Summary

Economic data for the week included no action by the Federal Reserve, a 4th quarter GDP report that came in largely in line with expectations, continued strength in the housing market, and jobless claims that came in a bit better.

Global equity markets experienced their worst week in a few months, with ongoing fears of economic slowing due to continued virus cases, in addition to some unique trading in certain U.S. stocks that raised volumes. Bonds were little changed despite that weakness in risk assets. Commodities were slightly higher due to tighter agricultural inventories.

Economic Notes

(0) As noted mid-week, the **FOMC** did little to update policy, other than an acknowledgement that economic improvement had 'moderated,' along with continued effects of the pandemic. While it's clear policy rates won't be rising for some time, markets have been keen on looking for signs of when bond purchases will be wound down. (The Fed is, of course, keen on avoiding a financial market reaction like the 2013 'Taper Tantrum,' where even a nod toward removing stimulus triggered a negative reaction.) There is still too much to be determined in coming months, with vaccine distribution efforts a lynchpin for economic recovery. The Fed has been extremely cautious in keeping expectations for accommodation in place—and avoiding central bank mistakes of the past in removing stimulus too early.

(0/+) The advance report on **U.S. Gross Domestic Product** for the 4th quarter of 2020 rose at a rate of 4.0%, which was just below expectations calling for 4.2%. The underlying components were largely as expected, with a rebound in business structures, equipment, intellectual property, and residential building (latter up over 30%); these offset continued weakness in services and government spending. Personal consumption rose 2.5%, which was about a half-percent below expectations, due to weakness in restaurants and travel. Inventories rose for the quarter, and accounted for about a quarter of the overall growth number. The core PCE inflation measure rose at an annualized rate of 1.4% for the quarter, obviously below trend and below target.

Tracking for Q1-2021 GDP has just begun, with estimates again ranging fairly widely, but expecting stronger-than-average performance. Consensus appears to be in the mid-single digits so far, with the Atlanta Fed's GDPNow coming in at 5.2% and New York Nowcast estimating 6.5%. This is based on this past week's data, with upcoming vaccine distributions and aftermath playing a leading role in recovery numbers for the first half of the year. That said, estimates look to remain above-average for several quarters.

(+) The advance goods **trade balance** report for December showed a shrinking of the deficit by -$3.0 bil to -$82.5 bil., which was narrower than the -$84.0 bil. expected by consensus. Trade activity in increased for exports by nearly $6 bil. across a broad group of products. Imports increased by about half that amount, largely in industrial supplies and autos, as consumer goods fell back.

(0) **Personal income** rose 0.6% in December, beating expectations of only 0.1%, largely driven by unemployment insurance benefits. Personal spending declined by -0.2%, which was a bit better than the -0.4% drop assumed by consensus. Year-over-year, personal income is up 4%, within which wages/salaries were only up 2%--the rest being the impact of stimulus. The savings rate rose by 0.8% to 13.7% for the month, well above the rate prior to the start of the pandemic. One interesting observation, to the chagrin of government officials, is that it appears savings are being put toward financial assets than consumption. **PCE inflation** for December rose by 0.4% on a headline and 0.3% on a core level, respectively. Year-over-year, headline and core PCE are up 1.3% and 1.5% respectively—remaining below the 2.0% Fed target.

(0/-) **Durable goods orders** for December ticked higher by 0.2%, falling short of the 1.0% increase expected by consensus forecast. Removing transportation bumped the increase up to 0.7%. Core capital goods orders rose a similar 0.6%, including a half-percent revision upward for the prior month. Core capital goods shipments rose 0.5%, which was just a tick below the 0.6% expectation. Durable goods inventories declined slightly, which was the first such drop in several months. Overall orders are up over 45% from the pandemic low, to near levels before Covid hit.

(+) The **S&P/Case-Shiller home price index** for November came in with a gain of 1.4%, surpassing the 1.0% increase expected by consensus. Prices rose in all 20 covered cities, with the largest gains in New York, Seattle, and Boston—all up close to or slightly better than 2%. Year-over-year, the index re-accelerated by about a percent to a very strong 9.1%.

(+) The **FHFA house price index**, which covers a far broader geography than the Case-Shiller, rose 1.0% in November, beating the forecasted 0.8%. For the single month, the Pacific and Mountain regions saw the strongest gains, around 1.5% each, although every national region was positive. Year-over-year, this index also re-accelerated to 11.0%. These year-over-year gains for both indexes reiterate the strong national housing market, led by a demand for larger single-family residences and low financing rates.

