THIS MONTH'S TOPIC

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Big Tech at the crossroads...

Big Tech's stock market performance has become more hesitant. A simple market rotation or a more durable phenomenon? With the exit from the crisis getting closer, sectors shunned during the pandemic could actually benefit from a catching-up movement. However, between its disruptive nature which is cannibalising traditional companies and interest rates which, apart from a slight increase, look set to remain durably low, Big Tech retains major advantages. Especially as its valuation is less exceptional than it seems, provided however that its profits momentum remains sustainable...

Since 2015, and more particularly since the beginning of the pandemic, Tech in general and **Big Tech** in particular have **reigned supreme** on the stock markets. **However, its development has been more hesitant over the last few weeks (see graph 1)**. With the prospect of the arrival of a vaccine and an exit from the crisis getting closer, sectors that have been the most adversely affected by the pandemic could actually benefit from a catching-up movement. **However, in the longer term**, between its disruptive nature which is cannibalising traditional companies and interest rates which, apart from a slight increase, look set to remain durably low, **Big Tech retains major advantages.**

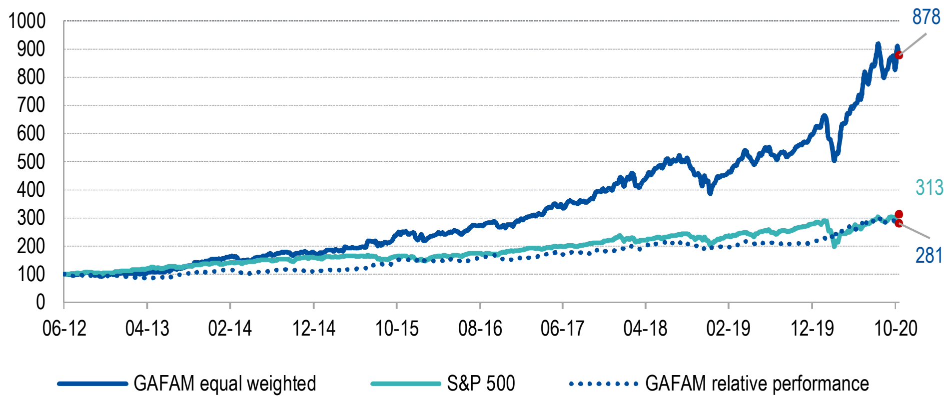
That said, in order for the sector to continue to distinguish itself, **two conditions** need to be confirmed. Firstly, that the **Fed** does not tighten its monetary policy too quickly. And secondly, that the sector's **earnings capacity** is not significantly altered. **In the case of the Fed**, on numerous occasions, it has demonstrated its willingness to be patient and, unless the vaccines and treatment announced radically change the outlook, **the horizon in terms of interest rates**, and therefore equity attraction (TINA for There Is No Alternative) and sector rotation, **seems to be relatively clear**. However, with regard to **earnings issues**, and therefore valuations, **numerous questions continue to be raised** whether in terms of taxation, regulations or obsolescence.

Before continuing, it is worth remembering that **Big Tech** is a new name for the famous **GAFAM** companies (Google, Amazon, Facebook, Apple and Microsoft). However, **this goes further** than the traditional acronym since, apart from their huge market capitalisation, what characterises these digital leaders is the fact that they have managed to create such a rich **ecosystem** that it has become difficult to do without them. And digital technology, which was already extensively present in everyday life, has moved to a new level since the pandemic and the restrictions of movement that followed.

