Investment insights from Silicon Valley

An investor's view of tech trends and challenges in 2022

www.allianztechnologytrust.com

SEPTEMBER 2022

Mike Seidenberg
Lead Portfolio Manager
Allianz Technology Trust

With over 40 years of experience of investing in technology companies, Mike Seidenberg and his team have 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, Mike heads up the Global Technology Team which manages US$11 billion* in assets.

*Source: Allianz Global Investors GmbH.

The threat of recession

The US economy has now sustained two quarters of negative growth, with Gross Domestic Product (GDP) contracting 0.9% from April to June, after a fall of 1.6% from January to March. While this is a technical recession, the criteria for an official recession are broader. It falls to the National Bureau of Economic Research (NBER) to make the final judgement and, for the time being, it is holding fire.

However, there can be no doubt that these are challenging economic times. Inflation continues to defy expectations, proving higher and more persistent than even the most gloomy predictions. To date, US central bank the Federal Reserve has been resolute, raising interest rates rapidly, including a 0.75% hike at its July meeting. We welcome its resolve: inflation is hard to contain. Once companies see they can raise prices, it becomes entrenched.

For the technology sector, there is a concern that as the economy becomes more difficult, sales cycles will elongate and demand will slide. To date, earnings have been reasonably resilient and that has helped put a floor on share prices. However, economic weakness could see demand start to slow and we are waiting to see the outcome for corporate earnings.

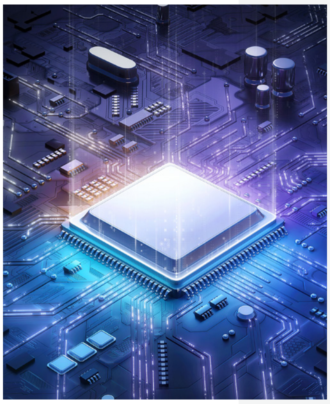
This has been a key factor in recent decision-making on the portfolio. The toughest spots are likely to be those that rely on the consumer. This might include the PC and laptop market, or the semiconductor companies that feed into those markets. We have already seen consumers delaying purchases of new hardware and corporations are likely to follow.

In contrast, there will be areas that are resilient. We have been talking to CEOs about their budget prioritisation, identifying those areas that are high on their lists. Moving to the cloud, for example, saves them money and gives them more flexibility. On cybersecurity, the threats are growing and the consequences of data breaches are rising. These are areas where corporations cannot afford to backtrack on their spending commitments.

Value. Shared.

Allianz Global Investors

Semiconductors



The semiconductor sector has a number of long-term tailwinds. Areas such as electric cars and the growth of artificial intelligence are creating demand for increasingly sophisticated semiconductors. Consulting group McKinsey recently said that the sector was poised to become a trillion dollar industry by 2030 after a decade of strong growth[1]. Supply chain shortages have shown the reliance of the global economy on semiconductors, though valuations have remained muted.

As such, semiconductors have been a 'value' play within many technology portfolios, including ours. We have held a significant position in the sector, spread across a number of different chip manufacturers.

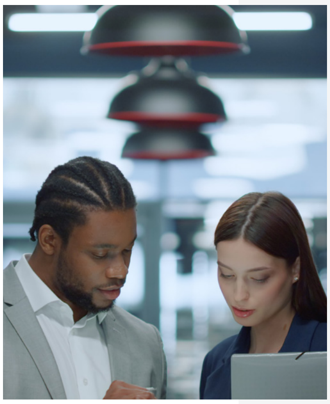
However, we are now refining this position. The weakness in the global consumer sector is impacting parts of the semiconductor industry. As demand for PCs or high end mobile phones diminishes, so does demand for some semiconductors. Today, parts of the semiconductor industry are seeing over-supply and orders cut back. Memory producers for example have been vulnerable to waning demand for PCs. That said, demand for electric car chips remains strong. We have reconfigured our semiconductor holdings to focus on the areas of strength.

Wage inflation

Companies such as Facebook and Amazon have slowed their frantic hiring

Many technology companies rely on their human capital to glean a competitive advantage. The best designers and engineers deliver innovation and technology know-how, which in turn attracts other great designers and engineers and creates a virtuous circle. Many companies have relied on lucrative share options to draw the right staff to their business.

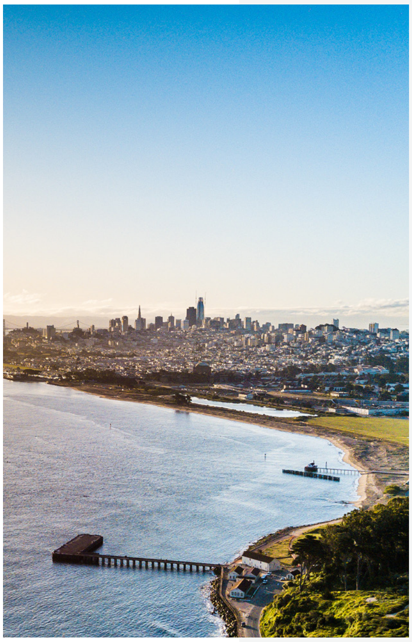
Against this backdrop, falling share prices – which diminishes the value of share options – and rising wage inflation would appear to be a significant problem for technology companies trying to retain their competitiveness. There is a danger that wage bills soar, at a time when margins are already under pressure.



However, in our view the picture is more nuanced. First, in a climate of real uncertainty, employees are staying in position. They want to stick with the 'safe' option in case the economy stalls. Also, the generous packages that may have lured them away are no longer on offer. Companies such as Facebook and Amazon have slowed their frantic hiring. Equally, some of the earlier-stage, VC (Venture Capitalist)-backed companies have seen funding harder to come by, curtailing their ability to hire. Wage bills haven't risen as much as might be expected.

That said, companies are employing softer tactics to retain key staff and help them through the cost of living crisis. Companies are bringing forward pay reviews, for example, or giving employees fuel allowances to get to work. They are also being more flexible on working arrangements.

M&A activity



Merger and acquisition (M&A) activity has been a key support for technology companies over the past decade. There has been considerable speculation as to whether a tougher economic climate would see activity dry up, or whether it can continue.

Certainly, we believe the nature of M&A activity will change. Mega-mergers are becoming more difficult because of regulatory scrutiny. However, private equity buyers are still flush with cash and have started looking at public companies with greater interest. Valuations are lower and more mature, stable businesses have greater appeal than higher-risk, earlier stage companies in this environment. We've already seen a couple of large private equity takeovers this year.

However, this is likely to be confined to certain sectors, where the trajectory of growth is clear. This would include cybersecurity, for example, or companies connected to the digitalisation trend. There is also interest in digital infrastructure companies such as those providing fibre networks and data centres. M&A will not disappear, but the easy money that has supported it over the past few years has diminished, creating a tighter market.

[1]https://www.mckinsey.com/industries/semiconductors/our-insights/the-semiconductor-decade-a-trillion-dollar-industry

This is no recommendation or solicitation to buy or sell any particular security. A ranking, a rating or an award provides no indicator of future performance an is not constant over time.

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