The heat is on for tech stocks amid U.S.-China cold war

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The U.S. and China are the two global leaders in technology, and the tech sector is the largest constituent in both countries' stock markets. Deteriorating relations between the two superpowers, with tech dominance a key issue, are sparking investor concerns. Recent selling has fanned the flames. We see a focus on innovation and battle for supremacy as long-term positives for the tech sector in both countries. Yet key differences – in everything from sector composition to performance and valuations – call for a nuanced approach. We focus primarily on China, where a recent company tour provided valuable insight.

Highlights

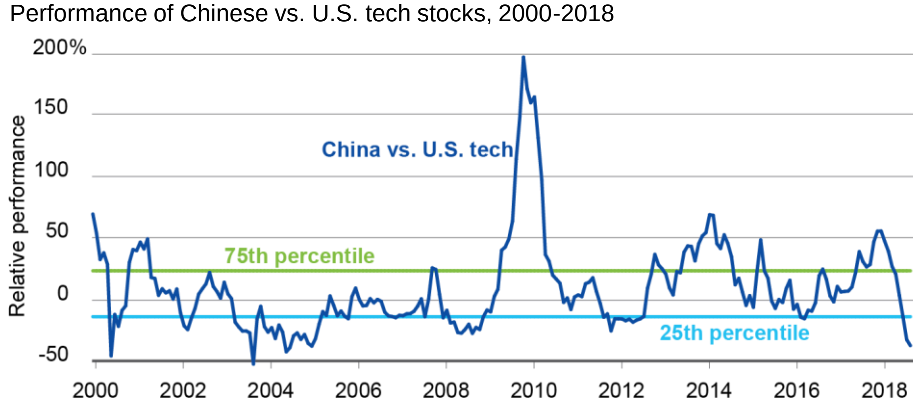
- **Price reset.** Recent selling in both Chinese and U.S. tech stocks has been painful, but we see it potentially creating more attractive entry points for long-term investors.
- **Tech decoupling.** We see U.S. and Chinese tech developing differently, a trend amplified by changes in trade, cross-country investment restrictions and the competition for dominance. This can mean two distinct opportunities for investors.
- **Risk and reward.** Chinese tech has lagged the U.S. in 2018 and valuations look compelling. Yet we are watching how trade disputes and strained relations affect Chinese IPO activity, global supply chains and cross-border investment.

Performance picture

U.S. tech is still up 10% year-to-date despite October selling, while China tech has plunged 28%, resulting in the largest relative performance disparity since 2004. See the chart below. This partly reflects downward revisions to Chinese tech earnings. Yet analysts project a rebound in 2019 amid strong demand, fiscal stimulus and waning regulatory hurdles. We also see China's focus on domestic demand and a strategic commitment to self-reliance as potential positives amid trade disputes. U.S. tech earnings, meanwhile, are expected to normalize after a boost from 2018 tax cuts.

Tough times for Chinese tech

Performance of Chinese vs. U.S. tech stocks, 2000-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Thomson Reuters, October 2018. Notes: The dark blue line represents the rolling 12-month performance of the China tech sector minus that of U.S. tech to illustrate out- or underperformance. The horizontal lines represent the 75th and 25th percentiles of this series and show the current level has been seen less than 25% of the time since 2000. Figures based on the MSCI USA and MSCI China indexes.

Two countries, two tech sectors

The tech sector is growing in both the U.S. and China. See the *Tech's growing heft* chart. Yet the two are quite different. U.S. tech's global focus is set against a domestic bent in China – where three stocks represent the lion's share of tech market cap. Other distinctions: the market for tech services is larger in China; the consumer base has a different income profile; and the regulatory framework is developing faster.

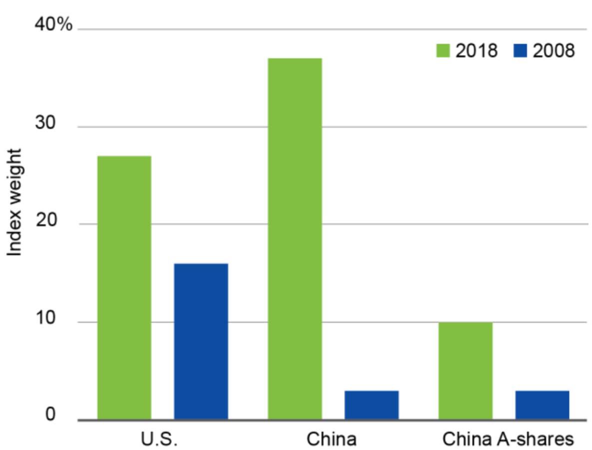
Chinese tech is an innovative hub tailoring experiences and services for a distinct domestic user. It is at pivotal points in acquiring new customers and tapping into higher value consumption, with many industries battling for market share. Competition is fierce and the sector continuously disrupts itself. Consolidation and acquisitions are common, but with a recognition that purchasing new assets can weigh on profit margins if user growth and ad revenues trail.

