Weekly Market Flash

Does the house always win?

January 31, 2021

Markets began a typical bull market correction this week, with weakness across sectors and countries. Negative news weighed on investors – from disappointment in Europe's vaccine distribution, to a minor liquidity tightening in China, to the sharp volatility spike caused by the financial battle between US retail investors and long-short hedge funds. In terms of asset allocation, we maintained our recently implemented defensive posture – and are ready to profit from further market drawdowns to rebuild long positions.

Highlights

▪ Retail investors gathered on Reddit and collectively decided to attack heavily shorted stocks this week. As a result, the VIX index rallied from 22 to well above 30.

▪ Bitcoin climbed more than 15% in less than 30 minutes on Friday, after Elon Musk apparently updated his Twitter feed with a #bitcoin hashtag. That resulted in a roughly USD100 billion gain in the market cap of Bitcoin in half an hour.

▪ The People's Bank of China drained USD36 billion equivalent of funds during January, using open-market operations.

▪ The EU risks sparking a global vaccine battle due to the decision to restrict vaccine exports. Under such measures, vaccines will only be allowed to leave the EU if the amount doesn't threaten agreed deliveries in the bloc.

Markets & Macro | More bubbles, and volatility, lay ahead

Starting to buy the dip.

Markets had several reasons to start a bull market correction this week – the main catalyst being the Reddit-inspired short squeeze in US stocks. Retail investors gathered in a dedicated forum (WallStreetBets) on the well-known social network platform Reddit, and collectively decided to attack, from the long side, heavily shorted stocks.

The violent action created huge moves in relatively illiquid stocks this week, with moves in the order of a 200% rise in one day. The context in which this is happening is the post-COVID overall extreme accommodation with cash needing to go somewhere, creating many rolling bubbles and dramatic de-risking episodes.

Our view: Long-short hedge funds typically run a short book with companies holding key features: poor balance sheets and fundamentals, unsustainable and declining business models. And as seen this week, the poorer the quality of the stock, the better for these retail investors, since they are more likely to squeeze short sellers.

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A further reason to trim risk is due to the exceptionality of the current episode. All the models beneath modern portfolio management are based on the assumption of statistically "normal" distributions. The social platforms-induced behavior of retail investors is all but economically rational (in conventional terms), and caught algorithms and risk managers off-guard. Consequently, funds were forced to cut their short as well as their beloved quality long holdings in order to de-gross their exposures, regardless of their view on the market. This is why we think the traditional buy-the-dip mentality didn't prevail this week.

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We will monitor the VIX index level as the primary indicator in the coming days, with the assumption that volatility should remain elevated for a few weeks and the correction should last a bit longer. If the de-grossing from the short squeeze causes the market to sell off, volatility would rise further, which then would cause more selling, and so on.

In the coming months, we can only expect more bubbles, and for their intensity to increase. We do not think it is possible for central banks to stimulate without creating bubbles/over leverage. They'll accept asset bubbles as a worthwhile tradeoff for what needs to be done – in order words, it may be the lesser of two evils...

In our opinion, the real game changer is retail investors enjoying the party with the support of social media and some populist politicians. A number of lawmakers also called for an investigation into brokers' decisions to suspend trading in the most volatile stocks under attack. The SEC said on Friday that it will look into such actions to uncover if the decisions made did indeed disadvantage retail investors.

In terms of asset allocation, we maintain our recently implemented defensive posture, ready to profit from further market drawdowns to rebuild our long positions. We start from the assumption that it's impossible to pick the bottom in a volatile market, and we are going to stick to our gradual approach and start to buy the dip with the S&P 500 index below 3'700. We'll continue to buy at lower prices if the correction is longer than expected. We still firmly believe in the coming economic boom once social restrictions are lifted thanks to the vaccination process gaining speed. The huge pent up demand and policy accommodation will complete the bullish picture.

#bitcoin: USD100bn gain in market cap.

