Investment Weekly

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The market tussle in the US creates opportunities

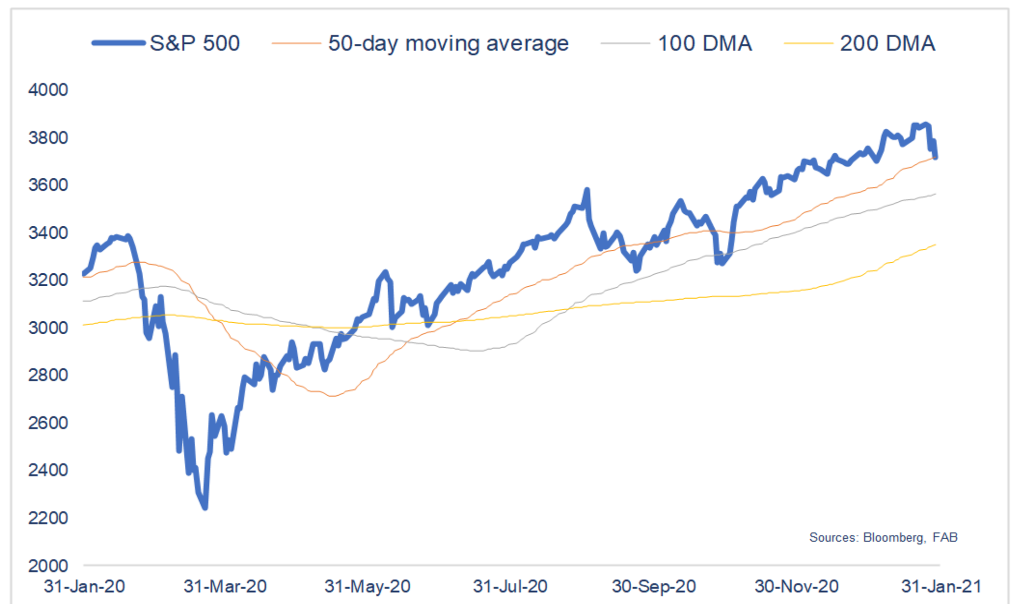
♦ The fight between retail investors, spurred by social media message boards, and short-selling hedge funds prompted the worst weekly losses for the S&P 500 since June.

♦ The S&P 500 was down 3.31% last week, apparently driven by institutions selling some long positions to make up for losses in some of the short ones.

♦ The US stock benchmark was testing its 50-day moving average and, if this is breached, some automatic stop-loss orders could be triggered, prompting some further short-term weakness .

♦ This technical glitch in the markets does not change the underlying fundamental argument in favour of overweight exposure to equities.

♦ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight alternatives.



Last week offered plenty of talking points for macro strategists, from a Federal Reserve meeting to slightly higher inflation in the US, and weaker industrial outlook in China. Yet, the story capturing everyone's imagination and causing the big swings in the market is unrelated to any of these factors: it is the David and Goliath tussle between the army of investors spurred by social media platforms, and hedge funds active in shorting stocks.

Certain stocks being 'pumped' by retail investors had a wild ride in the week, with one having risen nearly tenfold in 10 days, just to drop 44% on Thursday. The broader market, however, has suffered while market participants assessed exactly what has been happening.

The S&P 500 had its worst week since June, falling 3.31% over the period, , while the NASDAQ 100 fell by a similar percentage. The move in the US dragged global stocks in the same direction, with the MSCI All-Country World index dropping 3.57% over the week.

Some of the best-performing stocks of last year had a horrible week, which helps explain the broader market drop. Electric vehicle maker Tesla fell 6.27% last week, Facebook dropped 5.89%, Google's parent Alphabet Inc.'s class A shares fell 3.45%, and Amazon lost 2.61%. Just these four stocks represent about 18% of the S&P 500, so such a big collective move in them affected the entire index.

It seems logical that the funds shorting the stocks bought by the retail investors have been forced to liquidate some of their long positions to close their bearish bets. Many of the big movers have been hedge fund favourites. Also, 'market-neutral' funds had to reduce longs if they closed shorts.

The S&P 500 has touched a key moving average, which could trigger more selling

Long-short hedge funds hold stocks they like, while shorting those they think may be overpriced.

In a short-sale, the investor borrows the stock of a company which it expects to drop in price, and sells it. The investor has to return the borrowed stock later, but, if the price falls, it will be cheaper to buy it back when it is time to return the stock, and the manager books the profit.

