iFAST Research Update:
Digital Economy - Long-term growth intact, but limited upside

In the long-term, we believe that the digital economy will make up a larger part of the global economy. However, we maintain our 2.5 Stars "Neutral" rating for the sector, given its lofty valuations, potential slowdown in earnings growth, rising interest rate environment, and regulatory risks.

The pandemic-driven surge in demand for online goods and services has spurred digitalisation as the world went into lockdown. As a result, big-tech companies have enjoyed strong revenue and earnings growth in 2020 and 2021 driving their share prices up (Figure 1).

However, we see signs of an earnings slowdown in 4Q21, with big names like Amazon (NASDAQ: AMZN) and Apple (NASDAQ: AAPL) facing supply chain disruptions, and Meta Platforms (NASDAQ: FB) experiencing the impact of Apple's new privacy policies. The strong earnings growth delivered by internet companies over the past year may be difficult to sustain in the coming quarters, which could put a lid on further share price appreciation for the time being.

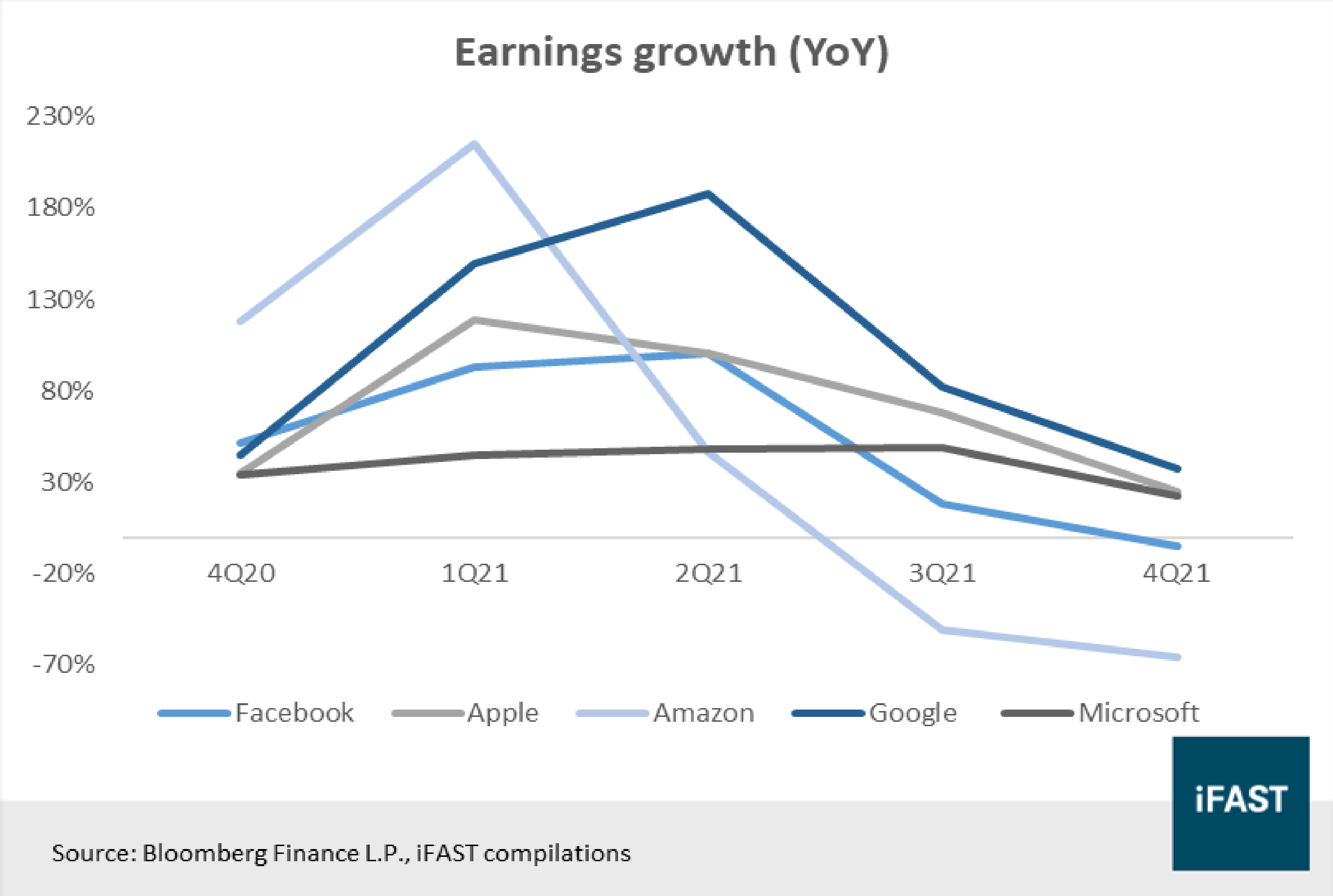
Figure 1: Share price performance of the O'Shares Global Internet Giants ETF

Source: Bloomberg Finance L.P., iFAST compilation. Data as of 15 Feb 2022.

