February 17, 2021–Technology Sector Update

BMO Nesbitt Burns

Week in **Review**

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Macro Overview:
Equity markets continue to rally in early 2021 with the US S&P 500 up 4.8%, the TSX up 5.4%, Europe up 4.1% and China Large Caps up 19% this year. The main drivers of this enthusiasm are a combination of positive trends on the Covid front, including accelerated vaccines in the US and solid earnings reports. Q4 results in particular from both the big Tech stocks and generally across most sectors exceeded expectations. Adding to this is the $1.9 Trillion stimulus package expected to pass the US Congress in the next few weeks. In contrast the Cdn. and US bond indices have fallen 1 – 2% with rising bond yields, while the reset preferred shares index benefiting from higher yields, is up 6.8% this year. Market commentators are increasingly skeptical of rising stock prices; in particular of US Tech names where valuations are at long term highs, reminiscent (in part) to the Tech bubble of 1999/2000. While fundamentals of the Tech sector are much more solid than during the 1999/2000 Tech bubble and interest rates much lower than the 6% of this prior era, a conservative investment strategy should include caution overexposure to these successful but also highly valued companies. We detail below several of the dominant Tech names which have been the main driver of the broader market returns within the US in recent years. In Canada the TSX had a modest 2.5% price gain in 2020 but excluding Shopify the TSX lost 2.5%, while in the US the large Tech names, led by Apple and Microsoft, and Tech-like names such as Alphabet and Amazon, accounted for almost all of the 16% S&P 500 gain in 2020. If the current high valuation of these market leaders came into question due to factors such as rising interest rates or a less than robust recovery, broad market indices could suffer the reverse effect to that seen in 2020.

Portfolio Positioning:
Our Portfolio positioning continues to exclude the high valuation Cdn. Tech sector but does include the leading US Tech names. Although these names have climbed in price, we have re-balanced the weighting in 2021. Overall we note that the US S&P 500 is trading at a 23x's 2021 expected earnings (a 20 year high) versus only 14x's for the TSX and considerably less if we exclude Shopify. Our Portfolio model continues with approximately equal weighting to the US and Cdn. Markets with a small international position in Europe and China. Our fixed income allocation is skewed to cash, short duration bonds and reset preferred shares to minimize the impact of rising yields in the bond markets and also maintain liquidity to take advantage of corrections on the equity markets. Gold is off about 7.1% YTD we are maintaining our allocation to the sector. In the first 2 months of the year we have seen rising bond yields that have outpaced the growth of inflation expectations which is likely a driving force in the sell-off.

Technology Sector and Tech related Overview:
While the pure technology index excludes such names as Amazon (consumer discretionary) and Alphabet (communications) we include them in our discussion as their profile is very similar to Technology. The move to cloud computing has and continues to be a driving force in earnings growth for the these names such as for Amazon and Microsoft the two leading cloud providers, but is also becoming important to Alphabet and Apple. The pandemic which hurt most sectors only enhanced the role of the large Tech names which have emerged stronger and much more valuable since the pandemic began. However valuations have marched higher with for example Apple (the market's most influential name) which traded at 16x's current year earnings in May of 2018, now trades at 29x's 2021 earnings. While some of this valuation jump can be explained by the increased contribution of Apple services providing recurring revenue, the earnings growth outlook is no higher that it was in 2018 but the market is paying almost 2 x's the price for current earnings. Microsoft's p/e has jumped from 25x's current year earnings in May of 2018 to 33x's now on 2021 earnings, although its earnings growth outlook has strengthened somewhat. In the comments below we note the ongoing success of these most influential names which so far are exhibiting no weaknesses, but we have turned cautious on valuations and would remain somewhat underweight as an allocation in our Portfolio model.

Thomson estimates				Ann.	Ann.		%	2020	2021	2022	2023	2021	2022	2023	2021- '23
13-Feb-21	Symbol	Pr. Tg.	Price	High	Low	Mcap	Yield	eps	eps	eps	eps	p/e	p/e	p/e	EPS Gr.
Apple (FYE Sept. 30th	AAPL-US	152	135.37	145.1	53.15	2273	0.61	3.69	4.65	4.68	5.50	29.1	28.9	24.6	8.8%
Amazon	AMZN-US	4003	3277.71	3,552.3	1,626.0	1651	0.00	41.77	47.68	66.44	90.94	68.7	49.3	36.0	38.1%
Facebook	FB-US	336	270.5	304.7	137.1	651	0.00	10.10	11.34	13.52	15.87	23.9	20.0	17.0	18.3%
Alphabet	GOOG-US	2283	2104.11	2123.6	1013.5	689	0.00	58.70	69.81	80.79	92.39	30.1	26.0	22.8	15.0%
Mastercard	MA-US	384	340.78	367.3	200.0	337	0.52	6.38	8.04	10.37	12.67	42.4	32.9	26.9	25.5%
Microsoft (FYE June 30	MSFT-US	273	244.99	245.9	132.5	1848	0.91	6.71	7.40	8.09	9.35	33.1	30.3	26.2	12.4%
Visa (FYE Sept. 30th)	V-US	241	210.10	220.4	133.9	356	0.61	4.84	5.50	6.88	8.17	38.2	30.5	25.7	21.9%

