



Why A Technology Bubble Could Be Just Around The Corner

Description

The last technology bubble burst around 16 years ago. It was a hugely painful experience for a large number of investors. Companies which had just been worth \$millions a matter of months (and sometimes weeks) earlier were now worth zero after the bubble burst.

Investors realised that the internet may not prove to be a revolution in the way the world operates, but rather an evolution which would take time to bear fruit. As such, companies with no profit, and in some cases no revenue, saw investor sentiment decline dramatically in a short space of time.

Today, valuations may not be in the same realm as they were at the time of the dot.com bubble. However, this time around it is the major technology companies which could be hugely overvalued. As such, the impact on the wider index could be even more dramatic.

Major contributors

The S&P 500 has risen by around 11% since the start of the year. Much of this growth has been due to the performance of just five stocks: Facebook, Apple, Amazon, Microsoft and Google. They are often referred to as the 'FAAMG' stocks, and they make up around 13% of the entire index by market capitalisation. Since the S&P is a market capitalisation-weighted index, their impact on the index's performance is significant. If they report disappointing earnings, or investors decide that their valuations are excessive, the entire S&P 500 could experience a pullback.

The same could be said for the wider technology sector. It now accounts for 23% of the S&P 500 by market capitalisation. This is the highest level since the dot.com bubble burst, when the figure was around 34%. Certainly, there is still some way to go before the figure reaches the same level as it did in the year 2000. However, with the FAAMG stocks accounting for around 40% of the gains made by the S&P 500 so far this year, it is clear that one small group of companies in one sector holds significant sway over the future performance of the entire index.

Looking ahead

Clearly, bubbles are much easier to identify after they have burst. However, the FAAMG group of companies appear to be moving into bubble territory. They have an average price-to-earnings (P/E) ratio of around 23, which suggests they may offer a narrow margin of safety. Given the uncertain outlook for the US economy and its apparently unstable political sphere, it would be unsurprising for their valuations to come under a degree of pressure in the medium term.

Certainly, the five companies in question are still some way off the P/E ratio of the tech sector in the year 2000. Just before the dot.com bubble burst, the sector had an average P/E ratio of around 58. As such, while the FAAMG bubble may not burst in the short run, it could be the source of the next major crisis to hit investors across the globe.

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Date

2025/08/27

Date Created

2017/08/19

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