Near-term risks on share price

Although we remain positive on the long-term growth of the digital economy, in the near-term, valuations remain high and potential headwinds such as earnings growth slowdown, interest rate risks, and regulatory risks hold. Internet companies have experienced strong growth over the past two years, which could be difficult to sustain in the coming quarters, as observed in the slowdown in earnings growth for key big tech companies (Figure 2).

Figure 2: Earnings growth has declined from peak growth in late 2020 and early 2021



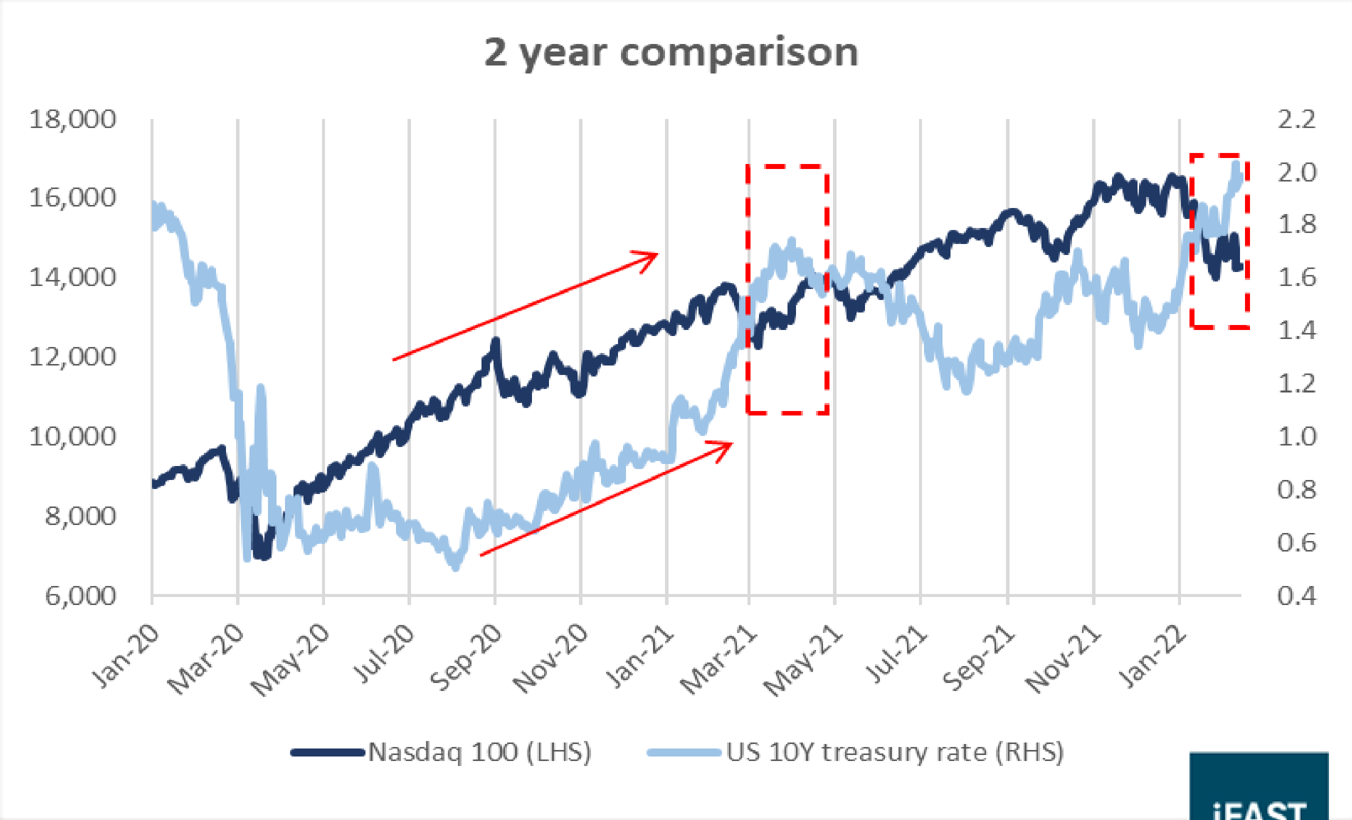
For example, Meta's (NASDAQ: FB) 4Q21 earnings decline of -5% year-over-year (YoY) and weak guidance for 1Q22 was taken very negatively by markets, with the stock falling over -20% the day after its earnings release.

