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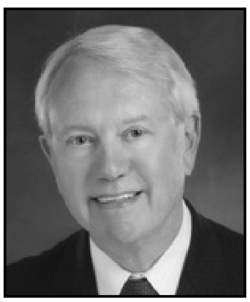
THE ECONOMY

SPACs, NFTs, TINA and raiders: A review of Q1

By Jim Flinchum

The economic news during the first quarter is steadily improving, with surprises mostly on the upside. The stock market news has also been steadily improving, while waiting for the economy to catch up.



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The Economy: Consumer Confidence has recovered to pre-pandemic levels. The ISM Manufacturing Index just catapulted to the best level in 37 years, when Reagan was president. Construction spending and the Leading Economic Index (LEI) disappointed in February, but mostly because of severe weather.

Job growth has been much stronger than expected. March saw 916,000 new jobs, easily beating expectations of 650,000. In addition, we learned January and February produced substantially more jobs than reported earlier. Unemployment dropped to 6%. GDP growth this year is expected to be a robust 6%-7%. Corporate profits, the mother's milk of stock prices, are expected to increase 14%-15% this year.

The Stock Market: Wall Streeters are fond of saying "TINA" – There Is No Alternative to stocks, and the market reflected that. The S & P stock index was up 5.8%, while the S & P bond index was down 4.5%.

While large cap stocks were up 5.8%, small cap stocks were up 18.2% during Q1. Smaller company stocks were catching up with the highflying large company stocks.

Value stocks were up 10.8%, while growth stocks were only up 2.1%. Growth stocks (normally plow any profits back into the company to finance its growth) have led value stocks since the Great Recession in 2009. Value stocks (which often plow any profits into dividends for shareholders) were due for an out-performance.

The best-performing sector was energy, up 30.8%, but that will be hard to continue. Second-best sector was financials, up 16.0%, and that might continue. The worst-performing sector was consumer staples (think: toilet paper) at only 1.2% for Q1. In a huge shift, the second-worst sector was information technology, up only 2%.

Internationally, Canadian and Mexican stock markets slightly out-performed U.S. stocks. Despite another Covid-surge, European markets generally did even better. With the exceptions of Taiwan and Singapore, Asia under-performed. Latin America, where they produce more people than exports, did the worst, down 6.1%.

SPACs: The strange world of SPACs continued during the first quarter. The SEC closely regulates companies raising capital from the public — maybe it over-regulates them, by requiring both reasonable and unreasonable disclosures, as well as projections. To bypass SEC rules, Special Purpose Acquisition Companies offered their shares for sale to the public, with only a promise to acquire some privately-held company. Sometimes called "blank-check" or "blind-pool" companies, SPACs have been a huge success. That worries me.

Reddit's Raiders: One of the strangest recent events during the last quarter was the coordinated or uncoordinated attack on hedge funds by social media followers on Reddit and other websites, who whipsawed several stocks like GameStop. If a hedge fund has heavily shorted any stock, it is forced to buy that stock, often at a higher price, in a "short squeeze," which the Raiders arranged by driving up the stock price. (If you are betting a stock will go down, you might short it, but if it goes up, you might face infinite losses and may be forced to buy the very stock you think will sink in order to stop further losses, and this buying of the stock forces up the share price even more. Bad idea!) This was the first time we have seen an attack on hedge funds by retail investors, many armed only with stimulus money and resentment. That worries me.

Family Offices: The increased concentration of wealth in the very wealthy has encouraged the wealthy to create their own family offices, which have enormous wealth and power but without the rules and scrutiny of the SEC. One (Archegos) rattled the stock market badly. It borrowed too much

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Sophia answers questions at Hanson Robotics studio in Hong Kong on March 29. Sophia is a robot of many talents – she speaks, sings and even makes art. In March, she caused a stir in the art world when a digital work she created as part of a collaboration was sold at an auction for $688,888 in the form of non-fungible token (NFT). ***VINCENT YU / AP***

money to hold stocks that suddenly lost market value, causing some $20 billion in "fire" sales and driving down the market value of venerable companies like ViacomCBS. Wealth and power are shifting from hedge funds into family offices, which need more regulation. That worries me.

Non-Fungible Tokens: Probably the strangest thing in financial markets last quarter was the surge of NFTs. Nobody is entirely sure of the definition yet, but they are usually digital images that can be purchased with cryptocurrencies and recorded on the blockchain. It is usually a digital image, that is freely-available to anybody. A clear example of a market overly-stuffed with cash? Absolutely!

That also worries me.

Interest Rates: The Fed can easily control short-term rates and has increasing control over long term rates. While short-term rates have remained constant during Q1, 10-year interest rates moved up, which spooked the stock market a little and spooked the bond market a lot. (Interest rate increases are bad for the bond values.)

The Fed will be forced to increase interest rates if inflation breaks out or if inflation expectations increase. The Fed has said they expect some inflation in the short-term to be temporary, due to the temporary stimulus and supply chain disruptions, and will not increase long-term rates to fight temporary inflation.

Outlook: The stock market continues to out-perform the economy, but we expect the economy to catch-up this spring, with Q2 estimates for corporate earnings to increase as much as 15%. While increased frothiness always increases anxiety about the stock market, I see no collapse in the short-term. It is the long-term that worries me.

I expect the rotation out of growth stocks and into value stocks to be short-lived, as we experience explosive economic growth this year.

One anxiety is the supply chain. Because there is a carrying cost (think: interest expense) to inventory, most businesses minimize that expense by minimizing inventory. As a result, "just-in-time" inventory management developed over the years, where inventory does not arrive until it can be sold immediately. That was efficient, but it made the supply chain fragile. The pandemic has brutalized that supply chain with shutdowns and worker shortages. Disruption of the supply chain may slow our recovery.

My Republican friends recently rediscovered their anxiety about the national debt ($28 trillion). My Democratic friends were worried during the last Administration, but they have since been converted to Modern Monetary Theory, which suggests that nations with a reserve currency, like the dollar, can issue unlimited amounts of debt. That's because the Fed will buy all the bonds issued by the Treasury. Who needs foreigners to buy our Treasury bonds, if the Fed will buy them?

My thought is that foreigners will stop accepting dollars in payment for our imports at some point, and that's when dollar will drop in value. We are not near that point. By the way, the dollar was up 3.1% in the first quarter.

For now, the band is still playing, and I'm still dancing.

Jim Flinchum *is an accredited investment fiduciary with Bay Capital Advisors, a registered investment advisory firm in Virginia Beach. He is a member of the National Association of Business Economics and can be contacted at www.baycapitaladvice.com.*