Wealth Weekly

Going Viral in a Bad Way

Last week was a tumultuous one for investors, with escalating concerns overseas about the coronavirus, Trump's ongoing impeachment trial, solid earnings results from major US tech companies and finally Brexit on Saturday. Closer to home, ResMed had a good result and Treasury Wine Estates a rotten one, Augusta Capital got a takeover offer, and private equity sold down a large stake in Oceania Healthcare.

Big tech looking pretty good in earnings season

Last week some of the world's largest technology companies delivered results as the US reporting season ramped up. Apple, Amazon and Microsoft had bumper results, while Facebook's and Visa's were tinged by slowing growth and a higher cost outlook, respectively. In our view, exposure to the global technology sector is important for investors given the sector's growth potential, and we prefer large, profitable tech companies with a global reach, relative to smaller, less profitable, Australasian companies.

Themes of the week

Concerns about the economic impact of the spreading Wuhan coronavirus made for wobbly markets last week. Past pandemics saw US equities decline by between -6% and -13%. It is too early for scientists or economists to judge which way this one will go. The best case scenario is that — like SARS in 2003 — the outbreak will peak and burn itself out in a matter of months, allowing preventative measures to be eased and affected economies and stocks to recover. The worst case is a Spanish flu-size pandemic until a vaccine becomes available, perhaps in a year or so. The economic and market impact of such an outcome is harder to estimate.

Across the ditch ResMed reported a strong result, driven by market share gains in masks, which is a negative indicator for NZ competitor Fisher & Paykel Healthcare (although not totally unexpected). In any wine collection there's bound to be the odd corked bottle and Treasury Wine Estates turned out to be such a stock when it reported a weak 1H20 due to lagging sales in Asia and the US. The company has some attractive attributes but given the risk of further downgrades we have moved to the sidelines on this one for now.

The mergers & acquisitions theme continued with NZX-listed property fund manager Augusta Capital receiving a friendly takeover offer from Australia's Centuria Capital Group (CNI.AX) at NZ$2 per share. Augusta's board is supporting the proposal and key management have signed on to stay in the business. We recommend Augusta shareholders await the Independent Advisors Report, which is expected to be released before the end of April. Abano Healthcare reported a challenging first half of its fiscal year last week, but there was nothing in the result to unsettle the ongoing takeover process.

Looking ahead

Reporting season continues in the northern hemisphere next week with Alphabet, Gilead Sciences, Walt Disney, Siemens and ING Group reporting results. Locally, the earnings calendar looks sparse until things pick up the week after next, when Contact Energy, Sky TV, SkyCity, NZX and Skellerup are expected to report.

Wealth Management Research
wmr@forsythbarr.co.nz

Matt Henry, CFA
matt.henry@forsythbarr.co.nz
+64 9 368 0115

Rob Mercer
rob.mercer@forsythbarr.co.nz
+64 4 495 1325

Kevin Stirrat
kevin.stirrat@forsythbarr.co.nz
+64 9 368 0069

Bernard Doyle
bernard.doyle@forsythbarr.co.nz
+64 9 368 0092

Florian Burch
florian.burch@forsythbarr.co.nz
+64 9 368 0106

Matt Sturmer
matt.sturmer@forsythbarr.co.nz
+64 4 495 8204

George Mear
george.mear@forsythbarr.co.nz
+64 9 368 0133

Ashton Olds
ashton.olds@forsythbarr.co.nz
+64 9 368 0127

In this week's report…

- Apple, Amazon and Microsoft's quarterly results were strong
- If past pandemics are anything to go by, the coronavirus could see temporary earnings reductions and downside in equities
- ResMed's solid result on the back of market share gains in masks isn't a great sign for F&P Healthcare
- Treasury Wine Estates had a very disappointing 1H result
- Bond markets aren't a fan of uncertainty, and that's reflected in interest rates falling over January

Health Check for Tech

Given the size of the US tech companies — Apple, Amazon, and Microsoft boast market caps over US$1tn and the Information Technology sector makes up ~23% of the S&P 500 Index — their results have a bearing on the overall US reporting season and outlook for 2020.

