May 5th, 2020 - Portfolio Thoughts and Tech Earnings

BMO Nesbitt Burns

Week in **Review**

BMO Wealth Management
BMO Nesbitt Burns

Portfolio Thoughts:

We are now six weeks out from the market lows of March 23rd and, we still do not feel that we are in an 'all clear mode' as we still don't know when the economy will be restarted and what lasting effects will be seen. It is reasonable to expect that with vaccines and therapies being urgently developed at some point in the near future there will be a solution. So the markets have moved up from their lows even as the economic numbers continue to get worse. We know that earnings for the next few quarters will be negatively affected and we expect riding through it could likely be difficult and volatile. In our Model Portfolio we have recently reduced slightly our equity after adding to it in March and plan to add again, if the opportunity presents itself. Diversification is the one risk management tool that is has been proven once again. Having some part of the portfolio in allocations negatively or uncorrelated to the equity markets has muted the volatility in portfolios so far in 2020. While volatility is a feature of investing in equities, it is often hard to reconcile the fact the market value of an enterprise moves around far more than the annual profits they are earning. We will continue to own businesses that we believe are able to grow in the new more challenging environment. It is also important for businesses to be both strongly capitalized and have durable cash flows so in the longer term they can both remain viable and be aggressive as opportunities become available.

Technology and Communications:

Riding two major tailwinds, Digital Transformations and E-Commerce, the technology sector has performance exceptionally well in the past many years, and even so in 2020 as the physical economy has grounded to a halt. Cloud computing, AI, data and analytics and cloud-based software platforms are enabling organizations to work through everything and even streamline operations in some cases, while maintaining contact with employees and customers during this time. Our technology investments are defensive, established and they are firms that we believe have a competitive advantage, are sitting on a strong balance sheet, are difficult to replicate and trade at reasonable valuations. We own direct positions in Google (Advertising and Communications), Amazon (Cloud and E-Commerce), MasterCard (Fintech and E-Commerce) and the Vanguard Tech ETF (with Apple & Microsoft making up 37% of the holdings).

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TECHNOLOGY AND COMMS	Symbol	Price	Yield	Down From Ann H	Mkt Cap	Conc. Target	Cons. Return	3 yr EPS Growth Est.	2020E	2021E	2022E
AMAZON.COM INC	AMZN-US	$2,315.99	0.0%	-6.4%	$1,154.58	$2,645.67	14.2%	39.0%	82.6	60.6	42.8
MASTERCARD INCORPORATED	MA-US	$269.42	0.6%	-22.4%	$267.55	$313.18	16.8%	24.2%	39.5	30.7	25.6
ALPHABET INC. (C)	GOOG-US	$1,326.80	0.0%	-13.4%	$446.02	$1,515.73	14.2%	25.0%	31.7	24.3	20.3
Some members of VGT											
APPLE INC	AAPL-US	$293.16	1.1%	-10.6%	$1,267.62	$308.91	6.5%	15.1%	24.0	19.9	18.1
MICROSOFT CORP	MSFT-US	$178.84	1.1%	-6.2%	$1,356.22	$193.94	9.6%	12.4%	31.5	28.8	24.9
SALESFORCE.COM INC	CRM-US	$161.50	0.0%	-17.5%	$144.54	$194.38	20.4%	24.5%	51.9	41.6	33.5
ADOBE INC.	ADBE-US	$349.11	0.0%	-9.7%	$168.20	$339.58	-2.7%	15.9%	35.8	31.3	26.7
NVIDIA CORP	NVDA-US	$291.29	0.2%	-7.9%	$179.18	$300.40	3.4%	18.5%	38.4	31.9	27.4

Google

Google beat on revenue ($41.2B vs $40.8B) but missed slightly on adjusted EBITDA ($14.3B vs $14.4). There were some big positives with revenue diversification paying off (YouTube, 10% of revenue and Cloud, 8% of revenue lessened the coronavirus impact on overall revenue). We also saw the numbers of online users and usage increases over the period which should be a benefit once the economy turns around. Also, analysts generally applauded the various steps that Alphabet is taking to control costs and improve efficiency during this downturn. The significant cash generated from the Google search business allows Alphabet to remain focused on innovation and the long-term growth opportunities that new areas present. Some would say that Alphabet is allocating too much capital toward high-risk bets, which face a very low probability of generating returns, however, given the amount of data they collect and the management team's strength and history of innovation we think that this will be an opportunity to grow further beyond their traditional search. Overall, we are increasingly comfortable in the company's ability to navigate the current environment while maintaining earnings & continuing to innovate for the long-term

Amazon

Amazon plans to invest more than $4 billion in the second quarter for coronavirus expenses (including facility productivity measures, protective equipment, cleaning, wage increases, and COVID-19 testing capabilities). This was more than the market had anticipated and the shares fell ~7% on the report. While this changes the near-term margin outlook, strong Q1 revenue ($75.5B vs $75B est) and strong Q2 revenue outlook (forecasted at $75-80B) due to increased demand in March, we feel this is more important to Amazons performance in the long-term.

We feel Amazon should remain a critical distribution channel for buyers/sellers. Even if recessionary conditions persist, Amazon's product mix towards consumer staples in recent years (including grocery) should make the business more resilient. Also, while Amazon Web Services, (Cloud) is ~65% of Operating Income the revenue growth in this past quarter was a softer than expected due to weak customer demand in higher discretionary categories however their margins still improved to 30.1%. We believe Amazon is well positioned as the market leader in e-commerce and cloud, where the secular shifts remain early — According to JP Morgan Research US e-commerce represents ~15% of adjusted retail sales, and ~15% of workforces are in the cloud today.

MasterCard

MasterCard's Q1 2020 EPS of $1.78 beat consensus of $1.72 by 3%. Given the COVID-19 impact of volumes, the growth was better than feared due to strength in e-commerce and contactless payments. Growth in cross-border transactions, which are particularly lucrative for the networks, will likely be under pressure this year and into next over fallout from the coronavirus outbreak and a reduction in global travel. Despite clear pressure on 2020 and 2021 earnings, Visa and MasterCard's global networks remain unparalleled, and we think this will remain the case for many years to come. MasterCard is the #2 global card network worldwide and benefits from the ongoing global secular shift toward card based and electronic payments. We feel that there is still plenty of runaway for growth in electronic payments with electronic payments only having surpassed cash payments on a global basis a couple of years ago. There is still huge opportunity for growth in emerging markets. Given the uncertain economic outlook, we continue to recommend MA as the technology heavy, asset light business model with a secular tailwind - a good place to be in our view.

VGT (Apple, Microsoft, tech)

Apple reported favorable trends in iPhone and Services revenue which tracked at $58.3B vs consensus of $54.2B. This was led primarily by better than expected iPhone revenue of $29.0B vs.JPM estimate of $23.9B. Apple Services also showed growth and a very resilient business model. Microsoft also exceeded consensus in all business segments on gross and operating margins, and saw significant growth in the cloud (Azure) which contributes 1/3 of revenue, while the other 2/3rd are business services and personal computing. With the global movement toward cloud architectures and digital transformation initiatives (likely sped up by the current pandemic) we continue to advocate exposure here. Salesforce, Adobe, and NVIDIA are also interesting parts of the VGT (<5% each), but are in good segments thus each have opportunities in the current environment.

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

We deliver a full complement of thoughtful, customized wealth solutions for private clients and institutions, drawing upon global resources, top ranked research and the collective wisdom of BMO Nesbitt Burns and our internal and external partners. For more information on our team we invite you to contact us.

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