“Short Squeeze”

Market Commentary – February 2021

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 4.0% in the fourth quarter of 2020. While this is significantly lower than 33.4% in 2020 Q3, a growth rate of 4.0% is very strong. The components of the 2020 Q4 GDP number are: consumer spending +1.70 percentage points, investment +4.06 percentage points, net exports -1.52 percentage points, and government spending -0.22 percentage point. The sum of these numbers equals +4.02%. Unemployment in December was 6.7%, which matched the reading in November. To provide some perspective, unemployment was 3.5% in February 2020 and peaked at 14.8% in April 2020. Keep in mind that the current unemployment rate is elevated because numerous key states are still relatively locked down due to COVID-19. This should alleviate in the coming months, which should help fuel further economic growth.

The Federal Reserve is “pedal to the metal” with respect to monetary policy easing to help ensure the U.S. economy exits the pandemic on solid footing. On January 21, the Federal Open Market Committee (FOMC) reiterated that its target federal funds rate will remain at 0% to 0.25% through 2023. Moreover, they will continue to grow its balance sheet by $120 billion per month with quantitative easing unlimited. As of January 27, there were $7.45 trillion in assets on the Fed’s balance sheet (curiously similar to a month ago, despite the public policy that assets will grow). Monetary stimulus is bullish for stocks in the short run, but one wonders whether there will be adverse unintended consequences from this policy down the road. The next FOMC decision on monetary policy is scheduled for March 17.

The short squeeze on GameStop stock (GME) in recent days must be watched for ripple effects throughout financial markets. Hedge funds were notoriously short GME, meaning that they borrowed stock and sold it at a (hopefully) high price, with plans to buy it back at a (hopefully) low price. Shorting is “buy low, sell high”, but in reverse: sell high, then buy low. When a stock rises in price, short investors lose money and may be forced to buy stock to “cover their short positions”. This can pressure a stock even higher (short squeeze). GME has experienced the mother of all short squeezes. The stock was at $4 per share in August 2020 ($280 million market cap). It was $20 per share by January 12, 2021, so shorts were already concerned. Then the stock exploded, hitting an intraday high of $483 on January 28, before closing at $325 on January 29. The market cap of GME is now $22.7 billion! The media claims that individual investors using platforms like Robinhood have ganged up to push the stock price higher, but it is unlikely individuals could cumulatively dedicate $22 billion to one trade. There is likely more to this story; investors with deep pockets (or perhaps even a nation) have probably contributed to the buying. Hedge funds may be forced to liquidate other positions to raise capital, which could pressure the stock market in general. It is possible that a contagion spreads throughout the entire market. History is being written.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) during 2021 is $167.01, which implies a price-to-earnings (P/E) ratio of 22.2 with the S&P 500 at 3,714. The earnings yield (E/P) of 4.50% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.11%.

With the S&P 500 pulling back from an all-time closing high of 3,855 on January 25, a correction in the coming weeks would be normal and healthy. The index is sitting at its 50-day moving average. Support should be found near 3,550 (September and October 2020 closing highs) and 3,350 (200-day moving average). Political risk is elevated, given concerns about socialist economic policies and a seemingly deep political divide in the U.S. There could be a significant black swan event brewing as a result. At the same time, the FOMC is flooding financial markets with liquidity. Absent a crystal ball, we continue to rely on maintaining a balance between stocks and cash, focusing on multi-cap value stocks.