Alert: Shopify (TSX:SHOP) Raised a Red Flag for Tech Stocks

Description

Shopify (TSX:SHOP)(NYSE:SHOP) declared its third-quarter earnings yesterday. Although the numbers were excellent and beyond expectations, Shopify stock was *down 7.8%.* This strange move, in my opinion, is a red flag for the tech sector and investors.

Here's why.

End of the growth spurt

Shopify's numbers were excellent. The company posted revenue of $1 billion, up 96% from a year earlier, and well ahead of analyst expectations of $882 million. Subscription and merchant solutions were both up 48% and 113%, respectively, from the previous year. Altogether, this was a stellar quarter. However, investors recognize that past performance isn't an indication of future returns.

Savvy investors, with enough capital to move the market, are forward looking. In other words, they're not interested in what happened over the previous quarter but are using the numbers to estimate what happens in future quarters.

The fact that Shopify stock dropped indicates that some investors believe growth in future quarters won't match up to this recent quarter. Ever since the crisis erupted, people have been stuck at home. Shops have been shut, while the government has handed out hundreds of dollars every week to anyone without a job. That pushed online sales to a record high.

Now, these trends are likely to reverse. The government is slowly pulling back stimulus measures. Fewer people are confined to their homes, while online shopping has already been adopted by nearly everyone. Growth over the next few quarters will be a struggle. Shopify stock seems to reflect that.

Shopify stock valuation

Another possible explanation for Shopify stock's bizarre move is that expectations were simply too high before the earnings were announced. The stock was trading 3% higher pre-market before the earnings. Meanwhile, it was trading at a price-to-sales ratio of 57.25.

Put simply, investors are too optimistic about Shopify and tech stocks in general. Now, expectations are so high that nearly everyone could fail to live up to them. This, again, is bad news for tech investors. If this earning season doesn't excite investors, the stock market could pull back from its recent high.

Tech stocks, particularly e-commerce and software companies, could be at the epicentre of a potential crash. This crash is already playing out across the so-called FAANG stocks south of the border.

With that in mind, it could be a good time to take some profits and reduce your exposure to the tech sector.

Bottom line

Shopify stock dropped yesterday, despite reporting stellar third-quarter earnings. This could mean one of two things: tech stocks are overvalued or investors expect growth to slow in a post-pandemic world. Either way, this is a red flag for tech investors.

If you're like me, a significant chunk of your portfolio is invested in technology companies. This could be a good time to take a closer look at the numbers, make realistic estimates of future growth, and perhaps lock in some profits.

2020 has been an excellent year for us tech investors. Let's not get complacent as we enter a new year.

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