MARKET COMMENTARY

A Frenetic Start

February 12, 2021

- A budding economic recovery and the hopes of additional stimulus drove strong returns for U.S. small cap stocks, emerging market stocks, commodity futures, and midstream energy assets in January.
- Heading into February, the rally in risky assets became frenetic, showing increasing signs of excesses and speculation.
- The sensational short squeeze in GameStop, an increase in unprofitable IPOs, and the recent trend in SPACs indicate that risk-seeking behavior has broadened.
- We recommend constructing portfolios that anticipate increased inflation and that take advantage of current opportunities while acknowledging elevated levels of risk.

Overview

A dawning economic recovery and further stimulus hopes helped drive strong returns for U.S. small cap stocks, emerging market stocks, commodity futures, and midstream energy assets in January. The rest of the major asset classes generated mixed results. Heading into February, however, the broad rally in risky assets became more frenetic as various markets took turns vying for the most remarkable and newsworthy. The competition was fierce. The U.S. stock market, as proxied by the S&P 500 Index, hit an impressive six-day winning streak in early February that took the index to an all-time high on February 8. The move pulled its price-to-earnings ratio (using trailing twelve-month reported earnings) to 39.8 times as of February 9, a valuation level only surpassed by a brief window of time at the end of the tech bubble.[1] Valuations based on more commonly quoted operating earnings are lower, at 26.9 times, but they are still extremely elevated.[1] Credit markets are similarly priced for near perfection. On February 8, the yield on the Bloomberg Barclays U.S. Corporate High Yield Index dropped to 3.96%, the lowest level in history.[2]

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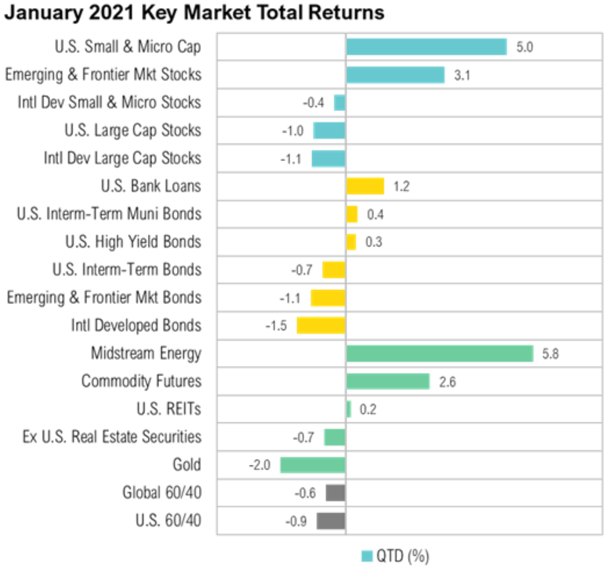
January 2021 Key Market Total Returns



Source: Bloomberg

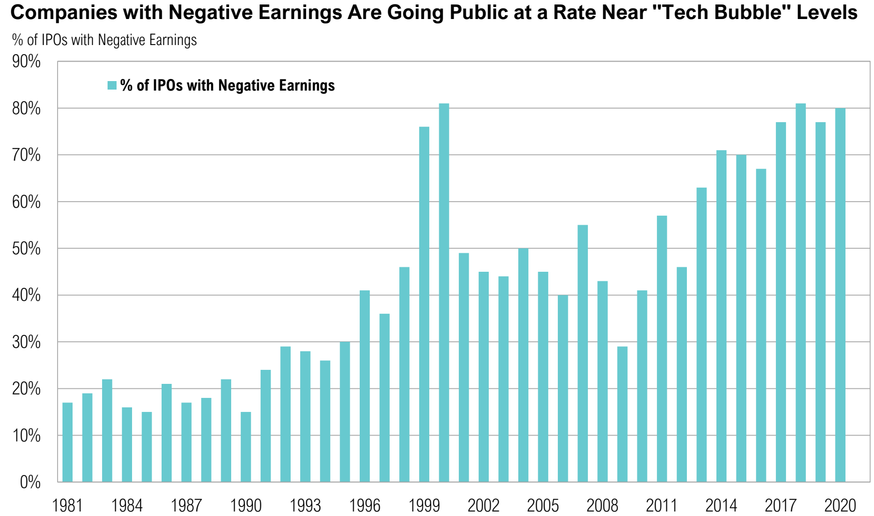
GameStop and the broader “meme stock” trend is the product of a perfect storm of conditions: vast online communities connected through social media, the rise of commission-free online stock trading platforms, and a global pandemic that has left people stuck at home with more free time on their hands.