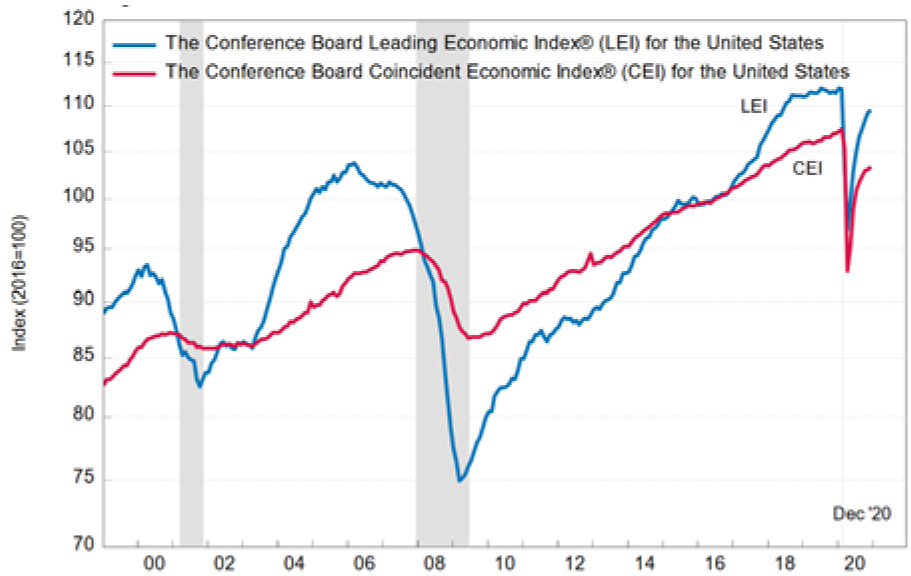
(+/0) **New home sales** in December reversed the prior month's drop by rising 1.6% to a seasonally-adjusted average annualized rate of 842k units, but lagged the 3.5% increase expected, including a downward revision for the prior month. Regionally, the Midwest and West saw gains, while the South experienced declines. Single-family home sales almost 19% in 2020, the best result in nearly 15 years.

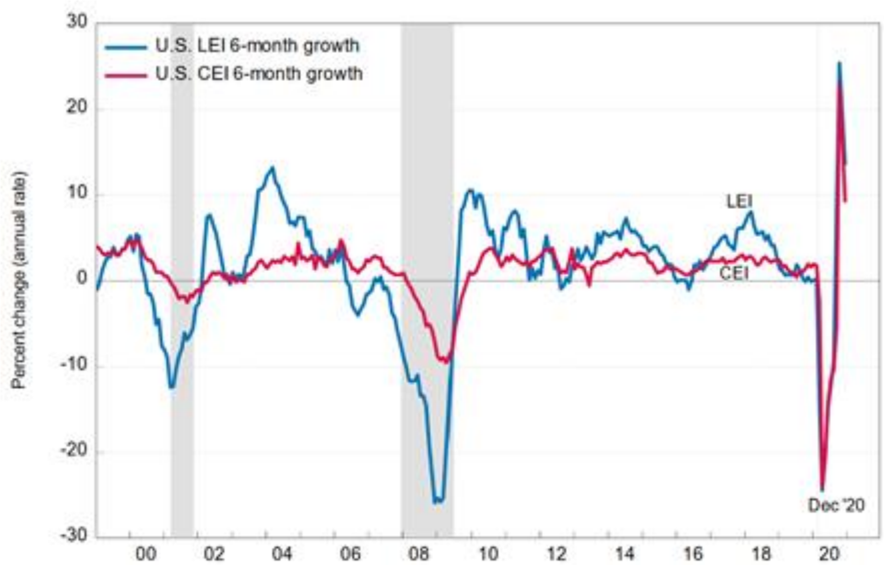
(-/0) **Pending home sales** fell by -0.3% in December, which was slightly better than the -0.5% drop expected. Regionally, the Northeast saw an increase of 3%, which was offset by a -4% decline in the Midwest—with little change in the West and South. Year-over-year, pending sales are up 23%, which is impressive considering the extremes of the past year. These general trend bodes well for home sales over the next several months, even with the recent moderation.

(+) The Conference Board **index of consumer confidence** for January rose by 2.2 points to 89.3, beating expectations calling for 89.0. Household perceptions of current conditions fell by nearly -3 points, which were offset by expectations for the future, which rose by over 5 points. The labor differential measure fell by a point, which implied jobs were slightly harder to get than plentiful.

(0) The **Univ. of Michigan index of consumer sentiment** ticked down by 0.2 of a point to 79.0 in the final January report, falling short of the 79.4 level expected by consensus. Consumer assessments of current conditions fell by a point, while expectations for the future rose minimally. Inflation expectations for the coming year were flat at a high 3.0%, as were those for the next 5-10 years at 2.7%.

