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Dotcon

"We've all heard that a million monkeys banging on a million typewriters will eventually produce the entire works of Shakespeare. Now, thanks to the Internet, we know this is not true."

- Robert Wilensky (attributed).

It's difficult to say precisely which was the most fatuous dotcom era business debacle. The turn of the millennium was a target-rich environment. The short-lived Webvan (online grocery) was pretty notorious, so it's interesting to see some Goldman alumni attempting once again to push water back uphill with Ocado. Pets.com (online petfood delivery) was also pretty facile, and it had a talking sock puppet mascot to boot. Boo.com (online fashion) showed that Americans did not have a monopoly on torching easily raised venture capital. The era also gave rise to a particularly radical business model: lose money on every sale, but make up for it in volume. So the inexplicable popularity of LinkedIn's recent IPO will prompt uncomfortable (or simply hysterical) memories on the part of those of us who lived through dotcom insanity the first time around. As far as this writer can tell, as a (free) user of the site, given the extent of unsolicited linking requests from complete strangers that it generates, the sole purpose of LinkedIn is to act as a rather grubby white-collar introduction service. Perhaps somebody, somewhere has gained commercial benefit from this lonely nerd referral tool, but one somehow doubts it.

But then there's no accounting for taste (or lack thereof). The FT quoted somebody from an anonymous-sounding wealth management firm:

"To some extent, investors are buying LinkedIn because they cannot get into Facebook. People are just desperate to get into social media."

Which is a bit like saying that people are determined to roll around in pig excrement because they cannot get enough horse excrement. One can hardly blame the underwriters (Bank of America Merrill Lynch, JP Morgan and Morgan Stanley) for selling people what they want, although it does seem like a short time for memories of the last toxic waste mis-selling scandal to have abated. One can blame the underwriters, albeit perversely, for having left so much money on the table. As the FT also reported:

"At their high on Thursday, LinkedIn's shares were trading at $122.69, up 173% on the $45 IPO price. At that price, it was valued at $11.6 billion, nearly quadruple it value at the beginning of the week when bankers put a price tag of $32-$35 on the shares."

Whatever one thinks of the fundamental value of the business (if any), the responsibility of the underwriter is to get the best price for the founders. In this, they conspicuously failed, which rather makes one wonder whether they deserved anything by way of underwriting fees when an unintermediated electronic auction would surely have delivered the goods. So much for the health of the free market in 2011.

The SuckedIn phenomenon does give rise to somewhat darker concerns, given the proximity of the first wave of dotcom disasters to the broader stock market collapse that occurred shortly afterwards. Overhyped travel website Lastminute.com managed – just – to squeeze through the IPO window on the 13th March 2000. Lastminute's stock price reached its high at launch, of 487.5p. Within 18 months it had fallen by 96%, to just 18.75p. Sadly, exploding dotbombs led the way for the wider stock market; the FTSE All Share halved between 2000 and 2003.

History may not repeat itself. But it may try. Unfortunately, monetary policy fundamentals are not as encouraging this time round. Back in 2000, the UK base rate stood at 6%. A marginally accommodating Bank of England trimmed them to 4% in 2002, and to 3.5% a year later. But this time, base rates already cower at the rock bottom level of 0.5%. They can only go higher – provided the Bank of England grows some guts. In the meantime, optically super-accommodative policy rates are inevitably triggering malinvestment, whether by corporations or individuals. Because actual deposit rates are also wafer thin or invisible, investors are understandably crowding into the stock market in the hope of salvaging something from their capital during inflation's reign of tyranny at circa 5%. But a Hobson's choice is in reality no choice at all. A stock market widely perceived as the only game in town may not be the most stable of asset classes when the tide goes out.

A summer sell-off in the UK equity market would hardly be an implausible outcome, given that the FTSE 100 currently seems anchored at the 6,000 level. But at least valuations seem reasonable. The UK market trades on a current price / earnings of 14.5 and prospectively stands at 10.5 (subject to the relevance of analysts' forecasts). Valuations in the US would seem stretched, though, with a number of commentators highlighting an estimated 40% overvaluation relative to the 10 year smoothed p/e. The US gets no buffer from dividend yields either, with the S&P 500 offering a puny 1.86% to the FTSE's 3.24% (and with plenty of individual value stocks yielding demonstrably more). CLSA consultant and market historian Russell Napier goes further, suggesting that a longer term target for the S&P 500 would be 400 (compared to c. 1300 today) – an effective decline of roughly 70%. Napier makes the point that the cyclically adjusted p/e of the market at its low in 2009 never remotely approached historic lows and so the market never became compellingly cheap; central bank intervention meant that reality was postponed. He makes a behavioural point too: "apathy is what actually determines the bottom of a bear market" – when investors have simply written off any remote interest in owning stocks. What we saw in March 2009 was a degree of despair, perhaps, but certainly not apathy:

"The most remarkable thing to me two years after the event [the March 2009 interim low] is just how much people want to play."

Napier concedes that in large part this is because the likes of Ben Bernanke have been bribing them to play. And as he wrote in a recent commentary:

"..whether equities will fall further depends on how flexible and successful the Fed's next monetary package will be. Given the risk, investors are better off watching from the sidelines.. A risk to reflation would send equities sharply lower. The failure of QEII will undermine investor faith in a monetary solution. With equities near bubble valuations, based on cyclically adjusted p/e, a failure to reflate risks major downside. The Fed will try again with a new package, but investors would do best by waiting to see how it plays out."

Note that there is no reference to anything like economic fundamentals or corporate earnings. We are all trapped in a monetary game of Ben Bernanke's making, not dissimilar to 'chicken'. And as Jeremy Grantham recently confessed, he no longer feels obliged to play slavishly by the Fed's rules.

Comstock Partners (in 'An ominous looking market top') recently highlighted eight major concerns:

- Massive US government and household debt
- The anticipated ending of QE2 on June 30th
- The anticipated tightening of fiscal policy (not a minute too soon if it does come)
- The ongoing EU sovereign debt crisis
- The risk of a Chinese economic overheating
- The health of post-quake Japan
- Middle East turmoil
- Soft US economic conditions absent yet more government stimulus.

None of which is new news and much of which transcends conventional debate about valuation. But the implications of all the commentary and commentators cited above are plain: equity markets are not conspicuously cheap relative to the known threats, those of the US least of all. Anyone arguing to the contrary is likely to belong to the sort of Wall Street sell-side firm that has just floated a glorified online rolodex at 578 times its 2010 earnings.

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