Weekly Market Insights

February 1, 2021

The big short and modernity takes an ugly turn!

Equity Markets

Major equity indexes ended the week in the red and wound up losing their gains for the year. Although investors appeared disappointed in the Johnson and Johnson vaccine, that appears to have little to do with the steep decline. It was mostly in response to the events involving a company named GameStop Corp. As most investors are aware by now, there is a battle going on between a large hedge fund that has a significant short position in the stock and a growing band of individual investors. The retail investors have joined together to take advantage of the shorts by buying the stock, driving up the price to ridiculous levels, which has created an enormous "short squeeze." No one knows how this will eventually turn out, but it almost surely will not conclude happily. One of the two contestants will be seriously damaged. At the moment, we don't think it will have a serious detrimental effect on the market as a whole. How this happened and whether the methods are legal are interesting questions. Regulators will have a lot of work to do. One question will be the legality of the sharing of information, but that is only one of many questions. 1919 Investment Counsel will keep you informed. This is a good reminder to the uninitiated—that when an investor buys a stock, one's loss is limited to the purchase price, whereas if one shorts a stock, their loss is theoretically infinite.

Although this particular incident is interesting by itself, it leads to a more far reaching and fundamental question that is closely related to last week's discussion of the international economic situation. As readers may recall, we wrote that time and events have passed global regulators' abilities to regulate, and they must adapt. The big question is—has modernity passed regulators' ability to regulate? We understand that it sounds like a graduate class term study, but it is important and needs immediate attention by regulators. Historically, the private world adapts and makes use of new technologies far more quickly than governments. This interesting fact is obvious in all areas of behavior. The culprit is the invention of the internet and the remarkable advances in communications. These problems will be solved. The question is how and when. In short, technology has changed and will continue to change the world.

The Economy

A lot of economic data, both for January and the year 2020, was released this past week. We will skip our weekly review in favor of Ryan Schutte's discussion of this week's releases. We suggest reading this part carefully because we have a strong view on how to interpret these indicators under pandemic conditions.

International

Global economic conditions, for the most part, are still being governed by the pandemic, but as we wrote last week, lots of interesting things are happening.

Some of us can remember in September of 1960 when Juan Pablo Perez Alfonzo of Venezuela and Abdullah Tariki from Saudi Arabia formed OPEC, and the world settled into believing OPEC would forever control the price of oil. Then came the Club of Rome's prediction of the world running out of oil by 1990, and OPEC became more powerful. They were the dominant power and predicted to become more powerful. Alas, technology interfered. Along came fracking. The vaunted power and reputation of OPEC dissolved, and now the oil and gas world is dictated to by a new alliance—U.S, Saudi Arabia and Russia. Technology turned the energy world upside down.

The remarkable growth of China is straining global relationships. China began its modern economic rise because of its ability to harness cheap labor and become the workshop of the world. This reminds us of the meteoric rise of Japan and its subsequent slowdown. Then China, by hook or by crook, depending on who is writing, gained prowess in more sophisticated technology and became a modern manufacturer in its own right. As it became richer, the economically

advanced countries began to look at China not only to produce its simpler products, but as a ripe target to export consumer goods. Ignoring human rights and some cheating (see last week's article), this is an excellent capitalist progression. But again, technology advances! Those states that exported labor-intensive manufacturing are finding that advances in technology can be substituted for inexpensive labor and are contemplating bringing back much of that manufacturing business. This is just an example that governments and business managers must remember. When Smith, Hume, Ricardo and the rest admired capitalism, it was not meant to be comfortable, nor were the associated financial markets intended to make anyone rich, but to benefit consumers. Free trade actually should keep prices down, and managers continue to struggle to be the most technically efficient.

January Economic Update

We have cautioned readers against looking at indicators through the lens of a microscope and accepting results at face value. This holds true in "normal" times and is even more important at the present when economic turbulence may impact indicator reliability. Indicators relating to economic output, the consumer, and employment highlight this past month's releases, and we will do our best to provide a thorough review.

The fourth quarter GDP[1] release revealed that growth slowed at the end of 2020 as COVID cases picked up and economic restrictions took hold. The seasonally-adjusted annual rate came in with a 4% increase from the prior quarter but signaled a 3.5% contraction for the year. The yearly decrease in output primarily reflects declines in personal consumption expenditures, private investment, and net exports but was partially offset by government spending and residential investment. We will not spend too much time poring over the details, as these results were to be expected. Instead, we will concentrate on what factors could lead increased growth in 2021.

As we have highlighted in the past, the consumer is vital to the U.S. economy and will, therefore, play a large role in its recovery. This recession is unique in that the pandemic caused a severe curtailment of consumption, so any indication of a sustained uptick is a clear positive for the economy. January's indicators relating to the consumer were mixed; however, digging into the details of the reports show some signs of promise. A prime example comes with the consumer confidence and sentiment readings, with the former increasing and the latter slightly declining. While both indices are depressed relative to pre-pandemic levels, the expectations components were steady to slightly improved. This is important because the last substantial dip in consumers' expectations for incomes, businesses, and employment came in October and economic activity in the remainder of 2020 faltered. With more fiscal aid and continued vaccinations pointing to a better economic environment ahead, we can expect consumers' expectations to improve.

Personal incomes increased 0.6% in December and finished up 2.8% on the year; however, the year-over-year income number actually indicates a decline when the impacts of government transfers are removed. This emphasizes the importance income replacement programs have had, and will continue to have, in upholding consumer confidence. Fortunately, stimulus measures were passed at the tail end of 2020 and the prospects of future stimulus looks likely.

Despite positive incomes, consumption expenditures drifted 0.2% lower over the month with the largest spending declines seen at bars and restaurants. Importantly, December's data fails to capture the impacts of renewed stimulus measures, and timelier data actually shows consumers spent 6.2% more compared to the same period last year.[2] Also, the decline in consumption coincides with a drastic increase in savings that occurred throughout the course of 2020.

[1]Gross Domestic Product measures the value of the final goods and services produced in the United States (without double counting the intermediate goods and services used up to produce them). Changes in GDP are the most popular indicator of the nation's overall economic health.
[2]Percent Change in All Consumer Spending, Opportunity Insights Economic Tracker, https://tracktherecovery.org/.

Weekly Market Insights (cont'd)

The personal savings rate sits at 13.7% compared to the pre-pandemic average of around 8%, and may provide a catalyst for improved expenditures as vaccinations and reopenings ensue.

Progress in the U.S. employment situation seems to have stalled with around 10 million jobs still missing from the labor market. January began with the employment report showing a decline in payrolls for the first time since April, and the unemployment rate holding steady at 6.7%. While initial and continuing unemployment insurance claims fell last week, there is still a long way to go. We may see slow improvements as COVID cases continue to decline from the latest peak, but a complete labor market recovery is impossible until the population has been largely vaccinated and a full economic reopening can take place. Until that becomes a reality, income replacement programs will be essential in plugging the unemployment and consumption gaps that currently plague the economy.

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