Yardeni Research

MORNING BRIEFING
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Speed Bumps for Tech

Check out the accompanying chart collection.

(1) A look at what could clip the wings of high-flying tech stocks. (2) Regulators could dampen the fun. (3) Netflix, Logitech earnings may signal that the Covid-related tech-spending surge has run its course. (4) Tech IPOs looking frothy? (5) As deurbanization continues, homebuilders keep building. (6) Mortgage rates stay low while homebuilding shares fly high. (7) Introducing the zeptosecond. (8) Scientists aim to learn more about electrons and chemical reactions.

Information Technology: Peering into the Future. The Covid-19 pandemic has driven home just how important technology is to our daily lives, including our livelihoods. It's unfathomable to consider what might have happened to the economy if Covid had struck in 1985, when we didn't have the technology to work from home. Businesses, schools, and individuals have spent a bundle making their technology devices and systems faster, more secure, and more useful by adding peripherals like video cameras and headsets.

The S&P 500 Information Technology sector has led the market for much of this year and enters the homestretch as the undisputed leader. Here's the performance derby for the S&P 500 sectors ytd through Tuesday's close: Information Technology (30.3%), Consumer Discretionary (26.4), Communication Services (9.1), Materials (6.9), S&P 500 (6.6), Health Care (4.2), Consumer Staples (3.8), Industrials (-0.4), Utilities (-1.2), Real Estate (-7.7), Financials (-19.4), and Energy (-50.4) (*Fig. 1*).

Technology-related shares represent half of the 20 top-performing stocks ytd in the S&P 500. Some are card-carrying members of the S&P 500 Information Technology sector, like semiconductor companies NVIDIA (up 132.0% ytd) and Advance Micro Devices (77.9); software companies ServiceNow (83.6), Cadence Design Systems (62.4), Synopsis (62.6), and Salesforce.com (57.4); as well as Apple (60.7) and PayPal Holdings (86.7). Others reside in different S&P 500 sectors including Amazon (60.1) in Consumer Discretionary and Netflix (62.4) in Communications Services.

After these companies' fantastic run so far this year, we thought it time to take a look at some of the hurdles they may face next year. For one, regulators at home and abroad are gunning to rein in some of the largest US technology names. Also, the Covid-induced tech spending enjoyed over the past six months won't likely be replicated. Lastly, there has been a surge of IPOs in the cloud and software space that have performed admirably so far, but some companies have scant earnings and high valuations, a potential sign that the market is getting frothy. Let's take a deeper look:

(1) *Beware of regulators.* In a widely anticipated move, the US Department of Justice (DOJ) filed on Tuesday an antitrust lawsuit against Alphabet's Google, claiming that the search provider uses anticompetitive practices to maintain its market dominance. Eleven Republican state attorneys general joined the DOJ as plaintiffs.

As an October 20 *WSJ* article explained, "The Justice Department alleges that Google is illegally maintaining its monopoly in search through exclusionary contracts with distributors like mobile-phone makers, wireless carriers and web browsers to make Google their default search engine," for which Google pays billions of dollars a year. The government says that gives Google control over about 80% of the US search market, denying competitors the ability to gain a foothold. Google's chief legal officer has countered that the suit is flawed and that consumers use Google because they choose to, not because they are coerced or lack alternatives.

This won't likely be the only lawsuit that Google or other tech giants will face in the coming year. The DOJ continues to investigate Google's digital advertising business, and the Federal Communications Commission (FCC) is conducting a review of the social media platforms that may result in the roll back of legal protections they enjoy.

In general, the social media companies, like Facebook and Twitter, cannot be sued for content that others publish on their platforms in the same way that newspapers and broadcasters can be sued. However, conservatives have argued that protection should be lifted because the platforms are not agnostic, and they have been censoring conservative content. The issue gained momentum after Twitter applied a fact-checking notice to President Trump's tweets that contained claims regarding voter fraud. The outcome of the election could determine whether the FCC review is completed or acted upon.

Large tech companies face heat abroad as well. The UK competition regulator has told its government to establish a digital regulator within a year or his agency "will take action" against Facebook and Google, an October 18 *FT* article reported. Under consideration: launching antitrust cases against the companies that are run in parallel with similar cases in the EU.