In the e-commerce segment, Amazon (NASDAQ: AMZN) posted its second quarter of negative earnings growth at -65% YoY in 4Q21, following a -50% YoY earnings decline in 3Q21, as supply chain disruptions persisted.

Besides a potential slowdown in earnings growth, rising inflation and the potential for interest rate hikes also poses as a downside to the digital economy. Although rising interest rates are thought to lower the valuations of tech stocks, the relationship between the two is not as simple as it seems.

While there have been occasions where news of rate hikes have coincided with short-term pullbacks in tech stocks, there are also many occasions where both interest rates and share prices rise in tandem (Figure 3). This goes to show that changes in interest rates is not the only component behind share price movements.

Figure 3: Nasdaq 100 versus the US 10-year treasury rate – 2 years



Source: Bloomberg Finance L.P., iFAST compilation. Data as of 15 Feb 2022.

Nevertheless, as we head into 2022 where inflation persists and rate hikes begin, tech stocks may remain volatile and downside risks hold.

More importantly, inflation and rising interest rates could potentially weigh on the earnings of the tech companies, unless managed properly.

In an inflationary environment, rising costs and wages would weigh on a company's expenses, unless the company has the bargaining power over its suppliers or customers, where suppliers do not pass the rising costs to the company or customers take on the rising costs in the form of higher prices.

In a rising interest rate environment, the cost of debt for a company increases as the interest paid for the company's debts will increase. In this case, a company with a lower debt-to-equity ratio would be more favorable.

Finally, calls for tighter regulations around the world is another headwind faced by big tech firms. In the US, the big tech companies face various headwinds such as the G7 global minimum tax, which could weigh on earnings.

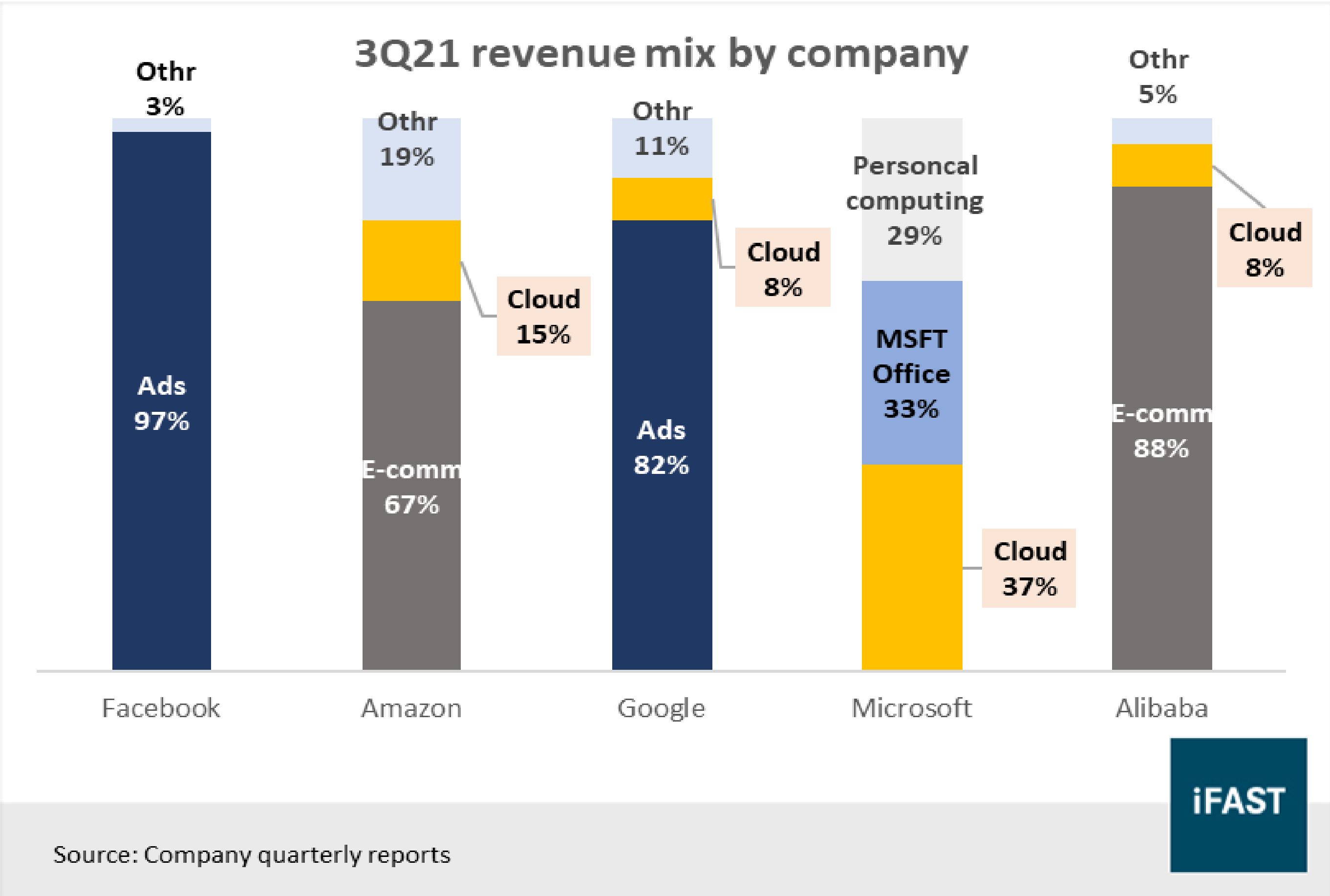
With the looming downside risks including earnings growth slowdown, interest rate and inflationary risks, and regulatory risks, we maintain our neutral view on the digital economy. While the long-term growth story of the digital economy remains intact, we think that investors should wait for downside risks to be priced in and for valuations to become more attractive.

