opinion

Will America's internet giants prove to be toothless?

The next few years are likely to be less friendly to Facebook, Amazon, Apple and Google

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THE GLOBALIST

For several years, the stocks of America's Internet giants — Facebook, Apple, Amazon, Google — have been the way to make money. And yet, for all their past prowess, these four companies all have major weaknesses in their business models that are becoming increasingly apparent.

They could thus be destined for a replay of the 1999 dot-coms, the 1972 Nifty Fifty, the 1929 Investment Trusts or the 1720 South Sea Company.

Facebook

To begin with Facebook, we learned that Facebook intends to set up its own "Supreme Court" to police "hate speech" on its service. This may suit Mark Zuckerberg's dreams of world domination, but it in no way represents what a private corporation ought to be doing.

At the core of the problem is Facebook's ability to scoop up private information on people and sell it to third parties, or indeed use it itself in pursuit of some nefarious non-economic goal.

When Facebook started, it appeared to be largely a means for teenagers to communicate, which could be monetized through advertising, but as it has grown its sinister potential has more clearly appeared.

There simply is no solution to Facebook's censorship problem. In a traditional media environment, a wide variety of media outlets use the skilled judgment of journalists with decades of experience to decide what to print. If they got it wrong, their publication lost subscribers and money.

Not so with Facebook. It is effectively a monopoly. There is no way it can censor the news without becoming Pravda. Unfortunately, for all of Zuckerberg's soothsaying, under his leadership, becoming Pravda appears to be Facebook's ambition rather than its fear.

The only solution would be to break up Facebook into half a dozen competing outlets, each with a different political outlook, thereby reproducing a healthy newspaper environment, like in the United Kingdom several decades ago.

Alternatively, de-globalization may result in entities like the European Union imposing revenue-based taxes on Facebook. Over time, this could lead to "clean/er" national equivalents and a dissipation of Facebook's power by this means.

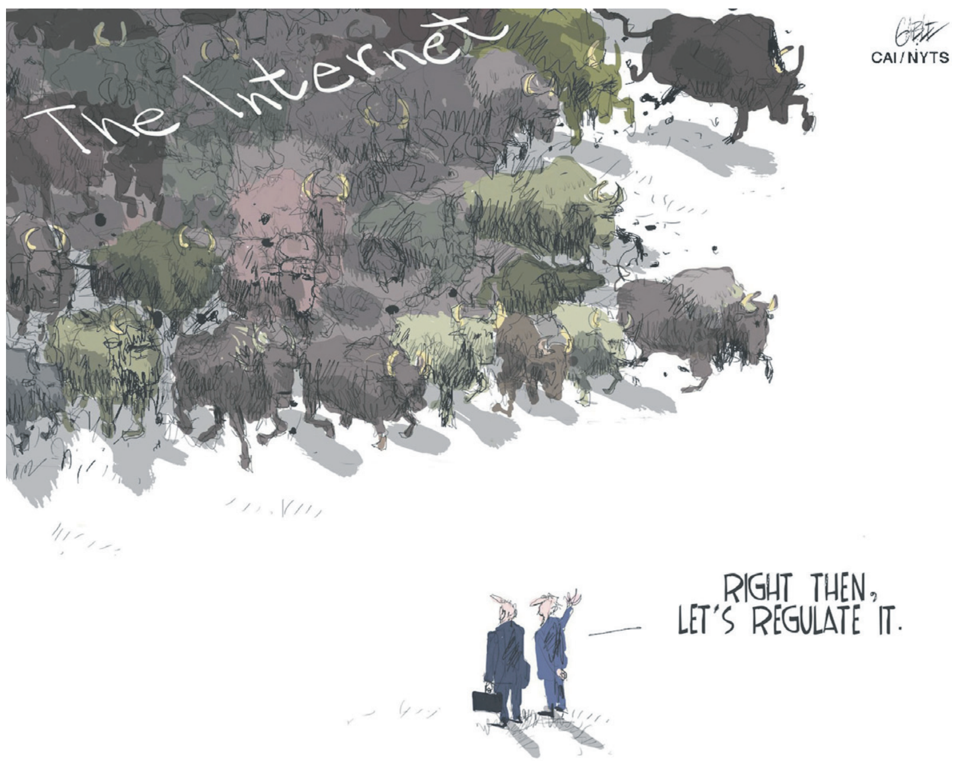
Either way, Facebook's monopoly power will not last, and its revenue generating capacity will be correspondingly diminished. Its business model is broken.