In addition to considering lawsuits, the EU is establishing rules to ensure that tech giants give access to competitors and share data with rivals, an October 11 *FT* article reported. The list reportedly includes 20 large Internet companies chosen based on their revenue and number of users, which implies that US corporations like Apple, Facebook, and Google will likely be included. There are also proposals to revise the EU's Digital Services Act, which governs the Internet, for the first time in two decades.

(2) *Beware the earnings pull forward.* In addition to changing how we worked and lived, Covid-19 changed what we purchased. The increased time at home boosted the number of new Netflix subscribers, and the scramble to set up a home office meant a surge in Logitech's fiscal Q1 and Q2 earnings. However, that burst of activity is unlikely to be repeated in the current quarter.

Netflix added 15.8 million subscribers in Q1 and more than 10 million subs in Q2, making its first-half 2020 subscriber additions only 10% lower than the new subscribers signed up in all of 2019. To the company's credit, it warned on July 16 that it has seen a "pull-forward" of demand in the first half of 2020 from the second half of the year. Analysts reduced their estimates for Q3 subscriber additions from 5.3 million to 3.6 million, but it wasn't enough.

On Tuesday night, Netflix reported net new subscribers increased only 2.2 million in Q3, a bit less than the company's 2.5 million forecast and far below analysts' target. The company also forecast 6 million new subscribers in Q4, a touch below analysts' forecast of 6.3 million. Shares tumbled 5.7% after the market closed Tuesday due to the report.

Logitech also appears to be expecting a slowdown in the second half of its fiscal year. The Swiss company makes all the products needed to work or game from home, including keyboards, mice, headsets, speakers, and cameras. Logitech's sales rose 75% to $1.3 billion in FQ2 ending September, and non-GAAP operating earnings surged to $354 million, up 295% from $89 million a year ago. Analysts were only expecting $834.6 million of revenue, and shares rallied 15.5% to $92.64 on the news.

The company forecast full year non-GAAP operating income of $700 million to $725 million, up more than 80% y/y. Based on its forecast, Logitech expects non-GAAP operating income of $229 million to $254 million in the second half of fiscal 2021 (ending March), flat to 10.0% higher than the $231 million of non-GAAP operating income it generated in the second half of fiscal 2020.

(3) *Beware of the record-setting IPO market.* With two months to go in the year, there have already been 332 IPOs, more than any year since 2000, when 397 IPOs were priced, according to data on stockanalysis.com. Almost a quarter of the deals are in the tech sector, according to Renaissance Capital. And some of the largest, best-performing issues were sold by companies in the cloud and software industries.

Snowflake, a cloud data warehousing provider, raised $3.4 billion in the largest software IPO ever. Since its September 16 offering, Snowflake shares have soared 109.8% versus 1.2% for the S&P 500. Application development software company JFrog's shares are up 85.8% since pricing on September 16. Shares of Unity Software, which makes video game development tools, have risen 67.6% since its $1.3 billion IPO on September 18 (versus 2.6% for the S&P 500). And shares of Bentley Systems, which makes infrastructure software, are up 73.8% since pricing on September 23 (versus 3.8% for the S&P 500).

(4) *Beware of the data*. The S&P 500 Information Technology sector is expected to have revenue growth of 3.5% this year and 8.0% in 2021 (*Fig. 2* and *Fig. 3*). That's expected to lead to solid earnings growth of 4.2% in 2020 and 13.6% in 2021 (*Fig. 4* and *Fig. 5*). Analysts' net earnings revisions have been positive in October (12.6%), September (15.1%), and August (9.4%) (*Fig. 6*).

The sector's forward P/E, at 27.0, is high but not outrageous (*Fig. 7*). It undoubtedly has risen since the 2008 recession, when the sector's forward P/E hit a low of 9.9 in November 2008. However, it's only roughly twice the expected forward earnings-per-share growth rate and far below the P/Es in the 40s during the tech bubble.

More concerning are the increases in some tech-related industries' forward P/Es. The Internet & Direct Marketing Retail industry, which boasts Amazon as a member, has a forward P/E of 67.6, up from 40.8 a year ago. The Movies & Entertainment industry, which contains Netflix, has a forward P/E of 56.4, more than double the 26.3 of a year ago. Lastly, the Application Software industry has a 49.8 forward P/E, up from 33.6 a year ago.

