The Long and Short of it

Originally quoted in Shakespeare's The Merry Wives of Windsor, this phrase means the plain truth or substance of a discussion. Ironically, longs and shorts are the focus of this month's trading action and our main topic today.

Hedge funds are multibillion dollar players in today's market. A large number of them follow a long/short strategy - they buy the shares of strong companies (go long) and borrow shares of weak companies to sell (go short) assuming that both trends will continue and they make money both ways. In normalized markets, this has proven to be very profitable.

Then came Gamestop, a fading video game retailer. Professionals were so convinced this company would fail they sold short 137% of the public shares available. How this happened will definitely be a matter that regulators and government officials will be investigating. Public message boards such as Reddit got hold of this information and retail investors started to buy the stock en masse, driving the price higher in what is known as a short squeeze. As short seller losses began to grow, they too were forced to buy the stock and drove the share price from under $10 to over $300. Short seller losses on Gamestop alone, on paper and actually realized, are over $15 billion without counting either the use of leverage or the interest they had to pay to borrow the shares. Other heavily shorted companies have also been targeted, pushing this number even higher.

The fallout from the short squeeze is that hedge funds had to sell billions of dollars worth of their quality holdings to pay for these buybacks, driving down the overall markets to the end of January.

Given the current situation, here is what we are focusing on for the month ahead:

1) The short squeeze continues - It is estimated by Wall St. professionals that approximately 70 - 75% of the GameStop short positions have been covered. This situation is resolving itself quickly but we still face market volatility until this issue is closed.

2) Covid-19 remains a focal point. President Biden has set a target of 100 million inoculations in his first 100 days in office. The U.S. new daily case count has fallen in half from the Wave 3 high but remains in the 140,000 range which is still far too high. Also, another good sign is that the testing positivity rate has dropped back below 10%. These remain key figures to watch.

3) As we predicted, U.S. corporate profits have been coming in much higher than expected. Companies such as Apple, Microsoft and MasterCard all reported better than expected earnings and more importantly, were very upbeat about their prospects going forward. However, this good news is not yet reflected in share prices due to the short squeeze selling pressure.

4) The strength of the U.S. dollar, or lack thereof recently, has been a cause for concern over the past few weeks. We must remember that the U.S. dollar is the world's reserve currency in times of crisis and we believe this is an early sign of confidence in a global recovery. The currency markets seem to be signaling that there are signs of hope that we are emerging from the pandemic, in much the same way that the stock markets are already pricing in future growth.

Given this eventful and colourful background, here is how we are proceeding:

1) The GameStop short squeeze will likely end badly for small investors. Once the hedge funds either cover their positions or meet their margin requirements, their forced buying will stop and when that happens, the rush to exit the stock will quickly collapse the share price, as there are no natural buyers of this stock at anything close to the current price. This will help to calm the markets and ease any selling pressure on core hedge fund holdings.

2) It is now a matter of patience with Covid, as far as investing is concerned. Disappointment over the speed of inoculations is now used as a secondary excuse for market sell offs, but not a primary cause. As more people get the vaccine and the new case count continues to fall, the economic background will improve, and the outlook for the overall market will improve.

3) Corporate earnings remain our key signpost. The number of companies beating Wall St. estimates this quarter has definitely exceeded expectations. Once the short squeeze selling has stopped, we expect these higher earnings and raised future expectations to raise share prices in the coming months. As a result, we are adjusting the portfolios to increase our growth investments to best take advantage.

4) The U.S. dollar is now in its more traditional trading range, particularly against the Canadian dollar. Improvement in base commodity prices such as oil and iron ore would help the Canadian dollar but we believe it will remain in the $1.20 to $1.30 range and therefore are maintaining our U.S. equity weighting at this time, as we believe the prospects for these companies outweigh any currency risk.

It has been an eventful month: the Capitol Hill insurrection, a new President and a historic short squeeze all within the first 30 days of the new year. These media rich distractions will not deter us from continuing to focus on our long term investment objectives and the resilient and improving investment climate. The long and short of it is, while it may continue to be bumpy for a while, better days are definitely ahead.

On a personal note, February marks the 20th anniversary of Cooper Wealth Management. On behalf of the entire team, we would like to thank you for the opportunity to be of service and we look forward to the years ahead.

As always, questions, concerns and feedback are always welcome. We look forward to hearing from you.

Yours truly,

Trevor, Walter and the Cooper Wealth Management team

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