Online services have grown in areas where offline services are insufficient or inefficient, such as education, health care and entertainment. The explosion of digital entertainment such as streaming video has filled the void left by limited content from official media outlets. Tech is not always displacing analog solutions – high demand often compels leaps directly to online service. Technology is also seen as a solution for rising labor costs and aging populations. The Chinese are devoting considerable resources to the development of artificial intelligence, a key strategic priority, and are on their way to becoming a global leader in the space.

Meanwhile, the U.S. maintains its stronghold in enterprise software and cloud services. It remains the global leader in semiconductors, though China's ambitious plan to supply the majority of its own chips looms on the horizon. Existing differences in the Chinese and U.S. tech sectors are magnified by U.S. changes to cross-border direct investment. If Chinese companies cannot invest in U.S. tech and U.S. firms were similarly restricted in China, chances of co-development (as well as direct competition) fall – and the likelihood of separate protocols for key technologies rises.

Tech's growing heft

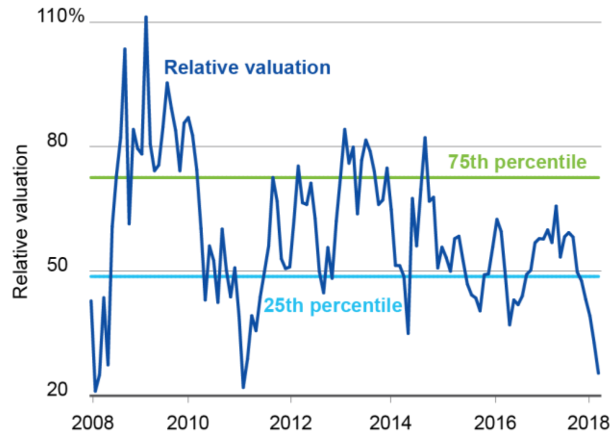
Tech weight in U.S. and China markets, 2008 vs. 2018



Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, October 2018. Notes: The bars show the weighting of tech shares in each market currently and at the end of 2008. Figures based on the MSCI USA, MSCI China and MSCI China A indexes. It is not possible to invest directly in an index.

Shrinking premium

Chinese vs. U.S. tech stock valuations, 2008-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, October 2018. Notes: The dark blue line shows the premium or discount of Chinese tech relative to U.S. tech based on forward 12-month price-to-earnings ratios. The horizontal lines represent the 25th and 75th percentiles of the premium/discount since September 2008. Figures based on the MSCI USA and MSCI China indexes. It is not possible to invest directly in an index.

What's worrying investors?

Chinese tech stocks have underperformed this year, pushing their typical premium to U.S. tech near its lowest this decade. See the *Shrinking premium* chart. Risks to growth and consumption, alongside geopolitics and trade uncertainty, are reasons. Our BlackRock geopolitical risk indicator (BGRI) shows U.S.-China relations and global trade tensions are the two worldwide risks gaining the most market attention – and the effects are starting to feel more tangible. We've seen delays in order volume and timing for hardware equipment manufactured in China, for example. Companies are even contemplating shifting production to other ASEAN countries.

China may be willing to compromise with the U.S. in seeking to reduce the bilateral trade deficit. But rivalry in the tech sector and disputes over market access are likely to persist and raise the specter of tech fragmentation. This stokes speculation over potential "winners" and "losers," yet it could also open the door to the emergence of distinct opportunities for investors. Another uncertainty: A possible digital services tax on foreign tech firms in the UK and other countries.

Other obstacles make fewer headlines: Regulatory and policy changes in China have had a big impact on the activity and revenue for tech and media companies this year. Chinese tech earnings were up 56% in 2017, IBES data show, as companies grew unfettered and unregulated. But 2018 has been a year of policy catch-up. Most of the new regulation aims to create a robust business environment over the longer term, even if some of the changes have been painful. One case in point is China's large gaming industry: The government approved licenses for up to 7,000 new games in 2017 and 2,000 more in the first quarter of 2018 before halting new licensure, Chinese media reported in August. The move had a huge impact on the business lines of key tech companies. We expect some regulation will ultimately shake out smaller players who may find it harder to adapt, yet most companies we've talked with feel confident the changes will help secure a brighter future.

Reasons for optimism

A side-effect of the increased scrutiny and regulation of the Chinese tech sector has been the development of government relations functions within companies across the sector. Many companies are working to directly involve both official institutions and state-owned enterprises in their platforms and future planning. Chinese tech and media companies know they need to partner with the government – or at least have a productive dialogue – to succeed.

Most of the policy and regulatory changes on the social side are aimed at improving the economy and social safety net. Policy disruption is not over yet, but Chinese tech and media companies overall are growing and expanding rapidly, despite the tighter regulatory environment.

