Clearing the Air on Tech

Let's just get right into it and clear the air on what is happening with tariffs, the technology sector and the market dip. Despite sharp sell-off in recent weeks, TD Asset Management Inc. (TDAM) finds only limited evidence of fundamental business deterioration in the technology sector. When considering the impact of tariffs, long story short, we do not feel that tariffs affect the operations of technology companies. Most Big Tech companies generate the majority of profits domestically, but even more important is that services cannot be tariffed and will be unaffected.

While an economic slowdown would affect all businesses, we argue that technology companies would weather the storm better than most. After all, how likely is it for you to cancel Spotify or for a business to cancel Microsoft Office? We think the sell-off in technology reflects market dynamics of a rotation away from technology winners and towards less economically sensitive industries, not reflective of underlying business fundamentals. The pace of technological advancement is only accelerating, which we think will extend the runway for growth in technology companies.

What matters

Now that we cleared the air on the impact of tariffs and the rationale behind the recent selloff, we can take a closer look at some of the more meaningful drivers of returns and factors to watch in the tech space.

Big tech earnings recap - are poor share price reactions an indicator of bigger problems?

Shares of the tech giants fell as much as 5-10%[1] after results in the cloud businesses fell short of expectations. While this is headline-grabbing, it's important to ignore the short-term noise and focus on the results, which again showed strong fundamentals. Consider that the hyperscalers added $2.7 billion more in revenue compared to the prior quarter[2], their best result yet. We maintain that cloud has strong secular tailwinds and growth will remain robust for years to come. Core business segments such as Microsoft Office, Google Search, YouTube, and Amazon Retail met or beat high expectations, confirming the health of these companies. Looking to the financial statements, revenue and earnings growth accelerated for the second year in a row at 16% and 45% respectively, triple the broader market[1]. For 2025, we anticipate revenue to continue growing at low teens and earnings at mid-teens.

Capital expenditure spending is continuing, but the rate of change is slowing

The consistent theme has been big tech companies doubling down on capital expenditures (capex) to meet accelerating artificial intelligence (AI) demand. The dollar amounts are enormous and far in excess of any single capital program in history: the Big Five (Alphabet, Amazon, Apple, Meta, and Microsoft) are expected to spend as much as $350 billion in 2025[1]. Going beyond headlines, we think it's notable that capex growth is decelerating, to 36% in 2025 from 58% last year[1]. Above all, we are asking ourselves, is this productive spend that management expects to generate a return on or simply a private-sector version of the space race?

We think this is the year where the rubber hits the road as we anticipate several breakthroughs in AI usability in the consumer and enterprise space. On the consumer side, Meta is already showing gains in their main applications using AI infrastructure, with revenues accelerating to 22% in 2024[3] and the promise of multiple AI powered products this year. More evidence for tangible returns on AI can be seen with Microsoft, having a $13 billion run-rate in AI cloud revenues, growing 157%[4].

DeepSeek is important, but not seminal

DeepSeek was undeniably a step forward in AI innovation. But it was also one of dozens of such steps that happen in any given year for an emerging technology. There have been many articles written on DeepSeek, so there is no need to rehash the facts. We feel that this is a positive development and the market's initial reaction may not have been correct. Rather than view this as a threat to markets, we think this is a 'Sputnik' moment that invigorated technological competition and ultimately benefitted humanity via faster innovation.

We feel there are 3 takeaways from DeepSeek:

- The cost to deliver AI will decrease,
- More AI will be used with lower costs and,
- Value will accrue to the hyperscalers that own the AI rails and software companies that can deliver AI solutions.

Bubble or opportunity?

It's convenient (and lazy) to revert back to the internet as an analogy for our times. Substantial capital investment in infrastructure, infectious euphoria around a breakthrough technology, skyrocketing public market valuation, and an eventual bust isn't followed by true value creation (think Big Tech) for another decade. We strongly disagree with this categorization.

We think the roll-out will come in stages, first in the consumer realm, driving higher consumer engagement, behavior predication, and better advertisement targeting and monetization. We already see this with companies like Meta and Alphabet. In the business context, AI is often seen as a holy grail, but what will it actually mean for the corporate world?

We think there are three main outcomes from AI integration as:

- Employees will become more productive, accomplishing more with the same time,
- Some roles will change dramatically as AI can automate swaths of manual tasks and,
- Margins for the largest companies will expand as the workforce is more efficient.

Overall, we think AI will be a boon for the economy and the stock market as it becomes more efficacious and cost-efficient.

[1]Source: Bloomberg Finance L.P Data as of March 1st, 2025
[2]Source: Alphabet, Microsoft, Amazon filings as of March 1st, 2025
[3]Source: Meta filings as of March 1st, 2025
[4]Source: Microsoft filings as of March 1st, 2025