Apple (AAPL) has made a strong start to FY20 by delivering a gangbuster 1Q result ,with revenue growth of +9% yoy and EPS growth of +19% yoy, both beating market projections. The result was underpinned by strong demand for AAPL's wearables (iWatch, AirPods Pro) and robust iPhone sales following the release of the iPhone 11 in September 2019. Revenue from Apple's Services segment grew +17% yoy, accounting for 14% of total revenues, while Wearables revenue grew a staggering +37% yoy. Apple's Wearables segment could have posted even more impressive growth but demand exceeded the constrained supply. Apple guided to stronger than expected 2Q revenue of US$63–$67bn above consensus at $62.5bn, noting that the low-end of the range includes some accommodation for the ongoing coronavirus situation in China. Just days following the result, Apple announced it is temporarily closing its 42 stores in China until 9 February. Online sales will continue. Each week of no China sales amounts to a -1.3% reduction in Apple's revenues.

Amazon (AMZN) finished its FY19 on a strong note by reporting a stellar 4Q result. Revenue growth of +21% yoy was stronger than expected, while EPS came in more than +50% ahead of consensus estimates. Amazon Web Services (AWS) saw revenue growth of +35%, highlighting the strength of Amazon's cloud offering in a highly competitive market. Jeff Bezos (CEO) commented that more people had joined Prime in the quarter than ever before and that Amazon now has more than 150m paid Prime members around the world, which was up from 100m members in April 2018. Guidance for 1Q20 points to revenue of between US$69–73bn, which is largely in-line with market expectations. Amazon stated it doesn't "have any visibility" on whether the coronavirus will impact its 1Q20 results. Given Amazon shares had underperformed through 2019, the result was well received by the market.

Microsoft (MSFT) delivered an impressive 1Q20 result, posting revenue growth of +14% and EPS growth of ~+40% yoy, beating market expectations by a comfortable margin. Microsoft's Intelligent Cloud division grew +27% yoy, +62% yoy growth in the Azure subscription service. On the whole, the result highlighted robust traction in Microsoft's Commercial Cloud, while product cycles helped boost Windows and Server licence growth. Microsoft's dominance in on-premise and public-cloud infrastructure should make it the top hybrid-cloud company as enterprises continue to modernise legacy IT platforms.

Facebook's (FB) 4Q19 result was largely in line with expectations, with revenue growth of +25% yoy, and EPS growth of +7% yoy. However, net income growth slowed markedly — up only +6% in 4Q19 yoy, compared to +61% growth in 4Q18 — as expenses grew +51% due to increased hiring. On the engagement front, the number of global monthly active users were up +8% yoy to 2.5bn, and global daily active users were up +9% to 1.66b. Through 2020, investors will likely focus on how Facebook navigates the political and regulatory environment.

Visa (V) reported a 1Q20 result that was largely in line with expectations, delivering EPS growth of +13% yoy on revenue growth of +10%, while total payments volumes rose +8%. V reiterated targets for net revenue growth in the low double digits, and EPS growth of mid-teens on an adjusted basis. An incremental negative is that Visa said it expects to pay a higher percentage of its revenues to its bank partners, but this should incentivise them to increase the total payments volume that the banks' clients put through Visa's network.

Thus far 249 of the 505 companies in the S&P 500 index have reported results. This week we expect results from Gilead Sciences, Merck, Siemens, Alphabet, Takeda Pharmaceuticals, Walt Disney and Sanofi.

Figure 1. Rolling week price changes versus EPS upgrades/downgrades

Best	1wk price chg (%)	1mth F1 EPS chg (%)	1mth F2 EPS chg (%)
Amazon.Com Inc	+9.9%	+1.8%	+2.6%
Microsoft Corp	+4.9%	+4.6%	+3.4%
Apple Inc	+0.2%	+5.2%	+4.2%
Visa Inc-Class A Shares	-1.3%	-0.8%	-0.6%
Facebook Inc-Class A	-6.0%	+0.2%	+2.2%

Source: Forsyth Barr analysis

Themes of the week

Equities

Wuhan coronavirus update

The Wuhan coronavirus epidemic is still not under control and hundreds of people have died. Chinese markets haven't reopened as the Government has extended the New Year holiday to try to cope with the outbreak. Indices in Hong Kong, where markets reopened briefly early last week, are down about -9% (in Hong Kong dollars and US dollars) from when the outbreak started grabbing headlines around 20 January. If the 2003 experience with SARS (which was less infectious but more lethal) is anything to go by, equities, especially in Asia, could stay depressed until infections stabilise. During SARS, the MSCI Asia ex-Japan index fell -7.7% from when deaths were reported until the market bottomed; by coincidence, that's also how much that index is down since 20 January. But to put that in context, the MSCI World index rose +5.5% over the same period (it's now down -3%).