Another example of extreme and unhealthy price action occurred in Bitcoin, the "anti-institution" asset. Bitcoin climbed more than 15% in less than 30 minutes on Friday, after Elon Musk apparently updated his Twitter feed with a #bitcoin hashtag. That resulted in a roughly USD100 billion gain in the market cap of Bitcoin in half an hour.

"While Bitcoin has pulled back from the highs, it will be interesting to see if this is sufficient to be a catalyst for the next major leg higher – or whether trapped recent longs will use it as a chance to exit."

Our view: While Bitcoin has pulled back from the highs, it will be interesting to see if this is sufficient to be a catalyst for the next major leg higher – or whether trapped recent longs will use it as a chance to exit.

Elsewhere this week, the European Union risked sparking a global vaccine battle due to the decision to restrict exports of vaccines. Under such measures, vaccines will only be allowed to leave the EU if the amount doesn't threaten the agreed deliveries in the bloc. This decision is facing criticism from global institutions like the WTO and WHO, with the EU accused of engaging in protectionist policies.

The EU's dramatic decision – which seems to fit the populist framework politicians embrace when under pressure – tries to compensate for perceived missteps in negotiations with drugmakers and the slow rollout of national vaccination programs. Governments are under intense pressure as deaths mount and voters are frustrated with damaging lockdowns that keep being extended. Such problems may have near-term economic consequences, as fear of the virus causes further economic damage.

Equities | GameStop: an isolated event or a bigger problem?

De-grossing – and high levels of volatility – will continue.

"The GameStop saga is simply another manifestation of the same exuberance we were concerned about two weeks ago."

The Dow and the S&P 500 indexes are both down on the year now, ending a volatile January that started with a big rally. In terms of market focus, neither the FOMC meeting nor the Big Tech (Apple and Facebook) quarterly earnings were a match to the GameStop short squeeze saga. The topic has been extensively covered by media – in particular, this FT article provides a good summary.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	29,982.62	-3.27%	-1.95%	-1.95%
S&P 500	3,714.24	-3.29%	-1.02%	-1.02%
Nasdaq	13,070.69	-3.48%	1.44%	1.44%
Euro Stoxx 50	3,481.44	-3.36%	-1.84%	-1.84%
FTSE 100	6,407.46	-4.29%	-0.79%	-0.79%
CAC 40	5,399.21	-2.88%	-2.60%	-2.60%
DAX	13,432.87	-3.18%	-2.08%	-2.08%
FTSE MIB	21,572.53	-2.34%	-2.61%	-2.61%
Nikkei 225	27,663.39	-3.38%	0.80%	0.80%
Hang Seng	28,283.71	-3.95%	3.87%	3.87%
CSI 300	5,351.97	-3.91%	2.70%	2.70%

Source: Bloomberg, as at January 29, 2021. Performance figures in indices' local currencies.

Our view: We won't attempt to weigh in on the mortality of what is happening here. Instead, we'll focus on a few key questions that we hope will guide investors through this market episode:

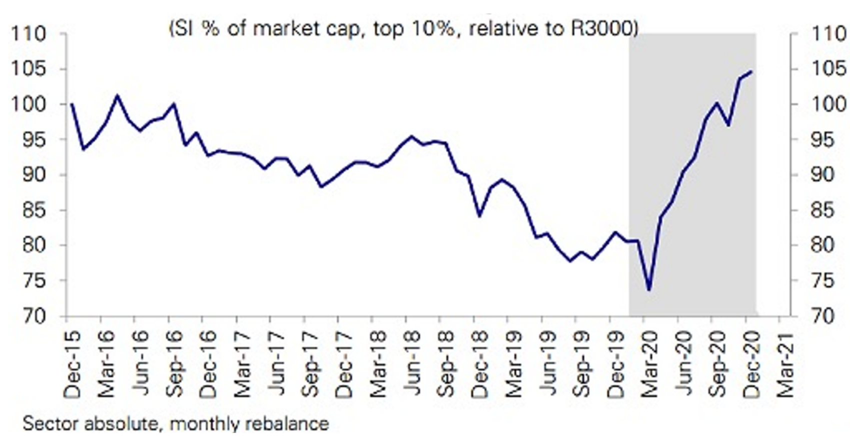
1. Is the GameStop saga an isolated event or part of a bigger market problem?