Moreover, while the two terms are often used interchangeably, since end-2018, **Big Tech goes beyond the simple IT sector** as defined by the new **GICS classification,** which can be a source of confusion. Currently, only **Apple and Microsoft remain part of the IT sector,** whereas **Amazon** comes under the Consumer Discretionary sector (Internet & Direct Marketing sub-sector) and **Google and Facebook** the Communication Services sector (Interactive Media & Services sub-sector). **This distinction is a means of putting into perspective the popular belief that Tech is necessarily expensive.**

Graph 2 shows that **Tech in the broadest sense** (IT + Google, Facebook and Amazon) **now accounts for 40% of the S&P** vs. 35% at the peak of the TMT bubble in 2000. However, **GAFAM** companies **account for 25%** vs. 5% at the time. Consequently, **IT strictly speaking excluding Apple**

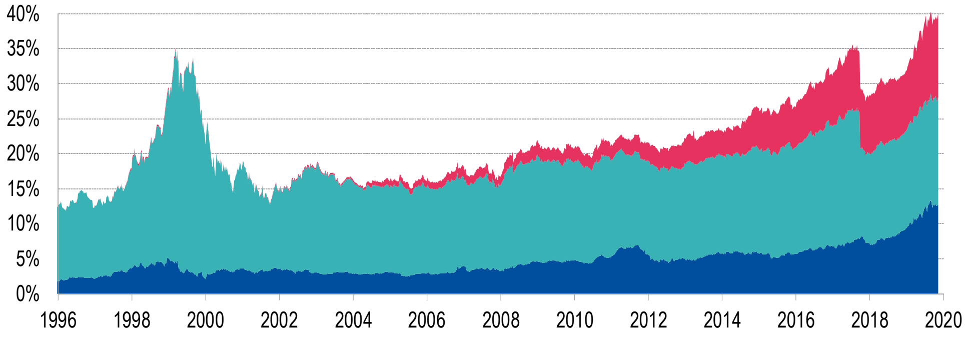
1/ **GAFAM and S&P 500 Total return** (100, June 30, 2012)



Source: Datastream, Amundi Research, data as of 13 November 2020

THIS MONTH'S TOPIC

2/ US IT sector *stricto censu* and at large in % of S&P weighting



Source: Datastream, Amundi Research, data as of 13 November 2020

Big Tech's real issue is not so much its valuation as the sustainability of its profits

and Microsoft has seen its weighting halved, from 30% to 15%. This is why it is important to be wary of generalisations when reference is made to a new valuation bubble. While certain Tech or related stocks, members of the S&P 500 or the Nasdaq, such as Netflix, Uber or Tesla may seem expensive, this is not the case for all stocks. Moreover, **while GAFAM companies enjoy record valuations, this does not necessarily mean they are expensive**. With the exception perhaps of Amazon, the issue is not so much their **valuation** multiples as the sustainability of their profits; a little like the banks on the eve of the Great Financial Crisis in 2008 but for other reasons.

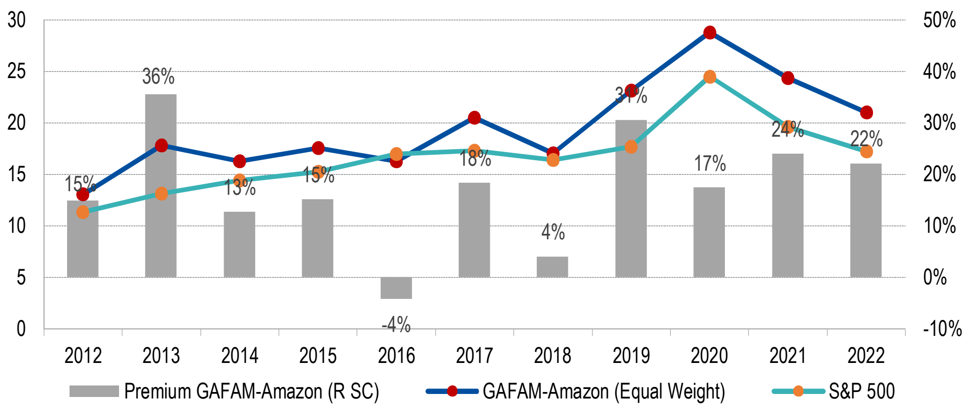
Apart from Amazon, the valuation of the other GAFAM companies seems relatively "normal". Accordingly, **on the basis of 12M Forward PE ratios**, **their premium** to the S&P 500 (38%) **remains close to its average** for the last eight years (33%).

