GLOBAL X
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Sector Views February 2023: Tech Talk

2023 started with a bang for the Information Technology (Info Tech) sector. The S&P 500 Info Tech sector ended January with a +9.3% total return and was basically flat through February.[1] In January, slowing inflation data and excitement about Artificial Intelligence (A.I.) helped drive the sector higher. Whilst in February, inflationary forces from hotter than expected jobs numbers and potential higher for longer policy rates became headwinds to market performance, particularly to growthier areas. In this month's piece, we will focus on the Information Technology sector, look at sector earnings and earnings dispersion across the industry groups, how margin growth compares across industries, and current sector headwinds and tailwinds.

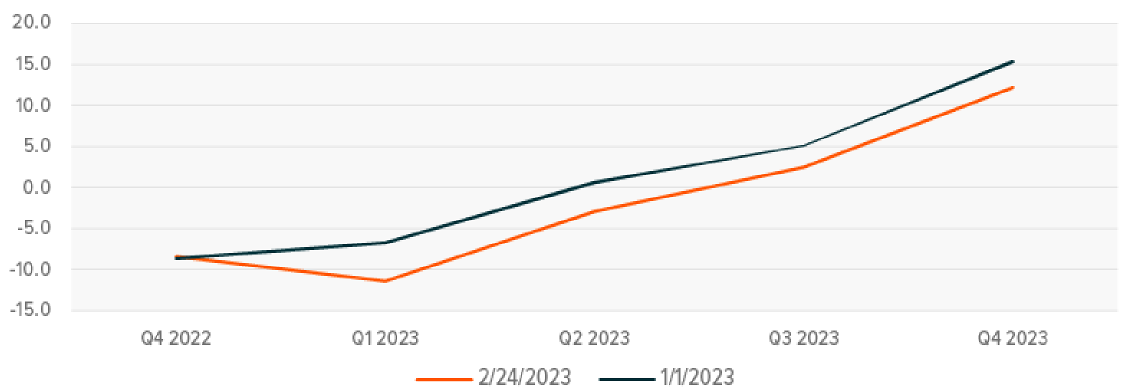
Key Takeaways:

- The Info Tech sector has the highest percentage of companies (82%) reporting earnings above estimates.[2]
- In Q4 2022, the Software & Services group led in top and bottom line growth benefitting from subscription revenue, while the Semiconductors & Equipment group lagged.
- Slowing sales and margin pressure is a potential challenge for the sector, while excitement around A.I. and CAPEX spending on automation is a growing opportunity.

Earnings Overview

As Q4 2022 earnings settle in, with about 95% of the S&P 500 index reporting, the Information Technology sector is reporting a year-over-year decline in revenues and earnings of -1.9% and -10.8%, respectively.[3] For the sector, expectations for quarterly earnings growth throughout 2023 have also softened.[4]

REPORTED & ESTIMATED EARNINGS GROWTH
Source: Refinitiv, S&P 500 Earnings Scorecard data as of February 24, 2023



Industry Group Performance Diverge

The three industry groups in the Information Technology sector are Software & Services (47% weight of sector based on market cap), Technology Hardware & Equipment (31%), and Semiconductors & Equipment (22%). In Q4 2022, the Software & Services group led in top and bottom-line growth +5.4% and +2.4%, respectively, while the Semiconductors & Equipment group lagged with -10.3% and -30.9%, respectively.[5] Software & Services, which includes themes like cloud computing and cybersecurity, benefitted from subscription revenue.

Margins have diverged across the industry groups as well, as firms continue to cut costs. Operating margins, which factor in the variable costs like labor and production expense, declined most for the Semiconductors industry group (-5.8%), slightly declined for Technology Hardware (-1.2%) and remained flat for Software & Services (+0.2%).[6] The Info Tech sector was among the first to remove excess labor capacity as labor growth in the sector was well above trend in the preceding years. This resizing is likely to come with short term costs but could put the sector in a stronger position longer term.

Fiscal stimulus from the $53B Chips Act allocated $39B in manufacturing incentives to bring production to the U.S. and $13B for R&D and training.[7] Additionally, data center rollouts and interest in Artificial Intelligence (A.I.), fueled by the wide adoption of ChatGPT, provided tailwinds for this industry group. This was particularly positive for logic names and integrated circuit companies and likely aided in performance.

