CIO believes that the environment remains favorable for quality tech stocks and that investors should ensure they have sufficient exposure to AI beneficiaries within and outside the US. (UBS)

Environment remains favorable for quality tech stocks

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The sell-off in tech stocks led the retreat in US equities last week, with the Nasdaq's 2.1% loss outpacing the S&P 500's 0.8% decline. More broadly, the outperformers in the first half of the year have become relative underperformers this month amid a rotation out of big tech into laggards.

The Nasdaq composite has fallen 2.1% since the start of July, while the Russell 2000 small-cap index is up 10.4%. In the first half of this year, the tech benchmark rallied over 19%, while small companies only eked out a gain of 0.2%.

This reversal was driven in part by the mixed interpretation of earnings reports from several prominent tech companies over the past week. Following its impressive run since late last year, investors have increasingly become concerned about the pace and timing of artificial intelligence (AI) revenue and what it may mean for continued investments in AI infrastructure.

With results still due from some big firms this week, market volatility is likely to continue. But we believe the tech sector should find support in the coming weeks and resume its leadership. In fact, the recent pullback creates a re-entry opportunity, in our view, especially for those companies with strong earnings growth visibility.

Tech valuations have become attractive again. During the past decade, there has been at least one 10% valuation reset in global tech every year, except for the strong bull market in 2017. Barring the 30% reset in 2022, which was driven by rising interest rates, our analysis over the past 10 years shows that tech indexes typically rebound strongly over the six months after a 10% correction. With key global tech benchmarks having declined 9-10% from their recent peaks, this provides investors with some tactical opportunities, in our view. Separately, while the tech sector appears to be expensive after the rally this year, price-to-earnings multiples remain much lower than in the dot-com era, when many tech stocks had much lower-quality earnings.

Tech fundamentals remain solid. One major reason for those rebounds over the years is that investors have rewarded the tech sector for its strong growth. While more details will emerge from leading tech companies this week, we believe a net profit growth of 20-25% for global tech in the second quarter is within reach. Today's tech leaders also offer high-quality margins, strong free cash flows, and solid balance sheets, a positive driver amid slowing economic activity. With AI likely a key growth driver in the years to come, we believe large investments by companies are needed to participate in the technology's further development. As Alphabet CEO Sundar Pichai pointed out, "the risk of underinvesting is dramatically greater than the risk of overinvesting for us here." We retain a positive outlook on AI beneficiaries in the semiconductor, software, and internet sectors.

Technical factors supporting the rotation are likely to fade. Investor positioning has played a significant role in amplifying the recent rotation trade, with the most shorted stocks earlier this year being squeezed higher. Call option activity on small caps has spiked and banks hedging these option positions have exacerbated the move higher. But the positioning influence on the rotation trade will soon dissipate, as such technicals typically do after about a month.

So we believe that the environment remains favorable for quality tech stocks and that investors should ensure they have sufficient exposure to AI beneficiaries within and outside the US. Beyond tech, we also like global quality wealth compounders and quality companies in Europe and Asia.

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