(+/0) The Conference Board's **Index of Leading Economic Indicators** rose 0.3% in December, which showed growth but at a decelerated pace compared to the two prior months. This was in keeping with broader data showing a moderating of economic conditions as Covid cases and weak labor markets continued. Regardless, most data points came in positive, with higher ISM new orders, stock prices, and building permits; while higher jobless claims and weaker consumer sentiment weighed on the index negatively. The coincident economic index rose 0.3%, while the lagging index rose a mere 0.1%. On a trailing six-month basis, the leading index rose at a 13.5% annualized rate for the second half of 2020, which represented a reversal of the first half of the year, which experienced a decline of an annualized -14.8%. Despite the tempering, conditions remain positive, showing repair.





Source: The Conference Board. Shaded areas represent recessions as defined by the NBER.

(+) **Initial jobless claims** for the Jan. 23 ending week fell by -67k to 847k, to below the 875k level forecast. **Continuing claims** for the Jan. 16 week fell by -203k to a level of 4.771 mil., below the median forecast of 5.088 mil. (However, adding in additional pandemic emergency aid programs elevated the total to over 10 mil.) Claims were mixed by state, with sharp increases in FL and IL, while CA claims declined dramatically. Some of this is based on lockdown/resumption activity, counting issues, and local dynamics.

Question of the Week

What is the GameStop situation all about?

We don't like to spend too much time on market anomalies, let alone individual stocks that fall outside long-term asset allocation principles, but this seems to have taken over the headlines last week. Rarely do stock market quirks become mainstream news; in this case, it carried over to market sentiment to some extent and definitely raised trading volumes.

GameStop is a video game retailer, and an example of a stock that has been a favorite recent target of short-sellers. This is largely because of skepticism about the company's long-term business fundamentals (the stock was selling at under $5/share). Like many brick-and-mortar based retailers, Covid has accelerated the movement to online commerce, and has punished these types of companies—putting their future in greater doubt. Taking a step back, selling a stock short is practically the most negative view an investor can take, since it's the polar opposite of owning it. It involves borrowing the shares from another party, and selling them in advance, so in essence hoping for a sharp downturn to re-buy ('cover') the position later at a lower price. So it's like buy low, sell high, excepted executed in reverse. Investors like hedge funds (often in long/short or market neutral strategies) take short positions in companies for reasons like weak financial prospects, over-optimistic expectations, or even potential fraud. Naturally, this can be risky, especially if extra leverage is used. Such investors may even convey bad news about a company to weaken its stock price, which sounds odd at first thought, but really is not that much different than Warren Buffet talking about his admiration for Coca-Cola—hoping the stock price goes up.

Based on reports, it seems a group of retail investors (presumably video game fans, who may have taken the GameStop assault personally) decided to take a stand against 'greedy' hedge funds and punish them for taking advantage of these troubled companies. In that sense, this has been described as a morality play (and/or these folks have given hedge funds too much credit, as fund failures are far more common than successes, but not as publicized). They've gathered support on Reddit, an online news aggregator and discussion site, as well as Twitter and other forums. By buying large amounts of the stock in aggregate, as well as that of a few other market short targets, like BlackBerry, AMC, and Bed Bath & Beyond, the group hoped to create a 'short squeeze'. This happens when demand for owning long positions turns the tables on and overwhelms short position holders, pushing prices sharply higher, and creating huge losses for the shorts. Short squeezes can result in dramatic market movements, but have been a common practice for centuries, and often involving well-known investors. Similar past cases, the result this time has been a sharp increase in volatility and quick and extreme price jumps for several of these companies. It also creates a feedback loop where the more (unjustifiably) expensive a stock gets, the greater the interest and potential profit in shorting it—if the shorts can hold on long enough, suffering losses in the meantime. Shorting is a risky bet, since a stock can fall to a limit of $0, but losses are theoretically unlimited (the stock price can grow to the sky, and the shorting party has to return the borrowed shares at some point, regardless of price).

In addition, this has been described as the mobilization of a populist effort to 're-democratize' Wall Street. While this sounds dramatic, the backdrop is favorable to something like this happening. With brokerages offering easy-to-use platforms and commission-free trades, and some investors with a lot of free time on their hands due to Covid. This may have turned some trading sites into a 'gaming' interface of their own, rather than a vehicle to allocate investments for conventional reasons. It's been suggested that such activity emerging may be signs of a broader bullishness in equity markets without fundamental basis, but in reality these events have occurred before over the years as one-offs rather than part of larger trends. (It happened with trading in 'volatility' strategies a few years ago and famously with silver in 1980.) This type of event is naturally easier with smaller, cheap companies, than large ones with strong mainstream demand. AMC has already taken advantage of the new 'popularity' in its stock by issuing more equity.