Equity losers. China's robust measures to contain the Wuhan coronavirus will have direct impacts on tourism-dependent companies and on firms that are staying shut through the extended holiday, while changes in consumer behaviour due to fears about catching the virus will indirectly affect others. Given these effects, our research partners have lowered their economic growth forecast for China (which makes up 17% of world GDP) from +5.8% to +5.5% in 2020. Beyond mainland China, the economies that look most vulnerable to the impact of reduced travel demand are Hong Kong, Vietnam and Thailand.

In Macau, casino visitation in the first week of the Chinese New Year was down between -50% and -70%. Other firms like retailers and restaurants will feel the effects of consumers avoiding public places; Starbucks reportedly hasn't opened a large proportion of its stores in China and Apple is closing its stores for a week. Luxury goods sales, one-third of which globally are from Chinese clientele, could be impacted by both reduced travel and the lack of the feel-good factor that's required to spur luxury spending, potentially curtailing this year's earnings by between -6% (for Hugo Boss) to -20% (for Swatch). European spirits exporters could see earnings hits of between -1% (for Diageo) and -8% (for Remy Cointreau) if there is prolonged disruption followed by a partial recovery.

Our Australian research partners have identified the following stocks as being potentially negatively impacted: Qantas, Sydney Airport, Crown Resorts, Star Entertainment, Virgin, Flight Centre, Webjet, Corporate Travel, IDP Education and Treasury Wine Estates.

Closer to home, the direct earnings exposure of NZ listed tourism companies to China is relatively modest. For example, only 3% of Auckland Airport's international passengers were from China in 2019, although their revenue contributions are probably larger than that. Back in 2003, the NZ stocks that seemed most affected by the SARS outbreak had recouped their losses a few months after the virus peaked.

The a2 Milk Company and Synlait have large export exposures to China, but because infant formula is a necessity we expect demand to be relatively unaffected. Last week the companies told us they haven't seen any impact to their China sales so far. A2 said it has two to three months of inventory in China, which should help with supply continuity.

Equity winners? We would be surprised to see material positive impacts on many stocks from this situation.

- Any lift in respiratory illness typically boosts Fisher & Paykel Healthcare's (FPH) hospital product sales (both consumables and hardware). Tens of thousands of people are infected at this point, but this number is small compared to the ~5m patients annually using FPH's Invasive Ventilation products. ResMed sold $5m of equipment to China in the SARS epidemic.
- 3M has a strong respiratory business and could benefit from increased demand for face masks, but some of the 11% of revenues that the conglomerate derives from China could be negatively affected by disruptions.
- Antiviral drug makers AbbVie, Johnson & Johnson and Gilead Sciences are reportedly donating HIV drugs and drug candidates to China for trials to see if they help treat the disease.
- Johnson & Johnson is working on a vaccine but it won't be ready for another eight to 12 months. If the virus persists long enough, CSL might manufacture a vaccine, but analysts see this as unlikely for now.

We think the potential outcomes are too uncertain to judge how this pandemic will evolve and the size of its impact on company earnings and stocks over the coming months. Longer-term, while the human toll of the virus will sadly be irreversible, for economies and major companies it will be a temporary setback from which they will recover.

ResMed — Solid result

ResMed (RMD) reported an impressive 2Q20 result that was ahead of expectations, with the key highlight being another standout quarter for masks (RMD has launched four new masks in the last 12 months). Market share gains were evident globally for RMD in masks with +16% growth in constant currencies (cc), well ahead of estimated industry growth. Devices saw +8% cc growth, modestly ahead of industry growth. Rounding out a strong result, gross margins were up +60bp, driven by strength in the high margin mask category.

The result supports our view that RMD is in the strongest position at the moment in the masks category, with Fisher & Paykel Healthcare (FPH) still losing market share. FPH has launched a new mask this week which will reach the US market in six months or so and another new launch is due before financial year-end. We forecast that FPH will continue to lose market share in FY20, but new products will change this trajectory from FY21. However, this is reliant on a favourable industry response in what is currently a competitive landscape of well-regarded products.

Any impact to RMD and FPH from the coronavirus outbreak is likely to be muted and temporary, as the number of people that have fallen ill is, until now, modest relative to RMD's and FPH's global businesses.

