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The Effect of Stock Market Prices

The price of stock of a company is supposed to reflect fundamentals of the company. Ideally the price of stock would be some approximation of what the future dividends, holders of stock would get. However, we do not live in an ideal world. We live in real world and real world rarely seems to cross path with ideal scenario. The prices of stock do have an effect on the economy. The effects are far from self fulfilling prophecies as many buyers of stock would like them to be. High prices of stocks quite often, if not always create conditions for making the fundamentals of the company worse. Low prices on the other hand frequently make the fundamentals of the company better. We would illustrate both cases with examples.

Take the case of technology boom that happened close to year 2000. There was general over optimism with anything related internet. Specifically there was a hope that demand for bandwidth to carry internet traffic would explode exponentially. It was hoped that anybody who caters to this demand would get traffic on their network and thereby would make tons of profits. So, the share prices of the companies making networks to carry this traffic increased. Even share prices of companies which only announced such plans also increased. Not only that anybody who came up with a plan to invest in new network of their own could easily raise capital from venture capitalist and then cash out after some time with an IPO. At least that was the plan. However, in all this euphoria there was a lack of discipline and no body looked at real demand. No body looked at cash flows or even looked at the excess capacity that was created. The result was that if X capacity was needed 10X capacity was brought creating a glut. The prices for the bandwidth plummeted. Nobody was able recoup even their costs. Not even the companies who entered the market first, since the pay back times were long and prices nose dived. These networks were sold at a huge discount. Some $30 billion in international telecommunications infrastructure owned by United States companies was sold to foreign-owned entities from 2000 to 2004 for a total of about $4 billion. SingTel bought Global Crossing's $10 billion network for about $250 million.

Low stock prices also tend to improve the fundamentals of the company, though the positive effects of low stock prices are not as big in magnitude compared to negative effects of high stock prices. The low metal prices in the 80s and 90s made capital raising difficult for metal stocks. So the growth in capacity for metal production was muted. Even the capacity to increase the capacity was limited. So when Chinese demand became substantial in comparison to world capacity and continued to grow at high rates there was no easy way in which capacity could be increased. This lead to much higher prices for all the industrial metals. As the costs remained almost same the profits increased many times. The stock prices of the major metal producers like BHP and Rio Tinto went up 8-10 times during last eight years. In year 2000, at the height of the tech bubble nobody expected that to happen. The fact that nobody expected it to happen was one of the enablers for this rise in profits. As scarcity of capital ultimately lead to slow expansion in capacity and high prices.

It seems ironic that high stock prices relative to fundamentals lead to worsening of fundamentals while sometimes low stock prices are instrumental in improving the fundamentals of the company thereby increasing the stock price. Apart from the change in fundamentals caused by high and low prices there are also a question of expectation. High stock prices mean high expectation which is inherently difficult to fulfil. Just above average or even good performance is not good enough. So, when high expectations are not fulfilled prices fall. Low stock prices mean low expectations which are easy to exceed leading to increase in share prices.