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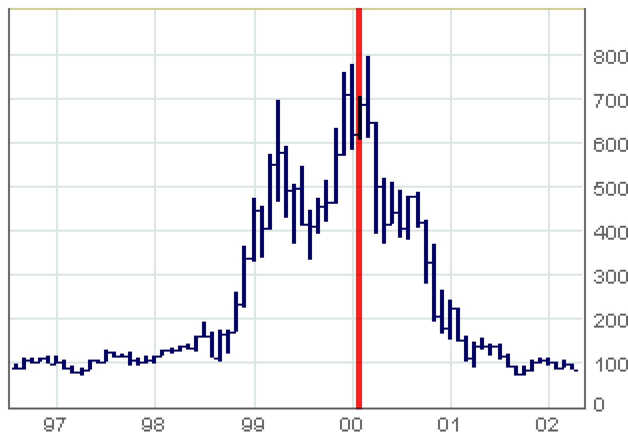
Donald Luskin

When **America Online** and **Time Warner** announced their intention to merge on January 10, 2000, I wrote that the merger would mean the end of the great bull market in Internet stocks. AOL was the Internet company that started the online revolution, and its stock set the *double, split, double again, split again* pattern that defined a remarkable investing era. But the merger signaled that the dream of limitless growth prospects and limitless stock prices was ending. If merging with an exhausted old-media conglomerate was the best strategic idea that AOL could come up to spend its superlatively valued stock currency, then it was obvious that the time had come for the market to take away the value of that currency.



Indeed, just a month after the merger announcement, the bull market in Internet stocks topped out. Today the value of the average Internet stock is about 15% of what it was when the AOL Time Warner merger was announced. This wholesale collapse in investment value is reflected in all its epic tragedy in AOL's history-making $54 billion goodwill write-down announced yesterday.

But it is reflected even more tellingly in terms of valuation. When the merger was announced, AOL's market capitalization was $180 billion, and its forward price/earnings ratio was 224 (based on consensus earnings estimates). When the merger was announced, its terms valued Time Warner at $150 billion, implying a forward p/e of 69.

Today the combined company's market capitalization is $86 billion. Its forward p/e is 22.

In other words, now AOL is just another large-cap multinational with a market multiple. And based on the conference call last night, this is just another company with nothing to say as it struggles to keep its already dramatically lowered forecasts in place against the backdrop of an economy that doesn't seem to be recovering very robustly. This is what techstocks look like when the dreams finally die. It looks like hell.

Growth investors have struggled to keep their dreams alive this earnings season as, one after another, former high-fliers like **Intel**, **IBM** and **Microsoft** have announced results that met or beat low expectations -- and they only did so by means of severe cost-cutting. At the same time, these companies have guided flat to lower, and have generally been willing to make only the most tentative and qualified recovery forecasts. In each case, the day after the earnings announcement the stocks have rallied as die-hard techstock investors tried to tell themselves

"the worst is over" stories. And now, each of these stocks has fallen back to its pre-announcement levels, and the NASDAQ is scraping at new lows for the year.

What makes techstocks so resistant to recovery is the fact they are not just struggling against the normal cycle of creative exhaustion and renewal that is their glorious -- if risky -- hallmark. No, the road to this techstock hell is paved with **Alan Greenspan's** good intentions. By cranking up interest rates in 1999 and 2000 to burst a what he saw as an "asset inflation" bubble -- just when the technology and investment cycle was probably cresting anyway -- Greenspan turned a healthy correction into a catastrophe, and crippled the economy's ability to take the kinds of risks necessary to renew the cycle of growth.

As **Trend Macrolytics chief economist David Gitlitz** put it on Tuesday, "The risk premium in the cost of capital remains at levels inhibiting not only the resumption of robust rates of high-tech capital investment. The high price of risk continues to stand as a direct impediment to the financing of innovative and entrepreneurial enterprise that is the lifeblood of any economic expansion" (see "Where's the Risk?" April 23, 2002).

We expect that Friday's preliminary first quarter GDP numbers will be strong, based on nothing more than last year's record inventory liquidation. The recovery headlines will give techstock investors another chance to dream. But even as technical signs of recovery in the overall economy command the headlines, corporations and individuals are not willing to risk the kinds of investments that would spell a return to sustainable growth for technology companies.

Techstock investors are probably starting to get the hint. The forward p/e for the S&P Information Technology sector now stands at 33, sharply down from a record 50 in December 2001 at the height of "super-V" recovery mania (matching the record set at the top of the so-called bubble in March, 2000). This move back toward sensible valuation has driven strong gains in our tactical asset allocation Model Position in which we suggested selling technology stocks and replacing them with long-term Treasury bonds, and we've now suggested reducing exposure to that position (see "Mind the Gap" April 24, 2002).

There's still a long way to go. The technology sector's p/e of 33 is still well above the long-term norm of 19 -- and still well above even the 27 level reached at the capitulation bottom of April, 2001. But now we can at least begin to see the general outlines of what an appropriately valued market for techstocks would look like. Once again, AOL leads the way to the future. TM