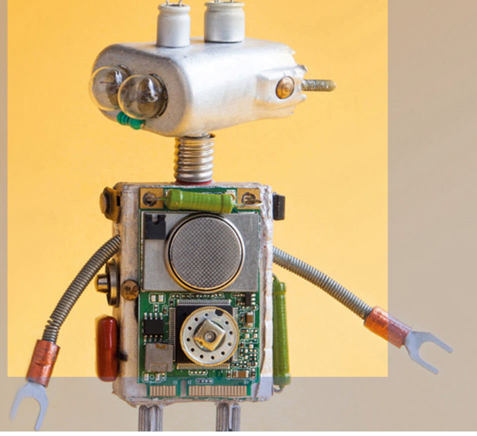

Active is: Investment Insights

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Investing involves risk. The value of an investment and the income from it may fall as well as rise and investors may not get back the full amount invested.

Investment Insights from Silicon Valley

Walter Price
Lead Manager
Allianz Technology Trust

With over 40 years of experience of investing in technology companies, Walter Price has witnessed the evolution of the technology sector from the birth of the personal computer to the arrival of the internet and now the shift to cloud computing. Based in San Francisco, giving him close proximity to many of the world's most innovative companies, he heads up the Global Technology Team which manages US$4 billion* in assets.

*Source: Allianz Global Investors GmbH.

Earnings and the economic landscape

The fourth quarter earnings season is in its final stages. It came amid a difficult backdrop: tariff negotiations with China are ongoing, the US government has only just emerged from a protracted shut-down and the global economy appears to be slowing. This unwelcome combination is giving companies considerable headwinds.

This was reflected in some downbeat forecasts – Netflix and Amazon were both clear about the potential difficulties they face in the first half of 2019. Share prices for Apple and Facebook proved more resilient, but only after some weakness for both companies in the preceding few months.

It is clear that semi-conductors are going through an inventory correction as a result of the weakness in China. Most have forecast a difficult first half with a rebound in the second half of 2019. Nevertheless, some of the US-based chipmakers beat these lowered expectations, suggesting the picture for the sector may not be as bad as initially thought.

In all this, the real question is whether China will improve. Its economy got worse in December and has yet to show signs of a turnaround in spite of some policy measures by the Chinese government. We remain sceptical that it will turn on a dime. The Chinese government is likely to be cautious in its stimulus and as such, may not do enough to turn around the economy meaningfully.

In the US, the government shutdown has shown that the country is firmly back to a two-party system again. The two sides are trying to work out how to deal with each other and compromise, as well as making political inroads ahead of the election in 2020. It is a fluid situation.

In our view, this period is reminiscent of the 1990s, where the economy was up and down. This time around it may not suffer recession but will hit bad patches. Gradually, financial markets are adapting to this new reality. Nevertheless, there are structural trends in technology. Businesses recognise the power of Artificial Intelligence (AI), for example, and they can't make AI work for them unless their data is in the cloud, which in turn drives the adoption of the cloud. Technology is less vulnerable to the ebb and flow of the global economy as a result.

Apple: not just a China problem

All technology managers need to have an eye on Apple. It is the largest stock in the benchmark index and can be an important driver of relative performance in either direction. It has been a difficult run for the company, the world's largest IT company by revenue. Much of its growth was coming from China and, unsurprisingly, it was exposed to the slowdown in economic activity there.

Competition doesn't necessarily work fairly in China and Apple has been a victim. The government is cracking down on products that it doesn't control, meaning that Apple's competitors can deliver products at a lower price. Apple is likely to suffer the same fate as other Western companies that have moved into China with a US-based command-and-control centre. It is difficult to make this model work in the large emerging markets. Samsung, in contrast, has been more pragmatic. It has a high end and a low end product range and has pushed the low end, which has been a more successful approach. Huawei is the incumbent to beat.

But China was not Apple's only problem. Investors had hoped for a renewed product cycle, but increasingly high prices saw the number of subscribers plateau. Without growth in users, many of the network providers got rid of the subsidies that allowed people to buy the phones affordably on a bundled deal. Customers found that their old phones worked well enough and the new phones offered no compelling reason to upgrade. The result is a company that increasingly looks as if its strongest growth may be behind it.

The area to watch now is the growth in the services business. There is still some exciting potential there, but it may not be enough to drive the business on its own.

M&A buoyant

JP Morgan recently went on record to say that Apple should consider deploying its considerable cash pile on a major strategic acquisition, such as Netflix. It seemed a bold prediction but fitted – said the investment bank – with Apple's desire to be an aggregator of content rather than a traditional media company. At the same time, the Netflix subscription model fitted well with Apple's. Others have speculated that Apple should look to buy one of the major studios, such as Sony Pictures.

Apple management may or may not be contemplating such a deal as a way to put some of its $130bn cash pile to use. However, it shows that Merger and Acquisition (M&A) activity is alive and well in the technology sector. It has been particularly buoyant in the services sector: SAP bought Qualtrics International for $8bn in November of last year, paying around 20x revenues. Salesforce.com continues to be on the hunt for strategic additions and has bought a series of smaller companies. The Sprint/T-Mobile deal remains on the cards, albeit tied up with the regulators. The largest technology companies have cash, valuations are low and we believe this will continue to support acquisition activity.

Facebook's real prize is Instagram

Facebook has been on a PR offensive, with the company promising to do 'whatever it takes' to make its social media platforms safer. The stakes are high: people have been exploiting the platforms and unhealthy postings have reduced user engagement. The group wants to ensure that nothing dents the potential of Instagram, which is currently providing the lion's share of revenue growth.

Instagram has appeal because it is visual rather than text-based. Images can be circulated either to a closed group of friends or to everyone on the network. This means that people with similar interests can join up and share postings. There is a large chunk of TV advertising looking for a new home, as people increasingly watch on demand, or fast track through the ads. Instagram is innovating with visual images, creating a wave of growth at a time when people are looking for something new. It is Facebook's big hope for the future and after a tricky 2018, it will want to ensure that nothing jeopardises its nascent success.

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Please note that we can only offer information and are unable to provide investment advice. You should contact your financial adviser before making any investment decision.

Contact Details

Telephone:
0800 389 4696

E-mail:
investment-trusts@allianzgi.com