Key Private Bank

Key Investment Perspectives

February 2021

by Justin Tantalo, CFA,® Senior Lead Research Analyst

Capital markets

Risk assets were slightly lower in January, coming off of a very strong quarter to end 2020. The market reflected noisy news flow that included the storming of the US Capitol early in the month, thousands of National Guardsmen in Washington on Inauguration Day, and an epic short squeeze that captivated investors throughout the month's final few days. Looking at the bigger picture, however, the global economic recovery continues to gain momentum as the ramp-up in COVID-19 vaccinations hopefully marks the high-water mark of daily infections and ultimately the beginning of the end to the global pandemic.

It appears likely that new COVID-19 cases in the United States peaked in early January at an average of just over 300,000 new cases per day. By the end of the month that figure had declined by about 50% to an average of 150,000 new cases per day, reflecting the combined impact of less social gathering (vs. the holiday season) and early progress on vaccine distribution. Encouragingly, both hospitalization rates and daily death rates have broadly followed the same downward trend. We expect this to continue as vaccine distribution in the US ramps up from its end-of-January daily run rate of ≈1.5 million dosages.

The strong rally in risk assets in the fourth quarter of 2020 reflected the news that a viable vaccine — and likely numerous vaccines — had been discovered and, subject to timing and distribution hiccups, investors could start looking forward to the end of global lockdowns. While we will likely have noisy months ahead like the one we experienced in January, the underlying trend in the global economy is one of recovery and expansion. That is typically a powerful tailwind for risk assets.

January Market Data

Asset Classes	1 Month	3 Month	2021 YTD	1 Year
US All Cap	-0.44	16.69	-0.44	20.48
US Large Cap	-0.82	15.54	-0.82	19.84
US Small Cap	5.03	35.15	5.03	30.17
US Large Cap Growth	-0.74	14.46	-0.74	34.46
US Large Cap Value	-0.92	16.72	-0.92	4.09
US Small Cap Growth	4.82	34.83	4.82	42.69
US Small Cap Value	5.26	35.53	5.26	16.42
Developed International	-0.85	20.54	-0.85	11.62
Int'l Emerging Markets	3.02	18.40	3.02	24.33
US Treasury	-0.96	-0.84	-0.96	4.42
US Investment Grade	-1.28	1.91	-1.28	5.99
US High Yield	0.33	6.26	0.33	7.44
Municipal Bonds	0.64	2.78	0.64	4.01
Real Estate	-0.07	11.82	-0.07	-6.37
Commodities	2.63	11.51	2.63	7.31

Sources: S&P GSCI, Russell, Barclays, Key Private Bank.

Global equities

US equities as measured by the Russell 3000 Index ended the month down 0.44%. There was meaningful dispersion of returns across capitalization size: Large caps declined 0.82% for the month while small caps were up over 5.0%. Small cap stocks typically outperform their large cap peers early in an economic recovery. As we'll discuss later in this review, some of the rally in small cap stocks is likely due to short covering by hedge funds and other speculative sources of buying. Small cap vs. large cap was a much stronger style factor in January than value vs. growth: In large caps, growth outperformed value by 0.16% (-0.76% vs. -0.92%) while small cap value outperformed small cap growth by 0.44% (+5.26% vs. +4.82%). The outperformance of growth over value took a pause after an exceptional run in 2020 when growth outperformed value by 30% in small caps and more than 35% in large caps.

International equities were mixed in January. Developed international markets declined by 0.82% while emerging markets rallied by just over 3.0%. Emerging markets have experienced renewed interest for a number of reasons, including fears of a weaker US dollar (USD) due to US fiscal and monetary excesses — typically very bullish for emerging markets — and a rally in Chinese equities, which are the bellwether in the emerging market index. China navigated the COVID-19 economic impact better than most countries and continues to make progress with its reform and growth agenda. China's GDP growth in the last quarter of 2020 was already back to a year-over-year trend rate of +6.5%.

Fixed income markets

Reflecting the weakness in fixed income markets in January, the Bloomberg Barclays US Aggregate Index was down by 0.72% for the month. Within the major segments of the asset class, investment-grade corporate bonds were down 1.28% while US Treasuries fell 0.96%. Rising interest rates drove declines in these segments as investment-grade credit spreads were largely flat for the month. Specifically, the 10-year US Treasury yield rose from 0.92% to 1.06% during the month as higher inflation expectations continue to work themselves into a steeper yield curve. Select segments of fixed income saw marginally positive returns in January, including mortgage-backed securities (+0.08%) and high-yield corporate debt (+0.33%).

