Tuesday, May 8. 2007

When The Music Stops

There is a saying among Native Indians "He who doesn't consider what is distant, will find sorrow near at hand". I suspect we are entering an age where, to paraphrase Douglas Casey, the inevitable is finally becoming imminent. Today's post is about a couple of trainwrecks, one that just happened which everybody could have and should have seen coming, the other is still on the rails...for now.

In the case of e-gold the hammer has already fallen, with indictments on money laundering charges being handed down and many large exchange providers having their accounts frozen.

The founder of 1MDC, (a pseudo-DGC in that it is itself backed by e-gold) once posted to a dgc mailing list that he felt his client base was safe because "if e-gold ever failed, he would simply move his users' balances to another digital gold currency", an attitude which has been proven by events, not to work when the music stops and those without chairs find that their contingency plans were contigent on having one. Now, all 1MDC users find themselves out of luck with 1MDC's e-gold accounts being seized in the indictments and there will be no flight to another DGC for their users.

Having also recently finished reading about the failure of Long Term Capital Management, I find common theme I've been encountering lately is the idea that the totality of potential failure conditions are known in advance and can thus be planned for and nullified. LTCM had early signs that their underlying assumptions may not be applicable everywhere or even valid in their original forms, yet they continued to ratchet up their leverage and diversify into more exotic trades and spreads. When things started to wrong they simply refused to acknowledge it because the things that were going wrong simply didn't fit into their models, ergo, a kind of groupwide denial set in that it couldn't be real. It wasn't until it was too late, far too late that they had to go to the fed, hat in hand, to organize a bailout.

Of course retrospect is now obvious: the time to start mitigating against an e-gold disaster was a long time ago and I hinted as much in my When Will E-gold Get Accountable? post several years ago, which earned me a lot of flames on the DGC mailing lists but got me quoted in Business Week magazine. While easyDNS is still the only ICANN accreditted registrar that accepts digital gold currencies as payment, we made it a practice to redeem our e-gold as fast as it came in. I may like digital gold as a medium of exchange, but when it comes to storing value I feel better off with the physical ingots spread around a few bank vaults.

It wasn't especially prescient of me to see trouble on the horizon for e-gold. Nor does it seem so for my favorite sparring topic in the blogosphere lately, the ridiculously overheated valuations in the domain aftermarket.

Marc Faber's market commentary this month is entitled "Is The US Economy already in Recession" makes a good case for calling the economic situation in the US recessionary.

"In fact what is interesting is that home prices have been declining at a time of even faster monetary growth. But wheras accelerating money supply has lately failed to boost home prices, faster money supply growth has continued to have some 'favorable' consequences for other asset markets".

I have long suspected the domain aftermarket has been a beneficiary of this phenomenon. Faber himself could have been referring to it when he wrote

"We are truly in the midst of a buying frenzy or buying panic during which investors collectively believe that they can play the asset inflation game until it stops and then all get out profitably at the same time."

In fact he wasn't referring to the domain aftermarket but he did go on to note that "it would seem that the global asset inflation is slowly narrowing with fewer and fewer assets still surging".

The secondary market in domains will seemingly be among the last asset class standing when the music stops but where domainers and I diverge is their belief that domain valuations will not be overly affected by a sharp asset repricing across other markets.

This to me sounds more like wishful thinking than sound economic reasoning. If one posits as a starting point for example, a sudden sharp 30% to 50% decline in the USD, any armchair economist could tell you why gold would go UP as a result. Or taking a different vector, let's say interest rates surge heavily, a logical case could be made for why the housing market would crater even deeper. These things are explainable within known economic frameworks.

Bearing in mind my core, base thesis that There is no such thing as the 'New Economy'I can't think of an economic scenario where domain name valuations would sustain or appreciate through a secular bear market in equities, a recession, stagflation or any other financial storm.

Overall ad spending will fall, not rise, cutting the legs out from under PPC, the one pillar holding up valuations that actually means anything. Nobody is going to care about "potential" future earnings of a domain name or how great a brand it could maybe someday be built into. All that is going to matter is what a domain name or website is generating in cashflow right now, and how much that cashflow will fall further through the course of the recession. Multiples will come down.

We aren't there yet. Right now we're in some Orwellian coma where inflation is undereported, GDP growth would be less than zero if it wasn't for those farcial hedonic adjustments and the unemployment rate holds steady at that magical 4.4% its been at for years (somehow those regular and frequent headlines about mass layoffs across every sector of the economy never budges that unalarming and digestable number)...and then we have the DOW at fantasy-land alltime highs, as are domain name valuations.

George Ure is always fond of saying "Better a couple years too early than a couple minutes too late", I've already sold most of my non-performing domain names, the ones that are "brandable", catchy, and full of that wonderful "potential" stuff. The ones I didn't have concrete development plans are being thinned out. I'm keeping the ones that generate cashflow and started developing the ones that don't (yet). In one exception, I have bought a name for a tidy sum, but did so for exceptional reasons (I liked it a lot, I wanted it, thought it was undervalued relative to the current parabolic valuations and it fit a development idea I've had for awhile).

Faber again puts it aptly

"If selling panics provide favorable entry points in asset markets, I suppose that buying frenzies should offer excellent exit opportunities. I would, therefore, use the current strength in equity markets around the world, which has left them in extremely overbought position, as an opportunity to sell and certainly not increase positions."

I feel the same way about the domain aftermarket, but hey, don't mind me I'm just some nutjob contrarian.

Posted by Mark Jeftovic in Tech Wreck 2.0 at 10:59

Nothing wrong with being contrarian Mark. I think there may come a correction when the global imbalances you're speaking of unwind. But the fact that even the contrarian is holding on to some domains gives me hope for a brighter tomorrow

BTW... I love this quote: "I have bought a name for a tidy sum, but did so for exceptional reasons (I liked it a lot, I wanted it, thought it was undervalued relative to the current parabolic valuations and it fit a development idea I've had for awhile)."

There are a billion other folks and companies who could say the exact same thing each day. Yet there are only 100 million ish' domains registered and supposedly all the good ones are gone.   All the better to own some good ones.
Anonymous on May 9 2007, 07:54

Related to your piece:

http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aHBopkXhEA24

Interesting quote: "Home prices continue to climb in the wealthiest California suburbs, at a much slower pace."

...still, they're rising. I think there's a lot of inflation (dollar devaluation coming). Look at the five dollar bill in your wallet... its the new 'one'. Happened in 81 when home prices doubled.. this time the Fed is not taking rates to 18% tho. Buy something.. anything. Just don't hold cash and I think you'll do fine as the world recalibrates.
Anonymous on May 9 2007, 11:33