Corporate digital transformation the next growth driver

Nevertheless, within the digital economy, we expect segments that are exposed to corporate demand, such as cloud, software-as-a-service (SaaS), and cybersecurity to do well in the coming years. The pandemic was a wake-up call for businesses to speed up the adoption of technology in order to remain competitive as the global economy becomes increasingly digitalised.

Among the big-tech companies, Microsoft (NASDAQ: MSFT) and Google (NASDAQ: GOOGL) have managed to outperform the other big tech players over the past few quarters. A key reason for this is because both these companies are more exposed to corporate demand, offering cloud, digital advertising, and a variety of software products and services (Figure 4).

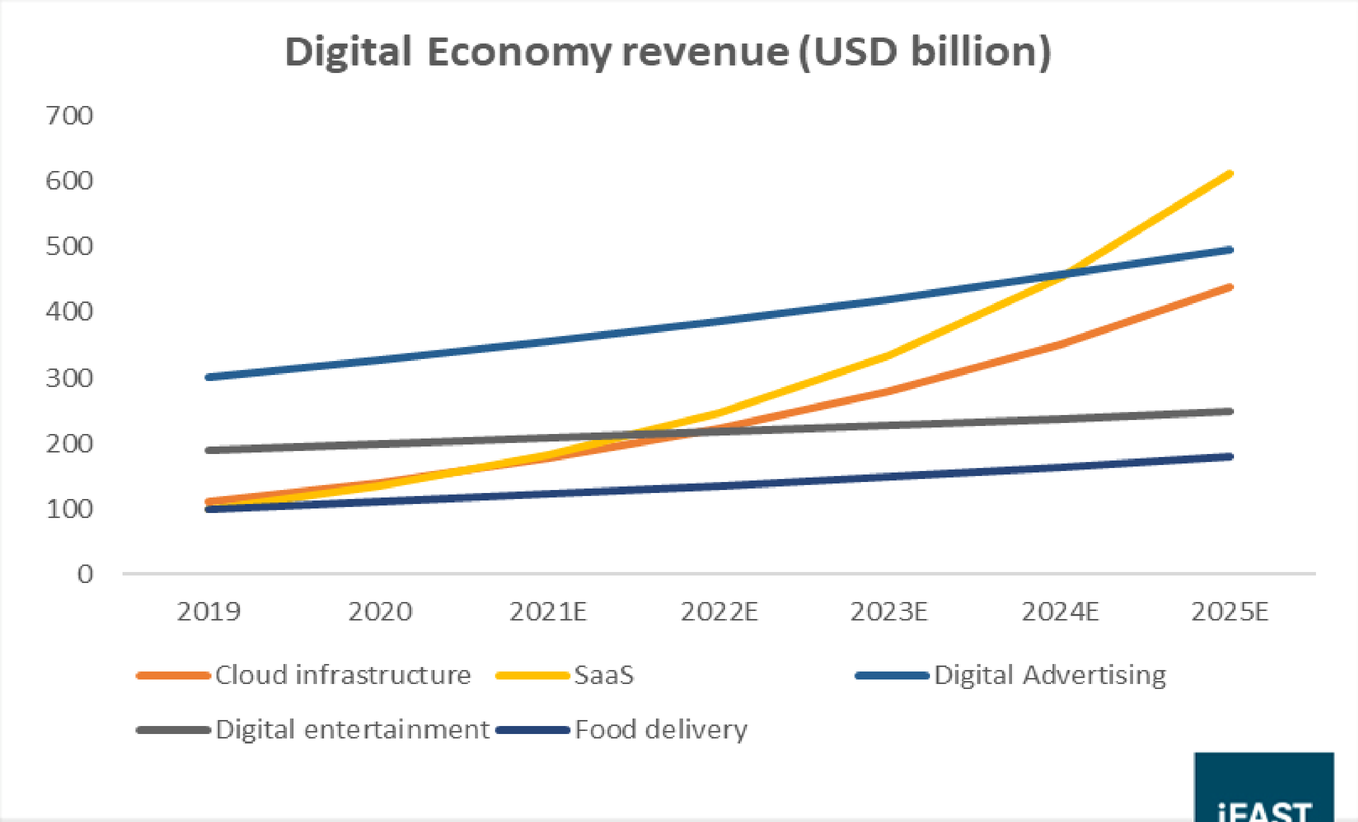
Figure 4: Companies that have higher exposure to corporate demand are doing well, such as Microsoft and Google



