John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday February 3, 2021

In the last ten days, U.S. stocks gave back all the January gains. That was not a surprise. Stocks had a great run and were overdue for a setback. But the trigger that pulled stocks down was a surprise. The pandemic has kept people at home and provided some extra cash. It turns out that many individual investors have become day traders. There are now websites such as reddit.com where individual investors can swap tales of hot stocks to trade. WallStreetBets, an online stock trading forum, has thousands of members. The resulting trading volumes are setting records. Charles Schwab, now combined with Ameritrade, hit a record trading volume day on November 9 with 7.8 million client trades. The daily average through the middle of January rose to more than 8 million client trades a day. Other firms are experiencing similar volumes in daily trading.

Wall Street giants blame the late Jack Bogel, founder of Vanguard. Bogel preached low-cost long-term investing. He pioneered, offering no load mutual funds with operating costs as low as 0.05% a year. Before Bogel, stock mutual funds often carried an up-front commission or load of 8% and annual expenses as high as 2% a year. Now there are no commissions and annual running costs are down to 0.05% or less a year. The Bogel revolution hit trading costs as well as mutual fund costs. Decades ago, it could cost 5% to trade a stock. In those days there were no individual day traders because the high transaction costs made that a losing game. Transaction costs have plummeted, and can be zero in some cases. This opened the door for individual investors to try their luck competing with the big hedge funds. In the days of high individual transaction costs, the hedge funds had the trading field to themselves because with their huge trading volumes they could drive a hard bargain on transaction costs. The hedge funds are still at it, trading huge volumes. But last month the hedge fund managers felt the pain from individual investors. The fund managers found stocks like GameStop, AMC Entertainment, BlackBerry Ltd., iRobot Corp and others to be overvalued, and ripe for a decline. These fund managers do their homework, including in-depth research of company operations and management. They sell stocks like that short, meaning they do not own the stocks they are selling. They borrow shares, sell them and expect to buy them back later at a lower price, locking in a profit. GameStop made the headlines last month. Hedge funds sold GameStop short only to run into a short squeeze. That rag tag group of individual traders keep buying GameStop. In a few days after January 12 the stock soared, up 1,545%. Yes, that is right - GameStop went up more than a thousand percent in a few days. For the hedge funds with short positions that meant huge losses. Data Firm says that the short sales of GameStop resulted in hedge fund losses of $19 billion. Add in the other short sales and the total loses were $70 billion, according to Ortex Data. Faced with huge losses on their short sales the hedge fund managers had to sell other stocks to raise enough cash to cover the losses. Hedge fund selling of billions of dollars' worth of other stocks is what triggered the stock market sell off last month.

Can it happen again? Yes, but hedge fund managers have learned a hard lesson. They will be monitoring the popular day trading websites, making sure they don't get caught in another massive short squeeze. So my guess is that this short squeeze will not have a lasting impact. Stocks will recover and respond to fundamentals, especially earnings.

The pandemic has also had an impact on the major banks. They used to be hungry for deposits as low-cost funding for loans. However, loan demand recently has been depressed. Meanwhile the high household savings rate has produced mountains of deposits. At JPMorgan, 2020 saw an additional $580 billion in deposits. Bank of America added $360 billion in deposits. You might think this is a big benefit for the banks. It isn't. After the financial crisis of 2008 and 2009 the Congress imposed new regulations on the banks. Banks face high capital requirements if they grow too large. Those penalties would be worthwhile if there were accompanying loan demand to fuel profits. But in the current environment the new deposits are a source of cost without an offset. The result is something I never would have thought possible - bankers are asking big depositors to mover their money. Banks don't want all the new deposits.

When I look at the big short squeeze and at banks turning away deposits, I find myself in agreement with the editors of *The Economist*: "The covid-19 crisis has shown the resilience of the financial system. But it has also revealed its oddities."

We now have the first look at U.S. economic performance in 2020. The fourth quarter growth was welcome, but not enough to make up for the earlier contraction. For all of 2020 the Commerce Department said the U.S. economy contracted at a 3.5% annual rate, measured year-over-year. That was the largest U.S. contraction since 1946. In other words, the U.S. economy has suffered only very mild recessions in the last 74 years. I remember the pessimists warning us of the coming deep recessions in the 1970s and 1980s and even at the turn of the century. Newsletters preaching pessimism out-sold more optimistic newsletters like the one I wrote. People were willing to pay for tales of gloom and doom that never developed. On the contrary, the U.S. economy weathered those financial storms and kept on growing - and so has the stock market.

The Federal Reserve has noted a slight slowing recently. U.S. consumer spending fell 0.2% in December. But the Fed will keep buying $120 billion worth of bonds every month and will keep interest rates low until the economy has made a full and sustainable recovery. Stocks can go down temporarily. We have seen that over and over again. But every time during my lifetime they have recovered and gone on to new highs. I expect that will be the case this time as well.

I will have the next market review and update one week from today on Wednesday February 10, 2021.

All the best,

John Dessauer