In our January 10 edition of the Market Flash, we stated that "the week's price action revealed several pockets of asset price exuberance that would be challenging to support on a fundamental basis. It remains to be seen if and how this speculative behavior spreads to other areas of the market." The GameStop saga is simply another manifestation of the same exuberance we were concerned about two weeks ago.

"This type of behavior is to be expected when tremendous stimulus meets crippling lockdowns – and we expect this behavior to persist and propagate as long as the liquidity and lockdowns are in place."

This is not a new phenomenon. In fact, the outperformance of the most shorted stocks began with the Federal Reserve's aggressive stimulus response to the pandemic back in March 2020.

Figure 2: Performance of stocks with high short interest



Source: Compustat, Deutsche Bank Asset Allocation.

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2. Is there a systematic risk here?

We take some comfort in that yields on intermediate and long-term US Treasuries didn't decrease by much. For all intents and purposes, the market is treating the GameStop episode as an isolated disruption for now.

The current market volatility appears to be induced by hedge funds' de-grossing activity. Until this de-grossing (and possibly also de-risking) adjustment is complete, we expect volatility to remain high, which through the feedback loop will trigger selling pressure by the quants.

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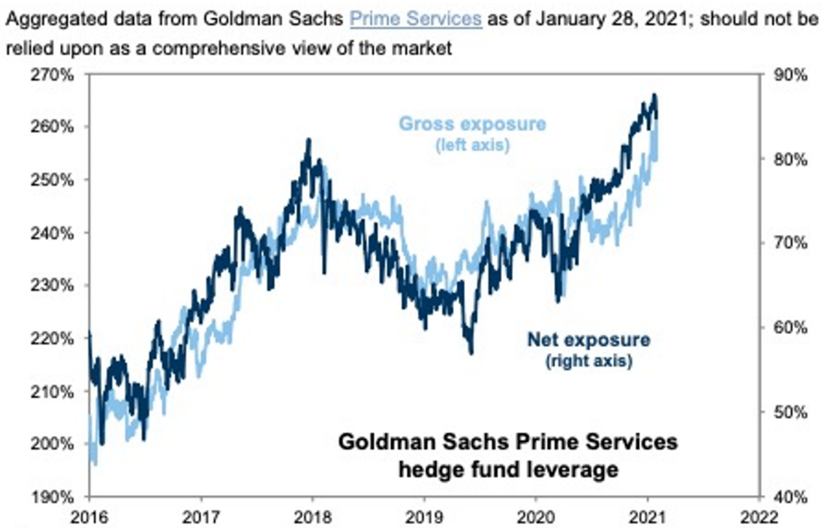
Figure 3: Despite active de-grossing this week, fund leverage remains elevated



Source: Goldman Sachs.

One thing to watch is how the unfolding of the saga will affect the household sector's equity allocation, which has been a key pillar of current market levels and is at a multi-year high. The bigger concern to us is the "populistic" response of some policymakers on both sides of the aisle, siding with the Robinhood investors without any consideration to the impact of such market behavior on taxpayers' pension and 401(k) plans. Where Biden's SEC leans on in this "debate" will hold many important clues for how the new administration is likely to tackle similar "bubbles" in the future.

3. What are the red flags to watch?

We are squarely focused on the vaccine rollout and the status of the fiscal stimulus, which are critical to validating the reflation trade. Meanwhile, Chinese authorities are exhibiting signs of concern about the potential for asset bubbles – the CSI 300 index is up 2.7% on the year and southbound equity flows from mainland China to Hong Kong hit a record high this week, pushing the Hang Seng index to end January up 3.87%. There are also signs of a bubble forming in the Chinese property market. As a result, the People's Bank of China (PBOC) turned more hawkish by draining USD12.1 billion of liquidity from the financial system during the week.