US bond returns were strong in 2020, but should investors expect similar returns in the future? In short, we don't think so. Since the current yield-to-maturity (YTM) is the best predictor of future total returns for long term buy-and-hold investors, the 1.1% YTM in the Bloomberg Barclays US Aggregate Index suggests returns are likely to disappoint. Some investors will find it easier said than done to accept this outlook rather than believe in the continuation of excellent fixed income returns that has lasted for decades, but the math is sobering.

Commodities

Commodities futures continued their year-end rally in January based on expectations of stronger commodity demand from a pickup in economic growth and the possibility of higher inflation in the future. The Bloomberg Commodity Index was up 2.63% for the month: Agricultural products rose 6.2%, led by corn (+13.0%), while crude oil (+7.5%) drove returns in energy (+7.0%). Driven directionally by the rise in US interest rates, precious metals ended the month down, with gold declining by 2.6%.

Real Estate

Listed real estate as represented by FTSE Nareit All Equity REIT declined by 0.07% in January. The residential segment of the index posted positive returns of 0.5%, consistent with the reams of anecdotal evidence of rising home prices in the US and bullishness around new home construction. However, this was more than offset by declines in office (-3.3%) and lodging/resorts (-5.1%). Elsewhere, the regional malls segment, which has been among the hardest hit over the past few years, was the best performing segment (+11.6%) in January. Mall REITs have been particularly weak given long-standing e-commerce growth trends and the acute impact of shutdowns from COVID-19.

Hedge Funds

Hedge funds overall had a relatively good start to the year, with the HFRX Global Hedge Fund Index down 0.16% for the month. The hedge fund universe is large and disparate, with a variety of underlying strategies across numerous asset classes. Of the lot, the most notable challenges were in long/short equity funds, which were down 1.04% during the month. These strategies struggled with a short squeeze led by retail investors in GameStop and other heavily shorted equities, which we explore in further detail in the next segment of this report.

Elsewhere in hedge funds, event-driven strategies performed best, up on average 0.62% for the month. These strategies are benefiting from their use of special-purpose acquisition companies (SPACs) as a new expression of merger arbitrage, using SPACs' explicit $10 in trust as a downside hedge. SPACs continue to perform well, but the strong pipeline of new issuances has some wondering if we're near a top. Even A-Rod is launching a SPAC.

The juice isn't worth the short squeeze

If you only followed the news flow, you might have reasonably guessed that January's spike in equity market volatility would have come from the deadly storming of the US Capitol on January 6 or maybe the news that 25,000 National Guardsmen were called to Washington, DC, to protect the inauguration of Joe Biden and Kamala Harris on January 20. It came from neither. Instead, the spike in equity market volatility arose in late January from a David-vs.-Goliath battle involving a multi-billion-dollar hedge fund, a surreal Reddit investing forum, and the shares of GameStop, a beleaguered mall-based retailer of video games. So much for a return to normalcy in 2021.

To better understand what drove the frenzied short squeeze of GameStop, it helps to take a step back to review the rise in activity of retail investors over the past two years. Retail investors have historically been a large and important segment of the US equity market. Using its broadest definition, the Federal Reserve estimates that US households directly control more than 38% of domestic equities. This figure excludes shares indirectly owned through institutionally managed mutual funds and ETFs and thus represents the proportion of US equities that individuals directly control. Retail investors come in all shapes and sizes: Some are large enough to be institutions in their own right while others have modest investment balances. In most market environments their activity blends in imperceptibly. Over the past two years, however, a powerful combination of factors has energized segments of the retail investor base. Consider:

- **Zero commissions**: In 2019, large retail-oriented brokerages cut trading commissions for stocks and options to zero, removing an important friction in small-sum trading.
- **Higher savings rate**: COVID-19 restrictions meant less opportunity to spend on discretionary items/ leisure, all while stimulus payments and enhanced unemployment benefits supported incomes. The US Bureau of Economic Analysis reports that in 2020 the personal savings rate approximately doubled from trend to an average of 15%.
- **More free time**: A general lack of sporting/gaming options due to COVID-19 shutdowns meant more free time to ruminate over trading opportunities and research them.

Whether through direct ownership or via call options, the impact of the energized retail investor was acute in 2020.

The combination of free time, higher savings, and friction-free trading resulted in a surge of retail investor activity. JMP Securities estimates that a record 10 million retail accounts were opened in 2020, while Bloomberg Intelligence believes that retail investors accounted for 19.5% of aggregate traded value, up from 14.5% in the previous year. A five percentage-point increase in market share over one year is a sizable surge.

