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Could Regulators or Politicians De-FANG the Stock Market Rally?

Technology Continues to Outperform but Volatility has Ratcheted Up

It’s no secret that the information technology sector has been leading the market for the past several years. The long-running “rally in the valley” is part of a broader trend in the stock market where growth stocks have been outperforming value names. While things have arguably gotten a bit frothy (until recently), the valuations aren’t at the same level as they were during the late 1990s technology bubble and we’re not hearing as much discussion about the “new (internet-driven) economy” as we did back then. Nevertheless, there is no shortage of technology-related themes that investors have been trying to play. These include:

• Mobility
• Social Networking
• Cloud Computing
• Big Data
• Artificial Intelligence
• Cybersecurity

The big winners have been the “FANG” stocks—Facebook, Amazon, Netflix and Alphabet (Google). Throw in Apple and Microsoft—two other behemoths which are benefitting from these same trends—and you have a $3.5 trillion basket of “world-beating” companies. Investors have piled into these stocks individually and through the numerous mutual funds, index funds and ETFs that own them. In fact, recent broker surveys indicate that both traditional equity fund managers and hedge funds were more overweight technology than any other sector and it wasn’t even close.

Recent Events Have Been Negative for IT

So what could prevent the tech sector from devouring what’s left of the global economy? Over the past few weeks, we’ve gotten a steady dose of negative news affecting the sector which led to one of the worst two-week stretches for the NASDAQ in a number of years. Here are a few of the key events which sparked the selloff:

• In early March, the Committee on Foreign Investment in the United States (CFIUS) stepped in to block Broadcom’s proposed acquisition of Qualcomm on the basis of national security. The timing of the move was highly unusual (before shareholders had an opportunity to vote on it) and cast doubts over future semiconductor M&A.
• On 3/18, news reports revealed that Cambridge Analytica, a U.K.-based political consulting firm, had been able to capture Facebook data from an estimated 50 million users in an attempt to aid Donald Trump’s 2016 presidential campaign. The news rocked Facebook’s stock and those of internet advertising rivals Alphabet and Twitter.
• On 3/21, the EU published a proposal to apply a 3% revenue tax on major digital companies who it believes are taking advantage of loopholes to avoid paying taxes.
• On 3/22, President Trump signed an executive memorandum that would impose $60 billion of tariffs on Chinese imports. The U.S. technology sector derives more than 50% of its revenue internationally, so the prospect of a trade war would be very disruptive.
• On 3/27, NVIDIA announced that it was suspending its autonomous vehicle testing programs until it can determine what caused a fatal Uber vehicle crash in Arizona.
On 3/29, President Trump tweeted that he was concerned about Amazon’s e-commerce dominance which negatively impacts traditional retailers and the fact that it isn’t paying enough in taxes.

Large technology IPOs are on the rise in the U.S., which can be a headwind in an already struggling market.

**Tech Stocks May be Riskier than the Market Assumes**

We have been saying for some time that we thought the market was underestimating the riskiness of some of the high-flying technology stocks (including the FANG complex) that have become consensus longs and arguably over-owned. Among the risk factors that investors need to consider are their economic sensitivity, above average international exposure, the impact of foreign currency fluctuations, and the risk of intellectual property theft.

One of the biggest and difficult to quantify risks is legal/regulatory risk. The internet giants, especially Facebook and Alphabet which depend on data from users to drive online advertising revenues, appear to be in the crosshairs of regulators and politicians in Europe and, to a lesser extent (so far), in the U.S. Amazon (which S&P lumps in the consumer discretionary sector) has drawn repeated criticism from President Trump, who recently tweeted, “If the P.O. increased its parcel rates, Amazon’s shipping costs would rise by $2.6 billion. This Post Office scam must stop. Amazon must pay real costs (and taxes) now!” The technology sector is no stranger to regulatory risk—recall IBM in the 1970s and Microsoft in the early 2000s—but it comes to the foreground infrequently and is difficult to discount on an ongoing basis.

**Facebook’s Data Privacy Problem**

Facebook is an amazing company but some would argue that it has become ethically challenged as it tries to balance its role in connecting friends, family and businesses around the world with its desire to make money. The company knows a lot about its users, which is why it’s such a fantastic audience targeting tool. No other company has the global reach (2.1 billion users) or level of engagement (time spent on the platform) as Facebook. OK, Google comes close.

The problem is that in building this massive user database, it appears that Facebook wasn’t always as careful as it could have been in safeguarding user privacy. By sharing some of its data with third-party apps, Facebook was able to move beyond its own “walled garden” and gather additional information about its users (and their friends) that would help it sell more ads.

In response to the media firestorm around Cambridge Analytica, Facebook has promised to investigate all of the apps that had access to user data prior to its 2014 privacy policy changes. In addition, Facebook will provide a tool at the top of the News Feed which will make it easier to change your privacy settings (rather than scrolling through ~20 different screens) and provide greater transparency into all of the third party apps that have access to your data. That’s in addition to hiring an extra 10,000 human curators to eliminate objectionable posts and videos.

It’s still unclear whether these moves will prevent further slippage in user engagement (which has no doubt taken at least a minor hit from the flood of negative news). We’ll have a better sense when Facebook reports Q1 earnings in a few weeks.

**European Privacy Regulations are coming**

A bit further out, the social network and other tech heavyweights are bracing for new European privacy regulations which go into effect in late May. Known as the General Data Protection Regulation, or GDPR, the measure will allow European consumers to have more control over their personal information. We think GDPR will have a bigger impact on Facebook than Google, based on the types of information each company captures, the way they use it for targeting and the likelihood that each can get opt-in participation from users. The financial impact will depend on Facebook’s ability to use alternative means for targeting ads as well as how advertisers react to the recent controversy.
Don’t Forget Value Tech Stocks

Although the technology megacaps dominate the headlines, it is important to remember that within the technology space, value stocks can also play a meaningful role. Figure 1 compares the five largest companies in the Russell 1000 Technology Value Index with the five largest companies in the Nasdaq 100 Index. While Growth Tech outperformed in 2017, Value Tech led the way in 2016. The average price return for the past two years has been similar between the two groups, but the Technology Value stocks trade at a considerable valuation discount to the well-known megacaps atop the Nasdaq 100 (Apple, Alphabet, Microsoft, Amazon, and Facebook).

What to Expect Going Forward

Equity valuation is a complex mix of growth, risk, psychology, and other market influences, and the nature of the technology sector leads to heightened sensitivity to these factors. Even after its recent swoon, the technology sector continues to compare favorably with broader market indices (see Figure 2). The tech sector does face greater hurdles than were present in 2017, but the prominence of technology in society and the economy will continue to increase. The tech sector has also not experienced the widespread misallocation of resources that plagued it back in the late 1990s, so we do not expect the tech correction to develop into a tech wreck. Many companies in the sector enjoy high profit margins based on competitive advantages, economic moats around their businesses, and “positive network externalities” associated with having dominant platforms. Regulation or other governmental pressures may be unwelcome and pose headwinds, but in taking a long-term view we want to step back and ask the question whether the fundamental economic backdrop for the industry has changed. So far, the answer is no.
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