Palmetto Wealth Management

The Pause that Refreshes?

John M. Gustafson – 31 March 2021

After a year of global pandemic and huge market swings in both directions, some signs of normalcy seem to have appeared once again. After an unbelievable start to the year with riots and continuing political nonsense, we do seem to have settled nicely.

During the late 1990's technology boom, we would have flat-ish markets for a quarter, as we're seeing today when the winners would take a breather and everyone would wonder, is the bull over or is this the pause that refreshes? Some of you may recognize that as an old Coca-Cola slogan – and when I say old, I mean literally almost 100 years ago - 1929! I'm not in any way inferring that's where we are now in the stock market, but it is an odd coincidence. (Along the lines of the Spanish Flu / COVID similarities – hopefully we get the roaring 20's in between!)

"What most entrepreneurs don't understand is that it's not the economy that bursts a bubble, but investor sentiment." - Jay Samit

Looking at U.S. valuations right now, they are certainly rich but nowhere near a bubble outside of some of the very speculative tech names that boomed during quarantine. Basically, the fastest drivers of last year are taking the biggest pause, but the general large, cap blue chips are doing slightly better, so our portfolios aren't feeling the full sting - more of a sideways grind at this point.

We are getting to a level where some of the big players in hedge-fund land have seemingly become a little too confident in their holdings. Last week, a big dog blew themselves up and spooked everyone late in the day with massive sell orders. We're learning now that it was entirely because they got way too far over their skis on margin using swaps that hid the exposure - until it didn't. At that point, their custodians blindly sold them out to cover the debt.

Believe me, there is nothing more indiscriminate than the margin department blowing you up – they only care about cashing in the collateral to cover your loan. They don't care how they do it. It's another old market adage, it always better to sell when you can rather than when you must.

With history as a guide, that fund is likely not the only one in this position, so anything that has been a "winner" over the past year is likely vulnerable to continued volatility in the near term as others try to get out of the way of the margin clerks before they get "the call."

This is not a systemic issue as we all witnessed in 2008, this is a much different type of credit and it is not leveraged up by multiples boosted by fake valuations. It is highly-liquid collateral that has gone against the owners far enough to tip into the lender's problem bucket. Something to watch in terms of how we adjust portfolios or enter / exit positions, but not a canary in the coal mine of pending disaster.

"The young man knows the rules, but the old man knows the exceptions." - Oliver Wendell Holmes

Over the past few years, using psychology for the market movements has led to less surprises than using strict valuation metrics. There is always a reason to claim good value or to worry about something being too rich, but the modern breadth of market participants means there are many folks who simply buy for reasons other than financial metrics.

Take the example of Robinhood and Gamestop frenzy that most of you heard about in the past month. Basically, a couple of sizeable hedge funds determined that Gamestop was essentially worthless, so they sold it short – repeatedly... To the point it became one of the most shorted companies in the market – with more stock "sold" than was actually outstanding because of the multiplier of borrowing to sell short.

This became somewhat of a cause celeb on Reddit message boards amongst a young crowd, relatively new to the stock market with plenty of newfound time on their hands thanks to quarantine. It was like a school of sharks buying, buying, buying and driving the price upward – thereby triggering margin calls for the short-sellers' custodians, forcing them to jump on board and buy the stock back to cover their positions – and pay off their margin debt. (there's that leverage issue again...)

In the "old days" (pre-commission free, retail trading from your iPhone) this sort of thing would happen occasionally when a group of hedge funds or large institutional investors learned that another large pool of money was having some troubles. i.e. Excessive losses on bad strategy, margin calls because of it, investor mass withdrawals, etc. Since investment positions are publicly filed quarterly for large funds, others could easily all see what was vulnerable. The market vernacular among traders was called a "gang tackle." That's exactly what happened here – though rather than a few large funds attacking a weak one, it was thousands of retail investors attacking the large funds. If you recall, "Man Bites Dog" stories filled the news for days...

In my eyes, not a problem or sign of valuation issues, but clearly another data point to watch in the near term when adding or exiting. Progress continues...

"If I advocate for cautious optimism, it is not because I do not have faith in the future, but because I do not want to encourage blind faith." - Aung San Suu Kyi

As of this writing, I am slightly more positive on 2021 than I was at the end of the year. There were too many unknowable unknowns (and boy did that come true!) and heavy concern as to what could and would be done in terms of more COVID relief. Well, as we all know now, the stimulus bill passed and whether you think it was necessary or not, there are a couple of very positive items for the economy and the markets.

First, this was a relatively "clean" bill – meaning there was no ridiculous, unrelated foreign aid and other non-germane spending that everyone hated in the December bill. Second, the reason the migratory deficit-hawks in the GOP – who have apparently returned from their four year hiatus - were so opposed to the bill is simply because they all know that when you get up in Bernanke's helicopter and spray cash all over, it works. (at least in the short term – but that's the only way politicians know how to think these days) The deficits stink, but nobody has cared about those for the past four years when things were booming and they still spent it all anyway. Remember, even after the corporate tax cut we had quarter after quarter of record tax revenue – they simply spent it all. So here we are...

One BIG outside economic issue that everyone attempted to value was thankfully just remedied – the *Ever Given* cargo ship, stuck in the Suez Canal, effective pausing global trade for a week. We all had our fill of the enormous, global economic impact that became daily headlines - stock up on toilet paper AGAIN! Alas, that bullet was dodged...

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The big fomented concern now is the amount of stimulus money sloshing through the U.S. economy will be of such significance that it will cause a spike in inflation and choke off future growth. We are seeing bond yields rise moderately, but it makes me laugh a little that people are so concerned by rates that remain less than a third of what they were almost all of the 20th century. We seemed to have good, long term growth back then and it was shown that it's far easier to keep inflation in check than the Japanese have experienced trying to jump start a flat economy.

An old friend always reminded me that our country runs very well on cheap gas and cheap money. Conditions we've seen for well over a decade, but again, even doubling our current interest rates we would still look at them in context as "cheap."

Learning from the crisis of 2008, we clearly learned that it would be better to send the money out quickly as we reach the end of the pandemic restrictions, rather than continue to hope that we come out of it sooner and get back to "normal."

If you were happy with record spending when our coffers were filled with record revenues, it's difficult to suddenly be conservative on the budget as we sit in a pandemic and the Federal Government is the buyer of last resort to allow the general economy to keep the lights on while we fight to move beyond the virus. And unlike '08, these are payments to small businesses and individuals, not to the crony-capitalists that caused the crisis and became “too big to fail.” (Also why these bills are wildly popular across the public, political spectrum - causing the minority party to push back.)

“Without continual growth and progress, such words as improvement, achievement and success have no meaning.” - Benjamin Franklin

My current bottom line: I’m comfortable where the economy sits, with stimulus in the wild and a likely infrastructure plan to come. I’ll be keeping an opportunistic eye on rates (we still have A LOT of cash on hand) and thankfully try to ignore the hypocritical politicians for a little while as they have finally mostly receded from our daily lives.

I’m always searching for improvements, but see no glaring needs for change at this point and may even pick at some of the higher-quality tech names that are being dragged down with the more speculative names from 2020. Stay tuned...

Thank you as always for your trust and your business. Stay safe & healthy and we’ll talk in person again soon. Cheers!