This goes to show that corporate digital transformation will likely be the next growth driver for the digital economy.

Based on our analysis, leading US vendors confirm that corporates have begun implementing a big push towards digital transformation. Additionally, corporate digital transformation will also drive the growth of the cloud computing industry. From a Goldman Sachs IT spending survey, the majority of the 100 CIOs interviewed expect IT spending to increase from last year, with cloud adoption to double over the next three years (Figure 5).

Figure 5: Cloud & SaaS to grow more than double the rate of other digital economy segments



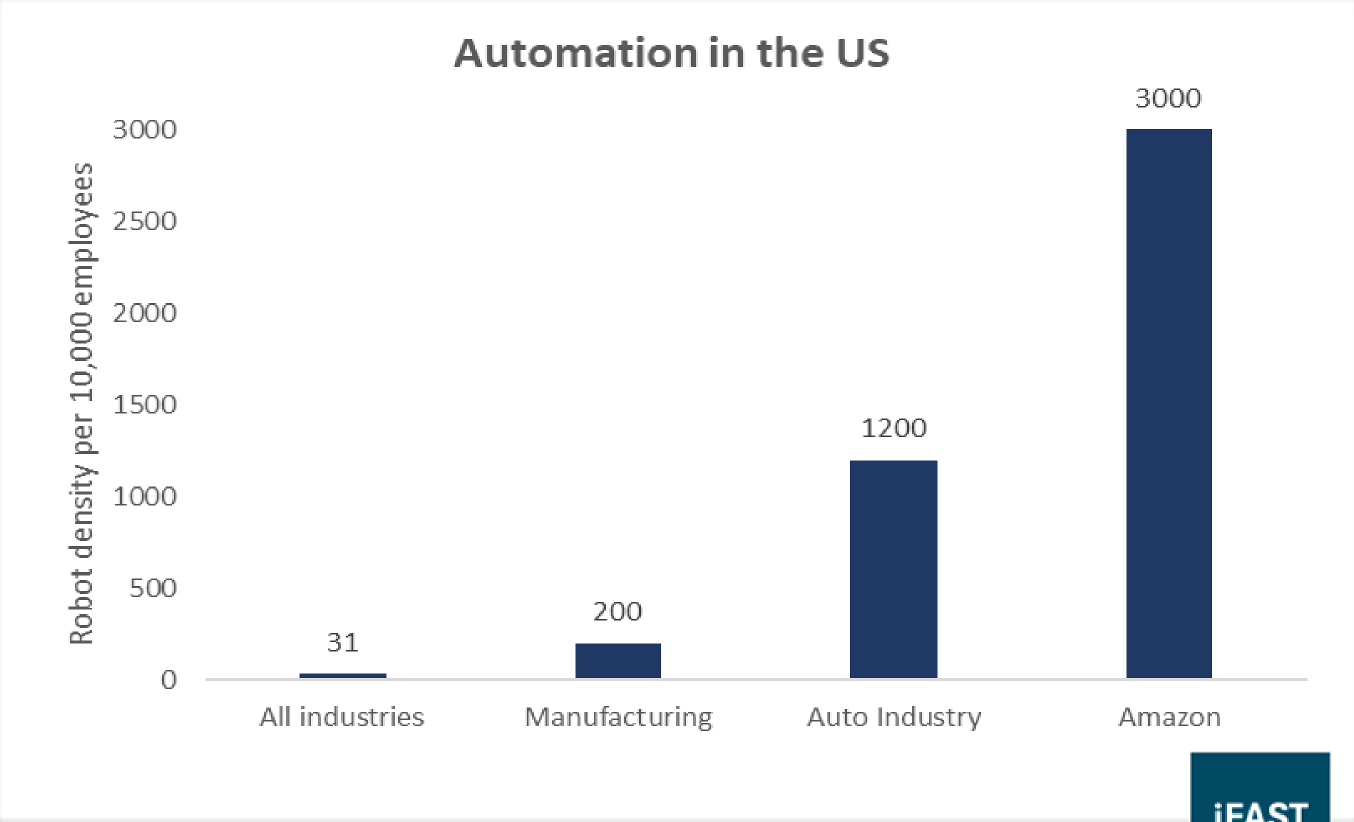
Source: OShares.com, iFAST compilations

Although we are not extremely bullish on the near-term prospects of the digital economy, in the long-term, we remain positive on the growth of the digital economy and expect a smooth uptick in demand for digital services as corporates ramp up their digitalisation efforts.

Digital transformation opportunities hold for traditional industries

In the long-term, the growth potential for the digital economy is significant, as many industries have yet to embark on a large scale digital transformation. Over the past decade industries that have gone ahead in digital transformation include the retail, entertainment, and advertising industries which are led by the Internet giants. However, many industries, including logistics, supply chain, and manufacturing lag behind (Figure 6). But the tides are turning and these industries are expected to catch up over the next few years, making the digital economy an ever more significant aspect of economies.

