MORNING BRIEFING
January 20, 2022

Meta's Foes

Check out the accompanying pdf.

(1) Throwing the book at Meta. (2) Meta keeps regulators around the world busy. (3) FTC antitrust case allowed to proceed. (4) Congress wants Meta and Big Tech to end anticompetitive practices and protect children. (5) State attorneys general target Meta too. (6) UK regulator requires Meta to sell Giphy. (7) EU considers the Digital Markets Act. (8) Lawsuit aims to sidestep Section 230. (9) Microsoft's Activision deal should boost revenue and increase its gaming content. (10) Race to fill the metaverse with content. (11) Metaverse "land" prices skyrocket. (12) Walmart appears ready to jump into the metaverse, too.

Technology: The World's Piñata. The world is after Meta Platforms. Literally. Regulators and legislators at home and abroad are pushing and prodding to change the way the company—formerly known as "Facebook"—does business. A whistleblower has divulged documents showing how the company's social platforms hurt some teenaged girls. And assorted lawsuits and shareholders have the company in their sights.

While the headlines have been ugly, Meta's business and stock so far have escaped largely unscathed. While Meta shares have slightly underperformed the market over the past three months, they have outperformed over the past year—up 26.6% y/y through Tuesday's close compared to 21.5% for the S&P 500 and 11.6% for Nasdaq.

But "unscathed" may not characterize the company for long. Lawmakers in Congress have proposed a number of bills targeting Meta, among other tech giants, and the Federal Trade Commission (FTC) is expected to become more aggressive now that it's headed by Biden appointee Lina Khan, an academic who wrote about breaking up Amazon.com.

Among the biggest risks to Meta may be distraction. As Meta defends itself from various attacks, its leaders may take their eye off the business while Meta's competition proceeds to innovate and grow. Case in point: Microsoft announced the acquisition of Activision Blizzard on Tuesday, a deal that could advance its ambition to lead the metaverse. (More on that below.)

Here's a look at some of the many arrows heading Meta's direction:

(1) *FTC gets the green light to proceed.* Earlier this month, a federal judge allowed the FTC to move forward with its antitrust lawsuit against Meta. The lawsuit alleges that Meta has monopoly power in the market for social-networking services. If the FTC is successful, Meta might have to divest Instagram, acquired in 2012, and WhatsApp, acquired in 2014. The revised case was allowed to proceed because it included more market-share statistics and evidence supporting the allegations that Meta controls prices and blocks competition in social networking, a January 11 Axios *article* reported.

“Although the agency may well face a tall task down the road in proving its allegations, the Court believes that it has now cleared the pleading bar and may proceed to discovery,” wrote Judge James Boasberg from the U.S. District Court for the District of Columbia. The discovery phase, which can take months or years, allows the government to search through Meta’s data and documents.

The FTC, along with several states’ attorneys general (AGs), is also investigating Meta’s Oculus virtual reality unit, according to a January 14 Bloomberg *article*. Meta bought Oculus in 2014 for $2 billion, and its headsets represented 75% of the new headsets sold globally in Q1-2021, according to Counterpoint Research. FTC officials reportedly are considering whether the company has broken antitrust laws, using its market power to stifle competition in the virtual reality (VR) space. Specifically, they’re looking into whether Meta discriminates against third-party sellers of apps and whether it underprices the Oculus Quest 2 headset to squeeze out competitors.

The FTC has also reportedly opened an antitrust probe into Meta’s planned acquisition of VR fitness app Supernatural. “While the FTC might eventually approve the Supernatural deal, its decision to investigate signals that Meta’s playbook of quickly buying the hottest VR startups on its platform may already be coming to an end,” a December 16 *article* in *The Verge* reported.

(2) *Arrows out of Washington, DC*. Various bills floating around the halls of Congress target Meta and other tech giants. But members of Congress will have to act fast, preferably by summer before the focus turns to midterm elections, to turn the bills into laws. If the Republicans regain control of the Senate after the midterms—as is expected—these bills would stand little chance of passing.

Among the highest-profile bills is the American Innovation and Choice Online Act. With the backing of Senators Amy Klobuchar (D-MN) and Lindsey Graham (R-SC), the bill would prohibit Big Tech companies from acting anticompetitively and favoring their own services, a

January 10 Axios *article* reported. Klobuchar and Senator Tom Cotton (R-AR) also introduced the Platform Competition and Opportunity Act, a bill that would make it more difficult for Big Tech to make acquisitions.