Moreover, this type of ratio does not take account of the **abundant cash** of these companies. For this, it is necessary to resort to the Enterprise Value (EV=Market capitalisation – Net debt). And effectively, **EV/EBIT** reveals an even more moderate premium (see graph 3) with 17% in 2020 and 24% in 2021 vs. 38% for the 12M Forward PE ratio.

After these reminders about valuation, let's move on to earnings. **Graph 4** shows that the **net earnings of the Tech sector in the broadest sense** increased from **USD 89 billion to USD 299 billion between 2007 and 2019**, i.e. an average rate of increase of **+10.7% per year** compared to +2.5% for the other S&P stocks. Consequently, over the same period the share of profits of the Tech sector in the broadest sense increased **from 11% to 24**% of the S&P 500. **GAFAM** companies did even better since their profits grew on average by **+16.9%** per year vs. +6.4% for the other IT stocks. Finally, within GAFAM companies, first place goes to Facebook (+51.4% per year but from 2011 to 2019), ahead of Amazon (+30.5% per year), Apple (+24.7%), Google (+19.1%) and Microsoft (+8.3%). Given their earnings power, the unparalleled market capitalisation of GAFAM companies (in terms of absolute amount rather than in ratios) appears more comprehensible. **However, the issue of the sustainability of these profits is more acute than ever.**

Unlike at the **end of the 1990s**, the US Tech sector now generates enormous profits. During the Great Financial Crisis in 2008 and even more so during the COVID crisis, it has demonstrated **the robustness of its profits. Therefore, trends in the**

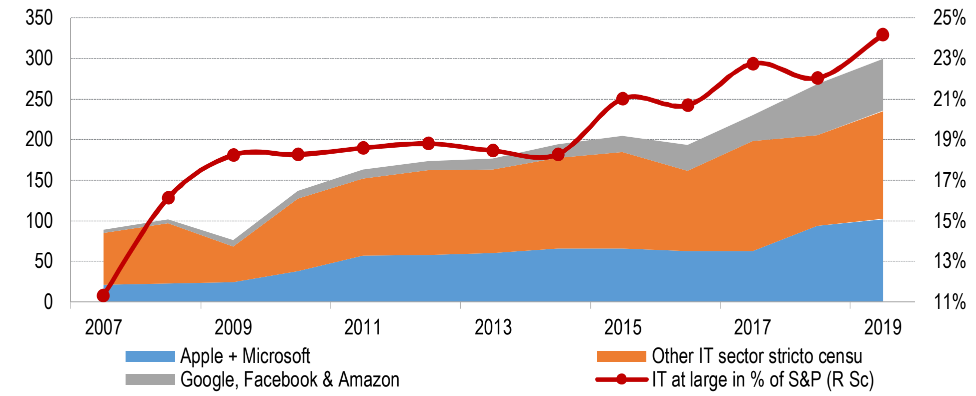
3/ EV/EBIT S&P 500 vs Microsoft, Apple, Google and Facebook



Source: Factset, Amundi Research, data as of 13 November 2020

THIS MONTH'S TOPIC

4/ **IT at large Results, in USD bn and % of S&P 500**



Source: Factset, Amundi Research, data as of 31 December 2019

Obsolescence and regulatory upheaval, more than taxation, could change the situation

economy are of less concern than other types of issues that may arise such as obsolescence, taxation or regulations.

While GAFAM companies currently seem to be at the forefront, **obsolescence is nevertheless a recurrent threat for the Tech sector**. If we go back twenty years, **numerous leading groups** are merely shadows of their former selves, because they were unable to adapt. Accordingly, **BlackBerry, Ericsson, HP, Motorola and Nokia** whose capitalisation together was more than Microsoft in 2000 (USD 444 billion vs. USD 422 billion) account for less than 8% today. The comparison with Apple is even more cruel since at end-2000 its capitalisation was only USD 5 billion and it only started to reach the USD 100 billion mark in 2007 before exceeding USD 2,000 billion today. Similarly, Amazon, whose capitalisation is currently USD 1,570 billion, had a capitalisation of only USD 5 billion in 2000. As for Google and Facebook, founded in 1998 and 2004 respectively, they were floated on the stock market in 2004 and 2012 and now have a market capitalisation of USD 1,200 billion and USD 789 billion respectively.

