Tech giants face tough task to sustain second half stock rally

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The world's largest technology stocks drove a banner first half for the S&P 500. The question for the rest of the year is whether their strength continues.

Wall Street has tilted toward the tech sector to a historic degree, raising the stakes should the AI-fueled rally falter. Valuations are stretched, while earnings growth is poised to slow from here.

That adds to uncertainty for investors betting that Big Tech's rally will continue, according to Lisa Shalett, chief investment officer at Morgan Stanley's wealth management unit, who warns of "stretched momentum, weak breadth and complacency" in the market.

The S&P 500 Index has risen 17% this year, including a 0.2% rise on July 9. Two-thirds of that advance rests of the shoulders of just six names: Nvidia Corp., Microsoft Corp., Alphabet Inc., Amazon.com Inc., Meta Platforms Inc., and Apple Inc.

Nvidia, the AI-focused chipmaker that has soared 165% this year, accounts for nearly 30% of the S&P's advance in 2024, as of its last close, the highest contribution for a market leader in at least a decade.

An equal-weighted version of the S&P 500 is up just 3.9% this year, and large-caps are trouncing small-cap stocks by a historic margin.

The dominance of the tech sector—especially with gains concentrated within a few key companies seen at the forefront of an AI revolution—suggests some parallels to the dot-com era, when euphoria over the internet preceded a bubble burst that took years to recover from.

However, today's megacaps are universally seen as stronger, with massive cash flows, strong competitive positions, and robust long-term demand trends.

Matt Stucky, chief portfolio manager of equities at Northwestern Mutual Wealth Management Company, said that given uncertainty about the economic outlook, many investors were favoring megacaps for such high-quality characteristics as margins and growth.

"However," he added, "they have gotten more expensive, and this is one of the most momentum-focused markets I've seen in the past 25 years. If the excitement around AI were to reverse, then yeah, we're going to look vulnerable."

The market's rise this year reflects both the strength of the megacap rally and their influence in major indexes. The Magnificent Seven—which also includes Tesla Inc., up 2.1% this year—accounts a third of the S&P 500's market capitalization, according to data compiled by Bloomberg, a record level.

There are signs that Wall Street is growing cautious. According to Bank of America, strategists didn't add to their equity allocations in June, "suggesting uncertainty over how long the rally can last," while a Goldman Sachs analysis showed that hedge funds have been "aggressively" selling tech. Truist Advisory Services recently downgraded the sector to neutral, citing valuation.

Strategists at Citigroup Inc. see "significantly more volatility" on the way, and suggested that investors take profit in some high-flying AI stocks, particularly chip-makers.

Gina Martin Adams, chief equity strategist for Bloomberg Intelligence, said the earnings cycle could cause tech and adjacent sectors to forfeit their position as market leaders, with energy, health care, and financials grabbing the baton.

The Magnificent 7 are expected to show earnings growth of 29.9% this year, according to Bloomberg Intelligence, though that is seen slowing to 17.8% in 2025. Growth for the S&P 500 when these names are excluded is seen coming in at 6.4% this year and doubling to 13.3% in 2025.

Still, the double-digit growth pace speaks to the kind of positive fundamentals that many expect will continue to support the sector.

"While tech valuations are stretched, they're not at the point where alarm bells are going off," said Jason Alonzo, a portfolio manager at Harbor Capital Advisors.

"There's clearly a market narrative around AI that is being given the benefit of the doubt," he added. "However, we haven't seen much to suggest that building excitement is over-excessive or that we've gotten over our skis."

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