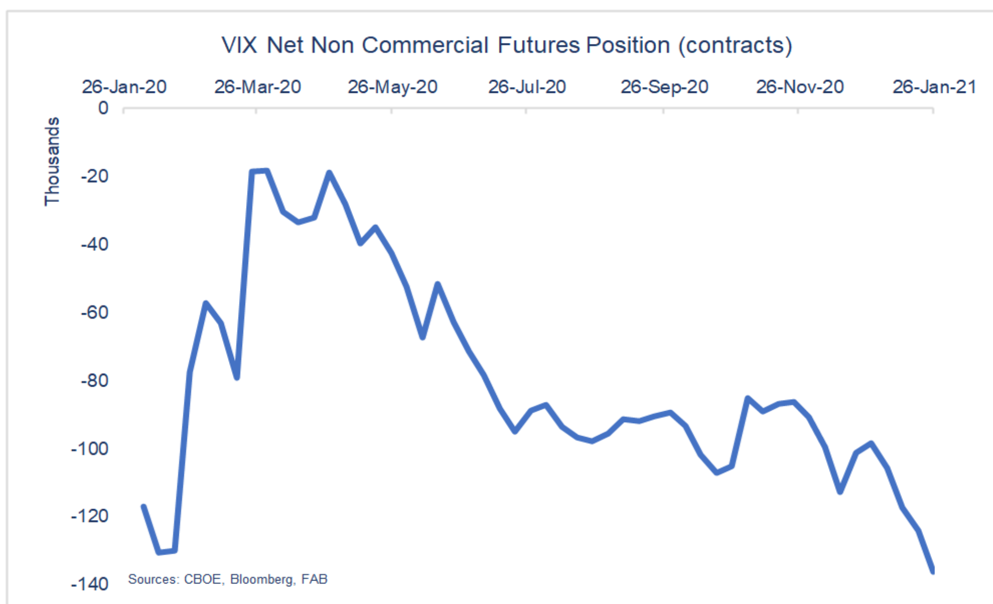
The trouble is when the price rises, causing an unrealized loss. In this case the manager may cut the loss by buying the stock to repay the borrowed shares, and because of that pressure the stock price goes even higher. This is called a 'short-squeeze'.

The manager covering the short, however, has to raise cash from somewhere to buy the stock. Many times, this may have to be done by selling some of the stocks about which the investor is bullish. This is probably happening right now.

If this is the case, this correction in the market, particularly in technology stocks, could continue a bit longer. Basically a temporary fire-sale is taking place.

Other technical reasons could prolong the sell-off a bit longer. On Friday, the S&P 500 closed at a level very close to its 50-day moving average, a widely used support marker. Many technical traders, particularly some kinds of hedge funds, put automatic stop-loss orders at this indicator. If these are triggered, there could be another bout of selling.

Finally, many investors have started to speculate on stock volatility falling. As of 19 January, the Chicago Board Options Exchange (CBOE) reported the highest number of speculative positions in a year that would profit from a drop in the VIX index. These short-volatility positions must be hurting after the VIX rose to 33.09, from 23.02 on Wednesday, the biggest one-day move since 16 March. These short positions could have helped trigger the spike in volatility as hedge funds covered their volatility shorts, too.



It was such a combination of events that drove the so-called 'volmageddon' in the first week of February, 2018, when a sudden increase in volatility prompted buying of the VIX, and resulted in a sudden correction of stock markets as market players compensated for some of their VIX positions by selling stocks and shorting the S&P 500 index.

To put it into perspective, ahead of the volmageddon week, the CBOE reported about 90,000 net-short VIX futures contracts, whereas on 19 January there were more than 137,000 such positions.

All of these, plus technical hedging in the options markets, suggest that there could be some more pain for stocks this week. However, history and these same technical issues suggest this is probably going to be a short-lived correction, and, as such, an opportunity to add exposure to equity markets.

In the two weeks of the volmageddon, in 2018, the S&P 500 fell almost 9%. It then rallied nearly 5% in the two following weeks and resumed its march upwards.

There were a large number of short contracts on the VIX, which could spur more volatility

While this sort of technical squeeze is unfolding only in the equities market, it has started to affect other asset classes. US Treasury yields dropped below 1% briefly last week as risk aversion increased. They resumed their rise on Friday and the 10-year bond ended the week at 1.09%, spurred by a higher-than-expected inflation print in the US.

The 'Core' Personal Consumption Expenditure deflator (which excludes food and energy), the inflation measure the Federal Reserve watches most closely, rose 1.5% in December, higher than the 1.3% consensus forecast. That, however, remains well below the 2% targeted by the Fed. Besides, as Jerome Powell reiterated last week, the Fed is willing to let inflation run above its target for a while before tightening monetary conditions.