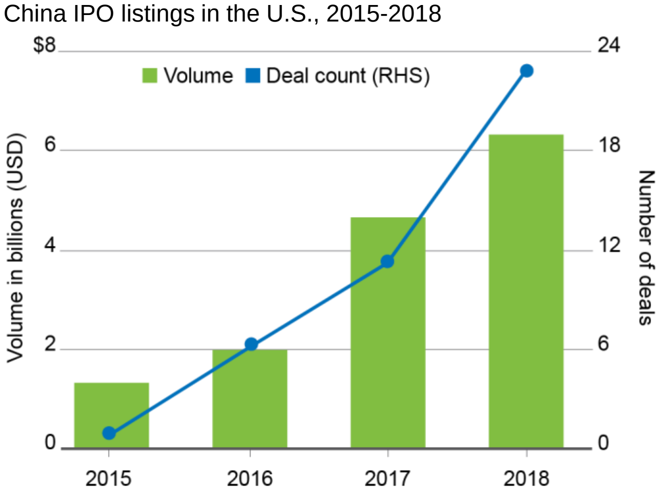
Chinese firms have been increasingly tapping into the U.S. for new equity capital. Chinese IPOs represented 20% of all global IPO deals in the third quarter of 2018, with the majority in the tech sector, data from Dealogic show. The *Going public* chart illustrates the trend since 2015. "New economy" companies – especially tech – have dominated the IPO market in Hong Kong, particularly after listing requirements were loosened in late April.

The China Securities Regulatory Commission also liberalized listing rules this year to pave the way for more domestic tech sector issuance, easing regulatory obstacles such as mandatory profit requirements. Listing reforms on both the mainland and Hong Kong should open the door for even more tech IPOs, in our view.

Chinese tech valuations have fallen this year, while our BGRI shows attention to the U.S.-China relations risk has risen. We believe the potential opportunity and value in Chinese tech firms may be under-recognized in their current share prices amid a heightened focus on strained U.S.-China relations, as well as regulatory change. For those with a long-term mindset and stomach for short-term volatility, we believe it may be an opportune time to step in.

Going public

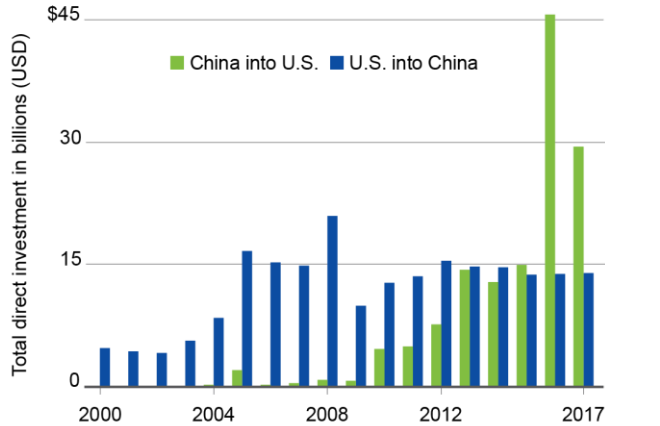
China IPO listings in the U.S., 2015-2018



Sources: BlackRock Investment Institute, with data from Dealogic, October 2018. Note: The green bars show annual deal volume in USD billions and the blue line shows the number of deals in each year.

Money flows

China and U.S. cross-border investment, 2000-2017



Sources: BlackRock Investment Institute, with data from Rhodium Group, October 2018. Note: The bars represent foreign direct investment, with green showing China's total investment in the U.S. and blue showing U.S. total investment in China.

What to watch, where to invest

We like both U.S. and Chinese tech longer term, and believe investors who choose one over the other are forfeiting significant opportunity. A drive to innovate supports both, while cross-country restrictions could limit redundancy and direct competition, setting up distinct opportunities.

Where to look? We advocate digging deeper than the largest three tech firms in China to find value in a range of software and services. This makes active stock picking key. We believe valuations may be nearing bottom after lagging U.S. tech in 2018. Policy changes along with lofty initial expectations led to downward earnings revisions in 2018, but 2019 could see a rebound: Companies are adapting to new regulations, and demand for content, software and services remains robust.

Within the diverse U.S. tech sector, we favor software as a service (SaaS), or software services distributed through the cloud. Moving key systems to the cloud can lower companies' costs and allow for more frequent and sophisticated system updates. Some U.S. tech stocks are trading at a premium now, but overall valuations are in line with their five-year average.

Changes to the MSCI's Global Industry Classification System (GICS) on Sept. 28 mean the tech sector looks different. Internet companies fell out of information technology (IT) and into the new communications services sector. This leaves the new IT sector largely comprised of hardware and software names. Sector investors may need to look to the newly named communications sector for some high-growth opportunities once classified under the IT label.

What to watch? Our eyes are on the IPO market for clues as to how many (or few) Chinese companies are coming to market. Trade tensions and strained relations may have an impact on whether Chinese companies list in the U.S. Some companies hit by regulatory pressure have been taken private temporarily and then listed on China's A shares market, removing U.S. investors from the ownership pool. Meanwhile, Chinese direct investment into the U.S. is on pace to decline over 90% in 2018 versus 2017, October data from Rhodium Group show. The *Money flows* chart illustrates recent trends.

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