In the case of taxation, the consequences of Joe Biden's election are not yet resolved. His programme provided for a partial change of the Trump reform by increasing the corporate tax rate to 28% whereas, at end-2017, his predecessor had lowered it from 35% to 21%. However, such a reform would require the support of the Senate. And if the Senate remained Republican in January, which currently seems most likely, Biden's leeway on tax matters would be substantially reduced. Moreover, even assuming a Democratic Senate and a corporate tax rate that would increase from 21% to 28%, tax optimisation is likely to reduce the bill. Accordingly, under Obama's second term, the real tax burden of GAFAM companies was on average **24%** instead of 35%. Then after the Trump reform, it fell to **15%** instead of 21%. By extrapolating this discount of 30% between effective and official rates, the new effective rate (70% of 28%) would be 20% instead of 15% previously. All other things being equal, the additional tax levy would ultimately be only 5% vs. 9% in theory. In addition to the corporate tax rate, **the OECD's GAFA tax plan,** paused since June, **could resurface** with the new administration. The initial idea was to tax digital companies where they generate their revenues rather than where their head offices are located. However, this reform has come up against contradictory interests both between the United States and the rest of the World and within the EU itself. Consequently, it could take considerable time to materialise for a probably minimal result; the most impacted in this matter being ultimately the tax havens (Ireland, Netherlands, Luxembourg, Delaware, etc.) charged with redistributing to other countries, more than the GAFAs themselves. The second component of the reform proposed by the OECD was based on **minimum global taxation amounting to 12.5% of profits**. This proposal is also included in Biden's programme, with a rate of 15%. In both cases, this could adversely affect certain younger or more aggressive companies, but is hardly likely to affect GAFAM companies which are situated slightly above its thresholds. **Ultimately, the tax aspects do not seem to be insurmountable for GAFAM companies.**

A tightening of the regulations would potentially be more problematic. We only have to look at what recently occurred in China with the sudden decision to halt the listing of **Ant Group**, which promised to be the world's biggest IPO. However, this success story which managed "to introduce digital disruption to the heart of Chinese finance and beyond" risked becoming increasingly difficult to regulate, or even generating credit bubbles. Jack Ma's tactless comments on the eve of the stock market flotation were therefore sufficient to aggravate the situation and

THIS MONTH'S TOPIC

However, the prophets of doom have often been mistaken

halt the operation. The United States is not China but the impact of GAFAs has also generated an increasingly intense debate. While they contribute considerably to US soft power, these digital giants are also accused of distorting the competition. In October, the House of Representatives' Antitrust Committee published a report recommending drastically limiting the power of GAFAs by prohibiting them from giving preference to their own products, by severely regulating purchases of start-ups, or even dismantling certain companies. However, this text signed only by Democratic representatives has no chance of succeeding without the support of the Senate. Nevertheless, this awakening of the authorities demonstrates that the adaptation of competition rules to the digital era could result in unexpected changes.

At this stage, we have too little information to give an opinion on the stock market and financial consequences of changes in the regulations. However, in the past, in these circumstances, we have often observed paradoxical consequences. Therefore, instead of having an adverse effect, the stripping of activities often increases the overall value. Similarly, while the emergence of new competitors may adversely affect existing players, it is often also the guarantee of faster growth in the sector as a whole.

