CHIEF INVESTMENT OFFICE

Equity Spotlight

Technology, Media and Telecommunication's Year of Efficiency

May 2023

All data, projections and opinions are as of the date of this report and subject to change.

SUMMARY

Given their fundamental qualities, balance sheet strength, and long-term secular tailwinds, we believe Equity portfolios should continue to maintain neutral positioning in both Technology and Communication Services stocks. Especially for long term investors, who can ride out near-term volatility to take advantage of the longer-term trends in digitalization, big data and more recently the emergence of Artificial Intelligence.

During Q1, the Technology sector suddenly found itself encompassed in a "sweet spot"—with falling long-term interest rates supporting valuation multiples and better-than-feared macro data points providing better base effects—while the sector's high solvency scores and strong fundamentals were sought following the twin bank rescues. Despite the Technology sector being the most immune to tightening credit conditions, its customers are some of the most vulnerable.

The Technology sector was trading at 25x price-to-earnings (P/E) ratio multiple through March, a 39% premium over the S&P 500, compared to a five-year average premium of 20%. In addition, FactSet estimates for Technology earnings growth in 2023 have been cut from +3% to -1%. This valuation level is above its prepandemic peak in early 2020, when real yields were around 0% and on their way to -1%. This implies Technology stocks were already pricing in a fair amount of Federal Reserve (Fed) easing. The move in Technology stocks seems counterintuitive, as they seem to be acting as "defensive growth", an oxymoron. Indeed, some investors might define the recent rebound as a "bear market rally" or flight-to-quality as concerns increased regarding regional banks and the potential for slower economic growth in 2023. These concerns were warranted, with headline seasonally adjusted Purchasing Managers' Index (PMI) falling from 51.4 in February to 48.4 in March, signaling a renewed deterioration in operating conditions across the global electronics manufacturing sector.

However, semiconductor strength in Q1 was front and center of the economic debate, as the market seemed to be ignoring any potential real macro effects from the bank deposit/liquidity issues. Semiconductor earnings estimates were reduced -33% from the peak last June, yet the group is trading at a 53% premium to the S&P 500. Further, second-half estimates are well above seasonal trends, inventory levels on balance sheets and in the channel are elevated, and there are small signs of potential cracks in industrial, data center, and maybe even auto industries. Those cracks began to emerge in April as Technology underperformed the S&P 500 by about 100 basis points (bps) during the

CIO ASSET CLASS VIEWS

Asset Class	CIO View				
	Underweight		Neutral	Overweight	
Equities			●		
U.S. Large-Cap				●	
U.S. Mid-Cap				●	
U.S. Small-Cap			●		
International Developed		●			
Emerging Markets			●		

Source: Chief Investment Office as of May 2, 2023.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

CIO EQUITY SECTOR VIEWS

Sector	CIO View				
	Underweight		Neutral	Overweight	
Healthcare					●
Energy				●	
Utilities				●	
Consumer Staples			●		
Information Technology			●		
Communication Services			●		
Industrials			●		
Financials			●		
Materials		●			
Real Estate		●			
Consumer Discretionary	●				

Source: Chief Investment Office as of May 2, 2023. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

month, with semiconductor stocks down 5% as a group, and semiconductor companies that reported Q1 earnings thus far are discussing quarter-over-quarter (QoQ) and year-over-year (YoY) days of inventory (DOI) increases and contracting lead times.

The takeaway from the big three cloud providers, having finished reporting their Q1 results, is that public cloud growth at the hyperscale level came in better than feared. That said, growth is still slowing. Overall growth across the big three slowed in Q1 but saw less of a deceleration compared to Q4 as customers are looking to optimize their existing cloud spend and postpone nonessential cloud migrations and projects in the near term. It is also important to note that despite the hype of spend on Artificial Intelligence, the big three capital expenditures (capex) decelerated on a year-over-year basis in Q1. This is an example of the "year of efficiency" for Technology and Communication Services companies.

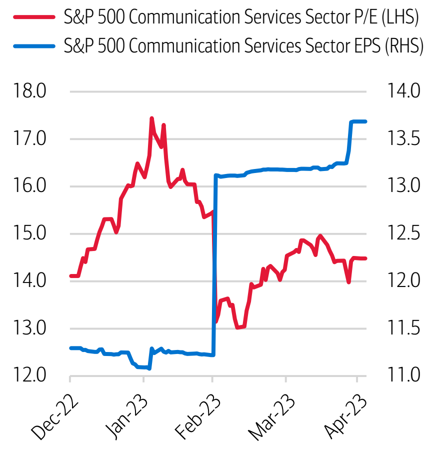
With a weakening backdrop and megacap Technology leading the "year of efficiency", it does raise the question, outside of financial prudence, of whether there are any future innovative drivers of Technology worth investing in. The simple answer is yes. Technology should continue to benefit from the combined effect of three powerful secular forces. The declining cost of infrastructure, the declining cost of collecting and managing data, and the declining cost of development are poised to dramatically expand the universe of business functions and processes to be automated. Deflation anyone?

The more immediate questions are, How does this affect earnings, and how should investors value Technology? Overall, Technology's year-to-date (YTD) performance has been entirely driven by multiple expansion. However, when digging into different subsectors, they are in different fundamental positions. In software, for example, free cash flow (FCF) and operating margins are the topic *du jour* with multiples below the five-year average, with comparisons to last cycle being nearly impossible. Semiconductor multiples don't look attractive today, but semis are cyclical, and earnings estimates continue to come down. Semis are also not experiencing the typical down cycle that is occurring in different end markets (ex: auto vs. memory).

Historically, Communication Services names were not the market refuge they have become recently. With regulatory overhangs, competition for advertising dollars, and the never-ending battle over content, how does an investor justify owning these companies? Despite the concerns, Communication Services are at or near trough valuation multiples, they screen for growth, and their parts are being valued greater than their whole, as management teams are now adjusting their business models for "the year of efficiency" and refocusing capex on Artificial Intelligence. This was reflected in the Communication Services sector's 21.4% YTD performance. With a slowing spend environment, boards could potentially push Communication Services megacaps to de-conglomerate to drive value creation and handle ongoing regulatory concerns. Over the last 20 years, since the dotcom crash, we have seen both Communication Services and Technology companies continue to get bigger. We are at a point now where companies have gotten so dominant, they cannot avoid the government's crosshairs. With a focus on Artificial Intelligence, a de-conglomeration call option, and an average multiple of 16x vs the S&P 500 Index trading around 18x, look for Communication Services to continue to hold up relatively well (Exhibit 1).

Given their fundamental qualities, balance sheet strength, and long-term secular tailwinds, we believe Equity portfolios should continue to maintain neutral positioning in both Technology and Communication Services stocks. Especially for long term investors, who can ride out near-term volatility to take advantage of the longer-term trends in digitalization, big data and more recently the emergence of Artificial Intelligence. We suggest staying in higher-quality, larger-cap stocks and reducing exposure to lower-quality, smaller stocks that do not have earnings or free cash flow.

Exhibit 1: Communication Services Earnings-per-share (EPS) Continues To Increase As Multiples Have Stayed Relatively Flat.



Source: FactSet. May 3, 2023. **Please refer to index definitions at the end of this report.**

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

S&P 500 Sector Index constitute a method of sorting publicly traded companies into 11 sectors-Information Technology, Health Care, Financials, Consumer Discretionary, Communication Services, Industrials, Consumer Staples, Energy, Utilities, Real Estate (REITs), and Materials. Also known as the Global Industry Classification Standard (GICS) sorts companies into sectors based on their primary business activity.

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