MARKET SPOTLIGHT – FEBRUARY 2021

Power to the People?

A strange thing happened in financial markets in early 2021. A beaten-down video game retailer named GameStop had languished for years under $20/share, touching a multi-year low around $3 in 2019. In mid-January, it started to lift, soaring close to $500/share before backing off, taking another run higher and then settling around $50/share—all in the space of about 10 trading days. Not much had fundamentally changed about GameStop except that a successful internet entrepreneur had joined its Board of Directors. This move was mostly about something else.

On the message board Reddit[1] and in YouTube videos, one analytically-minded independent investor had started talking about GameStop back in 2019. Not only did he believe there was unrecognized value in the stock, but he noted the massive reported short position in GameStop, making it a prime candidate for a short squeeze[2]. Many who read his analysis felt he told a compelling story. Word spread as more and more Redditors began to act on their convictions, armed with stimulus cheques and discount brokerage accounts. Since hedge funds held most of the GameStop short positions, buying GameStop became synonymous with taking down the traditional Wall Street establishment, a kind of people's revolt. These investors felt they were sending a message—together they could bring about the kind of change that the "Occupy Wall Street" movement had aimed for, but which had quickly fizzled out. Their success in sending GameStop stock "to the moon", if only temporarily, made many wonder if this movement was capable of achieving a permanent shift in the power structure of financial markets.

In this edition, we look at some of the implications of this event. Is this a once only, never to be repeated phenomenon or a disruptor with more tricks up its sleeve?

On another note, inflation is a concern that investors have raised over the past few months. Can gold act as a suitable portfolio hedge if inflation increases? Senior analyst Dan Greenspan weighs in.

Finally, Chief Investment Strategist Luc de la Durantaye takes a look at the renewed interest in cryptocurrency Bitcoin.

[1] Most of the chatter around GameStop happened on a subreddit called WallStreetBets

[2] A short squeeze can occur when a stock moves higher, incentivizing short sellers (who had bet that the price would fall) to buy the stock to stem losses or meet/reduce margin requirements. This buying, also known as "short covering", adds to the upward pressure on the stock's price, creating a feedback loop that can become a short squeeze.

Focus on what's important

Luc de la Durantaye
Chief Investment Strategist

The commotion around the trading in GameStop certainly had markets talking over the past few weeks. Looking at the overall financial environment, it's not surprising that conditions were in place for this to unfold. In our estimation, the fact that central banks have maintained interest rates at zero for such a long time continues to be a prime force driving investors to look elsewhere for returns.

Additionally, the development of some relatively new online trading platforms has brought about some changes in retail trading. Deep discount and no commission brokerages such as Robinhood have reduced transaction costs to almost zero. They've also facilitated the ability to buy or sell stocks in odd lots rather than standard lots of 100 shares at a time. Add to this the fact that many investors are working from home and you have a "perfect storm" to foster the growth of speculative trading tendencies.

These conditions are likely to remain for a while longer, so we're unlikely to see this behaviour disappear in the short term. As for the larger implications of this event, on the interest rate side, the central banks look at the bigger picture when determining monetary policy. For the most part, they consider financial conditions such as trends in interest rates, credit conditions, the U.S. dollar and the stock market. Unless the trends in these indicators deteriorate markedly and negatively impact the total economy, central banks will not react to localized volatility. The U.S. Treasury Department is more likely to investigate whether illegal activity is taking place and if the public is at any risk. The recent U.S. congressional hearings on the GameStop "incident" brought together in a public forum some of the main players and might have reassured the public that the government is taking notice. But it's unlikely to lead to legislative change by itself.

One area to monitor is the commercial banks. In particular, commercial banks that lend to hedge funds and/or trading platforms are vulnerable, as many of those funds and platforms have incurred losses due to the volatility of certain stocks. If those losses were important enough to put some commercial banks in difficulty through loan losses, that could possibly spill over to the broader market. However, our sense is that the North American commercial banks are well capitalized and diversified and such risks are fairly low.

Much Ado about Nothing

Craig Jerusalim
Senior Portfolio Manager, Global Equities

The speculative frenzy in GameStop has begun to abate, as we assumed it would. In the end, a company's fundamentals will determine its value, but human nature can intervene, sometimes dramatically, along the way. Finally, this became a classic game of "prisoners dilemma". If every retail investor had continued to hold their GameStop or bought more, the price could theoretically have continued to move higher and sent the short interest to zero. But no one wants to be left "holding the bag", so greed and self-interest kick in at some point, setting off a run for the exits.

What are the ramifications? I see three obvious ones. First, short sellers will be less vocal about their positions to avoid drawing attention from retail mobs. Second, I see this as yet another signpost, along with SPACs[3] and Bitcoin, of froth or excess speculation in the market. This has to be monitored as it has the potential to erode confidence in market dynamics and could hurt overall sentiment. Finally, I'd expect additional regulations to come into effect after the fact.

Other than those points, and a little bit of excitement, markets will move on to the next big thing, like they always do. GameStop will become a tiny footnote in history.

[3] Special purpose acquisition company

Gold as an inflation hedge?

Dan Greenspan
Senior Analyst & Resource Team Director
Materials, Energy

Over the past month or two, investors have been asking about inflation hedges, especially gold. With the economy possibly poised to reopen and many people with accumulated savings and more opportunities to spend, will the economy heat up too quickly and produce higher inflation?

