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FINANCIAL GROUP

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Portfolio Talk **Market Update 02/05/2021**

Last week we spent time talking about the virtues of shorting the markets and the risks involved. Those risks were quite evident this week when Robinhood had to reach into the pockets of their venture capitalists (VC's) to raise another $3.4 billion to maintain the capital requirements mandated by the regulatory authorities that oversee the brokerage industry. The deal, VC's will get additional shares of Robinhood equal to the amount of the infusion with a 30% discount to market value. Good deal for the VC's, especially given Robinhood could go public later this year. However, the blemish on their reputation is going to take time to diminish. Why, because they had to halt trading in GameStop and a few other speculative stocks while they waited for the additional capital. This frustrated many of their clients due to their inability to trade! Why is this important to know? Because of the ripple affect! When you drop a pebble into a still body of water, the initial splash is small, but the ripple affect (concentric circles emanating from the splash) covers a much larger area until the last one fades away. Think of it this way, Robinhood is the pebble and the first to get hit given they have to raise capital that dilutes their share value for their investors. Then their investors either have to invest more while their share value is reduced or face losing it all. That is followed by the individual investor that cannot trade in their accounts causing them to potentially lose the opportunity to reduce their risk/loss. At the same time short sellers and hedge funds must sell other positions in their portfolios in order to cover their margin calls caused by the shorts. This puts selling pressure on good companies that then affect retirement funds for teachers/firemen/police/etc.….and the markets start to sell off due to the systemic risk felt by the little splash of a pebble. Sounds a little farfetched? Maybe, but not as much as you may think. The leverage used in the markets can work for and against you. A lot of the trades done involving GameStop and the other speculative positions were done on margin (borrowed funds). When the markets are going higher leverage felt good, not so much in the reverse! An example of this pain was inflicted during the market crash of December 1929, when margins were as high as 90% of account values. When the market fell 10% individual investors lost everything. Our margin requirements today begin at 50% and once the account gets to 30% equity value (70% margin) the account must be maintained at 30% plus or it is liquidated. This protects against complete loss. Disruption felt with the likes of GameStop and the others gave us a glimpse in a small sampling as to what can occur in a larger scale.

I do not believe Robinhood's liquidity difficulty would be enough to cause major market disruption. Even if we did experience some indigestion, the markets would absorb the imbalances relatively quickly. But could this happen to a larger brokerage firm with much higher leverage? In 2008-09 we had two firms fall below the required capital levels, they were closed, and this started the bear market. Bear Sterns and Lehman Brothers had leverage that was equal to was 33-50% at their total capital! So yes, it could happen, but it is unlikely. We learned a lesson then and increased capital requirements when Dodd-Frank and the Volcker Rule were adopted in July 2010. The argument is that these regulations may have gone too far, but that is a discussion left for another day. Be comforted that the leverage in today's market, from a firm perspective, is in good shape! Janet Yellen, the US Secretary of Treasury and past Chair of the Federal Reserve, stated yesterday that the markets showed resiliency last week as the trading frenzy took place. She added that while this was good to know, authorities still need to investigate the activity to make sure any bad actors were identified and prosecuted if wrongdoing was a foot. Preliminary reports do indicate that institutions were heavily involved in the runup of prices, but was it collusion? We will know more in the coming weeks…….

Economic News

- Monday:
  - Markit Manufacturing PMI (final) for January, 59.2 vs. 59.1 previously…holding.
  - ISM Manufacturing Index for January, 58.7% vs. 60.0% expected and 60.7% previously…holding.
  - Construction Spending for December, 1.0% vs. 0.8% expected and 1.1% previously…good!
- Tuesday:
  - Motor Vehicle Sales (SAAR) for January, 16.6 million vs. 16.3 million previously…good!
- Wednesday:
  - Markit Services PMI (final) for January, 58.3 vs 57.5 previously…holding.
  - ISM Services Index for January, 58.7% vs. 57.0% expected and 57.2% previously…holding.
- Thursday:
  - Initial Jobless Claims (state, SA) for January 30th, 779,000 vs. 830,000 expected and 812,000 previously…slowing.
  - Continuing Jobless Claims (states, SA) for January 23rd, 4.59 million vs. 4.79 million previously…holding.
  - Productivity for Q4, -4.8% vs. -2.8% expected and 5.1% previously…slowing.
  - Unit Labor Costs for Q4, 6.8% vs. 5.0% expected and -7.0% previously…accelerating.
  - Factory Orders for December, 1.1% vs 0.7% expected and 1.3% previously…holding.
- Friday:
  - Nonfarm Payrolls for January, 49,000 vs. 50,000 expected and -140,000 previously…holding.
  - Unemployment Rate for January, 6.3% vs. 6.7% expected and 6.7% previously…better.
  - Average Hourly Earnings for January, 0.2% vs. 0.3% expected and 1.0% previously…low.
  - Trade Deficit for December, -66.6 billion vs. -65.7 billion expected and -68.1 billion previously…growing.

Earnings were good for most of the companies we own with slight misses on a couple. Qualcomm had a slight miss on revenue but hit earnings per share as expected. They are still well positioned to benefit from the 5G technology evolution. International Paper hit on expected revenue but missed on earnings per share. Management stated the struggles for the quarter were short term and not systemic. Google hit it out of the park on both earnings and revenue. AT&T had better than expected results on earnings and revenue and new management continues to focus on profitability, writing down their investment in DirecTV. We will continue to watch as earnings are released. As of now we believe the S&P 500 earnings projected growth of 21% in 2021 appears to be intact.

Finally, Johnson & Johnson (J&J) did apply for Emergency Use Authorization (EUA) at the FDA yesterday and look for approval in the next 7-14 days. J&J said they could supply 100 million doses to the US government by June of this year. And as Paul Harvey use to say, "And now you know the rest of the story!"

Stay Safe and get vaccinated!!! (if you want)

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IMPORTANT DISCLOSURES