Treasury Wine Estates — A bit like having a corked bottle of wine in the collection

Treasury Wine Estates (TWE) negatively surprised the market with the news that US and Asia wine volumes were down in the second half of 2019 (1H20), and margins had fallen across both markets. 1H20 operating profit growth of +8% yoy were below analysts' expectations for mid-teens growth and 1H20 EPS came in -9% below expectations. The company reduced its guidance for FY20 operating profit growth from +15–20% previously to +5–10%. This was particularly disappointing as FY20 guidance had been reiterated on 21 October 2019, when Michael Clarke (CEO) said he was 'pleased with 1Q20'. First time FY21 guidance was provided for +10–15% EBITS growth.

Changes being made to TWE's senior management add uncertainty to TWE's near-term earnings and have dented our confidence surrounding its US/Asian operations. In addition, TWE may suffer damage to its 2020 vintage from the Australian bushfires (although this won't be confirmed until 2021), and the Coronavirus brings additional risk of slowing demand out of China.

We continue to have a favourable view towards TWE's long term outlook, the quality of its operations in Australia, the US and France, and the quality of its brands. However, we believe it is too early to buy the current pull-back in share price because the correction was largely justified by the poor result and reduced guidance, and we can't rule out the risk of further near term profit downgrades.

Our Australian research affiliates, UBS and Citi, have Neutral ratings on the stock, with target prices of A$18.00 and A$13.70, respectively.

Fixed Interest

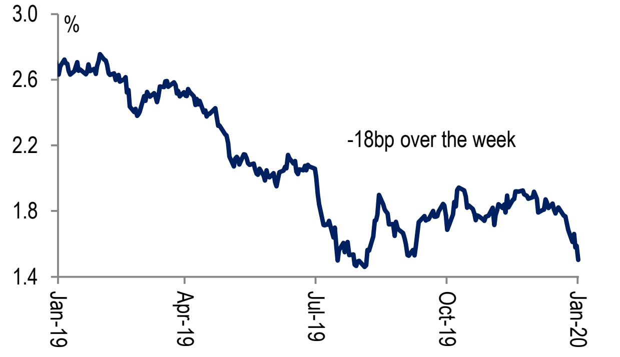
Risks can appear from anywhere…and have

The first month of 2020 has illustrated that there are always issues arising both locally and abroad that will impact financial markets. Within January alone we had the drama around President Trump and his impeachment, the start of the end of Brexit, an outbreak of coronavirus and an infrastructure spend up in New Zealand.

The bond market is not a fan of any sort of uncertainty, so the outbreak of the new coronavirus in China and the possible economic growth impacts have been reverberating around the markets of late. The yield on the US 10yr Treasury note (the world's most closely watched barometer of global economic health) has fallen -41bp over January, indicating some nervousness around the future economic state of not only the US but the wider global economy. New Zealand swap rates (wholesale interest rates that mortgage rates and term deposit rates are priced off) are not far behind, -28bp lower.

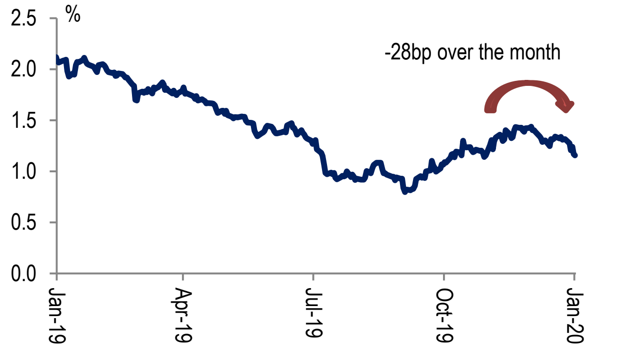
According to the RBNZ, retail floating mortgage rates have not moved since August 2019 so the movement in wholesale interest rates has yet to impact mums and dads. The Reserve Bank of New Zealand (RBNZ) is likely to address a number of these risks when it delivers its first Monetary Policy Statement of 2020 next Wednesday (12th Feb).

Figure 2. US 10yr yield



Source: Forsyth Barr analysis, Thomson Reuters

Figure 3. New Zealand 5yr Swap rate



Source: Forsyth Barr analysis, Thomson Reuters

Flight to quality in uncertain times

As risks appeared the flight to quality began pushing yields lower as highlighted above. While equity markets continued to enjoy positive gains with the S&P/NZX 50 Gross Index returning +2.0% over January, New Zealand Government bonds matched this performance. This illustrates the important role that fixed income plays in a diversified portfolio. New Zealand Government bonds (NZGB's) are regarded as risk free (they are rated AA+, the highest rating of any New Zealand bonds).