Amazon

Amazon is really two businesses. One of them, Amazon Web Services, is the leader in providing cloud services to businesses and consumers. It is a sensible business and has a good market position.

However, in 2017 it had only $17.5 billion in revenues and an operating profit of $4.3 billion. That's a nice business, worth about $150 billion if you give it a generous multiple of 35 times earnings, appropriate given its growth.

The problem is the rest of Amazon's business. In 2017, after 23 years in business, it still made an operating loss of about $1.3 billion, even though it had revenues of around $160 billion.


The Internet
CAI/NYTS
RIGHT THEN, LET'S REGULATE IT.

Even though Amazon has in the past benefited from huge subsidies in not charging state and local taxes (and still has a huge cash flow benefit from paying its state taxes later and not charging local taxes), a most astonishing fact remains: Its entire retailing operation, is still not profitable.

Yet, given that the web services business is worth around $150 billion, one has to wonder why its retail business is valued at $500 billion. For what? It's no good saying it is valued for its growth potential. Retailing is a notoriously low-margin business. Moreover, Amazon already represents over 40 percent of online sales. In other words, there is not much for it to expand.

With U.S. President Donald Trump threatening the company's sweetheart crony deal with the Post Office, which gives it postal rates some 40 percent below market, according to a Citigroup report, and comes to an end in October, the company's margins are unlikely to grow, even if it gets another point or two of market share in the retail market.

Given that hard reality, its share price is hopelessly over-inflated. In addition, the pains of its deflation may make it difficult for Amazon to sustain its expansion program and its heavy long-term debt. Amazon's business plan was initially brilliant, but it has failed to mature into a profitable, sustainable economic entity.

Apple

Apple is the oldest of the giants. In its early years, it had an excellent business with Steve Jobs for design and Steve Wozniak pushing the technological envelope, first developing one of the first usable personal computers, then adapting Xerox PARC technology to produce a personal computer, the Macintosh, that was far easier for non-technical types to master.

Then, after a lost decade, in which products like the Newton hand-held device failed because of poor design, Jobs returned to Apple and proceeded to produce a series of superbly designed products that in some cases, notably the smartphone, were truly paradigm-altering.

Sadly, Steve Jobs died in 2011. After his death, Apple has shown itself incapable of more than incremental product improvement. At the same time, his successor as CEO, Tim Cook, has concentrated on "non-entrepreneurial" maneuvers, such as tax-optimizing Apple's operations, growing its political influence and maintaining or increasing margins on each new "generation" of Apple products.

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Apple's politicization has already run into trouble; Apple was one of the chief targets of Trump's tax reform, intended to prevent companies piling up hundreds of billions of dollars in offshore tax havens.

With product innovation slowed (partly by technological factors such as the senescence of Moore's Law) and Cook's creative use of tax havens and intellectual property increasingly under attack, Apple's rating is far below that of the other giants. Its future must be in serious question, although with all that cash its survival is assured at least for the medium term.

Google

Finally, Google, which is now controlled by a holding company, Alphabet Inc., Google shares Facebook's strategic problems.

First, it is heavily dependent on the digital advertising business, in which Facebook and it hold a duopoly with around a 60 percent market share. The advertising business is highly cyclical, and it's unlikely that digital's share of the total business will grow significantly further.

Second, like Facebook, Google relies for much of its profits on scooping up endless information on its consumers, which comprise more or less the entire population, and using that information for legitimate or nefarious purposes.

As consumers become more aware of the uses to which their personal information is being put, they will erect more sophisticated defenses against its improper use, devastating Google's profit potential. Like the other three giants, Google has a fundamentally flawed business model.

In the past decade, because of artificial ultra-low interest rates worldwide, the Schumpeteran process of creative destruction has not operated properly. This has allowed the giants to grow to an enormous size, without correcting the flaws in their respective business models and practices. The next few years are likely to be very much less friendly to them.