The Children's Online Privacy Protection Act, introduced by Senators Ed Markey (D-MA) and Bill Cassidy (R-LA), aims to update existing legislation by limiting social platforms' collection of data from children under 15 years old, up from 13 today. The bill also gives children and their parents more legal resources regarding online harm, a January 19 *FT* *article* stated.

The Health Misinformation Act, co-sponsored by Klobuchar and Senator Ben Ray (D-NM), holds social media platforms responsible if their algorithms promote misinformation about vaccines, fake cures, and other harmful health-related claims during public health emergencies, a July 22 NPR *article* explains. Yet another bill would require tech companies to open up more data to outside researchers.

(3) *Busy state AGs*. Almost 50 states' AGs have asked a federal appeals court judge to reconsider their antitrust lawsuit against Meta that was thrown out by a judge in June. Judge James E. Boasberg of the US District Court of the District of Columbia said the states waited too long after Meta's deals closed to make the suit. The states countered that they have more timing latitude than private plaintiffs, a January 14 *NYT* *article* stated.

At least eight state AGs late last year launched an investigation into measures that Meta takes to increase young people's Instagram use and whether any harm results, a November 18 *WSJ* *article* stated. The AGs will also consider whether Meta has violated consumer protection laws and put the public at risk. Perhaps in response, Meta has paused the development of an Instagram product that targets children as users.

In January 2020, Facebook settled for $550 million an Illinois class-action lawsuit alleging that it broke a 2008 state law prohibiting companies from collecting biometric data without users' consent. Facebook allegedly created and stored face templates that powered an automatic photo-tagging feature. In November of last year, the company announced that it planned to shut down its facial recognition system. The system was part of a tool that allowed users to share photos on social media, a November 2 *WSJ* *article* reported.

(4) *Pressure from regulators abroad too.* In November, the UK's competition regulator required Meta to sell Giphy, an online image platform it bought for $400 million in 2020. Relative to Meta's size, the acquisition price and size are drops in the bucket. But the

regulator's decision should make it harder for Meta to acquire companies in the future, shutting down an important source of the company's past growth. Meta has applied for a review of the ruling.

In the European Union (EU), the Digital Markets Act was proposed by EU antitrust head Margrethe Vestager and agreed to by a key committee of EU lawmakers. It would limit tech giants' acquisitions and prohibit their targeting advertising to minors and others without consent. The legislation still needs to be "thrashed out" with the European Parliament and EU countries before it can be adopted, a November 23 CNBC *article* reported.

France's National Commission on Informatics and Liberty fined Facebook $70 million and Google $170 million for making it harder for users to refuse cookies than to accept them, a January 6 CyberScoop *article* reported. The two companies were ordered to fix the issues or face fines of more than $100,000 a day. And the Italian watchdog, the Autorita Garante della Concorrenza e del Mercado, in February 2021 fined Facebook 7 million euros over its use of data, a January 18 CNBC *article* reported. Ireland's regulator is looking into Instagram's handling of children's data and its account settings for children.

(5) *Private entities also have Meta in their sights.* In addition to being targeted by legislators and regulators, Meta finds itself the focus of lawsuits and shareholder actions. One of the more interesting lawsuits tries to pierce the protection Meta receives under Section 230 of the Communications Decency Act. That's a 1996 federal law that shields Internet sites from legal liability for things users post online, contending that Internet companies are passive hosts of information, acting like a bulletin board. Newspapers and TV stations don't enjoy such liability protection because they actively curate and create the information they disseminate.

In the Meta lawsuit, Facebook's recommendations for joining pages are under scrutiny. It claims that Facebook's algorithm recommended that Robert Alvin Justus Jr. join the Facebook page of the Boogaloo Bois, a movement of antigovernment extremists, where he "met" former Air Force Sergeant Steven Carrillo. The two men traveled to Oakland with the intent to kill federal agents. There, Carrillo shot and killed Dave Underwood, a federal security guard, and injured his partner. Carrillo has pled not guilty to separate murder and attempted murder charges, and Justus pled not guilty to aiding and abetting murder and attempted murder.

"[B]y making group recommendations based on users' interests, Facebook did 'something far different than simply facilitate a bulletin board.' The act of recommending that people join groups that share inflammatory content makes Facebook more than a passive platform protected by Section 230," said the plaintiff's attorney in a January 6 *WSJ* article.

