Key Questions

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Is GameStop's Rise "Game Over" for the Stock Market?

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No. But a new regulatory regime may unfold, and a new investment regime may already be underway.

Last week, we addressed the question, "Is the Federal Reserve fueling a stock market bubble?". In it, we discussed how ultra-low interest rates – and assurances from the Fed that they would remain very low for a long time – have incentivized investors to move out the risk curve to generate a reasonable rate of return.

We also discussed how some market participants received this message with even greater enthusiasm and elected to employ leverage in hopes of magnifying their returns. Consequently, we argued that some stocks had become overextended, and the stock market could become inherently more volatile over the long run. Still, we noted – and still believe – that the economic recovery will continue as COVID-19 vaccinations continue apace. With that, we also think those segments of the economy that were so adversely impacted (i.e., services, hospitality) will gradually return to some level of normalcy.

Right on cue, market volatility reaccelerated last week as several stocks not widely known began to dominate the broader financial narrative, even prompting President Biden and Treasury Secretary Yellen to acknowledge them. The company GameStop is most synonymous with this episode.

Founded in 1984, GameStop is the world's largest video game retailer, operating over 5,500 stores in ten countries. After several successful years, GameStop's business deteriorated in the mid-2010s as games moved online and other pressures besetting bricks-and-mortar retailers began to mount. Such challenges only intensified following the outbreak of COVID-19 and the resultant economic shutdown, and the company's financial performance suffered further.

At the pandemic's peak, GameStop's stock (ticker: GME) traded as low as $2.57/share before doubling by August and then more than tripling to finish 2020 at over $18/share on expectations that the company's fortunes would improve as the economy reopened. This is despite GameStop's sales declining more than 30% in the third quarter of 2020 from the year prior.

Two weeks after 2021 began, GME again nearly doubled. The stock then went parabolic, surging close to almost $500/share before finishing last week at $325/share — an astounding gain of 1,625% in one month!

GME's meteoric rise was not the result of a dramatic turnaround in the company's financial performance. Nor was it triggered by some exogenous event such as a takeover. Instead, GME caught the fascination of online traders who were determined to see the stock rise and used social media to incite a buying frenzy, all while simultaneously mounting a verbal (and economic) assault on those who were betting the stock would fall.

Betting that a stock will decline is referred to as short-selling, and although occasionally vilified, short-selling generally requires skill and serves an important purpose in a well-functioning market in my view. In the case of GME, short sellers were betting the company's business would continue to crumble, a position held by some well-known hedge fund managers, a group colloquially referred to as "the smart money."

When a stock is sold short, shares are borrowed and then returned once the position is closed, which ideally occurs after the stock has declined and the investor earns a profit. However, when a stock rises, the investor is in a losing position; in the event the stock moves materially higher, a so-called "short squeeze" results. In this scenario, the investor must buy the underlying stock's shares to cap her/his losses. In other words, when a stock moves sharply higher, a vicious cycle begins: The stock moves higher, and the short seller must buy more to cut her/his losses, which invariably pushes the stock even higher.

While investments held by most hedge funds are commonly kept outside the public's view, some fund managers' positions in GME had been revealed. Armed with this knowledge and a belief that hedge funds are synonymous with "The Establishment," GME became a prime target for a group of disenchanted individual traders intending to force a short squeeze. And that's precisely what happened.

Commission-free trading, excess cash from government stimulus payments, and lots of idle time (casinos are mostly closed, and there are fewer live sporting events to bet on) also provided an extra impetus to online trading which, fueled by technology, is now easier than ever before.

But easy trading is not always easy. During GME's swift ascent, trading was halted at points in time due to the stock's incredible volatility, exposing traders to significant risks and prompting regulators to consider action. Other regulators question whether GME's stock was manipulated, although this may be more difficult to prove.

The broader issue of this series of events is two-fold: Is the stock market at large at risk, and does this mark the beginning of a new investment regime where retail investors overpower those previously thought to be more sophisticated?

With respect to the former, further deleveraging is likely forcing some investors to sell their winners, which may weigh on the market as a whole in the near-to-intermediate term. However, we believe the more significant catalyst will be the rollout of vaccines and 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 GME and other such securities.

Meanwhile, a new investment regime will likely be driven by other factors, including those that are not purely economic in nature. Such forces are less predictable, and thus their impact is much more difficult to assess. Nevertheless, based on last week's market action, a regime change may already be underway.

For more information, please contact your Key Private Bank Advisor.

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