

Tech sell-off: Threat Or Opportunity?

The Technology sell-off of the last few days has been quite brutal even if a correction had been in the air for quite a long time with many investors quoting spectacular gains in 2017 and high valuations (we disagree on this) as the main reasons for taking profits or not investing in Technology.

In our view, such a move points to a healthy market and will ease market exuberance concerns as some investors lock in profits and switch to investments towards other strategies they deem more attractive on a risk/return basis and as some others, who were waiting for a correction, will take the opportunity to enter into the space or increase their exposure.

What's of utter importance when investing, especially in high-growth sectors like the ones we cover at AtonRā Partners, is to always have a perfect view of catalysts and triggers in order to have a competitive edge.

We believe that the main trigger of this Tech correction is not related to the US tax reform as some press articles suggest, but the combination of two factors, one being "interest rates" and the other one being "Net Neutrality".

On interest rates, we consider that the latest comments from the FED were the spark that ignited the fire on the markets. The outgoing FED's Governor, Mrs. Yellen, said last week that "The economic expansion is increasingly broad based across sectors as well as across much of the global economy".

The job of Mr. Jerome Powell, who is to take over the FED's top chair in February 2018, is to make sure that the transition towards a higher interest rates regime and a reduced FED balance sheet won't kill the 3rd most powerful US economic expansion since 1854.

Some market participants appear to start pondering (it's not the first time this happens this year) whether the FED is going at some point to be "behind the curve" when it comes to raising interest rates, triggering the potential for "runaway" inflation. The switch in allocation we witnessed in the last couple of days (from Technology to Banks) confirms the above statement, with some investors preparing for such an outcome.

We often say when meeting with investors that one of the main risks when investing in Technology and high-growth segments is interest rates rising unexpectedly and/or above consensus expectations. Even if most of the Technology and high-growth companies have little or no debt at all on their balance sheets, the ability of such companies to raise capital (for M&A purposes notably) in a shaky and disordered interest rates environment, is hampered, putting pressure on their valuation.

Will it happen? Our judgment is probably biased but we see Technology as a huge deflationary force as the aim of automation or any technological improvement is to do more with fewer resources. Just think of what is currently happening thanks to the advances in Artificial Intelligence and Robotics, which barely started to impact the real economy, or of what's currently going on in traditional industries such as retail with 2017 being considered the year of the Retail Apocalypse as purchasing habits shift towards the internet (there's more pain to come in our view for brick-and-mortar retailers).

On “Net Neutrality”, we are concerned that a possible change of the rules governing the internet in the US is a negative catalyst for the Technology sector overall. The FCC (Federal Communication Commission) is to vote on the “Net Neutrality” repeal during its December 14th 2017 session. With 5 FCC commissioners voting, of which 3 are Republicans, the outcome of the vote leaves little hope for proponents of Net Neutrality.

In essence, the FCC commissioners vote for an abdication of their authority and this might represent just the start of what we view as one of the most important judicial battles in the history of the US, which might bring some unintended consequences for US politics and possibly some unintended consequences (positive or negative) in one of the most important industries in the country, Technology.

We already highlighted this risk in the May 2017 monthly report of our Innovation certificate, explaining our view on Net Neutrality. With current market jitters, a refresh on this subject can be useful.

“Net Neutrality” is the non-discriminated and equal access to the Internet to all, meaning that all the traffic should be treated equally. Most of the existing tech business models (and as a result, innovation in many fields) rely on a free and equal Internet access which is regulated as a public utility, the same way as electricity, water, etc.

The new chairman of the US Federal Communication Commission, Ajit Pai, is about to repeal “Net Neutrality” regulations and to roll back the protections approved in 2015. While this is in line with Trump's political view that the government should not intervene in the economy, we believe it could have profound consequences for US consumers and companies not only in the US but globally.

What if tomorrow consumers don't have the choice of their internet content anymore as their ISP (Internet Service Provider) slows down or even blocks the access to certain websites, applications or blogs and favors content from websites that are able to pay a premium?

What if companies have to pay more in order to have their content accessed? This would impact their profitability and mechanically their ability to create and innovate as more money would be spent on making sure that customers get the proper access to their content. This could have profound consequences for businesses which rely on the Cloud, in other words everyone... with a divide between those who can afford price increases and those who cannot.

We also believe that it has the potential to play a key role in the future of Democracy in the US as freedom of speech could simply be hampered.

Proponents of the new regulation (mainly ISPs such as Verizon, AT&T, Comcast...) argue that such a change represents a boon for consumers who would be able to switch ISP providers when the service offered is not in line with their expectations. This is not true as in the US, switching providers is not as easy as it might seem. In fact, 51% of Americans have access to only one broadband service provider according to 2016 FCC data, 10% of Americans have not access at all and only 38% of the Americans can select more than one broadband service provider. To make things even worse, in markets (mainly on the East Coast) where a choice is possible, the choice is most of the times an illusion, as providers tend to share areas between themselves.

While such new rules are positive for ISPs (we believe the main reason behind the small rally in such names during the last few days), they represent a sword of Damocles hanging over the heads of Tech companies. Netflix for instance (not part of any of our portfolios) could be one of the main victims as the company accounts for one third of US Internet traffic during peak times. Should “Net Neutrality” be repealed, Netflix would pay a lot more in order to let its clients get access to its content more easily.

Removing existing Net Neutrality rules without putting something better in place would leave regulators (the Federal Trade Commission on the top) with zero powers to overcome possibly the worst behaviors which are to be expected in what would be a no more regulated industry.

We also believe that a huge judicial battle is to take place should the Net Neutrality repeal vote pass and see current jitters as short-lived as this vote is not likely to change the stronger than ever industry fundamentals.