In a different case, roughly 30 companies publishing more than 200 newspapers in the US are suing Facebook and Google, alleging that the two companies unfairly manipulated the advertising market, siphoning away the newspaper companies' revenue and crippling their business, a December 8 *New York Post* article reported. The papers are looking to recover damages equal to the revenue lost and establish a new system going forward in which newspapers can thrive. One attorney for the newspapers pointed to Australia's new laws that force the tech firms to pay for newspapers' content.

Large institutional shareholders have filed a shareholder proposal that calls for Meta's board of directors to oversee "efforts to reduce harmful content, an assessment of the risk of the company's metaverse efforts, and a review of the social media company's audit and risk committee," a December 13 *WSJ* article reported. Shareholders include the New York State Common Retirement Fund and Illinois State Treasurer. Because Meta CEO Mark Zuckerberg has super-voting shares that give him 58% of the vote, the proposals are likely to fail; but they send management a message nonetheless.

Disruptive Technologies: Microsoft Makes Its Move. Microsoft's $68.7 billion acquisition of Activision Blizzard checks a lot of boxes. Owning Activision will help Microsoft boost its gaming subscription revenue. It increases Microsoft's gaming content, on both consoles and mobile devices. And the purchase of Activision will eventually help Microsoft fill the metaverse's rooms with content. Not bad for a deal paid for in cash. Let's take a quick look at the deal and some of the other recent news about the metaverse:

(1) *Boosting revenues today.* Companies and investors love consistent, reoccurring subscription revenue. Microsoft's Game Pass is an annual subscription that gives users access to a wide library of video games. Revenue from Game Pass grew almost 30% last year to hit 25 million subscribers.

The Activision deal brings popular games Call of Duty and Warcraft into the fold. It follows Microsoft's $7.5 billion acquisition of ZeniMax Media in 2020 and the $2.5 billion acquisition of Mojang, maker of Minecraft, in 2014. While it's not clear which Activision games will be available on Game Pass, more content gives Microsoft more options.

Microsoft also makes money when gamers make in-game purchases of virtual goods and services, like weapons and clothing. Compound annual growth in the global market for microtransactions is expected to accelerate from 3.6% in 2021 to 10% in 2025, bringing revenue up to $51.1 billion, according to an August 19 ResearchandMarkets.com *report*. Activision's Candy Crush Saga, a popular mobile game, is estimated to generate more than $1 billion a year in in-app purchases, a January 19 CNBC *article* reported.

(2) *Content for the metaverse.* People will need a reason to put on VR headsets and visit the metaverse instead of streaming videos on TV or meeting friends in person. Video games are one of the first reasons people will have to visit this alternative reality. Gamers are used to working with others in alternative worlds. Doing that in the metaverse is just changing the label on what many gamers do currently.

The more content Microsoft has, the more likely it will be able to lure eyeballs to its metaverse. Content wars are nothing new. They are occurring now in the streaming wars, where Netflix and Amazon are spending billions to buy and create the best content. It happened online as websites battled it out for eyeballs. And it all started with ABC, NBC, and CBS duking it out during sweeps week.

In its press release for the deal, Microsoft stated that the acquisition will provide the "building blocks" for the metaverse. "Gaming is the most dynamic and exciting category in entertainment across all platforms today and will play a key role in the development of metaverse platforms," said Microsoft CEO Satya Nadella.

(3) *Everyone's jumping into the metaverse.* Microsoft's deal for Activision turned the already loud buzz around the metaverse up a notch or two. In a quintessential land rush, the metaverse is attracting everyone from large corporations to small investors.

Prices for "plots of land" in the metaverse soared as much as 500% over the past few months, sparked by Facebook's announcement that it was jumping into VR and changing its name, reported a January 12 CNBC *article*. And that was before this week's Microsoft/Activision deal.

Tokens.com, which invests in metaverse real estate and digital assets, paid almost $2.5 billion on a parcel of land in Decentraland, a popular metaverse world, the article stated. Republic Realm, another virtual real estate development company spent a record $4.3 million on a parcel of virtual land. Republic sold virtual private islands for $15,000 each last year, and today they're selling for about $300,000 each.

Walmart looks ready to jump into the metaverse. It filed new trademarks late last month implying plans to make and sell virtual goods in the metaverse and offer users a virtual currency and non-fungible tokens (NFTs), a January 16 CNBC *article* reported. Walmart's moves follow news that Nike has partnered with Roblox to create Nikeland, an online world, and that Nike has bought virtual sneaker company RTFKT. Gap, UnderArmour, and Adidas have also sold NFTs.