Corporate bonds returned +1.1% over the month, which again is a good return given the low volatility and secure nature of the investment compared to equities.

The risks mentioned above are all currently present, however, each one can be resolved relatively quickly (coronavirus is unknown) and markets will react accordingly. But what we do know is that there are risks lurking around every corner and it is imperative investors have an appropriate investment portfolio that provides the necessary protection characteristics to help minimise the potential impacts of such risks.

Despite interest rates and bond yield being near record lows, bonds continue to provide not only positive returns but also the stable safety net in uncertain times.

Research Worth Reading

New Zealand

Auckland Airport (AIA) — Duty Free to Fly Solo

AIA duty free retailers are likely struggling with high rentals and a lower weighting of higher spending Chinese visitors, even prior to the coronavirus outbreak. We think a potential move back to a single duty free operator after the next tender in 2022 could mitigate the underlying downside risk to the value of that tender. We believe AIA remains expensive at ~22x one year forward EBITDA, particularly given (1) downside risk to consensus forecasts in light of subdued passenger growth, exacerbated by the coronavirus outbreak, and (2) the likely deferral of AIA's Runway Land Charge from FY21. UNDERPERFORM.

Augusta Capital (AUG) — Takeover Offer — Entrepreneurial

AUG has entered into a Bid Implementation Agreement (BIA) at NZ$2.00/share, which if successful, will grant Centuria Capital Group Limited (CNI: ASX) 100% of AUG's shares. CNI's scale and capacity will allow AUG to achieve the financial and operating leverage necessary to successfully navigate its way through its current transitory phase to expand and develop its funds management business model. We recommend shareholders await further information from the issuance of the Target Company Statement and associated Independent Advisors Report (IAR) expected to be released before the end of April 2020. NEUTRAL.

F&P Healthcare (FPH) — Unmasking ResMed's 2Q20 Result

Recent data points continue to support market share gains for ResMed (RMD) in the Homecare segment, likely at the expense of FPH. This has been helped by a steady flow of new products. Our (and market) forecasts incorporate a re-acceleration in Homecare growth from FY21. We view this as an area of downside risk, given a highly competitive market rife with new products, and an incumbent (RMD) with strong momentum and products that are resonating well in market. FPH is a high quality company with an attractive outlook but valuation metrics are elevated even when adjusting for growth, relative to global peers, which leaves little room for error. UNDERPERFORM.

Electricity Sector — Calling RIO's Bluff

This paper reviews the economics of the NZ Aluminium Smelter (NZAS), looks at its position within RIO's portfolio and among global aluminium smelters, and considers the four possible outcomes from RIO's strategic review. We are calling Rio Tinto's (RIO) bluff that closure of NZAS is imminent without more favourable terms given climate change and minimising carbon emissions. Whether RIO remains a 79% owner is another question. Even if NZAS were to close, the impacts on the electricity sector (in the long-term) should not be material. We have a positive long-term view on the electricity sector. Our preferred stocks are Contact Energy (CEN) and Genesis Energy (GNE), which have OUTPERFORM ratings.

Australia

Transurban (TCL.AX) — West Gate Tunnel delays, downgrade to Hold

Ord Minnett expects meaningful delays and costs to exceed budget for TCL's West Gate Tunnel Project (WGTP). This follows the decision of the contractors to give notice of termination for the construction contract after they reportedly detected a dangerous industrial chemical in the soil. Hold (from Accumulate). (Published by Ord Minnett)

Treasury Wine Estates (TWE.AX) — Competition Heats Up

TWE's 1H20 result and accompanying weaker outlook has reset market expectations. Citi lowered its EPS forecasts by -12% in both FY20e and FY21e. Given cost inflation and lack of pricing power combined with excess supply issues in Americas, Citi expects TWE will not see any margin recovery in the next 18 months. Given the reduced valuation implied by the fall in the share price, Citi moved to Neutral (from Sell) with a target price of $13.70. (Published by Citi)

International

Global Economics Weekly — CoronaVIX Rises — Infection Fear Factor Defines Economic Costs

The coronavirus scare has resulted in a rise in the financial fear index, but conditions remain very accommodative by historical standards. A large-scale behavioural response (voluntary or via quarantine) would dominate the economic costs. In this situation, additional central bank easing will not provide much support to the economy. Our Chinese economists expect fiscal and monetary easing to contain the virus and slow the downward spiral of economic activity.

