Market rally and tech stocks

Monthly Market Update | July 2023

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Key takeaways

- The market has generated strong returns this year, a reversal from last year's trends and investor expectations.
- From a macroeconomic perspective, this has been driven by slowing interest rates as inflation improves and anticipation builds about an upcoming end to Fed rate hikes.
- From a sector perspective, technology stocks have disproportionately propelled the overall market, especially when it comes to the largest names.

Market update

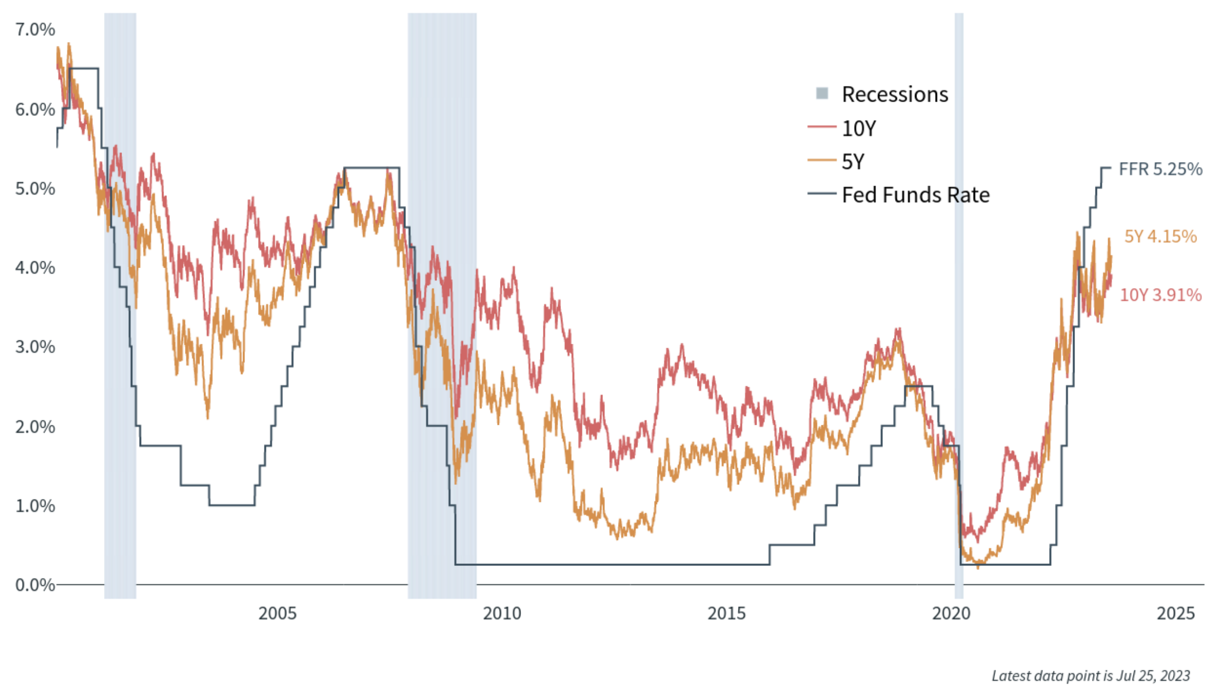
This update is provided in partnership with Clearnomics, a market insights platform for asset and wealth managers. Our goal is to help you stay abreast of ever-changing markets by putting current conditions into the context of economic and market history. Every monthly update will address key issues clients are asking about and share real-time insights you can use to improve the management of risks in your fund. The updates will also provide practical historical stress-testing scenarios to help you explore potential outcomes for portfolios in the current environment.

Despite ongoing economic uncertainty, the S&P 500 and Nasdaq Composite have gained about 19% and 35% this year, respectively. Not only is this a reversal of last year's market dynamics, but it represents a sharp reversal in many recession forecasts from the start of 2023. What's driving this strong market performance, and can it be sustained?

At an index level, this year's market rally has been fueled by two factors. First, Federal Reserve guidance and market-based projections suggest that interest rates may be approaching their peaks. This has provided relief to interest rate-sensitive sectors that struggled last year as inflation and rates were rising. Second, technology-specific themes such as artificial intelligence (AI) technologies have captured investors' imagination. The promises of AI range from better tools for knowledge workers and automation of clerical work to the overhaul and displacement of whole industries. Collectively, these trends have driven technology-related sectors, lifting the overall market.