Figure 6: Automation to drive digital transformation

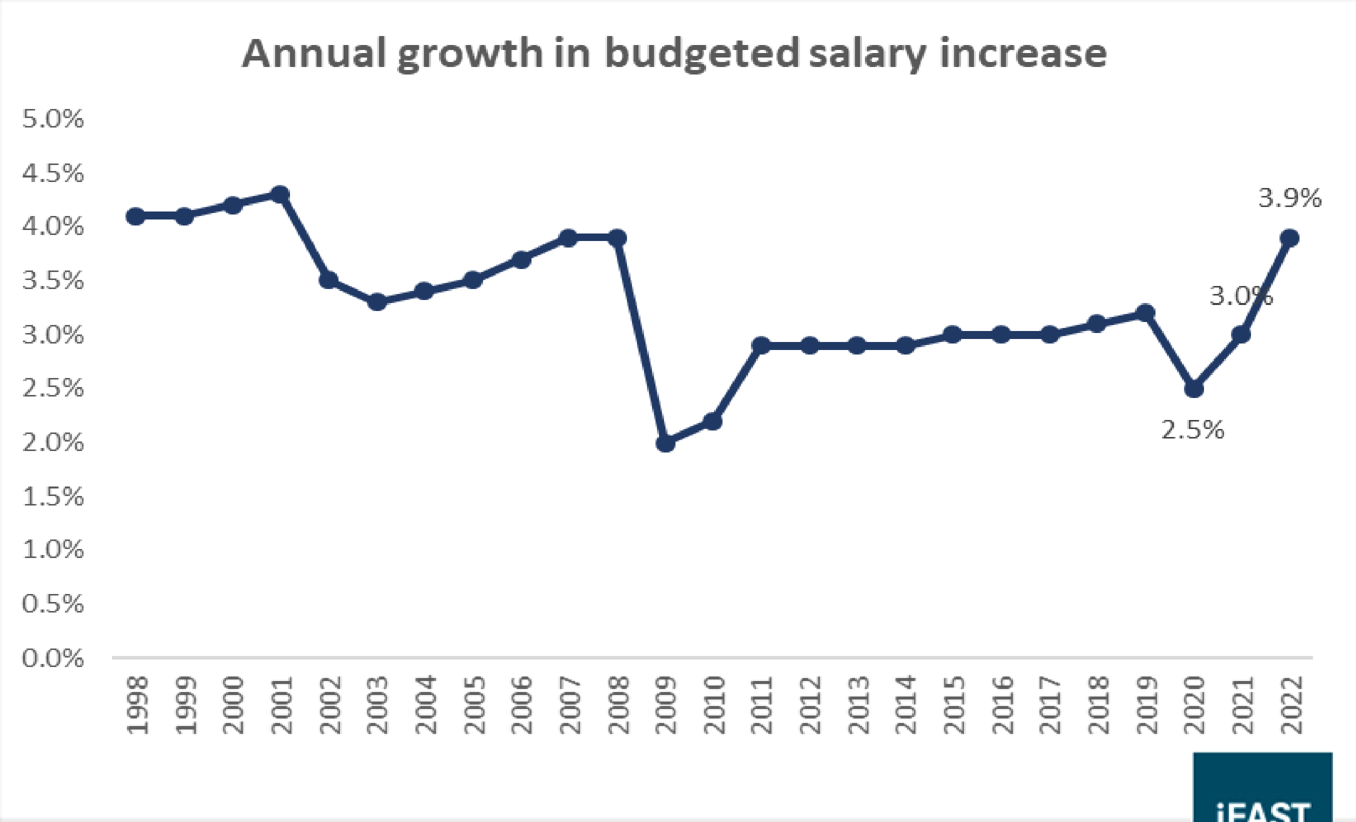


Source: Ark invest analysis 2021

In the case of the logistics industry, several catalysts including the recent labour shortages in the US, as well as the supply chain disruptions may potentially speed up the pace of digital transformation.

The unemployment rate in the US has plunged to a 22-month low of 3.9% in December 2021, suggesting the labour market is rapidly tightening. As companies scramble for scarce workers, wages are expected to jump to 3.9% in 2022 (Figure 7).

Figure 7: Wages in the US on the rise



Source: Conference Board

Alongside the tight labour market comes the supply chain disruptions, which have resulted in delays across the world. The industry is disrupted across all layers from truck drivers to port managers, to shipping companies, and to businesses.

Bottlenecks persist due to many market inefficiencies. For example, unlike the many seamless apps in e-commerce or e-services, the logistics industry lacks such a smooth seamless booking system, which has exacerbated the disruptions.

Hence, the shortages of manpower and inefficiencies in the logistics industry have pushed companies to accelerate their digital transformation process towards smart factories/manufacturing, which includes automation and transferring workloads to the cloud. According to MarketsandMarkets, the smart factory market is expected to grow at an 11% CAGR from 2021 till 2026 to USD 135 billion.

The digital transformation of such industries would in turn drive demand for enterprise softwares such as cloud, software, cyber security and database management, which makes up a total of 44% of the O'Shares Global Internet Giants ETF (BATS:OGIG) (Table 1).