Increased activity of retail investors also occurred in the options markets, where daily call options volume more than doubled in 2020, as did single-lot options contracts, which are almost exclusively used by smaller investors. Buying pressure in the options market can often translate into upward pressure on stock prices as options market makers hedge their short exposure by buying the underlying shares. Options also possess embedded leverage that magnifies their impact on underlying shares.

Whether through direct ownership or via call options, the impact of the energized retail investor was acute in 2020, and the performance of their favorite stocks reflected this. Goldman Sachs maintains an index of the most active equities traded by retail investors, and it trounced the broader US equity market last year. The basket now has a valuation of just under 100x forward earnings.

Chart 1 — Goldman Sachs Retail Favorites Index vs. S&P 500 Performance (January 2020–January 2021)

Sources: Goldman Sachs, S&P.

$12.5 B Estimated amount that the short squeeze in GameStop cost hedge funds in January, according to Financial analytics firm Ortex.

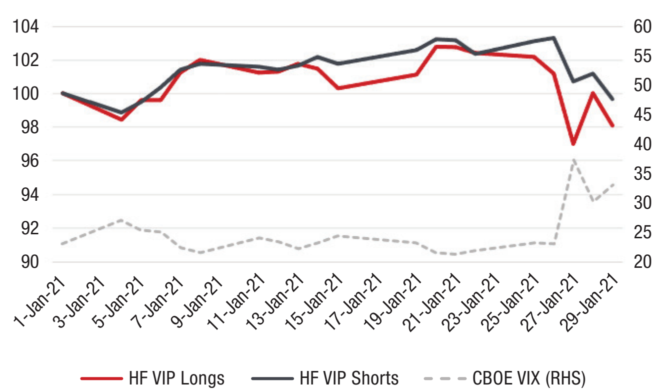
A vocal group of these encouraged retail investors have congregated around various social media outposts that include TikTok influencers, YouTube channels, and most famously WallStreetBets (WSB). WallStreetBets is a forum where participants can discuss aggressive stock and option trading strategies in a profane, colorful, and quirky manner. It has a message board construct on Reddit where popular/upvoted messages float to the top of the page, providing momentum to messages with initial appeal. This implicit momentum mechanism and viral membership growth (six million members at the end of January) meant that while investment sums of individual investors tended to be small compared with institutional traders, their coordinated action and use of leverage through options created substantial buying power. Speculative runs are nothing new on Wall Street. But those coordinated through social media arguably are, and in January WallStreetBets set its sights on a short squeeze of GameStop.

Short squeezes happen when investors (typically hedge funds) who short a stock (by selling borrowed shares to profit from an expected future decline in price) are forced to buy the stock back at increasingly higher prices. Squeezes can happen naturally through a lack of stock liquidity or occur as a result of a coordinated strategy when other investors corner the market and force prices higher. The price impact in a short squeeze can be dramatic. The most famous squeeze happened in Volkswagen shares in 2008: At the peak of the rally in its shares, Volkswagen was technically the largest company by market capitalization in the world. The squeeze resulted from coordination with Porsche, which was a minority stakeholder at the time. Porsche stealthily accumulated more shares to substantially reduce the quantity of shares available for shorts to buy and close their positions.

WallStreetBets members identified and targeted GameStop as a short squeeze in part because of the elevated aggregate short interest in the stock at 114% of total share count.[1] This level of short interest represents meaningful future demand for the shares, which is the vulnerability that WSB members exploited as they aggressively bid up the shares. Early adopters of the strategy can make money from the short sellers who are obliged to buy and return the shares they borrowed, hence the squeeze. GameStop shares rallied more than 1,600% in January due to demand from WSB speculators and hedge funds covering their short positions. Financial analytics firm Ortex estimates that the short squeeze in GameStop cost hedge funds a total of $12.5 billion in January.

The targeted attack on hedge fund short positions was strong enough to cause a contagion that threatened to impact the broader equity markets: It was this risk that caused volatility to spike near the end of the month. Specifically, in order to close problematic short positions and mitigate value-at-risk, hedge funds undertook what Morgan Stanley described as the largest de-grossing episode of the past decade.[2] The chart below displays the performance of two Goldman Sachs Custom Baskets, reflecting the top 50 common long and short positions alongside the VIX index, which is commonly called the "fear gauge" and measures implied equity volatility. What started as an attack on GameStop rippled across hedge fund holdings and ultimately the broader market; the S&P 500 Index declined by 5% in the last week of January.

