Key Questions

May 16, 2022

Have FAANG Stocks Been Permanently Defanged?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Over the past several years, the foundation of many stock market indices and equity-centric portfolios has centered around a handful of major technology stocks which are frequently referred to as the FAANG stocks. These stocks are heavily followed by both investors and the media as their importance to the overall economy has grown immensely. While these stocks still maintain a great deal of significance, many are wondering if recent events surrounding these companies are signaling a major turning point for the market, leaving the FAANG stocks with a less powerful "bite" going forward.

What exactly is FAANG, and why did the stocks have so much success, until recently?

The term FAANG is an acronym for Facebook (now Meta), Amazon, Apple, Netflix and Google (now Alphabet). These companies represent some of the largest technology companies in the world and currently make up about 15% of the S&P 500 Index.

If you were to include Microsoft into the mix, this concentration jumps to over 20%! A concentration this high has not been seen since the height of the technology stock bubble in March 2000, a fact we have referenced repeatedly including within our 2022 Outlook: Hot, Crowded and Flat.[1]

The FAANG companies grew rapidly over the past decade due to the ongoing consumer preference for online platforms. Actions that were once conducted only in the physical world have increasingly become more commonplace within cyberspace. Tasks such as shopping, connecting with friends and entertainment are all examples. This trend, which was already a positive for these companies, was further enhanced by the COVID-19 pandemic.

As governments around the world implemented lockdowns, consumers were forced to rely on technology more than ever as the physical world around them was shut down. This delivered a prime environment for the FAANG companies to flourish. In addition, given the macro conditions that were hurting numerous parts of the physical economy, investors were more than willing to pay a premium for known technology leaders.

Why are these companies now underperforming?

The tide began to turn when the economy reopened following the pandemic. As consumers became more confident with returning to normal, investor attention shifted back to a more normal economy. This was accompanied by slower expected growth rates in technology usage as government lockdown restrictions were lifted.

This shift occurred at a time when the valuations for the mega cap tech companies were elevated from being perceived as COVID-19 beneficiaries. As a rotation to more cyclical, value-oriented stocks developed, FAANG stocks saw their high price/earnings multiples come under pressure.

The situation was further exacerbated by rising inflation, partially caused by supply-chain issues and tighter monetary policy by the Federal Reserve manifested by higher interest rates. Rising rates lower the value of future profits and multiple compression for the FAANG stocks accelerated when it became apparent the Fed was going to need to increase rates significantly to combat inflation. Combine this with the threat of a potential recession, geopolitical events and rising labor costs and this is a less than ideal macro environment for high multiple stocks.

Macro conditions, however, are not the only problem for several of the FAANG stocks. Cracks have developed around the fundamentals and there are questions on whether growth can continue to proceed at expected levels. The companies that have displayed any sign of weakness in growth, such as Meta (Facebook) and Netflix, have been severely punished by the market.

For example, earlier this year, Netflix announced that the company lost subscribers for the first time in a decade and the stock has collapsed by 70% this year, partly as a result. Meta is another example, reporting weak user numbers which suggest that growth is stalling, causing its stock to fall 40% in 2022. Even Amazon, which appeared unrivaled only a year ago, has highlighted that momentum in online purchases is down, pushing the stock down over 30% this year. The only FAANG stock that is positive relative to the S&P 500 is Apple and the stock is only barely ahead (up 2%).

So how do we view the FAANG stocks, and how do we manage our technology exposure?

While over the past few years, mega cap tech names have behaved defensively in market declines, we believe the aggressive Fed has materially changed the game.

This has created a more difficult environment for investors to navigate. One simply can't hide out in mega cap growth anymore, as these stocks are among the weakest in the market as valuation multiples compress while rates rise.

At the KeyBank Investment Center, we manage portfolios with a quality bias. As a result, we do own select FAANG names; however, this is partially done to manage risk. Our strategy prioritizes identifying and overweighting differentiated opportunities across all sectors, rather than just owning the mega cap tech stocks in size. Currently, we are materially underweight in the Information Technology sector as we expect this sector to remain under pressure and we see better opportunities elsewhere, both in more defensive stocks and commodity-levered inflation beneficiaries.

Key Takeaways

The FAANG stocks are likely to continue to weigh on the market over the near-term as the exceptional operating environment of the past has evolved into a much more challenging world. Unless both growth trajectories can return to the levels of the past and macro conditions improve, the outlook for many of the FAANG stocks does not appear as promising as it once seemed, which sets the stocks up to be laggards, not leaders.

Longer-term, while it is unclear that the current mega caps can regain their leadership status, the technology sector will continue to advance and remain a robust source of innovation, progress and profits. And thus, we think investors should not disavow this important sector altogether, but remain selective and strive to identify the winners of tomorrow.

For more information, please contact your advisor.

About the Authors

Stephen Hoedt is responsible for the oversight of our proprietary equity strategies, individual equity due diligence, equity trading, and both taxable and municipal fixed income due diligence with an emphasis on credit research. Within the Equity Research team he is responsible for coverage of Energy, Financials, Industrials, and Materials.

Prior to joining Key, Steve was the Industrials and Materials Analyst for the National City corporation's Private Client Group. He began his investment career in 1993 as an equity research analyst with responsibilities for the computer hardware and software industries.

Steve has been quoted in several publications including Barron's and The Wall Street Journal, and has also appeared on CNBC and Bloomberg TV.

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[1] https://www.key.com/kpb/our-insights/articles/2022-outlook.jsp

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