



PRICE POINT

August 2018

Timely intelligence and analysis for our clients.



Laurence Taylor
Equity Portfolio Specialist

TECHNOLOGY WEAKNESS – TRANSIENT OR THE BEGINNING OF AN UNWIND?

Results Have Been Strong for the ‘Disruption’ Giants

We’ve clearly seen a strong period for the IT and e-commerce sector over the past 18 months especially from some index heavyweights. While it’s highly unusual to see companies the size of Facebook, Microsoft, Alphabet and Amazon deliver returns at such high levels, despite this theoretical headwind, they have delivered spectacular corporate results, which has in turn driven share prices meaningfully upwards¹.

While strong stock price movements have added to the concern of some investors that ‘disruptive IT’ is not a durable way to generate returns, Facebook delivering rising sales, earnings and cashflow above 20% p.a. in recent quarters gives some indication that strength in certain IT stocks hasn’t been based on a 2000’s style bubble and the ‘hope’ of monetisation. Instead, many stock prices have been moved by the evolution of the Internet, growing penetration of mobile devices and platforms driving monetisation from shifting consumption and user preferences.

Success Has Led to More Crowded Exposure

However, in tandem with concerns that the global economy is plateauing, the organic growth profile of many of these disruptive stocks has made them crowded. The surprise element unpriced into many high-growth companies 18 months ago (when markets were focused on the cyclical-value rally driven by Donald Trump’s election success) has also faded to leave higher valuations and expectations. With this backdrop and with Q2 ‘misses’ for Facebook and Netflix (two high profile IT bellwethers), some re-positioning by investors out of stocks that have become broadly owned is understandable. This is what we’ve seen in the second half of July as IT, and growth more broadly, underperformed.

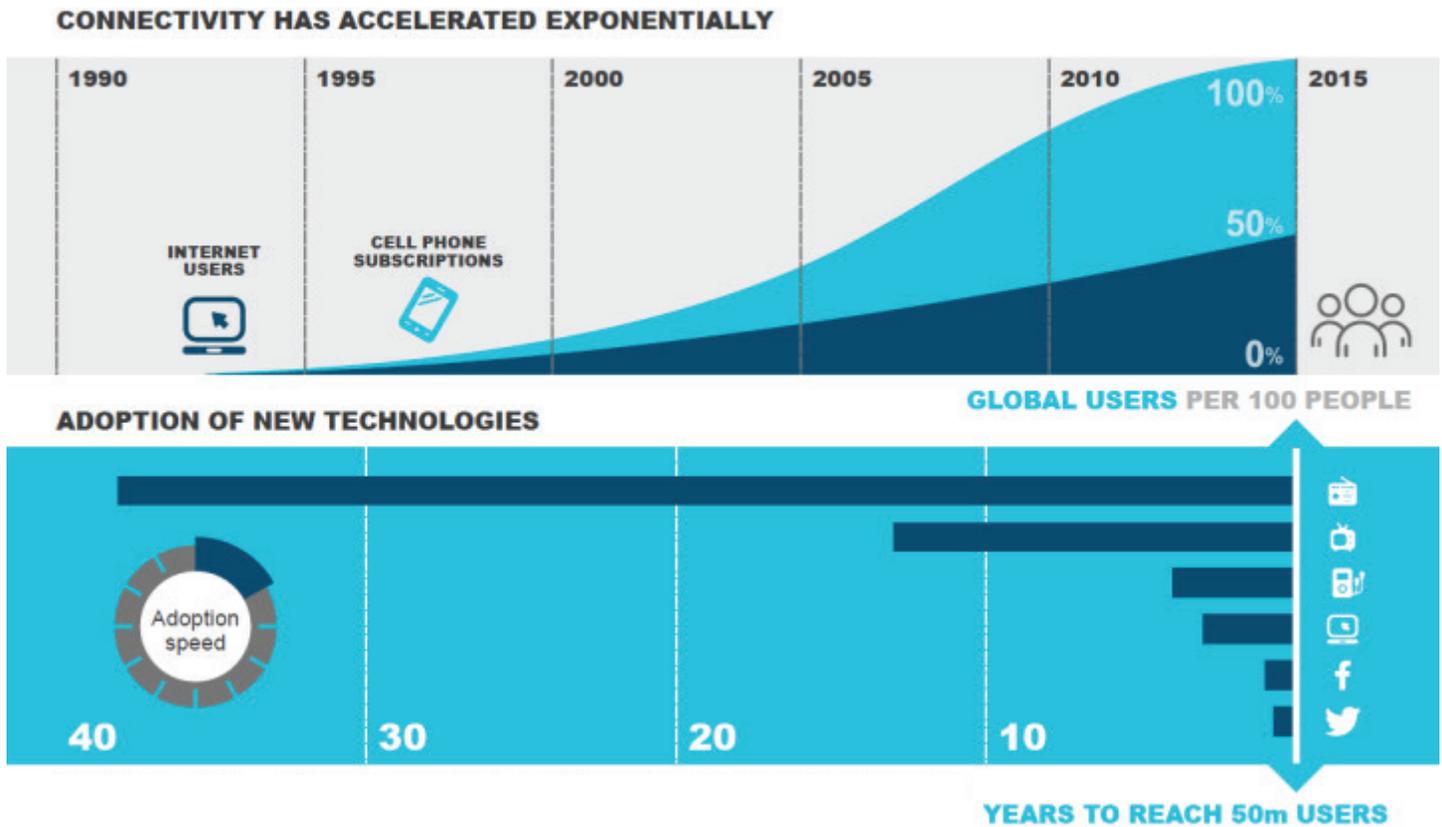
This Doesn’t Feel Like a Broad-based ‘Tech’ Bubble