The Fed also has a dual mandate of keeping inflation around 2% at the same time as unemployment remains around 4%. This week, the Bureau of Labor Statistics is set to announce the unemployment number for January. The consensus forecast is for it to remain at 6.7%, far above the Fed's target.

This is part of the reason why the Fed has repeatedly indicated it will not adjust interest rates, or even reduce asset purchases, anytime soon.

This continued commitment to loose monetary conditions, which could be around for a few years, is part of the reason why the FAB Asset Allocation Committee is overweight risk assets, such as high-yield bonds and equities. In an environment of low rates, investors will be forced to take more risk to meet required return targets.

Hence, there is good reason to believe that risk assets could continue to rise once the dust settles on all the position-squaring caused by the army of retail traders attacking the short-selling hedge funds .

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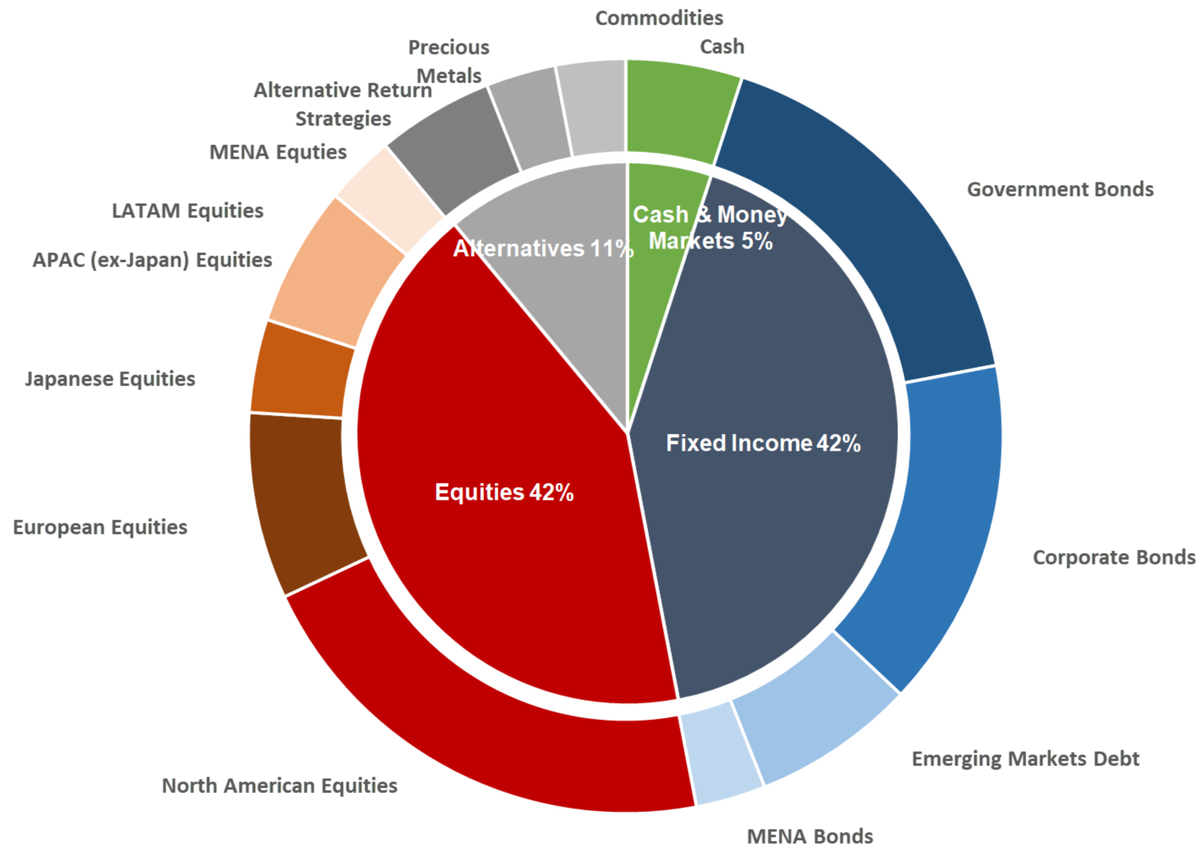
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	Moved into overweight equities position.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Overweight	Slightly overweight Japanese, US and Asia ex-Japan stock markets.
Alternatives	Underweight	However, still marginally overweight in precious metals

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