Financial Markets Update

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Four Popular Stocks

The financial markets currently award high valuations to companies that are currently losing money or have little income or cash flow relative to the valuations on their businesses.

Tesla (TSLA) has reported $13.0 billion of revenue during the last 12 months with a corresponding net loss of $2.6 billion. Although it has total liabilities of $22.6 billion and $3.9 billion in stockholders' equity, Elon Musk stated on the conference call today that there would be no need to raise additional capital and that the company's goal was to be profitable in every quarter going forward. His comments were enough to boost the stock price 16% despite a loss for the second quarter of $717.5 million. The company currently has a market capitalization of $51.0 billion.

Netflix (NFLX) has shown a profit of $989.6 million during the last 12 months ending June 30, 2018. However, the company continues to spend a significant amount of cash on new content for subscribers. During the last 12 months, cash from operating activities was negative at $1.66 billion. During the last 4 years, the company's total liabilities have increased by $13.5 billion to $18.2 billion. How much longer the company's negative operating cash flow will be financed by higher levels of debt remains to be seen. The company has a market capitalization of $150 billion.

Twitter (TWTR) has finally turned a profit in the first two quarters of this year after recording net losses since inception through 2017. The company has not relied as much on debt as some of the other companies mentioned here as they have raised additional equity capital in recent years. As of June 30, 2018, TWTR had $2.56 billion of long-term debt and $5.57 billion of shareholders' equity. In the first 6 months of 2018, TWTR had net income of $161.1 million and is now able to generate positive cash flow. However, the current market capitalization of $24.9 billion (after a 26% price decline since July 25) continues to reflect great expectations for the future.

Amazon (AMZN) is currently profitable and has reported net income of $6.3 billion during the last 12 months ending June 30, 2018. Based upon the earnings of the past 12 months, AMZN has a price/earnings ratio of 145. Again, great expectations are priced into the stock.

None of the four stocks above pays a dividend. Improvement of their balance sheets is likely to be a high priority for the companies instead of paying a dividend to shareholders during the next ten years. In the case of these companies, media attention appears to be the primary reason for high stock prices as the market has priced in dramatic earnings growth for many years to come. Our model portfolios steer away from such stocks with an emphasis on funds that hold stocks at more reasonable valuation levels. Some of the funds such as Vanguard High Dividend Yield ETF (VYM) and Wisdom Tree International Small Cap Dividend ETF (DLS) hold only companies that are paying a reasonable dividend. In the long run, we believe that this is a better strategy than trying to anticipate changes in the arguably irrational behavior of speculators.

Fed Update

The Federal Reserve Open Market Committee (FOMC) released a policy statement on August 1 that maintained the status quo for now. The FOMC voted to maintain the fed funds rate within a target range of 1.75 – 2.00%. The FOMC also directed their trading desk to reduce their balance sheet by $24 billion of US Treasury securities and $16 billion of mortgage-backed securities each month as securities matured. Thus, the Fed's assets are scheduled to decline at a pace of $40 billion per month.

The era of easy credit has created some potential problems for the financial markets and the economy. Since the financial crisis of 2008-2009, we have seen a heavy reliance on debt issuance by corporations for share buybacks, acquisitions, and other activities. Little of the debt issuance proceeds has gone towards building productive capacity.

Since the end of 2010, corporate debt of nonfinancial companies has increased 49.6% to $9.06 trillion. During the same period, US nonfinancial corporate profits increased 23.2% to $1.25 trillion. According to the New York Times, in 2007, 27% of the total value of bonds issued by companies in the S&P 500 Index were rated BBB, the lowest bracket for investment grade bonds. Today, 50% of the market value of bonds issued by S&P 500 companies have a BBB rating.

The Fed is currently projecting a fed funds rate of 3.0% by the end of 2019. Although the Fed's public statements regarding the current policy of gradual increases in short-term rates focus on inflation and employment, they must be concerned about the economic stimulus of large federal budget deficits and the and the negative consequences of corporate debt issuance that were encouraged by the Fed's past policies of abnormally low interest rates.

If you have any questions or comments, please contact me.

Sincerely,
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