Table 1: OGIG portfolio breakdown

Category	Weight
Internet Conglomerates	21%
Digital Advertising & Social Media	9%
Retail E-commerce (Fashion, Furniture, Pet Products, Electronics, Food Delivery & Travel Bookings)	19%
Digital Entertainment (Video-on-Demand, Music Streaming & Video Games)	7%
Enterprise Software (B2B, SaaS, Cloud, Cyber Security, Database Management, CRM & Accounting)	44%
Source: OShares.com, data as of 3Q21	

In the near-term, supply chain disruptions should continue to impact Internet companies as goods are delayed. But, in the long-term, we expect these disruptions to spur companies towards digital transformation, reiterating our thesis about the digital economy becoming an ever more significant aspect of economies.

Maintain 2.5 stars “Neutral” on near-term risks and stretched valuations

To sum up, in the long-term we are positive on the digital economy. Digital transformation of corporates and industries is expected to be a growth driver for the digital economy, and we like that the O'Shares Global Internet Giants ETF (BATS:OGIG) gives higher exposure to attractive segments such as enterprise software (Table 1). It is for this reason we recommend investors to include the digital economy as part of their core allocation.

However, US big-tech stocks have reached record highs as companies continued to beat earnings estimates, pushing valuations to a record high. While share prices of Internet companies have come down recently, as of 16 February 2022, the O'Shares Global Internet Giants ETF (BATS:OGIG) is still trading at 44X 2023 earnings, suggesting that it is more or less fairly valued based on the fair PE multiple of 45X we have assigned for this sector (Table 2). At 45X PE, the target price is USD 43.