Meta may be limited in what it can acquire due to the regulatory inquiries we outlined above. But the company is developing systems internally for the metaverse. Recent patent filings show the company had developed sensors that monitor a user's body movements so that their avatars in the metaverse can mirror the user's movements and expressions, a January 19 *New York Post* *article* reported. The data could also be used to deliver more specific ads.

The race for metaverse supremacy is on.

Calendars

US: Thurs: Initial & Continuous Job Claims 220k/1.58m; Philadelphia Fed Manufacturing Index 20.0; Existing Home Sales 6.44mu; Natural Gas Storage. **Fri:** Leading Indicators 0.8%; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: Thurs: Eurozone Headline & Core CPI 0.4%m/m/5.0%y/y & 0.4%m/m/2.6%y/y; Germany PPI 0.8%m/m/19.4%y/y; France Business Survey 111; UK Gfk Consumer Confidence -15; ECB Publishes Account of Monetary Policy Meeting. **Fri:** Eurozone Consumer Confidence -9.0; UK Headline & Core Retails Sales -0.6%m/m/3.4%y/y & -0.5%m/m/1.1%y/y; Canada Headline & Core Retail Sales 1.2%/1.3%; Lagarge; Mann. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) slipped further below 2.00 this week after moving above 2.00 two weeks ago for the first time since late November. The BBR sank for the second week to 1.59 this week after climbing three of the prior four weeks from 1.57 to 2.15. Bullish sentiment fell 10.8ppts the past two weeks to

39.8% after climbing 10.8ppts (to 50.6% from 39.8%) the prior three weeks—with the 50.6% reading two weeks ago the first percentage above 50.0% since late November. The latest two-week drop in bullish sentiment reflects a 9.3ppts (35.2% from 25.9%) jump in the correction count. Bearish sentiment edged up to 25.0% this week after slipping 2.3ppts (to 23.0 from 25.3) the previous four weeks. The AAII Ratio dropped for the second week last week to 39.4% after rebounding the prior two weeks from 39.1% to 55.2%, as bullish sentiment dropped from 37.7% to 24.9% over the two-week period, while bearish sentiment rose from 30.5% to 38.3%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin was steady at a record high of 13.3% last week. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and forward earnings per share were also at record highs. They've both been making new highs since the beginning of March 2021 after peaking just before Covid-19 in February 2020. Since the Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.1ppt w/w to 7.3%, just above its 12-month low of 7.1% in early December. That's down from a record high of 9.6% growth at the end of May 2021 and should continue to move lower as base effects subside. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth rose 0.1ppt to 9.0%, up from a 16-month low of 8.2% in early December, and should also continue to move lower due to base effects. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. On a positive note, this year analysts have been raising their consensus forecasts for 2021 and 2022 revenues and earnings growth; the imputed profit margin estimate that we calculate from those forecasts has been rising too. They expect revenues to rise 16.2% in 2021 (up 0.1ppt w/w) and 7.6% (up 0.1ppt w/w) in 2022 compared to the 2.1% decline reported in 2020. They expect earnings gains of 50.1% in 2021 (up 0.2ppt w/w) and 8.9% in 2022 (unchanged w/w) compared to a 13.4% decline in 2020. Analysts expect the profit margin to rise 3.0ppts y/y in 2021 to 13.1% (unchanged w/w) from 10.1% in 2020 and to improve 0.1ppt y/y to 13.2% in 2022 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.1pt to 21.2. That's down from an eight-month high of 21.7 at the end of 2021 and up from a 17-month low of 20.4 in mid-October. That also compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.01pt w/w to 2.82, but that's down from a record high of 2.88 at the end of 2021. That's up from its four-month low of 2.69 in mid-October and compares to its prior record high of 2.86 at the end of November and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise for 10 of the 11 S&P 500 sectors, forward earnings move higher for seven sectors, and the forward profit margin increase for five sectors. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margin. Energy still has forward revenues and earnings well below record highs, but its profit margin is the highest since November 2008. Financials, Real Estate, and Utilities have forward earnings at or near record highs, but their forward revenues and margins are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. For 2021, a y/y improvement is expected for all but Utilities. Four sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Financials, Materials, and Real Estate. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.0%, down from its 25.1% record high in December), Communication Services (16.7, down from its 17.0 record high in October), Real Estate (16.4, down from its 19.2 record high in 2016), Utilities (14.6, down from its 14.8 record high in April), Materials (13.3, down from its 13.4 record high in December), S&P 500 (13.3, a record high this week), Health Care (11.3, a new record high this week), Industrials (10.3, down from its 10.5 record high in December 2019), Consumer Staples (7.6, down from its 7.7 record high in June), Consumer Discretionary (8.0, down from its 8.3 record high in 2018), and Energy (9.2 [13-year high], down from a record-high 11.2 in 2007).

