Stock Market Resilience

April 5, 2021

The first quarter of this year witnessed a continuation of the bull market in stocks while bond prices fell as yields rose. The divergence in returns continued as the S&P 600 small cap index gained 18.2% easily outperforming the S&P 500 return of 6.2%. The variance in returns was also present when looking at growth versus value stocks. So far this year, the latter has surged 11.6% while growth stocks are up only 3.7% as measured by the S&P 500 growth and value indices. The rapidly expanding economy hyped by the recent $1.9 trillion federal spending program drove many stock indices to new highs during early April. The losers so far this year were government bonds, as measured by the 10-year Treasury, and gold. The 10-year Treasury has declined 5.7% while the price of gold has declined by 10%

A strong economy that is rapidly recovering from the year-ago shutdown - due to the coronavirus, record stimulative fiscal policy - with more to come, monetary policy committed to providing as much liquidity as needed and stability in inflation would lead one to believe that little can go wrong for investors. Since the big risk is not economic, the risk is likely to be an internal market event that could cause some degree of market volatility. Given the outcome of the few events that contributed to volatility during the first quarter, we expect the market can continue to weather such incidents.

The first event was the speculative trading surrounding a company known as GameStop. Over recent years, this company languished as it was a retail vendor of both new and used videogames. Many speculators were short the stock expecting the company to go out of business. Then a group of investors began buying the stock and driving it higher. As the short sellers were forced to buy back stock, the price surged by more than 800%. The result was that billions of dollars were lost over the course of a few days and the stock market only hiccupped.

The second event was the bankruptcy of a lender to risky businesses. The firm Greensill, located in Germany, collapsed as major banks withdrew credit lines as more information about the company’s risks became public. Once again, many banks that supported this company lost billions of dollars. Greensill’s intensely fast failure is one of the most spectacular collapses of a global finance firm in over a decade, yet there was little reverberation in the stock market.

Lastly was the swift meltdown of a family office known as Archegos Capital Management, which was founded by former hedge-fund manager Bill Hwang. His heavy borrowing to finance derivative securities in both U.S. and Chinese stocks came under pressure as certain of his favorite stocks declined in price. Once again, the speculation led to the loss of billions of dollars for both the family office and the banks that provided financing for those risky loans yet had little effect on the stock market.

If investors are making money in the stock market, the likelihood that speculators are making more is high -- until they do not. At current low borrowing rates, the speculation balloon became inflated until an event let the air out. During the turmoil in markets in March, especially the decline in growth stocks, the overall market easily absorbed these tumultuous events, even though speculators and well-respected bankers lost billions of dollars. Experience tells us that strong market advances are periodically exposed to the greed among speculators who want to make a quick, “easy” buck. Investors must be sensitive to these events and recognize that existing mechanisms can usually prevail keeping the direction of the overall stock market intact.

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