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THIS MONTH'S TOPIC

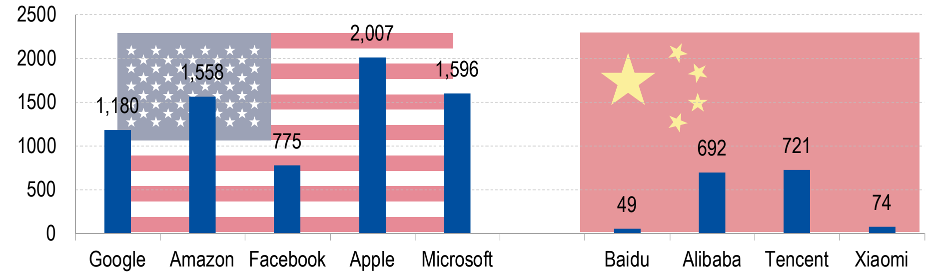
China: the other stronghold of digital technology

As US-China trade tensions have grown in recent years, we have all seen that over time, this rivalry has become especially intense when it comes to technology, data access and digital platforms. After running Huawei out of the US and encouraging its foreign partners to do the same, the Trump Administration turned its attention to TikTok, owned by the Chinese group ByteDance, and threaten it with a ban on operating in the US. TikTok, a highly popular app with the younger generation, was accused of siphoning US user data. An agreement implying that US corporations would buy into a company housing TikTok's international operations may be authorised by the US authorities. However, this deal would then have to be approved by China, seeking to protect Chinese technologies: "TikTok's algorithm, which delivers content to each user that is likely to be of interest to that particular user, is the centre of attention."

These examples are instructive about the new faces of competition between the US and China. In the coming weeks, with the new Biden Administration taking office, this rivalry will certainly take a more civilized turn. On the whole, however, US-China digital competition is set to continue. With its BATHX (Baidu, Alibaba, Tencent, Huawei and Xiaomi), China is the only country capable of rivalling with the GAFAM. Its strengths in the field of artificial intelligence, the size of its domestic market and the protectionism of its authorities, where applicable, have helped it advance in leaps and bounds. After locking up the domestic market, Chinese corporations are ready to expand their coverage around the world. GAFAM and BATX should therefore in all likelihood battle on third-party markets, and in particular in Europe; a wealthy region that has nevertheless fallen way behind digitally speaking.

The chart below compares the current market capitalisation of US and Chinese tech champions. For China, as Huawei is not publicly traded, the comparison is therefore limited to the BATX instead of the BATHX. With a combined capitalisation of more than USD 7 trillion, versus USD 1.5 trillion for the BATX, the GAFAM easily come out on top. It is worth noting, however, that Alibaba and Tencent, the respective rivals of Amazon and Facebook already boast an impressive market cap; the two stocks together weighing more than 60% of their US counterparts and nearly half (46%) of the whole Euro Stoxx 50 capitalisation.

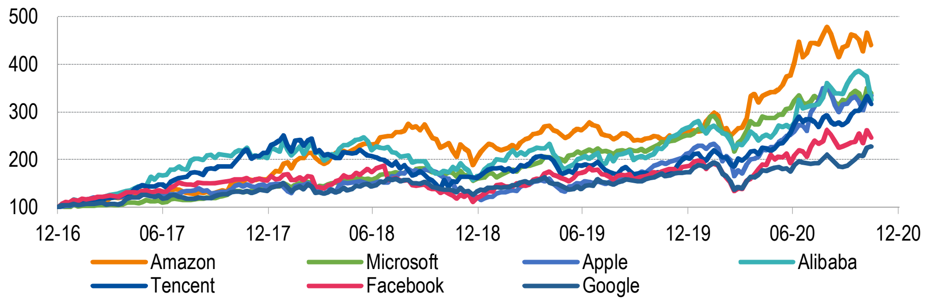
1/ **GAFAM vs BATX: Market capitalisation in Bn USD**
as of Nov 18, 2020



Source: Datastream, Amundi Research, data as of 18 November 2020

Furthermore, Chart 2 shows that in the last four years, China's champions have performed quite respectably: although Amazon dominates the rankings, Alibaba and Tencent are neck-and-neck with Apple and Microsoft, but significantly ahead of Facebook and Google.

2/ **Price return of US & China Tech champions**
Base 100 in USD on Dec 31, 2016



Source: Datastream, Amundi Research, data as of 18 November 2020

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