Apple:

Apple recorded record revenues for its most recent quarter - fiscal Q1 (December 31, 2020) of $111.4B, well ahead of the consensus $103B estimate. A combination of higher iPhone sales due to customers upgrading to 5G and better than estimated growth of services and wearables, combined with expanding margins, resulted in a strong 18% earnings beat. Apple is clearly firing on all cylinders and this impressive growth, particularly in its services division of 30%, which now accounts for 19% of total annual revenues, supports an expanding p/e multiple. However at the current price Apple is trading at 29x's 2021 estimates earnings vs. a p/e over the then current year of 16x's just three years ago.   We continue to hold Apple as the largest component of the Vanguard Tech ETF (at 22%) and believe that while its valuation fully reflects its strong growth and product dominance, we are comfortable with this modest underlying position, For investors holding a large position in Apple (say> 5%) we would recommend reducing this exposure while maintaining a more modest holding. We note that in the schedule (above) the 2021 – 2023 forecast eps growth of Apple is 8.8%, while impressive, given its high 29x's p/e on current earnings, we are concerned at this high valuation.

Alphabet:

Alphabet reported very strong Q4 results with revenue growth of 21% and eps growth of 28%, both well above consensus forecasts. Alphabet' revenues are comprised of: Search 56.5%. YouTube 12.2%, Google networks (networks linked to Google) 11.4%, cloud 8.3% and other services (Google play, Google nesting, Google Maps, etc.) 11.8%. All of Alphabet's main business drivers are growing strongly. Google Cloud, the number 3 player in cloud after Amazon and Microsoft now accounts for 8% of revenues and is viewed as a major source of growth and eventually earnings, although with the larger investments being made it is forecasted to have negative contributions through 2023. Other bets, including Waymo, the self-driving car project, is also producing losses which Alphabet believes will contribute to earnings growth down the road. We would continue to hold Alphabet as a core holding noting its 15% forward estimated earnings growth.

Amazon:

Amazon's sales exploded during the pandemic year of 2020, up 38% from the prior year and reported Q4 sales and earnings handily beat expectations. Looking ahead to 2022 we use JPM estimates to map out the next two years as shown in the schedule below. Essentially, even with the surge year of 2020 behind it, Amazon is forecast to enjoy sales growing at 20% and earnings at 26%, an enviable growth trajectory and one that begins to make sense of the current p/e multiple of 60x's. JPM has a 2021 yearend target of $4,400 or 38% above its current price. Amazon's main growth driver is online sales (including sales for third party vendors) and as well it is the leading cloud services provider capturing 40% of this growing market. Its Amazon Prime provides subscribers with Netflix like access to movies and shows as well as expedited delivery of a vast array of goods. While not broken out Amazon has an imbedded platform for online advertising which is enhancing profitability in its core online services. The company enjoys a fortress like balance sheet with no net debt and growing free cash flows, while paying no dividends. We would continue to hold Amazon as a key Portfolio position.

Amazon Financial Metrics - JPM estimates				
$ Billions (X sh data)	2020	2021	2022	2020-'2022 CAGR
Segmented Net Sales				
Merchandise	316	390	451	19.47%
Prime	25	33	41	28.06%
AWS - (Cloud)	45	57	70	24.72%
Total Net Sales	386	480	562	20.66%
Segment Op. Income				
Merchandise	9.4	15.2	23	56.42%
AWS - (Cloud)	13.5	15.8	19	18.63%
Total Op. Profit	**22.9**	**31**	**42**	35.43%
Total Ebitda	55	73	88	26.49%
EPS	53.57	65.31	85.88	26.62%
Current Share Price	**3,277**			
p/e	**61**	**50**	**38**	

Microsoft:

Microsoft reported impressive Q3 (Dec. 31) results with earnings beating estimates by 24% and strong revenue growth across its major business segments. Microsoft remains the dominant business and personal software applications provider, a position it has held for many years. Microsoft also is the number 2 cloud services provider, second to Amazon. Microsoft's current business segments broken out by revenue (2021 estimates) comprise of Productivity and Business Processes (its core software business and Linked In) – 33%; Intelligent Cloud – 35%, and Personal Computing (includes X-Box) - 32%. The Intelligent Cloud category includes Azure which is the cloud based software platform for deploying and managing software applications and this service is growing at 50%/year. Microsoft's financial metrics remain impressive with $80B of net cash while generating $50B of free cash flow annually. We expect continued growth of its dividend with the growth of earnings as well as share buybacks in the 1 % range of outstanding shares annually. Microsoft still dominates business & personal software applications and has transferred that market leading position to its intelligent cloud platform, incorporating its evolving software Applications to a continuous and more flexible cloud delivery relationship.

On the back of these strong numbers both BMO and JPM raised their target prices to $270 and $245 respectively. However given MSFT is trading close to these targets and at a current p/e of 33x's we view the stock as fully priced. In our models we continue to hold as a 16% allocation in the Vanguard Tech ETF and would otherwise not be comfortable being over a 5% weight in this name.

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Sources: Bloomberg, JP Morgan, Thomson & BMO Nesbitt Burns research

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