Under the surface, capital markets tell an even more astonishing story. In January, several so-called “meme stocks” sparked a revolution of sorts.[3] The top performing of these was short-squeezed GameStop, which jumped 1,625% and consequently gained the attention of high-profile figures, including Treasury Secretary Janet Yellen, Representative Alexandria Ocasio-Cortez, Senator Ted Cruz, and internet celebrity David Portnoy. Even the White House responded, with a comment from press secretary Psaki saying key officials were “monitoring the situation.”[4] A congressional hearing on the incident is scheduled for February 18.[5]

The meme stock trend is the product of a perfect storm of conditions: vast online communities connected through social media, the rise of commission-free online stock trading platforms, and a global pandemic that has left people stuck at home with more free time on their hands. GameStop resembles several other short squeezes in which traders launched a coordinated buying raid on the stocks of companies that were contending with an unusual amount of short-selling (the percentage of the company’s total market capitalization that has been sold short). These raids in turn overwhelmed the supply of shares available to buy, leading to rapid price increases. As GameStop proved, these squeezes can be stunningly effective; however, once the online mob loses interest and moves on, these stocks generally decline in price equally impressively. As of market close on February 9, GameStop was trading at $50.31, a 90% decline from its intraday high of $513.12 on January 28. According to Bloomberg, GameStop is expected to post negative earnings of $136 million on an adjusted basis in 2021.[6]

January was the busiest start to the year ever for initial public offerings (IPOs) with $63 billion of equity raised. IPOs have been increasingly launched by money-losing companies.

Companies with Negative Earnings Are Going Public at a Rate Near "Tech Bubble" Levels



Source: University of Florida (Jay Ritter)

There are more examples of frenetic behavior. According to Bloomberg, January was the busiest start to the year ever for initial public offerings (IPOs) with $63 billion of equity raised.[7] According to data compiled by University of Florida professor Jay Ritter, these IPOs are also increasingly launched by money-losing companies. In 2020, over 80% of IPOs lost money in the twelve months leading up to their offerings.[8] The IPO boom has been helped by a record $26 billion of issuance by Special Purpose Acquisition Companies (SPACs), commonly referred to as “blank-check” companies. The frenzied issuance has continued into 2021. For the year to date through February 10, 131 SPACs have gone public and raised $38.3 billion.[9]

SPACs have been around since the 1990s, but have only recently become popular with larger investors. At their best, they are an efficient way for private companies to tap public markets for liquidity without having to navigate the costly and onerous IPO process. Recent SPAC announcements include Shaquille O'Neal's Forest Road Acquisition Corp., which plans to take the Beachbody fitness brand public. On February 5, former Yankees star Alex Rodriguez filed to raise up to $575 million for a SPAC called Slam Corp., which will seek out acquisition targets in the "sports, media and entertainment, technology, and health and wellness industries."[13] More recently, on February 9, it was announced that Colin Kaepernick would raise $250 million for Mission Advancement Corp., which intends to acquire a company at "the intersection of consumer and impact."[14] In addition to the uptick in hazy yet grand pronouncements like these, investors are eagerly bidding up these pools of capital, often above the value of their assets, purely on the hopes of future, as-yet-to-be-identified business opportunities. Even though SPAC issuers are not required to earmark, disclose, or even know where the capital they are raising will be deployed, SPAC deals in 2021 recorded an average jump of 6.5% in their debuts, a nearly sixfold increase relative to their long-term average.[10]

Cryptocurrency markets also rocketed to feverish new highs in recent weeks as investors rushed into Bitcoin and Ethereum.

Not to be outdone, cryptocurrency markets also rocketed to feverish new highs in recent weeks as investors rushed into Bitcoin and Ethereum (ether), among others. On February 8, bitcoin jumped to over $47,000 per coin (up 65% this year alone) on news that Tesla had accumulated $1.5 billion worth of bitcoin and had plans to accept it as payment for its cars. That investment represented a non-trivial portion of the company's estimated $19 billion in corporate treasury. As the prospects for persistent low or negative rates around the world increase, even central banks want in on the digital coin craze. According to the BIS, 80% of central banks are looking at the pros and cons of central bank digital coins (CBDCs).[11]

Spot Commodity Prices Rallied to Highest Levels Since June 2014
Bloomberg Commodity Spot Index, *1/1/1980 - 2/10/2021*

Source: Bloomberg

The same underlying forces that pushed asset returns higher in January also increased concerns about inflation as the five-year Treasury Inflation Protection Security (TIPS) breakeven inflation rate rose to an almost eight-year high.

