In September of 2019 a Reddit user going by the username "DeepF*ckingValue" made a post on the WallStreetBets subreddit, then a small discussion board where users would post about their short-term speculation in the stock market, about his long position in bricks-and-mortar video game retailer GameStop. At that time the price of a share of GameStop was around $5 and the WallStreetBets subreddit had around 500,000 users. By the end of January 2021 GameStop would hit a high of $347 a share and WallStreetBets would have around 8 million users.

The price increase in GameStop shares was not because of any material change in the company's business, the retailer's sales were still in decline, and while people sheltered at home, GameStop's business model of operating physical locations for a product that could be delivered over the internet was in question. Suddenly the spending power of millions of Americans, armed with ample savings, stimulus checks, plenty of free time, and few other places to spend this money, was on full display as they signed up for Robinhood accounts and let 'er rip. The discount brokerage Robinhood, whose commission free platform proved especially popular with retail investors, grew it's cumulative funded accounts to 21.3 million by the second quarter of 2021, compared with 9.8 million in the second quarter of 2020.

Now, imagine this same scenario but instead of retail investors betting on a single stock, it's institutional investors putting the trillions in monetary stimulus, deployed by the Federal Reserve as much needed aid to combat the economic risks of the pandemic, to work bidding up prices in various markets. This resulted in an extraordinary rally in asset prices as they ascended to levels so far away from reality that even the most skilled mental gymnasts had trouble explaining it. Stocks like GameStop, theatre operator AMC, home retailer Bed Bath & Beyond, defunct smartphone maker Blackberry, and other so called "meme stocks" more than tripled in value by the middle of the year, as people spent time in online chatrooms talking up the stocks and both retail and institutional investors piled in to them.

The height of this type of exuberance was found in the IPO market. There were more than 1,000 IPOs in 2021 raising over $286 billion. In comparison, at the height of the dot com bubble, in 1999 there were 547 offerings that raised $107 billion. About 60% of the IPOs in 2021 were through vehicles called special purpose acquisition companies (SPACs). SPACs are holding companies with no commercial operations that raise money from investors, then go public, and within a predetermined amount of time merge with an existing company, in effect taking the target company public without going through the regulatory process involved in a traditional IPO. They are typically called "blank check companies" because the original investors have no idea which company they will ultimately be invested in. SPACs featured celebrity endorsements, glitzy roadshows, and lofty promises that would be prohibited in a normal IPO process but were allowed in SPACs.

A big part of the decline in markets this quarter is a result of unwinding the excess in 2021. At the end of the quarter only about 11% of SPACs that went public in 2021 were trading above their listing price and on average, SPAC shares have lost around 43%. Shares of GameStop, AMC, and Blackberry are down 16%, 41%, and 39% respectively, and shares of brokerage RobinHood are down 46%.

The decline in share prices of equites that skyrocketed in 2021 is one part of the decline in the overall market. The other is a serious set of economic headwinds caused by supply chain imbalances, geopolitical uncertainty, and the Federal Reserve's tightening of monetary policy. All of these are connected.

An example of this can be found in the U.S. automobile market. In 2021 U.S. auto sales were slightly above 15 million units, this is down from slightly more than 17 million units in 2019, which was the fifth consecutive year of sales above the 17 million unit mark. Despite the drop in unit sales in 2021 new vehicle prices were up 11.8%, according to the Bureau of Labor Statistics, and even more surprisingly used car and truck prices were up 37.3%. Demand for automobiles did not subside during the pandemic, their demand, as with other durable goods, actually went up. The problem is the lack of supply and that is due to supply chain issues causing a shortage of chips and other parts needed to get fully functioning cars and trucks to market. Car manufacturers' inability to produce enough vehicles to meet demand, due to supply chain issues, caused prices to explode higher.

The supply chain issues, due to an asynchronous global recovery from the pandemic, were well known going into 2022. Market participants expected these issues to be worked out in the first half of this year while economies that are vital to the proper functioning of global supply chains came back online. The idea was that as these economies came back on, and supply chains started functioning normally, it would ease upward price pressure by reducing the imbalance between supply and demand. Also, as the world started easing up on pandemic restrictions, the acute pivot of demand that happened during the pandemic, from services to goods, would finally start reversing. This would give the Federal Reserve a favorable environment in which to raise rates and achieve what they call a "soft landing", which refers to a situation in which the Fed is able to increase rates to slow down economic growth just enough to tame inflation while avoiding a recession.

That was the idea. The Russian invasion of Ukraine dealt another blow to the U.S. consumer by adding more pressure to prices. Food and energy prices rose sharply as prices for fertilizer, oil, and natural gas shot up. Russia is the largest producer and exporter of fertilizer which meant when Western sanctions were imposed on the country, those exports fell sharply. The price of natural gas has gone up 90% since the start of the year and the price of oil is above $100 a barrel, leading to gasoline prices that in March exceeded $4 a gallon as a national average. I picture the U.S. consumer as a boxer, a boxer who has so far taken on many direct hits and is still standing strong; the question is then, how many blows can this boxer take before they start to fall?

The Federal Reserve is in a tricky situation: it has to act swiftly and meaningfully to raise rates so that inflation does not embed itself into the economy but not raise rates too much, so that it causes a recession. It must stop its asset purchases enough so that liquidity in the financial system finds a healthy balance, but not too much, so that it causes asset prices to come crashing down. The Fed has to deal with a market that has skyrocketed higher in price, a consumer that is strong from the stimulus it provided which has now run out, and high inflation caused by supply chain issues that it doesn't have any control over.

In light of this, the stock market has been and continues to be very volatile. The market is trying to figure out where the U.S. economy will land after the Federal Reserve is done with its tightening cycle, and as it tries to figure this out more and more uncertainty is thrown at it. Meanwhile, and thankfully, the U.S. economy chugs along.

In environments with this many unknowns, it is important to switch our stance to a defensive one. Since the fourth quarter of 2021, I have been taking profits and reinvesting the proceeds in more defensive positions. This rebalancing accelerated greatly towards the end of the first quarter and in the beginning of the second quarter. Positions that had grown to be disproportionately large were trimmed down and the proceeds used to further diversify portfolios. Diversification is our first line of defense against volatility. The second is continuing to invest in quality companies that have predictable cash flows, enduring businesses, and strong dividends. Put simply we are hunkering down and waiting this period of volatility out until there is more clarity on the future of economic activity.

After two strong years of stock market growth the market is pulling back as it readjusts its expectations for the future. We too must readjust our expectations of returns in this year. In the short-term, we will have to endure through this period of heightened volatility. In the long run, which is where I focus, things still look good.

And in case you were wondering, Reddit user “DeepF*ckingValue” (DFV) did end up turning his $50,000 investment in GameStop into an eye popping $43 million. Most everyone else, however, lost. WallStreetBets is now one of the most highly trafficked websites with 11 million members, each trying to figure out, unsuccessfully, how to become the next DFV.

If you would like to discuss your portfolio in greater detail or make any changes to your investments, please reach out to me. I hope you all are doing well.

Nik Bhardwaj
Principal
Trillium Investments