Julius Bär

FAAMG: A BUBBLE IN THE MAKING?
NO, GROWTH AT A REASONABLE PRICE

- In our view, the large Internet-related outperformers within the US technology sector do not look overvalued and in aggregate still offer upside potential.
- We continue to be bullish on the global Information Technology sector and still recommend Alphabet (Google), Facebook and Microsoft.

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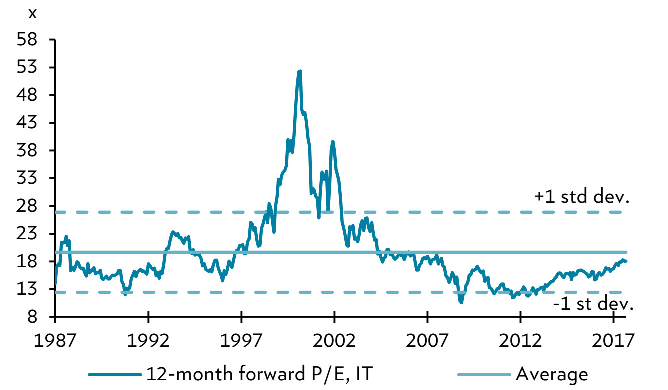
FAAMG: The music continues to play

We continue to be bullish on the global Information Technology (IT) sector, mainly due to our positive view on the semiconductor and software sub-segments. Global IT is benefiting from a macro environment, which is characterised by accelerating growth and rising rates that support IT companies due to their low financial leverage and high operating leverage. Global IT stocks are trading at a forward P/E of around 18x, broadly in line with the sector's long-term historical valuation multiple average. As a result, we believe that the good growth perspectives of the sector are not yet fully reflected at current levels.

Chart 1: IT valuation based on forward P/E



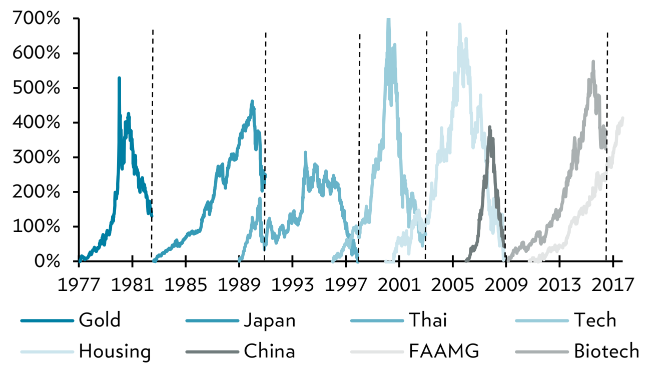
Source: Datastream, Julius Baer

However, within the IT segment, we would like to take a closer look at the FAAMG group (Facebook, Amazon, Apple, Microsoft, Google). Those five stocks have been the main performance drivers of the underlying IT and consumer indices and now represent around 13% of the S&P 500, roughly the same weighting as the US energy sector.

A recession would be needed to trigger a bubble burst.

While we agree that the share price performance of the FAAMG group may look like a bubble in the making, we would stress the fact that bubbles only tend to burst when the underlying market moves into a recession. According to our economists, global growth should accelerate towards the end of the year and stabilise at current levels in 2018. Leading indicators in all major regions around the globe support this forecast and thus a recession looks highly unlikely in the foreseeable future.

Chart 2: Performance history of financial bubbles



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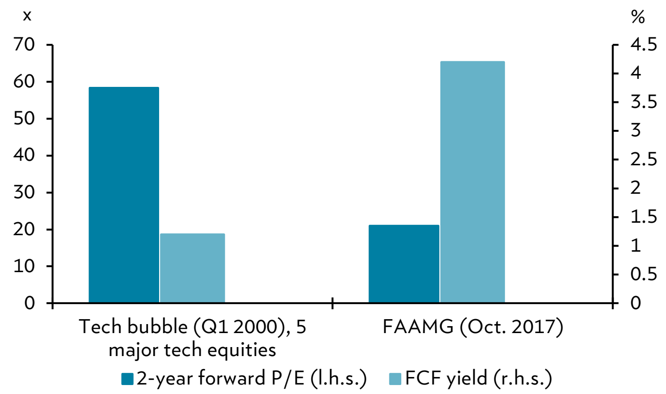
Furthermore, we would argue that valuations are a much more important factor in identifying bubbles than the sheer asset price performance. While we agree that some of those stocks trade on high multiples (e.g. Amazon and Netflix trade on 60x and 130x forward P/E, respectively), we do not believe that this is true for the FAAMG group as a whole, which trade at 21x forward earnings, a 20% premium to the S&P 500, which is broadly in line with the long-term average of the IT sector relative to the S&P 500. In addition, the free cash flow yield of the FAAMG group of 4.1% is fully in line with the free cash flow yield of the S&P 500.

