2024, following a 107% gain in 2023.

Despite the extent of this rally, we remain positive on the tech sector, for several key reasons:

Accelerating capital spending on AI is paying off, boosting earnings. Executives at Meta, Alphabet, and Microsoft all confirmed they will continue to increase investments in AI. Capital spending by these three firms firms now looks likely to reach USD 140 billion this year, up USD 16 billion on the prior estimate. Despite this outlay, the rapid progress toward commercializing AI is improving the outlook for earnings. While earnings growth for big tech will likely decelerate from around 40% in the first quarter to potentially 15–20% in 2025, this is still impressive as it comes off a high base. Based on the results, we also now expect faster profit growth from the broader global tech sector, with earnings per share rising 20% in 2024 from 18% previously, and at 16% for 2025.

Cash flow generation is improving, allowing big tech to sustain investment in innovations such as AI while also buying back shares. We now expect big tech's combined free cash flows to grow from USD 460bn in 2024 to USD 560bn in 2025—22% growth. This makes big tech companies relatively defensive within global tech, in our view.

Against this positive backdrop, valuations do not look demanding, in our view. Global tech valuations remain reasonable at 22.5 times 2025 forecast earnings and big tech's at 25 times, as we believe their premium P/E valuation is justified by their strong earnings momentum. Big tech and semiconductors should continue to lead the growth, keeping us positive on both groups as valuations are still reasonable.

So, with tech fundamentals staying robust, in particular from big tech in the first quarter, we continue to highlight the recent correction has provided interesting entry points for tech and AI-related stocks.

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