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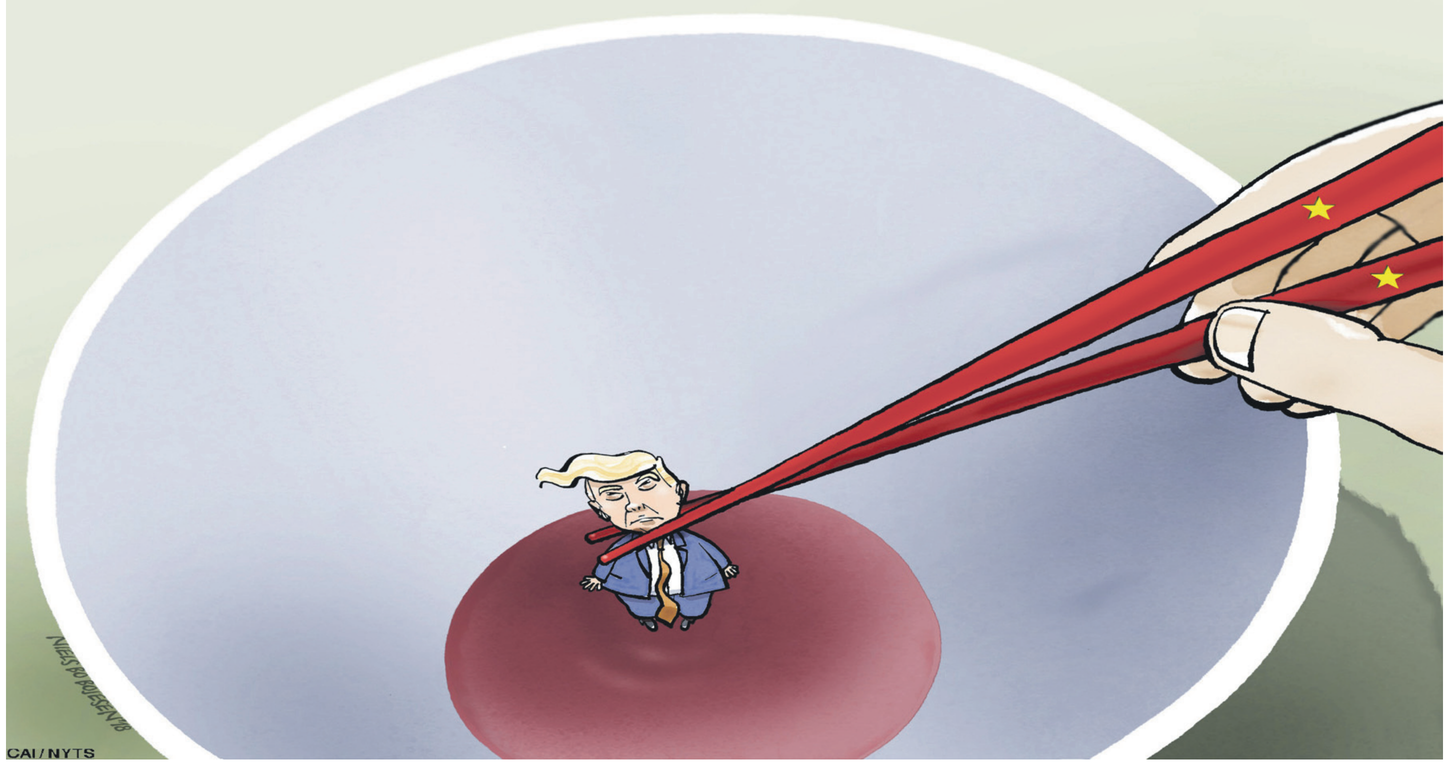

In trade dispute, China has a secret weapon

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Markets are quivering as fears of a U.S.-China trade war ebb and flow. Thus far, they've mostly been focused on tariffs that U.S. President Donald Trump wants to impose on a range of Chinese goods, and China's threats to retaliate. But investors may be overlooking a bigger risk in this dispute.

It's true that duties on U.S. imports would hurt — hands are already wringing in farm country — but there's a limit to how much pain they can really inflict. The persistent worry that China will dump its mammoth holdings of Treasury bills is probably unfounded as well.

The risks for U.S. firms already operating in China, however, could be significant. Here Beijing can stab at the soft underbelly of a wide range of American companies, from Apple Inc. to General Motors Co. to Starbucks Corp. Although these companies have well-established brands, sizable businesses, and strong connections to Chinese consumers, they could still face serious harm if Beijing wants to turn up the heat on Trump.