S&P 500 Sectors Forward Revenues and Earnings Recovery from Covid-19 Trough (*link*): The S&P 500's forward revenues and earnings as well as its implied forward profit margin bottomed at cyclical lows on May 28, 2020 after 14 weeks of Covid-19-related declines. Forward revenues and earnings have risen 23.0% and 59.6%, respectively, since then to new record highs. The forward profit margin has risen 3.3ppts to a record high of 13.3%. That exceeds its prior pre-Covid record of 12.4% in late 2018. During the latest week, consensus forward revenues rose for 10 of the 11 S&P 500 sectors, forward earnings moved higher for seven sectors, and the forward profit margin increased for five sectors. Here's how the S&P 500 and its 11 sectors rank by their changes in forward revenues and forward earnings since May 28, 2020: Energy (forward revenues up 41.8%, forward earnings up 2,176.4%), Materials (34.1, 102.6), Information Technology (29.5, 48.8), Industrials (28.1, 79.9), Communication Services (26.0, 57.8), S&P 500 (23.0, 59.6), Financials (20.9, 68.3), Health Care (19.1, 34.9), Consumer Discretionary (18.1, 102.3), Real Estate (14.4, 31.7), Consumer Staples (14.4, 21.2), and Utilities (0.4, 5.8).

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 9% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues are beating the consensus forecast by 2.4% and earnings have exceeded estimates by 6.4%. While these surprises are above the long-term trend, they're the weakest since Q1-2020. At the same point during the Q3 season, revenues were 2.5% above forecast and earnings beat by 14.4%. For the 43 companies that have reported Q4 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings during Q2 and Q3. The small sample of Q4 reporters so far collectively has a y/y revenue gain of 11.7% and an earnings gain of 19.6%. Just 77% of the Q4 reporters so far has reported a positive earnings surprise, below the 81% that have beaten revenues forecasts. Furthermore, fewer companies have reported positive y/y earnings growth in Q4 (81%) than positive y/y revenue growth (91). These figures will change markedly as more Q4-2021 results are reported in the coming weeks, but the early read on earnings is disappointing compared to the previous six quarters. We expect the y/y growth rates to continue easing in Q4 compared to Q2 and Q3. We also think the revenue and earnings surprises will moderate q/q as well due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

Housing Starts & Building Permits (*link*): Unseasonably mild weather boosted housing starts in December—with December 2021 the warmest December on record—but the outlook is cloudy. NAHB's chairman warns, "NAHB analysis indicates the aggregate cost of residential construction materials has increased almost 19% since December 2020. Policymakers need to take action to fix supply chains. Obtaining a new softwood lumber agreement with Canada and reducing tariffs is an excellent place to start." December housing starts climbed for the third straight month, by 1.4% m/m and 9.8% over the period to a nine-month high of 1.702mu (saar), as multi-family starts jumped 10.6% and 15.0% over the comparable periods to 530,000 units (saar)—the highest since February 2020. Single-family starts fell 2.3% in December to 1.172mu (saar), after an 11.6% jump and a 1.4% loss the prior two months. Building permits—a good leading indicator of housing starts—advanced for the fifth time in six months, by 9.1% in December and 17.5% over the period to an 11-month high of 1.873mu (saar), within 0.5% of its cyclical high of 1.883mu at the start of 2021. Single-family permits climbed for the fourth time in five months, by a total of 7.6%, to a seven-month high of 1.128mu (saar), while volatile multi-family permits rebounded 36.7% over the three months through December to 745,000 units (saar)—the highest since January 1990; these permits had plunged 18.8% in September. NAHB's January Housing Market Index (HMI) shows builders' confidence deteriorated for the first time in five months, though remains at an elevated level. The HMI dipped to 83 this month, after rising steadily from 75 in August to 84 by the end of last year; it was at a record high of 90 during November 2020. Two of the three components of the HMI moved lower this month—future sales (to 83 from 85) and traffic of prospective buyers (69 from 71)—while the measure for current sales was unchanged at 90. They were at record highs of 89, 77, and 96, respectively, during November 2020.

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