As we think about how sentiment may impact stock prices near term, one key question today concerns whether our holdings in IT are trading at extreme valuations given the growth potential? While valuations have clearly risen, we

The specific securities identified and described above and the following pages do not necessarily represent securities purchased, sold or recommended by T. Rowe Price. This information is not intended to be a recommendation to take any particular investment action and is subject to change. No assumptions should be made that the securities identified and discussed above were or will be profitable. The views and opinions are as of 31st July 2018.

¹ The views and opinions are as of 31st July 2018.

FIGURE 1: Adoption and Connectivity
 Have Accelerated Disruption, As of 31 December 2015



Source: World Bank, McKinsey

The information presented herein is shown for illustrative, informational purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action. The specific securities/companies identified and described above do not necessarily represent securities/companies that were purchased, sold or recommended and no assumptions should be made that the securities/companies identified and discussed were or will be profitable.

The trademarks shown above are the property of the respective owners. T. Rowe Price is not endorsed, sponsored, or otherwise affiliated with any of the trademark owners represented by the trademarks shown above.

believe the answer is no. Despite this, some near-term patience may be required after the spectacular gains of recent quarters, and we have been working hard to adjust position sizes for stock specific risks, including those centred on valuations.

The central question to stock-specific ownership is whether our holdings are on the right side of long-term changes in spending, consumption and user trends and whether the companies can capture this advantage in profit terms over the medium to long term. The investment thesis at initiation for each stock we own, centres on the durability of the business economics and the quality of the product driving growth in monetisation and profitability terms. This provides a strong platform for compounded returns, but only if we are right in our insights and we pay a reasonable valuation.

Is This the Beginning of the Long Awaited ‘Value’ Rally?

Neither of the above will necessarily defend individual stock prices in the near term if investors choose to reposition aggressively. How the recent sell-off evolves is dependent on multiple dimensions, but important considerations are 1) the alternative use of capital, given the long-term growth potential of the global economy remains muted and growth therefore remains a scarce commodity 2) corporate guidance through the remainder of the earnings season by companies in and

outside of the technology sector. If we see further misses in IT and strength elsewhere, this may force further short-term repositioning. The durability of earnings growth over the next 12-24 months is key however and we still find more ideas in IT and other disruptive industries than elsewhere, including deep cyclicals.

While commentary is growing with respect to whether a Value era might develop from this recent sell-off, this commentary often sits within a broader perspective of rising investor caution, especially following the IT sector experiencing a mixed earnings season. This is hard to envision however, given Value usually has more 'power' in periods of greater risk tolerance. If caution grows because investors perceive that risks are rising, buying cheaper cyclicals remains counter-intuitive, to us at least. The thesis may be that 'Value' could outperform because 'Growth' is expensive and 'Growth' will therefore fall further, but we are happy to contend this point given our bottom-up perspective on the stocks we own.