In some cases, such as automobiles, these companies have been effectively forced to produce locally by China's trade policies. In others, the nature of the business makes it necessary to be close to Chinese consumers. Whatever the reason, tariffs will have a minimal impact on many of these U.S. operations.

GM offers a good example. It has imported a mere 150 Camaros from the United States into China this year; the rest of the cars it and its partners have sold — more than 986,000 in the first quarter alone — were manufactured on the ground. If China really wanted to pressure a company like GM, it would have to resort to methods other than import barriers.

What might that look like? For one thing, bureaucrats wield tremendous control over the life and death of companies in China. Holding up the dizzying array of permits and licenses required of businesses would be one way to slow the expansion of American competitors in the Chinese market.

A more powerful — and potentially devastating — weapon would be a boycott of U.S. products. Beijing has used such campaigns in past disputes, sometimes with catastrophic consequences.

Six years ago, amid rising tensions with Japan over a batch of disputed islands, China used state media to rile up protesters, who attacked Japanese cars and businesses. Sales of Toyotas, Hondas and Nissans all plunged as a result.

More recently, China tried to pressure South Korea into ditching a U.S. missile-defense system that Beijing perceived as a threat. It blocked K-pop stars from the mainland, Chinese firms boycotted Korean products, and Korean businesses withered under the strain. In 2015, Hyundai Motor Co. was the third-most popular passenger vehicle brand in China, with 5 percent of the market; last year, its share had slipped to 3.1 percent, ranking Hyundai 11th.

You might argue that pressuring U.S. companies in this manner could backfire. After all, those companies employ a ton of people: GM (including its joint ventures) has 58,000 workers in China. But Beijing has previously shown that it's willing to absorb such costs to meet its strategic goals. Amid the anti-Korea campaign, Kia Motors Corp. reduced the working hours and pay of its Chinese employees as sales sunk.

In the current dispute, China has so far kept this sword in its scabbard, possibly because it wants to present its response to Trump's tariffs as reciprocal. Because of the imbalance in U.S.-China trade, however, there's a limit to how much Beijing can match Trump's tactics with tariffs alone. There are only so many American imports to tax. If the authorities choose to go after U.S. companies in China, they can whip up protests and boycotts at the drop of a Nike cap.

The fallout could be significant, and should seriously concern American executives. Imagine what would happen to GM if its sales in China — which represent more than 40 percent of its total — fell in similar proportion to Toyota's in 2012. Or if Starbucks, which is opening a new store in China every 15 hours, saw its coffee shops ransacked by protesters.

Hopefully, things won't degenerate to that point. But in their apparent naivete, Trump and his advisers have stumbled into a wrestling match with an authoritarian state capable of rallying far more public support for its positions than Trump could in a divided, democratic America. That's what investors should really worry about.

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How central banks should and shouldn't tackle global warming

Monitoring the impact of climate change is sensible, but tipping the scales is dangerous

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Central bankers have been dubbed "masters of the universe" for the tools and powers they have acquired since the financial crisis. Some of them now want to play a more active role in the fight against climate change.