Volatility Ahead

Challenges

- Sales have historically been the main drivers of margins; we could see more margin pressure if demand weakens.
- Higher for longer policy rates and a higher forecasted terminal rate could impact valuations.
- A stronger dollar could impact foreign currency exposure.

Opportunities

- The AI Revolution – technological innovation is naturally deflationary as it reduces the input cost of producing goods. AI could lower labor costs as technology could fill labor gaps and increase productivity.
- Capital Expenditure (CapEx) Spending on Automation – CapEx is inflationary in the short term and deflationary in the long term, as benefits of efficiencies are realized. Despite CapEx being cyclical, after decades of underinvestment spending might be a necessity this time. Several reasons include persistent supply challenges, the need to spend on automation amid wage inflation, and the energy transition.

Innovation doesn't stop. Companies in the Info Tech sector are able to adapt to changing market conditions to take advantage of new opportunities to innovate, become more efficient, and expand globally. Our sector views table provides more detail on sector positioning and the current tailwinds and headwinds for each sector.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit the sector. The development of augmented reality and the Metaverse may provide positive benefits in the long run.	The privacy overhang from major hardware providers could impact revenues for interactive media companies. Slower advertising spending remains a drag on social media earnings.	**Underweight**
Consumer Discretionary	Consumers increased their use of online ordering and deliveries over the past two years.[8] Greater savings and a tight job market could encourage spending.	Wage pressure combined with higher input costs in materials are a risk to margins, especially if companies are unable to increase sales prices. And a deeper economic contraction could weigh on consumer spending.	**Underweight**
Consumer Staples	Demand for consumer staples could remain steady, especially in the event of a deeper economic contraction.	Inflation is likely to negatively impact margins for companies that cannot pass through rising materials costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly.	**Overweight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally. OPEC+ production cuts and a delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies ramped up buybacks along with	A global economic contraction could weigh on demand.	**Market Weight**

	record profits and healthy balance sheets.		
Financials	For a sector that benefits from strong household and corporate balance sheets, consumer spending remains robust, and to a certain extent, rising rates are starting to benefit net interest margins.	A deeper economic contraction could offset the favorable rise in interest rates. A flattening or inversion of the yield curve will likely hurt margins.	**Market Weight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging markets benefit health care demand. Health Care is a defensive sector that typically outperforms during severe economic downturns.	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to negotiate prices on certain drugs could limit price increases on medicines.[9]	**Overweight**
Industrials	Reshoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI. An increase in U.S. public construction spending from fiscal packages could boost demand for tools and machinery for the foreseeable future.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance. Rising labor costs could pressure margins, particularly in the transport industry.	**Market Weight**
Information Technology	The sector displays quality factors and positive free cash flow growth. The increased adoption of cloud computing, cybersecurity, and cleantech are likely to remain in a post-COVID-19 world as societies adapt to these key disruptive technologies. Beneficiary of secular themes related to onshoring, automation & CapEx.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation in this space. Rising interest rates and slowing economic growth could negatively impact long duration growth sectors such as Information Technology.	**Market Weight**

Materials	Increased focus on electric vehicle adoption, alternative energy sources, and energy storage may benefit disruptive materials such as lithium, copper, and battery producers. The sector benefits from rising inflation, leading to higher prices for raw materials.	A deeper economic contraction could be a big headwind. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Underweight**
Real Estate	The sector can offer inflation-protected yield.	A fast rise in interest rates could increase the cost of financing, and a deeper economic contraction could raise the risk of costs not being passed along to tenants.	**Market Weight**
Utilities	A preferred defensive sector in recessionary environments due to the inelasticity of goods and services. Adoption of renewables could help transform the sector over the long run.	The potential for increased climate-related regulations over time may detract from this sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations. Rising yields could make Utilities less attractive versus bonds.	**Market Weight**

Footnotes

[1] FactSet Data as of February 27, 2023
[2] FactSet, Earnings Insight, February 24, 2023
[3] Bloomberg Data as of February 27, 2023
[4] Refinitiv, S&P 500 Earnings Scorecard, February 24, 2023
[5] Bloomberg Data as of February 27, 2023
[6] Bloomberg Data as of February 27, 2023
[7] WSJ, Chips Act Will Test Whether U.S. Can Reverse Semiconductor Exodus, February 22,2023
[8] Digital Commerce 360, US ecommerce in 2022 tops $1 trillion for first time, February 17, 2023
[9] CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022

Definitions

Capital Expenditures (CapEx): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.