Tech and financials led the recent selloff, as headline noise and regulatory risks spooked investors. But strong corporate fundamentals, including earnings growth, should ultimately drive stock returns.

U.S. stock markets fell out of bed to start the second quarter, with the benchmark S&P 500 index breaching its 200-day moving average and entering into correction territory after tumbling more than 10% from its January record high. The declines really began in mid-March, as fears over a trade war heated up, a wave of adverse tech-related headlines crashed on the sector and short-term lending rates leaped higher, shaking optimism in financials.

After record-low volatility last year, the market turbulence that returned in the first quarter of 2018 now looks likely to extend into the second. But active, longer-term investors should welcome the return of volatility to more normal levels: As the March-through-June period kicked off, the CBOE S&P 500
Volatility Index jumped to 23.6, which isn’t too far above its historical 19.4 average, and a little more than double the 2017 average of 11.1, its lowest ever in a calendar year. Volatility creates opportunities, and interestingly, the sectors leading the latest market selloff, technology and financials, were also leading the rally heading into 2018. They are now ripe with individual stock opportunities, as prices get swept lower in broad market swings, even as individual corporate fundamentals remain strong in many cases.

Take the tech giants. Since its February 1 record high through April 2, Facebook shed 20%, as fears grew about regulatory action to address privacy concerns surrounding user data and networks, and access to them by third-parties. In the wake of Facebook’s roles in Russian meddling in the U.S. 2016 presidential election and the more recent Cambridge Analytica disclosure, Facebook strengthened privacy and third-party access policies. But investors were already on edge after the social media giant announced moves to increase the quality of interactions on the app, “potentially creating poor optics around engagement, even though it was the right thing to do,” says Thornburg Portfolio Manager Connor Browne.

Similar concerns have swirled around Alphabet, particularly regarding Google’s ranking of search results. The worry is the impact of potential regulation, likely first out of Europe, where pressure is building to bridle, or even break up, “GAFA” – Google, Apple, Facebook, and Amazon—through higher taxes or even anti-trust measures. In a March 31, 2018 interview with Wired, French President Emmanuel Macron said the four digital titans are part of France’s “ecosystem,” but are in a “monopoly situation,” and asserted that the U.S. government and American people may conclude the companies are “not just too big to fail, but too big to be governed” and “choose to dismantle” them as industrial era oil monopolies were.1 This follows remarks by Sebastien Soriano, Macron’s telecom minister, who said, “Taxing the web giants won’t be enough to reduce their domination…The question is not whether we should dismantle Google, but how to dismantle Google.”2

The tech giants may be slapped with higher taxes, but as discussed in this recent post, it won’t be easy, and the odds of breaking them up are long. The real threat would be new regulation that crimps ad targeting via more restricted use of “personally identifiable information.” Measures that limit the effectiveness of targeted advertising, and in turn its pricing, would undercut the tech giants’ ad-related revenue growth.

The key legislation here is the European Union’s General Data Protection Regulation (GDPR), which aims to give E.U. citizens greater control over the use and warehousing of their data. It also outlines penalties of up to EUR20 million or 4% of worldwide revenue, whichever is greater, if a company fails to safeguard users’ data. This new data protection regime comes into force on May 25, 2018, and its requirements extend to both “controllers” and “processors” of data, and in effect will most likely rope in U.S. companies that handle data of E.U. citizens. The rules would go beyond the tech giants, extending to big U.S. banks with European clients.

Meanwhile, the E.U.’s draft ePrivacy Regulation (ePR) around privacy protections of electronic communications—both email and voice calls—would prohibit data processing not explicitly necessary for a service, and require broad user consent for nearly all data processing. In its current form, concerns are growing that it could crimp Internet of Things (IoT) development by effectively bogging down machine-to-machine (M2M) data flows.
The degree to which U.S. companies will actually be subject to GDPR and ePR remains to be seen. Macron suggests he would simply like to protect France’s sovereignty by regulating the U.S. tech companies providing services in France under the same regulatory regime governing French companies. He says the idea is to create a level playing field for all that includes taxation, in part because the U.S. tech companies disrupt France’s “traditional economic sectors,” which are subject to higher local taxes that the tech giants skirt.

The headline noise in tech pushed the NYSE Fang+ Index, an equal-weighted index of the top tech and consumer discretionary-related tech companies, 14% lower over a five-day trading period toward the end of March. Yet the index was still up nearly 7% from the beginning of the year through April 3. Why? “Fundamentals for IT companies have been good, and valuations seem reasonable, especially on a sum-of-the-parts basis,” says Thornburg Portfolio Manager Rob MacDonald. “The FAANGs (Facebook, Amazon, Apple, Netflix, and Google), especially Facebook, have taken a hit recently, and it is hard to know how severe both regulation and the consumer response will be, but a lot of bad news is priced in. Assuming earnings power isn’t greatly impacted, we still think these companies are good values today.”

Facebook’s adjusted annual revenue, for example, is expected to grow 36% in 2018, for a gross profit margin (revenues less cost of goods sold) projected at 87%. While the impact of pending European digital data privacy and sharing regulation is unclear, one potential side effect is that it stifles the very local tech alternatives that E.U. regulators would like to see develop, it could possibly entrench the more lightly regulated FAANGs, valuations on which have become less demanding in recent weeks.

The same holds true for the bigger U.S. banks. The KBW Bank Index fell nearly 10% from its February 1, 2018, high through April 3, but is still up 70% from the July 2016 bottom in the 10-year U.S. Treasury yield. The benchmark yield has declined nearly 6% from its February high of 2.95% to 2.78% on April 3, 2018. Short-term rates are still slated to head higher—boosting banks’ net interest income—as the economy is chugging along at 2.9% annual growth, consumer and business confidence levels are at or near record highs, and non-residential fixed asset investment has been bouncing back.

Streamlining of the 2010 Dodd-Frank regulatory framework should also allow banks to pay out more in dividends, particularly with capital positions at ample levels, while the December tax reform could boost earnings 10% and lift return on tangible common equity well over 100 basis points, according to various sell-side estimates. Despite the sector’s strong equity price performance since mid-2016, MacDonald says banks are still a good value. The current price-to-tangible-book ratio of the top five U.S. banks currently runs at an average of 1.6, higher than the 1.1 average from the third quarter of 2016, but hardly exorbitant.

The drivers of market turbulence in recent weeks—Trump tweets, trade war fears and tech regulatory uncertainty—likely aren’t going away. As we pointed out in early February, market corrections are helpful for upgrading portfolios at better price points. The volatility created usually proves helpful for long-term investors, who should be more focused on corporate fundamentals. S&P 500 firms are expected to report first-quarter earnings growth of 17%, and sales growth of 7.2%, according to Factset. And thanks to the selloff, the bluechip index’s 12-month forward price-to-earnings ratio has fallen to 16.2x, down more than two multiple points from the beginning of the year, and now at a level
not seen since early November 2016.

Better valuations coupled with higher earnings should ultimately drive equity prices far more than tweets and related headline noise.

1. Emmanuel Macron Talks to Wired About France’s AI Strategy— Wired, March 31, 2018


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