Exhibit 1

Market interest rates have risen alongside the fed funds rate



Sources: Clearnomics, Federal Reserve, NBER

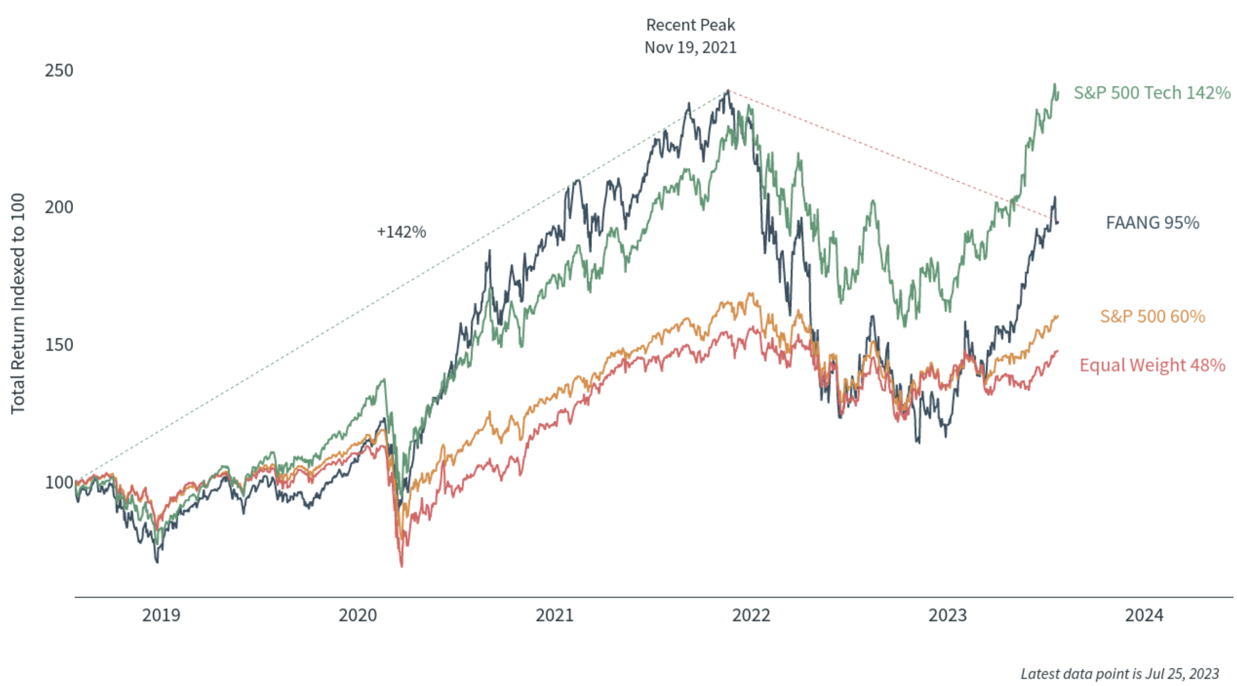
Many investors now expect that the Fed is nearing the end of its rate hike cycle. Stable or declining long-term interest rates are a tailwind for the stock market, because there are many ways in which rates and stocks are linked. Technology-related sectors are especially sensitive to changes in long-term interest rates because they rely on continued investment to generate growth. Specifically, technology companies often derive value from cash flows far into the future, and thus small changes in rates can have large impacts on their present values.

The present value of a stream of cash flows is simply the idea that the value of a dollar generated years into the future is worth less than a dollar today. How much less depends on a number of factors that can be summarized by the level of interest rates, which are themselves the product of the opportunity costs to investors, economic growth trends and more. This dynamic has affected equities across information technology, communication services, and even consumer discretionary, especially due to the high concentrations of the overall market in the largest tech stocks.

At the same time, interest rates are still well below nominal growth, especially when considering the rapid growth rates of the tech sector. So, while growth has been steady but slow across the economy, many large tech companies are still experiencing top-line expansion. With the 10-year Treasury yield hovering between 3.8% and 4%, there are likely to be attractive investment opportunities for larger companies with access to financing, even as credit conditions tighten. Thus, large tech companies that can attract capital due to their high growth rates could be in a position to take advantage of the current economic environment.

Exhibit 2

Market returns have been concentrated in tech-related sectors



Sources: Clearnomics, Standard & Poor's

In addition, a few key AI-related names have benefited immensely this year. Over the past two decades, investors have experienced numerous hype cycles over new technologies. In the past few years, these have included the metaverse, virtual reality, blockchain technology, self-driving cars and space exploration.

Each of these technologies is accompanied by narratives on how it will transform society. The computer scientist Roy Amara famously said that people tend to overestimate the impact of technology in the short run and underestimate its effect in the long run. Although many new technologies do eventually play an important role in business and everyday life, investors can often get ahead of themselves in the meantime.

From a purely economic perspective, the promise of any new technology is a boost to productivity. Whether it's new machines, software or just a better way of doing things, technology allows us to accomplish more with less. After all, the simplest way to think about the economy is that growth occurs when there are more workers (labor), more machines (capital) or improved technology (e.g., better-trained workers and/or superior machines). Productivity, or the ability for the same number of workers to produce more, is what improves quality of life generation after generation.

As a result, the market gains so far this year have been driven by interest rate dynamics and short-term enthusiasm for new technologies. In the long run, the promise of long-term boosts in productivity could support economic growth. However, most everyday investors should continue to focus on what they can control rather than trying to capitalize on the latest market trends. Those that have appropriate portfolio exposures have already benefited from these trends, while also staying prudent as valuations rise to higher levels. The relationship between interest rates, inflation and economic growth will likely continue to drive sector dispersion in the coming quarters.

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