Consumer Discretionary: Booming Homebuilding. The Covid-inspired homebuying boom continued in September as the exodus from cities into suburbs persisted. Here's a quick look at some of the recent data points:

(1) *Homebuilders keep building.* Single-family homebuilding starts jumped 8.5% to a cyclical high of 1.108 million units (saar) in September (*Fig. 8*). Activity may remain strong, with single-family building permits increasing by 7.8% to a cyclical high of 1.119 million units (saar) in September (*Fig. 9*). And amazingly, even after the recent surge in activity, home starts and permits have only returned to more normal levels of activity after many years of depressed building in the wake of the 2008 financial crisis.

(2) *Mortgage applications take a breather.* That said, we'll keep an eye on mortgage applications to fund the purchase of a home, as they fell 2% last week, marking the fourth week of declines. As a result, the new purchase index is down 6.9% from its peak during the September 18 week, but remains up 26.0% y/y (*Fig. 10*). At 3.04%, the 30-year mortgage rate continues to hover close to the September 17 all-time low of 2.93% (*Fig. 11*).

(3) *Homebuilding stocks hit new high.* The S&P 500 Homebuilding industry stock price index has finally topped its previous peak hit in 2004, before the housing industry imploded in the Great Financial Crisis. It's up 35.1% ytd, making it the 12^{th} best-performing industry among those we track in the S&P 500 (*Fig. 12*). Its performance is topped by other housing-related industries: Household Appliances, up 35.5% ytd, and Home Improvement Retail, up 35.7% ytd.

The S&P 500 Homebuilding industry's revenue is expected to increase 4.1% this year and 12.9% in 2021, while its earnings are forecast to jump 24.2% in 2020 and 14.6% next year (*Fig. 13* and *Fig. 14*).

Disruptive Technologies: Measuring the Unmeasurable. If you attended school in the 1970s, you might remember the introduction of the decimal system and, perhaps, being miffed at having to learn a new way of measuring things when inches, feet, and yards did the job nicely. Now, as scientists have gotten better at measuring things in ever smaller increments, there's more lingo to learn.

Nanoseconds measure events that are billionths of a second, picoseconds measure trillionths of a second, femtoseconds quadrillionths of a second, and attoseconds quintillionths of a second. These are all part of the International System of Units, which include 10 prefixes for decimal amounts and an additional 10 prefixes for larger multiples of the basic units.

We bring you this lesson on measurement and prefixes because you'll hear these terms increasingly, as scientists, armed with new know-how on measuring shorter periods of time, have developed better ways to observe and measure the movement of electrons, which could lead to better understanding of chemical and biochemical reactions.

It was recently reported that scientists have measured the shortest interval of time ever: 247 zeptoseconds, which is a trillionth of a billionth of a second. One zeptosecond equals 10^{-21} seconds. Scientists at Goethe University in Frankfurt, the Fritz Haber Institute of the Max Planck Society in Berlin, and DESY, a particle accelerator in Hamburg, measured this distance by firing x-rays from the particle accelerator at a hydrogen molecule, an October 19 NBC News article explained.

When hit, the hydrogen molecule's electrons were ejected, an event that was measured by using a COLTRIMS reaction microscope. Scientists saw for the first time that the electron shell in a molecule does not react to light at the same time. There is a delay as the photon travels through the hydrogen molecule, first hitting one electron and then the next.

Another set of researchers at the ETH Zurich in Switzerland have tracked an electron's motion in liquid water, a September 24 article in Physics World reported. Previously, electrons' motion had been measured only in gaseous environments. The ability to study electrons in liquid is important because many chemical reactions occur in liquids and are triggered by light, like photosynthesis in plants, eyesight in retinas, and DNA damage. "With the help of attosecond measurements, scientists should gain new insights into the most elementary steps of these processes in the coming years," the researchers' team leader told Physics World.

