Mitch on the Markets

Portfolio Manager Investing Insights

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Is Technology Now a 'Defensive' Sector?

When investors think about traditionally 'defensive' sectors, what usually comes to mind are Utilities, Defense (military spending), Healthcare, and/or Consumer Staples. These are the areas of the economy where demand remains pretty steady all the time, even during challenging periods like recessions. Demand for goods and services in these sectors is inelastic – people always need electricity, medicine, and household goods, and governments are always spending money on the military and defense capabilities.

For this reason, defensive sectors have tended to outperform during weaker parts of the economic cycle, including recessions and bear markets.

Up to this point, technology stocks have never been a part of this group. But during this pandemic and economic recession, technology stocks have been behaving a lot like defensive stocks traditionally during downturns.[1] It is worth exploring why.

The numbers bear it out. Year-to-date through May 31st, the Nasdaq is actually in positive territory, with a price return of +6.59%. The iShares Technology ETF, with symbol IYW, is up +8.85%, while the S&P 500 is down -5.29% over the same period.[2] Technology stocks outperformed on the way down *and* on the way back up, while other cyclical sectors took a beating.

I do not see Tech's outperformance as a fluke, or unjustified. Tech earnings are taking a hit, just like every other sector. But over the last three months, only Utilities, Consumer Staples, and Health Care have posted better earnings than Tech – and not by a lot.

Given the nature of this economic recession, the Tech sector's relative success should come as little surprise to many readers. The pandemic has dealt a major blow to spending across the economy, but households and businesses have relied on technology more than ever to stay connected, and in many cases, to continue working. A recent poll of Fortune 500 CEOs found that 75% of companies have – or are making – plans to spend more on technology in the coming years.[3]

Corporate America was already well aware that technology would play a critical role in the future of business, and the pandemic is merely accelerating already existing trends in cloud computing, enterprise software, remote working capabilities, video conferencing, e-commerce, and investment in robust technology infrastructure. In a sense, the crisis played right into the Tech sector's hands, and stocks are just responding to the secular trends already underway.

Does this mean investors should run out and buy more technology stocks? Not necessarily, in my view. Stocks in the sector notoriously trade at high multiples, and not all technology stocks have robust earnings and cash flows. There is also a legitimate regulation risk for the sector, particularly as lawmakers catch up to antitrust and data privacy issues. The US Justice Department, for instance, has indicated that it may soon file antitrust charges against Google, perhaps as early as this summer. An antitrust lawsuit brought against Google today could be one of the biggest in history, bringing back memories of the Justice Department and 20 states joining together to sue Microsoft in the 1990s.[4] A successful lawsuit against Google could create a substantial tail risk for other major technology companies.

Another risk to keep in mind is cyclicality. If the economy starts to pick up steam and fear of the pandemic fades into the background – perhaps because of a vaccine – then investors could use the opportunity to rotate into cyclical sectors that currently trade at far more attractive multiples than Technology. This outcome may happen sooner than most think.

Bottom Line for Investors

There is little doubt that technology will play a critical role in the future of business. Companies across every sector are accelerating plans to invest in new technology that will allow employees to work remote and keep the business moving even during a lockdown. Technology companies that build infrastructure and provide software and services are likely to benefit long-term as a result.

Investors do not have to go all-in on Tech in order to participate, however, and doing so is a risky proposition – particularly as many new technology companies focus more on growth over cash flows and earnings. An overweight to the Technology sector within a broadly diversified portfolio is a smarter approach, in my view, giving investors the benefit of exposure to an exciting growth sector in a risk-controlled way.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The BlackRock Blog, May 26, 2020. https://www.blackrockblog.com/2020/05/26/why-technology-is-proving-surprisingly-defensive/

[2] Yahoo Finance, June 1, 2020. https://finance.yahoo.com/

[3] The BlackRock Blog, May 26, 2020. https://www.blackrockblog.com/2020/05/26/why-technology-is-proving-surprisingly-defensive/

[4] The Wall Street Journal, May 15, 2020. https://www.wsj.com/articles/justice-department-state-attorneys-general-likely-to-bring-antitrust-lawsuits-against-google-11589573622

IN FOCUS THIS WEEK

- Chilling relations between the U.S. and China
- The world's longest ongoing economic expansion could be in danger
- Food prices move higher as supply bottlenecks continue

Chilling Relations Between the U.S. and China

Tensions between the U.S. and China have been on the rise, and escalations took place this week when China voted to impose national security laws on Hong Kong. The United States is yet to decide on a formal response, but all signs point to revoking Hong Kong's "special status" as a trading partner. The move would amount to the United States no longer recognizing Hong Kong as a self-governing, autonomous region of China – a move that is likely to infuriate Beijing. This escalation comes as China is *supposed* to be fulfilling purchase obligations associated with the trade deal, and also as the U.S. steps up allegations against China for covering-up the pandemic. Chilling relations between the U.S. and China have some worried about a new cold war, which could be an extraordinarily costly outcome. China's companies are massive customers for U.S. sophisticated technology, and supply chains are overwhelmingly dependent on Chinese factories and workers. Decoupling the two economies could mean higher costs for consumers and a hit to earnings for the U.S.'s largest corporations. This is coming at a time when China's economic recovery could help jump-start the global economy. A private gauge of China's services sector activity showed a sharp rebound in May, as domestic demand returned and as government stimulus took hold.[1]

First Economic Recession in 28 Years

The developed world's longest ongoing economic expansion may be coming to an end. For 28 years, *Australia has never experienced a recession*, defined as two consecutive quarters of economic contraction. But the longest streak may be in jeopardy. Earlier in 2020, some readers may recall the bush fires that ravaged Australia, which current estimates show may have resulted in a Q1 contraction of -0.3%. Second-quarter estimates for GDP contraction are almost certain to be lower, given the hit to consumer spending and services activity felt across the world as a result of the pandemic.[2]

Food Prices Move Higher as Supply Bottlenecks Continue

The United States has been feeling the pinch of a national meat-supply crunch, driven by supply-demand imbalances and supply chain issues tied to the coronavirus outbreak. Even as meatpacking plants reopen and some grocery stores implement limits on meat buying, prices for meat have been pushing higher over the last several weeks. At the retail level, beef prices went up +21.7% and pork prices rose +17.7% year-over-year for the week ending May 23, with chicken also jumping +10.5%. Production has been an issue – the U.S. food industry is going into the summer months with production 7% lower than it was at the same time last year, and with restaurants coming back online across the country, supply is likely to remain tight for the weeks ahead.[3]

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[1] The Wall Street Journal, June 2, 2020. https://www.wsj.com/articles/dear-america-a-cold-war-with-china-will-be-expensive-11591094926

[2] The Wall Street Journal, June 3, 2020. https://www.wsj.com/articles/a-record-breaking-economic-boom-is-about-to-go-bust-11591174013

[3] The Wall Street Journal, May 31, 2020. https://www.wsj.com/articles/meat-plants-reopen-but-burgers-stay-pricey-11590933601

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