There have been calls for the Fed to raise Reg T margin requirements to stem this speculative behavior, at least via leverage, but brokerage firms have put on their own limits in some cases. (Bans on GameStop and other stocks have already been implemented by Robinhood, a favored broker for small investors, resulting in its own backlash from those opposing restrictions. A credit crunch on their part seemed to be partially behind it.) Unless this behavior becomes much more widespread and systematic, affecting overall U.S. financial stability, this is out of the Fed's mandate. The SEC is investigating under the premise that this could be considered organized stock manipulation (through the online messages), along the same lines as a classic 'pump and dump' scheme. Insider trading has also been mentioned, but that seems more of a longshot, unless actual company insider information was shared and used. Time will tell whether a formal criminal case of any kind occurs.

This brings up a variety of potential issues, though, including how to regulate (or not regulate) this type of market activity. Many retail investors seem to see this as an 'us versus them' moment. On a deeper level, what is considered a fair market? Should smaller investors be protected from themselves? Or, should they be allowed to take the same risks as institutions? Who gets the blame if this turns out badly? How much leeway to give securities markets has been a long-standing question for much of the past century and prior. More regulation tends to pop up if things end badly, which of course they could here, if small investors end up losing their shirts. There is talk again of regulating the shorting of stocks, but the counterargument is that short sellers play an important economic role in efficient market price discovery and keeping supply/demand conditions in balance. Removing these bearish folks could create even more unpredictable stock price behavior, and infuse a tilt toward perpetual bullishness. Of course, this could have its own set of eventual problems.

Market Notes

Period ending 1/29/2021	1 Week (%)	YTD (%)
DJIA	-3.27	-1.95
S&P 500	-3.29	-1.01
NASDAQ	-3.48	1.44
Russell 2000	-4.38	5.03
MSCI-EAFE	-3.45	-1.07
MSCI-EM	-4.46	3.07
BBgBarc U.S. Aggregate	0.03	-0.72

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2020	0.09	0.13	0.36	0.93	1.65
1/22/2021	0.08	0.13	0.44	1.10	1.85
1/29/2021	0.06	0.11	0.45	1.11	1.87

U.S. stocks fell back starting mid-week with their largest decline in three months, with Congressional delays in getting a stimulus package together, the seeming uncertainty surrounding the Federal Reserve's official meeting statement (that the economic recovery has 'moderated' wasn't a surprise), and, unfortunately, higher trading volumes surrounding the short squeezed stocks discussed earlier. The Senate has yet to wrap up administrative rules and procedures, which has delayed the process. Additionally, many legislators have balked at the large bill of $1.9 tril. (which may have been initially inflated with the realization that the final figure would be far lower). Improvement in jobless claims appeared to help sentiment by the week's end.

Every S&P sector declined last week, with cyclically-sensitive energy and materials taking the brunt of the damage, down over -5% each. Real estate held up best, with minimal change, along with other defensive groups consumer staples and utilities, which only declined about a percent each.

Last week, over a third of S&P 500 companies reported Q4 earnings, bringing the cumulative total having reported to about half. The results have been better than expected. Per FactSet, while the bulk of firms have experienced a year-over-year earnings decline (-3% for the market thus far), over 80% have beaten earnings estimates with 70% outperforming on the revenue side. The strongest results have originated from technology, healthcare, and financials.

Foreign stocks behaved in similar fashion to domestic stocks last week, with concerns over continued high virus counts, as well as vaccine supply shortages and delays in distribution. There was very little differentiation by region. GDP results for several European countries came in as expected, showing minimal growth at all, and 2021 estimates are a few percent below those in the U.S. Emerging markets suffered a bit worse than developed countries, with more cyclically-sensitive nations such as Mexico faring a bit worse than average, but little differentiation otherwise.

U.S. bonds changed minimally for the second straight week, with treasuries rising slightly and corporates falling back, as spreads widened. High yield and senior bank loans fared worst, with larger declines during the week, along with weaker equity markets. Foreign bonds were little changed, and held back by a stronger dollar last week.

Commodities gained on net, despite the usual headwind of a weaker dollar. Strong price gains in agriculture (seemingly due to lower crop estimates and higher Chinese demand) offset a drop in industrial metals, while energy and precious metals were little changed for the week. The price of crude oil fell minimally to just over $52/barrel.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JohnCochrane.Blogspot.com, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.