CIO Viewpoint

Retail trading triggers questions around market values

Investment Solutions

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When retail investors grouped on Reddit, a social media platform, to buy shares in a number of heavily shorted firms last month, commentators inferred that investors can move markets through online trading. The episode cost short-selling hedge funds millions. It also triggered questions about equity market valuations and whether central banks have been too generous in their pandemic responses.

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Key takeaways

- Retail online trading upset short sellers, creating volatility in targeted stocks
- Volatility was likely driven by high personal savings rather than central bank liquidity
- Equity valuations do not look unjustified in this low-yield, low-inflation and low-growth environment
- Market volatility offers opportunities to invest in the economic recovery. We remain well-diversified and keep portfolio hedges.

Until last month, GameStop was not a household company name. With little change in either the company's financials or outlook, the Texas-based firm's shares rose from USD 19 on 1 January to trade as high as USD 483 on 28 January. The stock currently trades at USD 63.77 (5 February). The business sells computer games and refurbishes consoles from more than 5,000 physical stores. The stock became a target for short sellers who expected its price to fall.

Short-selling involves borrowing the stock and selling it on, under the assumption that it can later be bought back at a lower price in order to settle the trade with the stock's lender. Shorting a stock is one of the most difficult exercises in trading. In part because short positions are theoretically open to unlimited losses if prices start rising. Short sellers, it is worth adding, often carry out extensive research to assess corporate fundamentals. Shorting also plays a useful market role; by betting against companies that they believe overvalued, short sellers can weed out weaknesses, creating liquidity and pushing prices closer to fundamentals. Still, in the case of GameStop, short positions equalled as much as 138% of its free-floating stock, meaning that its shares were borrowed more than once in short trades.

As retail investors began buying shares in 13 firms through online brokers such as Robinhood.com, prices climbed. That forced the hedge funds specialised in short selling the names to cover their short positions by buying stocks, reinforcing the price rises.

Most traded stock

On 26 January, GameStop Corp. became the most traded US stock, and online brokers suspended purchases to protect regulatory capital requirements as some hedge funds reported losses as high as 50%. Losses looked concentrated among a few funds as the HFRX Equity hedge benchmark only fell by around 2.5% that week, in line with the S&P500. Robinhood.com, whose mission is to "democratize finance for all," stands to lose if there are losses in clients' accounts. Its critics argue that rather than ban buying, the broker could have raised the margin requirements to make it too expensive to trade in the 13 stocks.

The GameStop turmoil is significant because it marks the first time that US retail traders coordinated collective trades through social media. The scale of those trades, amplified by other hedge funds and index-investors' purchases, meant they were able to shift the direction of market prices. The disruption for now appears to be US-specific, where wider use of free online brokerages coupled with tighter market spreads created the preconditions for the price moves.

Last week, the market's overseers took a formal interest. Janet Yellen, US Treasury secretary and a former Federal Reserve chair, convened a meeting of the Fed, Securities and Exchange Commission and Commodity Futures Trading Commission. The meeting reviewed whether such trades and practices are price distorting.

Too much liquidity?

Is the abundant liquidity provided by central banks to tackle the Covid pandemic partly to blame for this price volatility? We do not believe so. Financial market liquidity was not the root cause of these recent trades, which were rather driven by the high levels of personal savings built up through the pandemic.

Spending to support the economy through the pandemic in the US is the highest in the developed world. As a result of its asset-buying programmes, assets on the Fed's balance sheet equate to around 40% of US gross domestic product. That is not excessive compared with the 67% for the European Central Bank while at the Swiss National Bank and Bank of Japan, this ratio is well above 100%.

The risk is that cheap credit creates inefficient capital distribution and that central banks' liquidity injections fail to trickle into real economies. Instead, the support may be propping up asset prices and investors, exacerbating social inequalities.

The Biden administration now plans to increase fiscal spending further. While more generous fiscal support may create inflationary pressures over time, it seems likely that the central bank will see that coming, and has the policy space to respond. In the meantime, additional spending will continue to underpin risk assets.

Overvalued?

Are the equity market's record valuations merited? Certainly, low interest rates favour equity markets' relative value proposition and central bank liquidity adds to the financial flows being allocated to these markets. While not cheap, valuations do not look overblown either. Markets therefore have some cause for rational optimism.

Once the public health challenges are behind us, we expect economies to return rapidly to their pre-crisis activity levels. Markets have very quickly priced-in an earnings recovery to mirror the promise of vaccines in ending the pandemic.

The question is whether the recent volatility in a few stocks is enough to trigger a wider decline in risk assets. It is true that US markets are trading at levels that, in historical terms, look expensive. However, after market collapses, such as in March 2020, valuations commonly look high, especially in a low-yield, low-inflation environment. This in turn makes other assets such as government bonds and credit relatively unattractive. In addition, valuations in equity markets outside the US look much less stretched, and are set to benefit as economies recover. All told, investors can expect higher equity market volatility at these price levels, as well as more modest returns.

Investors had low expectations for earnings from the last three months of 2020. With the reporting season still underway, around three-quarters of European and US companies have beaten estimates for earnings per share, reinforcing the idea that an economic recovery is on track. Cyclical sectors in particular posted positive surprises with financials and industrials delivering in Europe, with consumer discretionary, financials and materials in the US. That suggests there is the potential for further earnings upgrades in these sectors as the recovery progresses.

Polishing positions

Professional investors may be looking at the GameStop trades and recall the story of Joe Kennedy, John F. Kennedy's father, who being offered stock tips by the person paid to polish his shoes one day, decided to short his entire equity portfolio just in time to avoid the 1929 Wall Street crash.

Nearly a century later, it is harder to find someone to shine your shoes, but everyone can easily swap tips through social media and then trade freely online. Technology has thus changed access to real time data and puts trading tools in the hands of millions, creating the conditions for huge shifts in market volumes. This evolution sets up a new volatility risk for equity investors. We are likely to see hedge funds add risk measures, such as taking account of the levels of the short interest in a stock.

We believe that with a well-diversified portfolio including hedges such as gold and the Japanese yen, market volatility offers opportunities to invest in the economic recovery. We have kept our overweight position in equities and alternatives, while reducing our holdings of cash and high-quality bonds over the last few months.

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