Peak season Apple is an enterprise that actually makes things, though its wild ride in the valuations is in part propelled by its offerings in services
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STATES OF MATTER

An eye on tomorrow

Valuations in new economy stocks are buoyant, with Apple hitting a trillion dollars. How real are these expectations?

SUKUMAR MURALIDHARAN

Apple hit a trillion dollars in market valuation on August 2, with Amazon and Google not far behind. Facebook and Netflix brought up the rearguard among the quintet (the so-called FAANG companies) that set the pace in technology stocks.

Facebook suffered a massive sell-off on July 26, losing an estimated $120 billion in value on investor fears that its efforts to fight the fake news plague might impair earnings. It was a striking instance of how the market gives the company a perverse incentive to ignore an abuse that is causing serious concern among governments and the public alike.

Facebook's chairman Mark Zuckerberg suffered a loss in personal fortune of the order of $16 billion, a figure that could have crippled most economies. Yet Zuckerberg just shrugged off the setback and moved on.

How real are these numbers? Expectations are key and this question devolves into one about how well informed investors are about the future earnings potential of these stocks. Interestingly, on any given day, transactions in the stocks of FAANG companies (Facebook, Amazon, Apple, Netflix and Google) reveal vastly different prognoses of their earnings potential.

Among possible metrics, the price-earnings (PE) ratio is one that provides a rough guide to the money investors are willing to bet on a company, in return for a dollar's earnings today. The day it touched a trillion dollars in valuation, Apple had a PE ratio of just over 18, not far from the figure of 16 that an "old economy" stock like Exxon-Mobil registered at the same time. Among the FAANG fraternity, Apple is an enterprise that actually makes things, though its wild ride in the valuations is in part propelled by its offerings in services. The contribution here is modest. Out of Apple's total revenue of $53.3 billion in the most recent quarter, $9.5 billion i.e, about 18 per cent, came from services.

On the same day that Apple scaled the stratospheric peak of a trillion, Google (or more accurately, its holding company Alphabet) registered a PE ratio of 53, Amazon was in the region of 153, and Facebook, despite the debacle of July, hovered in the region of 26. Netflix, also dependent entirely on services revenue, had the most extravagant ratio of all at 157.

Obviously, the FAANG valuations are not about current earnings but about the prognoses of future growth. In the brave new world of networking driven by artificial intelligence, current figures are only very dim predictors of potential.

Yet, to paraphrase the 20th-century economist Lord Keynes, it is tough telling if these valuations represent a speculative bubble on a stream of enterprise, or a stream of speculation on which enterprise is a mere bubble. The record tax cuts enacted by the Donald Trump administration for corporations were expected to create an incentive for fresh investments. Yet the consensus today, is that their main impact has been to fuel a mass buyback of stocks by corporations.

This dubious technique of "building shareholder value" was for long regarded illegal, but was permitted in the 1980s subject to certain restraints which have weakened over time. Market valuations are in other words, driven by another magnitude that is soon going to touch the trillion dollar mark: the budget deficit.

Ten months into the current fiscal year (which for the US begins October), the Trump administration announced that its budget deficit would total a trillion dollars. An April exercise by the Congressional Budget Office had figured that the deficit would hit this psychological threshold in 2020. But revenue shortfalls and large increases in discretionary spending have brought that date much closer.

In a giant economy like the US, other magnitudes of a trillion are not hard to find. Outstanding student debt in 2018 is estimated at $1.5 trillion, second in magnitude among loan categories only to housing mortgage. And as with the housing market, borrowers are increasingly finding themselves saddled with negative equity. Having acquired an education at a high cost, they are finding that the jobs market does not value it in commensurate terms.

The FAANG valuations represent an expectation of the future. Yet with only half of all US nationals owning stock and the wealthiest 10 per cent owning over 80 per cent, these expectations do not quite offset the debt magnitudes, which are a burden of the past.

Dealing with these growing imbalances requires new thinking

Dealing with these growing imbalances requires new thinking, not the recycling of discredited nostrums. It calls for a steady hand at the tiller, not one driven by the impulse of the moment. Above all, it requires a climate of confidence that nations will honour their commitments, not tear up solemn trade agreements and financial arrangements to appease a momentary whim.

For all the froth in the markets which it touts as evidence of success, the Trump administration's actions against Iran and Turkey, and the salvos it continues to fire in an escalating trade war with China and Europe, suggest that the euphoria will be short-lived.

SUKUMAR MURALIDHARAN teaches at the school of journalism, OP Jindal Global University, Sonipat