The FAANGs Are Not a Thing, It's an Acronym Based on Very Different Things

To conclude, we are not defensive or applying extreme caution at this point, but we are not blind to the top-down risks (trade war, politics and the growing inequality imbalance) or bottom-up risks (valuations, regulation, cost inflation and management execution) that are evolving deep into an equity cycle. The key to long-term success inside and outside of IT remains stock picking and owning those companies that are genuine long-term top performers and avoiding those companies on the wrong side of change.

The market often doesn't care about differentiation at certain points in time, specifically as momentum builds to high levels, as we have seen at times this year. Equally, headline driven market corrections tend to clear out a degree of investor capital that is anchored on short-term data, especially in this era where heightened quantitative trading around volatility has grown. Ultimately, the nature of the 'Disruption giants' is embedded in singular and idiosyncratic characteristics and investors should treat them as such. While the market may disagree and continue to pressure 'the FAANGs' (Facebook, Amazon, Apple, Netflix, Google), we'll stay focused on the medium and long-term fundamentals of each stock.

Above all, we tend to find that headline driven sell-offs are helpful with respect to upgrading our portfolios and we'll obviously look to do this where appropriate, albeit with selectivity and gentle contrarianism at the heart of our stock specific actions.

Facebook

While we expect a period of slower growth in coming quarters for the company (Facebook has some heightened expense related to addressing privacy concerns, some FX earnings headwinds, and is pursuing its "Story" engagement strategy, which currently has lower levels of monetisation), we remain optimistic on its longer-term outlook. The company continues to disrupt print media advertising revenues via its platform and advertisers' feedback describing their experience on Facebook is universally positive. That's important, because it means the recent slowdown isn't due to advertisers no longer finding value in spending more money on Facebook.

Currently, the firm generates the bulk of its advertising revenue through news feed posts, but management expects that its Stories format will surpass news feed posts by next year. More importantly from a growth perspective, Stories are growing much faster than news feed posts. We think Stories (and potentially video as well) will be a bigger growth driver for Facebook than the news feed has been. The Story ads provide a better experience for both the user, and especially the advertiser, than a news feed ad. All of the data and targeting that Facebook has used to drive the effectiveness of news feed ads will be at its disposal on Story Ads and we think it is largely a matter of building the products and driving advertiser adoption. While adding uncertainty near term, we have confidence this will happen, though it will take time to execute. It is also worth noting that Stories live in all of Facebook's properties, including Messenger and WhatsApp, both of which have more than one billion users. We think Stories provides Facebook a tremendous amount of raw material to work with and greatly increases its ceiling in terms of future revenue generation.

While the market has reacted to the uncertainty of change and downward pressure on profits, we would point out that "slower growth" for Facebook is still very strong growth. The real reset for the stock is because management guided EBIT margins over the next two years to mid-thirty percent levels from current mid-forty percent levels. We believe they are being conservative. While we can't comment on trading activity intra-quarter, we believe the current valuation is justified by our growth outlook going forward.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia— Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material is intended to certain specific institutional investors for information purpose only and must not, therefore, be delivered to, or relied on by, a retail client.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to any strategy and/or product contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. Any strategy and/or any product mentioned herein may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is delivered to eligible institutional person and is for institutional use only. Under no circumstances should the material, in whole or in part, be copied or redistributed or provided in any medium without consent from T. Rowe Price. No distribution of this material to any member of the public is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. Any strategy and/or any products mentioned in the material has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. It is not intended for use with the public and not intended for general circulation or distribution in Malaysia.

Philippines—THIS MATERIAL IS FOR QUALIFIED BUYERS ONLY. ANY STRATEGY AND/OR ANY SECURITIES MENTIONED IN THIS DOCUMENT HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF ANY STRATEGY AND/OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Taiwan—The material is for general information only. Any strategy and/or any product mentioned in this material is not registered in Taiwan and may not be sold, issued or offered in Taiwan. No person or entity in Taiwan has been authorized to offer, sell, give advice regarding or otherwise intermediate the offering and sale of the strategy and/or any product associated with the strategy in Taiwan.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution to any member of the public in Thailand other than "institutional investors" is permitted.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. All rights reserved.