Valuations of the FAAMG stock relative to the market and IT peers are in line with long-term averages

The current P/E multiple of the FAAMG stocks looks rather undemanding relative to the 2-year forward valuation multiple of the five largest US technology stocks in 2000 (see table 5). In aggregate, we would argue that we do not yet see a valuation bubble in the FAAMG stocks.

Chart 3: FAAMG current valuation relative to the IT bubble in 2000



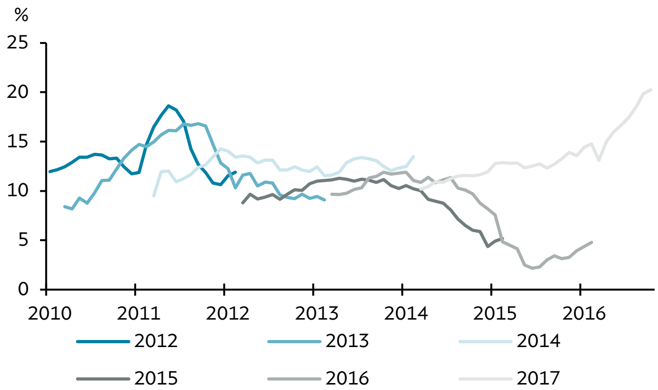
Source: Datastream, Julius Baer

Furthermore, we would argue that valuation of growth stocks must be evaluated in relation to the expected growth rates, and the FAAMG group's price/earnings to growth ratio of 1.6 is well below the 2.2 of the S&P 500. Moreover, the IT sector is currently the only sector in the US that generates double-digit earnings growth on a sustainable basis.

FAAMG offers structural growth in a period of general growth scarcity within the developed world

The global economy is currently experiencing unprecedented technological change and, according to our assessment, the FAAMG stocks rank among the major beneficiaries of the secular shift towards disrupted change. Against this background, one might argue that an even higher valuation premium against the market could be justified.

Chart 4: Global technology forecast



Source: Datastream, Julius Baer

Investment Conclusion

We maintain our Overweight rating on the global IT sector as valuations are undemanding and growth perspectives are very good. Within IT, we also keep our preference for the semiconductor and software sub-segments. With regard to the FAAMG stocks, we also have in aggregate a positive view. We see no valuation bubble and assume that the overall growth characteristics remain very strong. Within the FAAMG segment, we maintain our preference for Microsoft, Alphabet (Google) and Facebook, which are all Buy-rated.

Corporate rating summary

Facebook (Buy, price/target: USD171.8/199)
Amazon (Hold, price/target: USD975.9/1,000)
Apple (Hold, price/target: USD157.1/160)
Microsoft (Buy, price/target USD78.86/83)
Alphabet (Buy, price/target: USD988.49/1,090)
Netflix (Hold, price/target: USD196.02/190)

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Equity research

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CAGR	Compound annual growth rate	EPS	Earnings per share	P/B	Price-to-book value
DCF	Discounted cash flow	EV	Enterprise value	P/E	Price-to-earnings ratio
EBIT	Earnings before interest and taxes	FCF	Free cash flow	PEG	P/E divided by year-on-year EPS growth
EBITDA	Earnings before interest, taxes, depreciation and amortisation	MV	Market value	ROE	Return on equity
Consensus rating	Consensus rating indicates the analysts' opinions on the security. It shows the number of analysts covering the security and the breakdown between Buy, Hold and Sell ratings.	Consensus target	The consensus target is the average price to which analysts expect the security to rise.	FY	Fiscal year

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