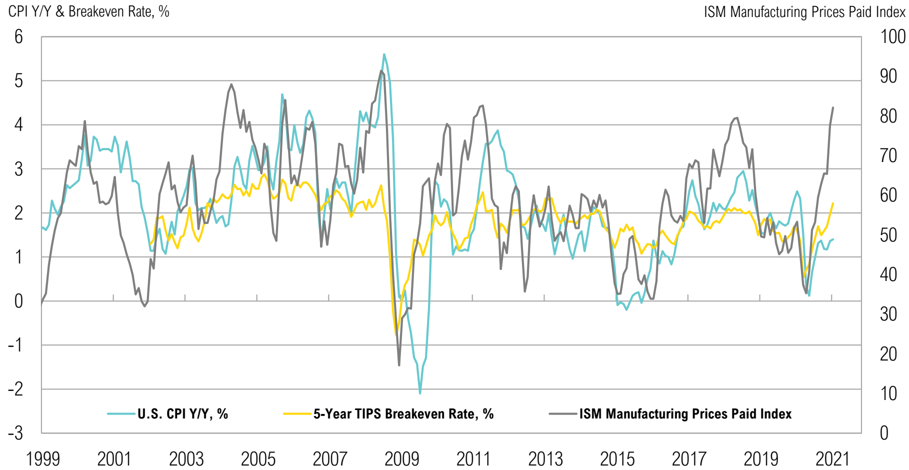
U.S. government bond markets continued their drift lower as longer term interest rates persistently, albeit slowly, inched higher. (Bond prices and yields move inversely.) In absolute terms, yields remain exceptionally low. The 1.06% yield on the 10-year Treasury was still lower than at any point prior to the COVID-19 pandemic. As for short-term interest rates, cash yields remain near all-time lows when adjusted for inflation.

Speaking of inflation, the same underlying forces that pushed asset returns higher in January also increased concerns about inflation. The five-year Treasury Inflation Protection Security (TIPS) breakeven inflation rate, a measure of the level of inflation expected by the bond market, rose from 1.95% on December 31 to 2.31%, an almost eight-year high. Inflationary pressures are building across the economy due to record levels of stimulus, which has increased the money supply and, in turn, prices. This is evidenced by the almost 10-year high in the ISM Prices Paid Index. If inflation remains at these levels (or rises), it will erode the purchasing power of cash and government bonds. Viewed through this lens, even these traditional "safe havens" carry risk.

Given that the Fed has indicated it is not concerned with transitory inflation this year, high levels of unemployment mean it will likely continue the policies that have supported investors' risk-taking behaviors.

Various Measures Suggest Inflation Will Continue to Rise

5-Yr TIPS Breakeven Rate (LHS) & U.S. CPI (LHS) VS. ISM Mfg. Prices Paid Index (RHS), *as of 1/31/2021*



Source: Bloomberg

Looking Forward

The Federal Reserve is widely understood to have two primary goals—to support full employment and maintain stable prices. On February 1, the Congressional Budget Office forecasted that the number of employed Americans, which came in at an even 150 million in January, would not recover to pre-pandemic levels until 2024. Given that the Fed has indicated it is not concerned with transitory inflation this year, high levels of unemployment mean it will likely continue those policies that have supported investors' risk-taking behaviors—and, as a result, the frenetic tone of the early part of this year may continue, too. In terms of stimulus, Congressional Democrats are using "budget reconciliation" to move President Biden's $1.9 trillion COVID-relief plan through the Senate, thereby eluding the threat of a filibuster, which would prevent a vote on the legislation until 60 senators agree to do so. This means Covid relief would require yes votes from only 51 senators. Congress has used the "budget reconciliation" process to enact 21 bills in the past 40 years.[12]

At current cash rates, higher inflation guarantees an erosion of real purchasing power in the years ahead. If that is the case, then even so-called "safe havens" are part of the bubble. And if everything is a bubble, maybe nothing is.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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