OPINION

Technology growth stocks: Tailwinds persist, but caution warranted

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Should investors only own a portfolio of hyper growth names or a blended portfolio of both GARP (growth at a reasonable price) and hyper growth names?

The trends that have dominated the stock market over the past 18 months are likely to continue in the near term. Growth stocks, particularly in the technology sector (some exceptions being Dollarama, Costco, Eli Lilly), still enjoy favorable conditions despite rich valuations. Given, the timing uncertainty of the next U.S. interest rate move which will likely be lower, this can continue to support elevated valuations of growth stocks. The U.S. Federal Reserve may be behind the curve in recognizing economic weakness, potentially risking moving too late on interest rate cuts. The Bank of Canada and European Central Bank have already begun cutting rates.

Economic growth is expected to slow further, limiting earnings growth in cyclical sectors. The trend in interest rates suggests a return to more normal levels rather than the ultra-low rates of the past decade. The market advance remains extremely narrow, with the 'Magnificent 6 + Nvidia' accounting for 65% of the S&P 500's 14.56% YTD return as of June 30th compared to 35% for the other 494 companies in S&P500 Index. This concentration justification by these six mega-cap companies is the stunning 100% of earnings growth in the past year. The S&P500 Equal Weight Index compared to the S&P500 Index is now near the widest level in terms of performance since 2000 when the internet bubble was imploding.

However, there are warning signs:

1. Excessive optimism: Investors are reacting extremely positively to tech news that isn't particularly bullish.

2. Insider selling: Increased selling of large growth stocks from insiders and hedge funds.

3. Market volatility: Even small pullbacks in big tech names can have substantial dollar impacts.

4. AI reality check: Companies need to deliver growth in numbers. As the saying goes, talk is cheap.

5. Software industry challenges: AI spending is crowding out Software as a Service (SaaS). Many software companies have been getting punished with poor guidance or missed expectations vs. analyst's lofty expectations. (Salesforce, Snowflake, Shopify, Cisco)

The current situation shares similarities with the late 1990s tech bubble:

1. Narrow market advance driven by a few large companies

2. Initial infrastructure build-out (internet backbone then, AI infrastructure now)

3. High expectations of future growth

However, today's tech leaders have real earnings and cash flow, unlike many companies during the dot-com bubble.

Economic indicators suggest a slowdown:

1. Weakening consumer confidence

2. Slowing job growth and dropping job openings

3. Declining real retail sales

4. Rising business bankruptcies

Regarding AI, there are signs of potential disappointment:

1. Declining proportion of companies planning to increase AI spending

2. Low adoption rate of AI in U.S. companies

3. High costs of AI infrastructure compared to what it generates currently in profits or earnings

While technology growth stocks continue to benefit from favourable conditions, investors should be cautious of potential risks and historic high market concentration. Economic indicators suggest a slowdown, which may eventually lead to a shift in market dynamics. If this is the case, one can reasonably postulate the drawdown outside of the hyper growth companies would be less severe while strengthening the setup for neglected sectors and reasonably priced companies with strong moats and fundamentals to benefit from a better reward to risk profile. Having a healthy barbell mix of high growth companies combined with steady, defensive value names can help navigate you to your destination regardless of where the winds end up blowing. Consequently, the Hyper Growth vs GARP (Growth at a Reasonable Price) debate could become more interesting than the Kendrick Lamar vs Drake battle of egos. Personally, my vote would be for our very own Canadian Drake!

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