Apple (AAPL) — Accelerating Growth For Sales, Earnings & Cash Flow; Reiterate Buy

AAPL's December (1Q20) results were much better than expected, as was the company's guidance. Going into the results Citi's research picked up that Apple's wearables were selling out and even to this date this strong demand continues. What was an additional surprise was the strength of Apple's iPhone sales, not only in the December results but also the March quarter outlook. Citi sees fiscal year 2020 sales growing +11% and EPS growing +21%. Buy. (Published by Citi)

Berkshire Hathaway (BRKb.US) — 2020 Outlook: Insurance pricings trends appear favourable; valuation remains attractive

UBS expects BRK's Insurance segment will benefit from improved pricing in its reinsurance and commercial insurance businesses in 2020. However, UBS remains cautious given the trend of rising awards in tort court cases. While UBS anticipates some deterioration in margins at GEICO due to competitive pricing and increased ad spend and investment, growth should improve. Buy. (Published by UBS)

Facebook (FB) — Revenue Deceleration Disappoints the Bulls

FB reported quarterly result that was largely in line with expectations and management maintained FY20 guidance. Ad revenue growth in North America continued to slow down sequentially, and growth in Asia-Pacific dropped below +30% (from +35% in 3Q). Average user numbers were solid. Buy. (Published by Citi)

Illumina (ILMN) — Guidance Disappoints as 1Q Comes In Significantly Below Expectations

ILMN posted 4Q19 results that were slightly above the preannouncement earlier in January, but issued 1Q20 guidance that was significantly below expectations with only ~1% top-line growth at the midpoint. While the recently provided 2020 guidance remains intact, the light 1Q guidance again implies a steep ramp throughout the year, which raises the risk that management will have to cut guidance as they did in mid-2019. Buy. (Published by Citi)

Microsoft (MSFT.US) — Solid Beat As Microsoft Executes On All Fronts

Healthy traction in the Commercial Cloud business plus product cycles boosting growth in Windows and Server licenses helped MSFT beat revenue and profit forecasts for Q3. UBS thinks the strength of MSFT's business is increasingly well-understood, but sees the stock being able to maintain its current valuation on the back of mid-to-high-teens free cash flow growth, as Cloud businesses like Azure still remain in their early days, while some on-premise businesses like Server licensing are proving more durable than previously feared. Buy. (Published by UBS)

LVMH Moët Hennessy Louis Vuitton (MC.FP) — H2 with an underlying beat and confident tone from management

LVMH reported its 2H20 results, which despite slightly lower than expected Q4 organic growth, delivered a small 1% underlying profit beat (excluding a one-off write-down in the Perfumes & Cosmetics business). Sales growth was driven by the continued strength in Fashion and Leather Goods. Importantly, management sounded confident about 2020, despite the market's continued concerns about the impact of coronavirus on the sector. Buy. (Published by UBS)

Calendar

Figure 4. Calendar

	New Zealand	Australia	International
3-Feb		CBA Manufacturing PMI Jan-20 Building Approvals Dec-19 Link Administration Shareholder Meeting	CN: Caixin Manufacturing PMI Jan-20 EU: Markit Manufacturing PMI Jan-20 UK: Markit Manufacturing PMI Jan-20 US: ISM Manufacturing Jan-20
4-Feb	Building Consents Dec-19	RBA Interest Rate Announcement	US: Factory Orders Dec-19 Alphabet FY19 result Takeda Pharmaceutical 3Q20 result
5-Feb	Employment Data 4Q19	CBA Composite PMI Jan-20 CIMIC Group FY19 result	EU: Retail Sales Dec-19 US: Trade Balance Dec-19 US: ISM Non-manufacturing Index Jan-20 Gilead Sciences FY19 result Walt Disney 1Q20 result Siemens 1Q20 result Siemens AGM
6-Feb	Waitangi Day	Trade Balance Dec-19 Retail Sales Dec-19	EU: ECB Economic Bulletin Merck & Co FY19 result ING Groep FY19 result
7-Feb	RBNZ Survey of Expectations 1Q20 Kathmandu Investor Day	Dexus 1H20 result Mirvac Group 1H20 result News Corp 2Q20 result	CN: Trade Balance Jan-20 US: Non-farm Payrolls Jan-20 Sanofi FY19 result

Black – company news, Red – economic news
Source: Forsyth Barr analysis