A CLOSER LOOK AT TECHNOLOGY STOCKS

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Interest Rates Rise Amid Geopolitical Risks – Markets had a lot to digest over the past three months as trade tensions grew, NAFTA negotiations reached a resolution and European stability was again tested in Italy. Global growth remained solid as the U.S. economy forged ahead posting 4.2% real GDP growth. As a result, the yield curve in the U.S. shifted over 20 basis points (0.2%) higher and the 2-year note touched its highest level since 2008.

New rounds of tariffs between the U.S. and China did little to impact the S&P 500 which set new highs over the third quarter, appreciating 7.7% . The Canadian stock market, measured by the S&P/TSX, under-performed its peers in the third quarter falling nearly 1.5% due to flat oil prices and a widening discount to Western Canadian Crude.

INDEX TOTAL RETURN	3Q18	1-YEAR
MSCI All Country World Index (USD)	4.28%	9.77%
S&P 500 Index (USD)	7.71%	17.91%
S&P/TSX Compostie Index (CAD)	(0.57%)	5.87%
MSCI Emerging Markets (USD)	(1.09%)	(0.81%)
MSCI EAFE Index (USD)	1.35%	2.74%
Barclays Global Agg Bond Index (USD)	(0.05%)	0.82%
Barclays US Agg Bond Index (USD)	0.02%	(1.22%)

Source: Morningstar

Technology Stocks Are Breaking Down – The US equity market has fallen nearly 10%, twice in 2018. While these types of pullbacks, labelled as corrections, happen on an annual basis, the market leaders are now beginning to show some weakness. Seven big technology leaders – Amazon, Nvidia, Apple, Microsoft, Facebook, Alphabet and Netflix – have contributed more than half of the 60% increase in the S&P 500 since the end of 2013. The parabolic advance that began, ironically during the taper tantrum, appears to have been broken. If this sell-off continues there is a high probability that it manifests into greater losses for the broader market.

Over the last six to eight months there has been growing backlash against data collection and privacy violations by the technology giants. Mainstream media sounded off about the violations following news that Facebook shared user data with Cambridge Analytica. This data was then allegedly used to influence voters in the US presidential election. Lawmakers summoned Facebook CEO, Mark Zuckerburg to appear before congress for questioning. However, the hearing turned into a side-show as Senator's displayed a clear lack of understanding of Facebook's operating model.

The Facebook business model, which centers around data collection, has allowed the company to capture nearly 20% of US digital ad spending. Meanwhile its main competitor, Alphabet, garners nearly 40%. The duopolistic nature of the digital add industry is not a one-off. Alphabet and Apple provide 99% of mobile operating systems while Apple and Microsoft supply 95% of desktop operating systems. This has formed a far different fundamental environment for technology shares than the market's experience during the dot-com bust (2000-2003).

Historically low interest rates combined with dominant market positions have propelled technology earnings. Unlike the dot-com era, technology firms today possess strong fundamentals, revenues and earnings rather than speculation. Going forward, analysts project the five biggest US tech companies—Apple, Alphabet, Microsoft, Amazon and Facebook, which account for 44% of the Nasdaq index—will see their profits grow to $170 billion and cash holdings reach $680 billion by 2020. This implies an average forward P/E ratio of 20x, which is reasonable given their growth especially when considering that Amazon is an outlier.

However, antitrust has also become one of the major focal points. And, Europe appears to be leading the charge on the regulatory side. Alphabet was hit with a record-breaking $5 billion fine by European Union (EU) regulators for alleged anti-competitive Android bundling. The EU is also addressing data and privacy with its General Data Protection Regulation (GDPR) rules. The antitrust backlash has led to numerous calls to beak-up the likes of Facebook, Google and mostly Amazon. Amazon is the most unique case as the company has essentially disrupted every industry in which it has become involved.

Jumping into large technology names following their massive price ascent should be approached with position sizing and timeframe top of mind. The firms are currently generating strong growth and have solid earnings however the environment appears to be changing. More importantly perhaps, these market generals have become increasingly important to the broad market indexes. Therefore, it stands to reason that further weakness here could make for a more difficult equity environment in general.