CALENDARS

US: **Thurs:** Leading Indicators 0.7%, Initial Jobless & Continuous Claims 860k/9.5m, Existing Home Sales 6.3mu, Kansas City Fed Manufacturing Index, EIA Natural Gas Inventories, Kaplan, Barkin, Presidential Debate, FDA Hearing on COVID-19 Vaccines. **Fri:** M-PMI & NM-PMI Flash Estimates 53.4/54.6, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Thurs:** Eurozone Consumer Confidence -15, Germany Gfk Consumer Confidence -

2.8, France Business Confidence 96, UK Gfk Consumer Confidence -28, Japan Core CPI -0.4% y/y, Panetta, Haldane, Baily. **Fri:** Eurozone, Germany, and France C-PMI Flash Estimates 49.3/53.2/48.0, Eurozone, Germany, and France M-PMI Flash Estimates 53.1/55.1/51.0, Eurozone, Germany, and France NM-PMI Flash Estimates 47.0/49.2/46.8, UK C-PMI, M-PMI & NM-PMI Flash Estimates 53.9/53.1/54.0, UK Retail Sales Total & Ex Fuel 3.7%/5.0% y/y, Mauderer. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose this week for the second week, climbing to 2.90 after sliding from 3.75 (highest since January 2018) to 2.35 over the prior five weeks. Bullish sentiment has increased 7.7ppts (to 59.2% from 51.5%) over the past four weeks, while bearish sentiment slipped for the second week to 20.4% this week, after climbing over the prior four weeks from 16.2% to 23.2%—which was the highest percentage since the June 2 week. The correction count fell for the third time in four weeks, dipping to 20.4% from 29.1% during the September 22 week. The AAII Ratio advanced for the third week last week from 35.1% to 49.3%, as bullish sentiment rose from 24.9% to 34.8% and bearish sentiment fell from 46.0% to 35.8% over the three-week period.

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 17% of S&P 500 companies finished reporting revenues and earnings for Q3-2020, revenues are beating the consensus forecast by a whopping 3.1%, and earnings have crushed estimates by 17.1%. The large surprises are primarily due to a lack of financial guidance from the companies that analysts follow. At the same point during the Q2 season, revenues were 2.6% above forecast and earnings beat by 12.6%. For the 84 companies that have reported through mid-day Tuesday, aggregate y/y revenue and earnings growth and the percentage of companies reporting a positive revenue and earnings surprise have improved from their Q2 measures. The small sample of Q3 reporters so far has a y/y revenue decline of 1.8%, and earnings are down 9.6%; those results mark a huge recovery from Q2, the worst quarter since Q1-2009 during the financial crisis. Nearly 86% of companies are reporting a positive earnings surprise, and 80% have beaten their revenues forecast. Slightly more companies are reporting positive y/y earnings growth in Q3 (55%) than are reporting positive y/y revenue growth (52%). Taking a look at the shares outstanding tallied so far, companies have put the brakes on share buybacks. Basic shares outstanding are up 0.2% q/q and down just 0.1% y/y. At the same point during the Q2 season, the share count was down 0.4% q/q and 2.5% y/y. The Q3-2020 figures are subject to change markedly as more results are reported in the coming weeks, but we expect y/y revenue and earnings growth results to remain negative. Now more than ever, what companies say about the state of their business and their plans to ride out the Covid-19 crisis will be investors' main focus. Few companies are providing guidance about their future financial periods.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI improved in October for a fifth straight month and was positive for a third month following 13 straight negative readings. NERI rose to a 31-month high of 15.1% from 13.6% in September and is up from an 11-year low of -37.4% in May. That compares to a tax-cut-induced record high of 22.1% in March 2018. During September and again in October, NERI was positive for 10 sectors, the most since September 2018. That compares to negative NERI readings for all 11 sectors from April to July. Eight of the 11 sectors improved m/m in October, down from all 11 improving from June to September. All 11 had been worsening on a m/m basis from March to May. Real Estate has the worst track record among the sectors, with 11 months of negative NERI. Here are the sectors' October NERIs compared with their September readings: Industrials (31-month high of 22.8% in October, up from 18.9% in September), Consumer Staples (20.3 [31-month high], 18.2), Materials (19.1 [31-month high], 12.6), Consumer Discretionary (17.2 [31-month high], 13.8), Health Care (15.3, 16.7 [30-month high]), S&P 500 (15.1 [31-month high], 13.5), Communication Services (14.1 [24-month high], 13.1), Financials (13.7 [31-month high], 7.9), Information Technology (12.6, 15.2 [27-month high]), Energy (11.6, 15.7 [26-month high]), Utilities (5.9 [21-month high], 2.7), and Real Estate (-6.3 [eight-month high], -6.5).

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