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Investment Institute

Market Commentary

Weekly perspective on current market sentiment

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Last Week's S&P 500 Index: +1.7%

Tech Domination

Key takeaways

- Information Technology was the best performing sector in 2019 as investors looked past negative earnings and focused instead on a 2020 earnings rebound.
- We are Most Favorable Information Technology. We expect high profitability and low leverage to continue to support positive returns for the sector this year.

Where Information Technology (Tech) goes, the S&P 500 will follow; this statement isn't too farfetched considering that the Tech sector makes up nearly a quarter of the S&P 500 Index. The next biggest sector is Health Care, which makes up 13.8%. Because of its sheer size, outperformance or underperformance of Tech weighs heavily on the overall index. Take 2019 for instance. Tech was by far the best performing sector, returning over 50%, which contributed nearly 10% to the S&P 500's overall return of 31.49%. The second-place sector was Communication Services, which returned 32.7%. However, because of a smaller index weight of only 10.3%, Communication Services contributed only 3.3% to the total index. The same holds true when you look at the sectors that lagged. The worst performers were Energy and Materials, 11.8% and 24.6%, respectively. Despite the good performance, the sectors' small weights meant they contributed only 0.7% a piece to the S&P 500's total return.

It may surprise investors that despite last year's stellar performance, Tech was not one of the best performers in terms of earnings growth. In fact, the sector was negative for the year. The award for the sector with highest growth goes to Health Care (9.5% earnings-per-share growth). Ironically, if you exclude Tech sector earnings from the S&P 500 Index, earnings growth increases from 0.7% to over 1.0%; however, the total return drops from 31.5% to 26.8%. The contradiction can, in large part, be explained by trade. Earnings were hurt as U.S./China tariffs disrupted supply chains and decreased demand during the first half of the year. As a Phase One deal became the talk of the town and eventually a reality, investors looked ahead to a more robust 2020 earnings picture.

So what does this mean for Tech going forward?

Tech offers investors exposure to high-quality stocks, and as economic growth continues to slow, investors will focus more heavily on quality characteristics. Two reasons keep us Most Favorable on the Tech sector. First, the sector is in the 97th percentile (highest amongst all sectors) from a profitability standpoint as measured by return on equity. Buybacks have provided a tailwind for profitability, and we expect this to continue, albeit at a slower pace than the past two years. The coronavirus has recently put strain on demand; however, we believe this is transitory and expect a rebound in the second half of the year. Second, the sector has ample cash, which gives firms the flexibility to adjust more quickly to changing economic dynamics (i.e., they can pay down debt, increase business spending, and/or repurchase shares).

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