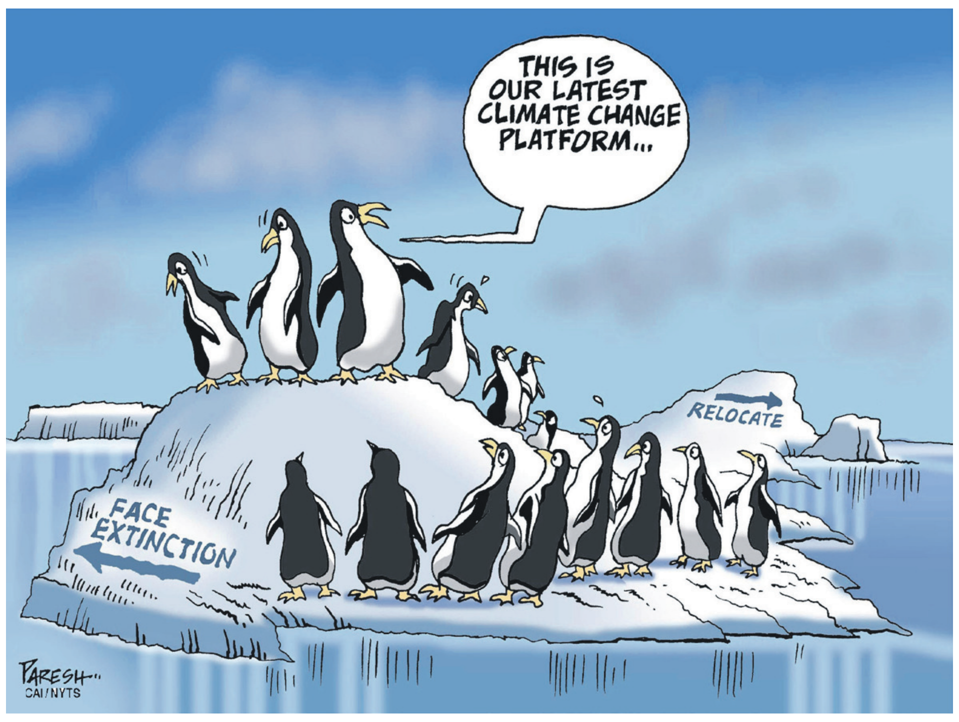
Monetary authorities are right to be mindful of the way in which climate risk affects their mandate to ensure price stability and guard financial stability. But that is different from seeking to promote the shift to a "greener" economy, which is the role of government.

Earlier this month central bank governors from the United Kingdom, France and the Netherlands met in Amsterdam to discuss how to adapt regulation to the risks posed by climate change. Together with five other institutions (from China, Germany, Mexico, Singapore and Sweden), these central banks have formed the "Network for Greening the Financial System" (NGFS). This group has two objectives: sharing and identifying best practices in the supervision of climate-related risks, and enhancing the role of the financial sector in mobilizing "green" financing.

The first is entirely reasonable and consistent with the central banks' traditional role. As Francois Villeroy de Galhau, governor of the Bank of France, said in a speech at the conference, "Climate stability is one of the determinants of financial stability." It is only right that financial supervisors take an interest in what is going on.

The clearest example concerns the regulation of insurers: Climate change has made extreme weather events such as hurricanes more frequent. Regulators must ensure that the industry updates its models and sets aside enough capital to deal with these growing climate-related risks.

To do so, central bankers may need to extend the supervisory horizon beyond their usual time span. Climate change may only pose a threat for the balance sheet some years down the road, but these risks should be assessed now. Villeroy de Galhau argued in his speech that the financial sector should move toward "a compulsory transparency requirement," so that companies are forced to provide a snapshot of their climate-related risks. It's an idea supervisors around the world should embrace.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FACE EXTINCTION
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The idea that central banks should promote "green investment" — which the central bank group also endorses — is more problematic. For a start, the goal could conflict with the main central bank objective of preserving financial stability. For example, if a bank loan to a company which produces renewable energy is given a lower risk weight than now just because it is "green," then supervisors would be giving banks the wrong incentive to load up on such assets. To his credit, Villeroy de Galhau said he would be against giving "green" assets a lower risk weight when establishing capital requirements — though it's an idea which the European Commission is currently looking at.

But the French central banker said he would be in favor of giving higher risk weights to "brown assets," which contribute to polluting the environment. He added that these could be included in the so-called "Pillar 2" requirements — which are set independently by supervisors. This plan would make "brown" assets dearer to hold in relative terms, but would not change the risk weight which is attached to "green" assets. The idea is that "brown" assets would become riskier as the world moves toward a low-carbon economy.

The problem with this idea is that it requires more speculation than central banks should be tasked with. What if this shift to a low-carbon economy happens more slowly than anticipated or does not happen at all? Another problem is deciding where to draw the line when it comes to central banks nudging economic actors along: Should central banks also then impose higher capital charges for loans to the gun industry just because they expect that at some stage there will be curbs in a country such as the U.S.?

In "promoting green investment" a central bank would risk overstepping its mandate. By choosing to treat bank loans differently depending on their green credentials, a central bank could also be accused of distorting competition in the economy.

This accusation would be particularly dangerous given the backlash central banks are facing. Over the last decade, monetary authorities have pushed their toolkits to the extreme. As a result, they have come under closer scrutiny from voters and politicians, who have questioned their independence and demanded greater accountability. The last thing central bankers need now is to suggest they are seeking to influence policy that should rightly be the preserve of elected officials.

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