"We reiterate our position that throughout 2021 we will get bouts of market doubt regarding the reflation trade."

As mentioned in last week's Market Flash, we reduced our exposure to Chinese equities in response to the PBOC's actions. An unsuccessful policy normalization attempt by the PBOC could create undesired ripple effects, given that inflows have recently accelerated into emerging market equities recently. Further, the risk of a third wave in countries like Japan, combined with disappointing vaccine distribution, could deliver an unexpected blow to global GDP, which we believe isn't priced in yet.

We reiterate our position that throughout 2021 we will get bouts of market doubt regarding the reflation trade. We look to capitalize on these moments by adding more to the reflation theme trades, without sacrificing our bias for quality (strong balance sheet and high earnings visibility).

Chart of the week

“If the curve does not quickly turn into contango (i.e. a negative spread), the VIX could point to 50+ potential and a much larger correction in the S&P 500 index.”

This week the VIX index had a moderate reaction with an inversion of the curve typical of a correction (conf June/October). The second panel shows the spread of the first versus the second VIX future contract. If the curve does not quickly turn into contango (i.e. a negative spread), the VIX could point to 50+ potential and a much larger correction in the S&P 500 index (volatility is proportional to the square root of time, so a 33% implied volatility is pricing an approximately 2% daily move, while 50% volatility prices approximately 3%).

Figure 4: VIX Index

Source: Bloomberg.

Fixed Income & Credit | Chinese bonds: a reality check

Corporate bond defaults on the rise.

“...the value of payment failures in the nation's domestic and offshore credit markets in 2020 was USD30 billion.”

According to Bloomberg and the various rating agencies, in China the rolling 12-month corporate bond default for domestic bonds is 0.56% of the bond market size. While defaults were once considered a rare occurrence in China’s bond market — with many borrowers having relied on financial support or a bailout in times of trouble – since 2014 the PBOC is working to create a market-driven credit system.

Defaults across the bond market have been rising since. China has also set deadlines for local governments to resolve their "zombie" companies. This has been clearly stated since end-2018, so while deadlines may have been pushed due to the pandemic, in 2021 it is inevitable to see a continued rise in defaults of unviable local government-owned operating entities and financing vehicles.

Our view: Chinese companies are trying to cope with unsustainable levels of debt and a crackdown on unregulated lending, also known as shadow banking, all against a backdrop of the pull back of some of Beijing’s support measures introduced to offset the impact of the pandemic. And given that China is the second largest bond market after the US, the numbers are staggering: the value of China's domestic bond market is USD16.6 trillion and the value of payment failures in the nation's domestic and offshore credit markets in 2020 was USD30 billion (USD8.1 billion only in China's offshore). It all appears well calculated and planned, except that defaults seem to have come out of nowhere – also because China’s local credit rating companies continue to assign top AAA ratings to most yuan-denominated debt and have even been accused of wayward behavior.

“To avoid being embroiled in the country’s murky bankruptcy procedures, we strongly prefer pure sovereign Chinese bonds.”

We remain very constructive on Chinese bonds due to their attractive yields (around 3%) and diversification benefits. To avoid being embroiled in the country’s murky bankruptcy procedures, we strongly prefer pure sovereign Chinese bonds.

Week Ahead | Key events to watch for

- **Next week will be packed with economic data releases** including PMIs, ISM reports for January as well as the highly unpredictable US jobs report on Friday (consensus at +50k). After the first negative reading in December, interrupting the jobs recovery, another negative print is possible.

- **The Bank of England’s latest decision** is due on Thursday, along with further political developments in Italy as consultations continue on a new government coalition.

- **In terms of earnings season**, Alphabet and Amazon will both be reporting in the week ahead.

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