Chart 2— Hedge Fund Very Important Shorts Compared to Broader Equities with Corresponding Volatility Index ("fear gauge") – January 2021



Sources: Goldman Sachs, CBOE.

Although equity market volatility spiked at the end of January, the corporate credit market was sending a rather calming message about the health of US corporates. Taken together, our interpretation is that this episode, though more unconventional than traditional short squeezes given the WallStreetBets angle and its class-themed revolution narrative, would ultimately unwind about as fast as it started. Losses would be booked, market manipulators (if any) would be investigated, and hedge funds would adjust their process to account from the newly appreciated risk of a retail-led squeeze (Chart 3).

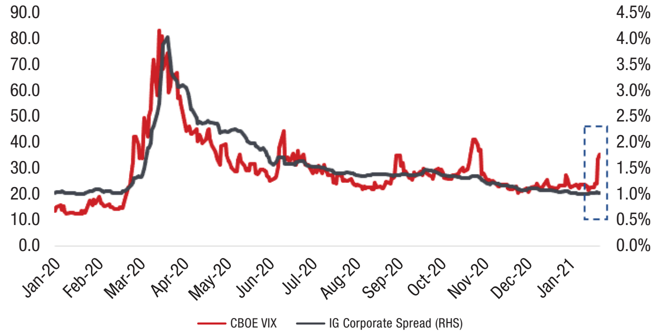
We continue to monitor events as they unfold for potential signs of an investment regime change, but we don't believe that WallStreetBets or an energized retail investor represents one. Investors should continue to focus on the broadening of the economic recovery. Assuming further progress in fighting the virus and the eventual attainment of herd immunity, stocks should outperform bonds and cash. That said, we want to be clear that investors should avoid speculative issues and not get caught up by the mania sweeping up GameStop and other such securities.

Tactical asset allocation

We continue to favor equities relative to bonds given the continued improvement in our proprietary indicators of macroeconomic conditions, corporate fundamentals, and investor psychology. Key Private Bank's DART (Dynamic Asset Reallocation Tool) Model systematically measures and scores thousands of indicators to provide a holistic view of US equity and international equity markets along with the relative attractiveness of equities vs. bonds. We recently neutralized our allocation to US equities vs. international after favoring the US for its defensive characteristics. A broadening global expansion, headwinds to the USD, and greater cyclical exposure were factors we considered in this tactical shift.

We also recently initiated a position in a diversified portfolio of real assets, including real estate, gold, listed infrastructure, and TIPs (Treasury Inflation-Protected Securities), and we further under-weighted bonds. Stronger economic conditions could benefit real assets and potentially pressure yields to move higher. While we are not forecasting a high-inflation environment, we acknowledge that the risk of an inflation surprise has increased as a result of direct fiscal and monetary coordination. Additionally, low bond yields and commensurately low expected returns provide a lower hurdle for real assets to add value to a portfolio. We continue to emphasize credit-oriented sectors within fixed income and alternative-oriented strategies for suitable investors. Even though high-quality bonds play a critical defensive role in a portfolio, the underweight appears warranted given our view for strong economic growth and low yields.

Chart 3 — Volatility Index vs. Corporate Option-Adjusted-Spread (January 2020 – January 2021)



Sources: CBOE, Federal Reserve.

Key Private Bank Asset Allocation Recommendations as of January 2021

Tactical Asset Allocation

Stocks	Bonds	Cash	Alts/Real Assets
Emphasize	De-emphasize	Neutral	Emphasize–Client Specific

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Neutral	De-emphasize	Emphasize

Fixed Income Emphasis

Duration	Treasuries/ Government	Investment Grade Corp.	High Yield
Neutral	De-emphasize	Emphasize	Neutral – Active Mgt.

For more information on how the current market climate might impact your portfolio, contact your Key Private Bank Advisor.

About the Author

Justin Tantalo has 15 years of experience in investment management, both in Asset Allocation and Fund Management. As a Senior Vice President with Key Private Bank, Justin applies his expertise in Asset Allocation and helps oversee the equities and alternatives third-party manager research effort.

Justin received an MA in Economics from the University of Waterloo (Canada) and BA in Economics from the University of Western Ontario (Canada). Justin is a CFA Charterholder.

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[1] It's rare, but short interest can exceed 100%, if shorted shares are sold to another investor, who lends the shares out to be shorted again.
[2] "De-grossing" refers to the process of hedge funds simultaneously selling long positions and buying back short positions in response to a spike of risk aversion.

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