If higher inflation occurs, we still believe interest rates will likely remain low, as the U.S. Federal Reserve has signaled a willingness to tolerate higher inflation than usual. The combination of higher inflation and still low interest rates would drive negative real rates that should support the price of gold. In an alternate scenario, where inflation remains low as the pandemic persists and consumer spending is restrained, we believe central banks and governments would remain accommodative via their monetary and fiscal policies. The combination of low rates and high government stimulus would also likely support the gold price.

Of course, there are risks to the positive gold outlook. Quickly rising interest rates that lead to a stronger USD or continued subdued inflation, even if spending ramps up, are two possible negatives. An increase in "risk on" investor sentiment could also drive outflows from gold and precious metals into other, more risky investments like base metals and energy.

In terms of the equity outlook for gold stocks, we believe their valuations remain reasonable. Companies seem to have heard shareholder concerns and are acting more responsibly, for now. In the past, gold miners were viewed as poor capital allocators. However, in this bullish commodity price cycle, we have seen measured and well considered M&A (mergers and acquisitions), dividends have increased and buybacks have been active. Furthermore, we believe companies are doing better on ESG[4] as well. The E and the S are well developed as these are critical factors that give the companies social license to operate their mines. Without proper environmental protections and social programs in place, mines won't remain open for long as local stakeholders will not tolerate them. Governance is starting to improve as well, with more diversity on boards and management teams, but there remains further room for improvement around G in the mining sector.

Bitcoin, the ultimate disruptor?

Luc de la Durantaye
Chief Investment Strategist

One of the buzzwords of the last decade was "disruptors"—innovations and technologies that upset the status quo. Airbnb is challenging the hotel industry, online shopping is disrupting traditional retail stores and digital currencies may one day be credible rivals to our dollar bills, euros and yen—or will they?

The COVID-19 pandemic did its own disrupting in 2020, bringing profound changes to the way we work and interact. One way we're adapting to the COVID challenge is by socializing and transacting business remotely. We're becoming more comfortable with performing financial transactions online, as money transfers, cheque deposits and even mortgage transactions increasingly take place virtually. An obvious next step to consider could be the use of a digital currency, namely a cryptocurrency like Bitcoin.

Making headlines again

Bitcoin and other cryptocurrencies gained a lot of attention several years ago. In early 2021, they're making headlines again with new all-time high price levels after several years of trading in a wide range between $5,000 and $10,000. Since October 2020, Bitcoin has soared, surpassing $50,000 in February.

The biggest shortfall we can see with Bitcoin (or any of the other cryptocurrencies) is the lack of a large stable "guarantor". Major fiat[5] currencies such as the U.S. or Canadian dollars have a government behind them to back their use as the sole means of exchange for that country. Cryptocurrencies lack a major proponent that can be relied on to sustain and expand their use as a means of exchange.

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[4] Environmental, Social and Governance issues

[5] Fiat money is currency that a government has declared to be legal tender but is not backed by a physical commodity.

Is Bitcoin a bargain?

It's difficult to calculate a fair value and determine a reasonable price for Bitcoin. It isn't issued by a government and has no data like inflation, trade balance or other economic fundamentals that are traditionally used to value currency. Bitcoin holders don't receive interest payments, making it more expensive to hold relative to many currencies that do. The difficulty in establishing a fair value increases its pricing uncertainty and is partly responsible for its large price volatility since inception.

Challenging traditional currencies

Bitcoin's history is very short, which makes it difficult to assess the soundness of its architecture or its ability to act as a store of value in the longer term. Although it's gained a lot of ground since inception and soared in the past few months, it really hasn't been tested and remains full of risks.

Theoretically, anyone could launch a cryptocurrency or new technology that competes with Bitcoin, with the potential to make it and blockchain obsolete. In fact, there are more than 4,000 cryptocurrencies already in existence[6], such as Ethereum, Litecoin, Bitcoin cash and others, but Bitcoin currently remains the most popular choice. One challenge could come from sovereign states. They might try to prohibit the use of cryptocurrencies to maintain their own monopoly on issuing fiat currencies and the benefits that this entails. Some sovereign nations have launched their own digital currencies, which could be seen as competitors to Bitcoin—Sweden's e-krona and China's DC/EP are paperless versions of existing fiat currencies.

Store of value or speculative asset?

Bitcoin is not really being used as a means of exchange at this time. As we mentioned, its value is extremely volatile (and therefore highly unpredictable), making Bitcoin very risky to use as a store of value for the future purchase of goods and services.

Certain currencies are often used as safe assets during crises. For example, investors used the U.S. dollar as a safe haven when there was global uncertainty following the 9/11 tragedy and the global financial crisis of 2008-9. So far, we haven't seen cryptocurrencies used in the same way. This suggests that, for the moment, they're seen as a speculative, not a safe haven asset.

We're staying on the cryptocurrency sidelines for the moment, but continuing to assess developments in the digital currency world. Currently, Bitcoin seems to be more a speculative phenomenon than a real currency opportunity. But disruptive forces continue to affect global politics, business, media and society as a whole. The post-COVID world could include the widespread use of alternate ways to store value and transact business.

Cryptocurrency is a digital asset designed to work as a medium of exchange. Individual coin ownership records are stored in a ledger in a form of computerized database using strong cryptography to secure transaction records, control the creation of additional coins, and verify the transfer of coin ownership. It typically does not exist in physical form (like paper money) and is typically not issued by a central authority.[7]

Blockchain is the digital platform behind Bitcoin and other cryptocurrencies. It is intended to create faster, more efficient ways to transmit, receive, and track orders using secure data.[8]

[6] https://coinmarketcap.com/

[7] https://en.wikipedia.org/wiki/Cryptocurrency

[8] https://www.investopedia.com/blockchain-4689765