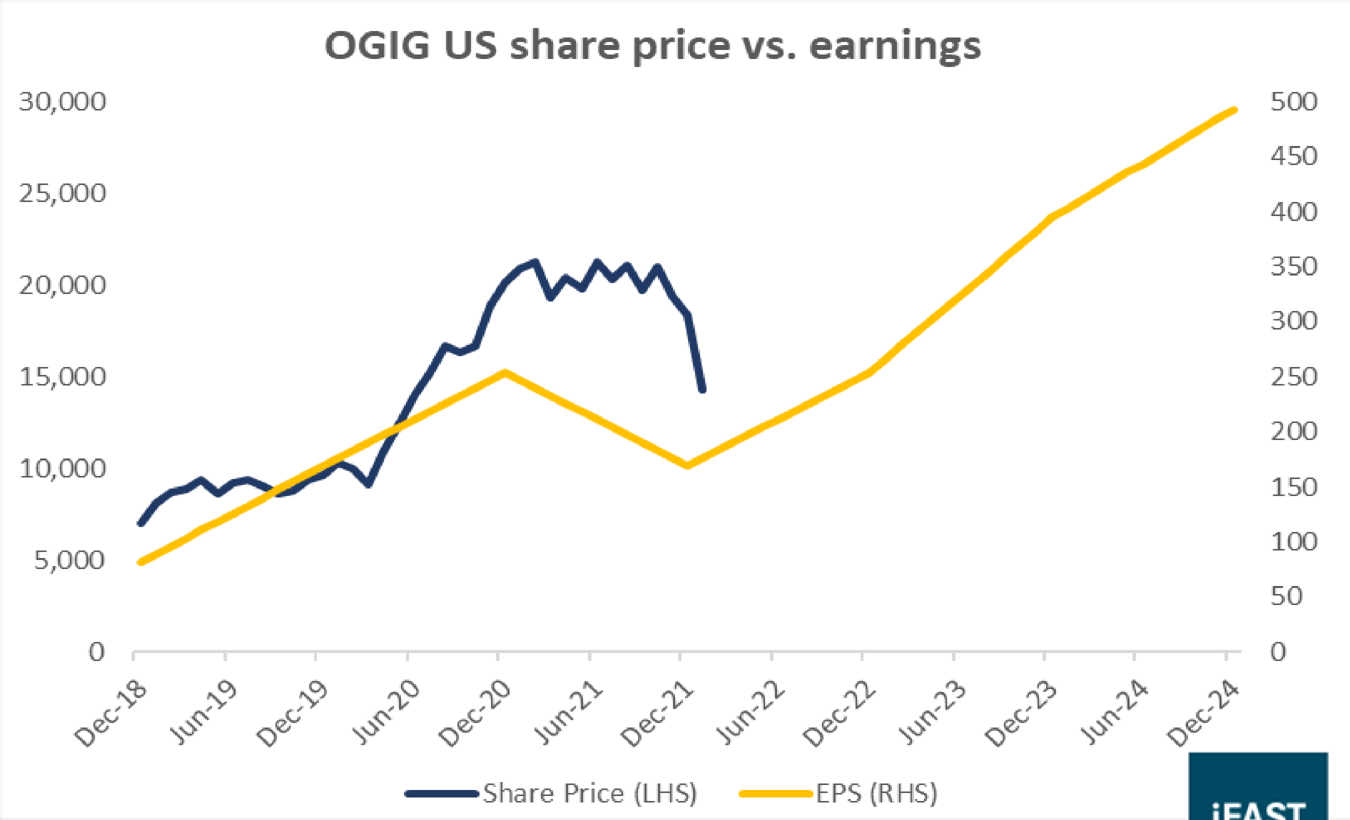
Table 2: Valuations of OGIG still looks stretched in the near-term

	2020	2021E	2022E	2023E
EPS	116.66	163.32	237.47	357.16
Earnings Growth	166%	40%	45%	50%
PE Ratio	-	97.24	66.88	44.47
Upside Potential	-	-	-	1.2%
Source: Bloomberg Finance L.P., iFAST Estimates *Based on the bull case PE multiple of 45X Data as of 16 Feb 2022				

The strong earnings growth seen over the past year may be difficult to sustain in the coming quarters. This, coupled with regulatory risks, and a rising interest rate environment may limit the upside of Internet companies in the near-term and hence we maintain a 2.5 Stars â€œNeutralâ€ rating for the digital economy.

Investors who have yet to include the digital economy in their portfolios but wish to do so at this point may consider using a regular savings plan, before switching to a lump sum investment should valuations come down even further. This will ensure that they buy more units when prices are low and less when prices are high, bringing the weighted average cost down.

Figure 8: In the long run, share prices are driven by earnings



Source: Bloomberg Finance L.P., iFAST estimates. Data as of 15 Feb 2022

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