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In a Nutshell

Blatant market manipulation is occurring in plain sight, and those charged with protecting the integrity of the United States capital markets are noticeably absent. Gamification of the stock market through a mashup of social media and smartphone-enabled trading will have long-term negative consequences if left unchecked. Current speculation is aplenty on whether the trend is meaningless digital coins or financial instruments used as lottery tickets, but the carelessness must end. Massive stimulus is feeding the speculation and inflating asset valuations, setting up stocks to underwhelm investors. Massive stimulus is also driving inflation. Consumers should prepare for above-average price increases over the short run before returning to a more normalized range. Do not let anyone confuse you that current price increases are due to an imaginary drop in prices last year. There was no month during 2020 in which prices declined on a year-over-year basis, and price levels this year are steadily above those in 2019. Inflation resulting from the supply and demand mismatch will work its way out, but that is the least of our concerns. Reckless behavior and inappropriate valuations are much more consequential.

Reckless Behavior

Robinhood is a casino. Yes, the trading app popular among millennials is a casino masquerading as a brokerage firm targeting first-time investors, and the predatory nature of their business model is troublesome. Robinhood was able to accomplish what casinos have struggled with for more than two decades, the lack of interest in gambling, and especially among younger generations. In 1989, 59% of revenue on the Las Vegas Strip came from gambling, falling to only 35% in 2019.

Robinhood discovered a way to enable gambling right from the comfort of your smartphone by marketing its products to those with limited to no financial markets experience, along with the use of effective psychological tactics championed by social media applications to increase user engagement. As it turns out, if you provide a fun game-like user experience, you can easily convince people to borrow money, trade complex financial instruments, and purchase risky financial assets, to profit from their naivety. We know these disturbing details now, as it is all spelled out in Robinhood's IPO filing released on July 1st.

Options trading is the single-largest contributor to the firm's revenue. A stock option is a financial instrument that allows you to bet whether the price of a stock will move up or down. Stock options are much more complex than stocks and require advanced knowledge of their underlying mechanics to use them properly. Under no circumstance is it appropriate for someone new to investing to be trading options. If Robinhood truly wanted to help the little guy and promote investing, they would encourage buying and holding quality companies for the long run. But as the company points out, there is no money to be made if users are not frequently placing trades. Robinhood disclosed more than 50% of its customers are first-time investors, and 61.1% of transaction-based revenue is from options. The majority of customers are new to investing, and the majority of transaction-based revenue is from complex financial instruments. Robinhood is a disservice to financial markets and is setting up a generation of investors for failure.

Adding fuel to the fire is the despicable and profane group on Reddit responsible for pumping up the prices of various "meme stocks" and the notorious GameStop and AMC short squeezes, WallStreetBets. Meme stocks are those passed around on social media generating enough buzz to go viral, provoking waves of online traders to buy them. The game is finding the stocks before going viral and making quick money once everyone else piles in, causing the stock's price to spike. The Reddit group is filled with an infinite supply of misinformation, conspiracy theories, and troubling investment "advice," all unchecked and taken as the utmost truth as far as the ten million members are concerned. Market manipulation schemes and very high-risk trading ideas spread like wildfire, and Robinhood, which encourages this type of behavior, is the perfect venue to carry out aggressive trading strategies. We welcome the Securities and Exchange Commission to step up at any time and start protecting investors from the disgraceful clowns on WallStreetBets, making unsuspecting newcomers bag holders for the variety of stocks they promote.

It would not be possible to speak of reckless behavior without mentioning cryptocurrency, which now has a global market capitalization north of one trillion dollars. The problem is quite simple; cryptocurrency is worthless. To be clear, the technology behind cryptocurrencies, blockchain, does have legitimate applications and future uses. But blockchain is just a record-keeping technology and acts as a database by storing data in blocks that are chained together. With that said, crypto as a currency has no value. Cryptocurrency does not even pass the most basic test of a quality currency, serving as a store of value. Meaning it must hold its value over time. Dramatic price changes are a staple of cryptocurrencies, with significant variations from one minute to the next commonplace, let alone the deviations observed over months or years.

Notwithstanding the small subset of people who think the world is coming to an end and owning cryptocurrency instead of dollars will somehow make a difference, the real motivation behind cryptocurrency is to make a quick buck. Increased enthusiasm and high-profile endorsements have led prices to skyrocket over the past couple of years, and now everyone wants a piece of the action. For our purposes, we will use bitcoin as an example since it is the largest cryptocurrency. Shifting our thought process away from a currency, we will look at bitcoin through the lens of a prospective investment. As any prudent investor would, we will ask a couple of questions to help us understand the characteristics of the investment opportunity. Does bitcoin pay a dividend? No. Does bitcoin generate any cash flows? No. Does bitcoin produce anything? No. Does bitcoin perform a service? No. Bitcoin makes for a considerably unproductive asset, rendering its prospects as an investment useless. Our only conclusion is the motivation to buy bitcoin is reliant upon the hope that at some point down the road, you can find someone to offer you more than you originally paid, and for no particular reason. Hope is not an investment strategy. You hope for your flight to be on time, not that your hard-earned money will be there when you need it.

Transient or Perennial? That Is the Question.

Inflation concerns have made their way to the forefront, causing fear on Main Street. According to the University of Michigan Surveys of Consumers on the expected change in prices during the next 12 months, 44% of respondents expect prices to increase by 5% or more over the next year, and 20% believe the increase will be double digits. Overall price levels are sure to continue rising, and growth in personal income is a revealing measure. From 1960 through the Great Recession ending in 2009, the United States experienced eight recessions. One year following the end of each recession, real disposable personal income increased 3.8% on average. In the one year after the Covid-induced recession, personal income is up 30.2%. We have a much greater pot of money chasing a smaller basket of goods. Many companies cut production in the wake of lockdowns resulting in supply chain pressures stemming from bottlenecks and a lack of workers. Concurrently, government support programs more than made up for lost income leaving many consumers flush with cash. The imbalances plaguing the economy need to work their way through the system by way of higher prices until excess demand is satisfied and supply normalizes. Short-run inflation will run hot, but the effects will lessen with time, and we expect inflation over the longer term to be in line with the sub-2% experienced over the past ten years.

The Federal Reserve expects inflation to come in at 3.4% this year, with slightly above-trend prints over the next couple of years, before reaching their long-run target of 2%. Today's buzzword is "transitory", and the Fed reiterates that any price increases are temporary, but many observers worry higher price levels may become permanent. The rapid appreciation in home prices, up 23.4% year-over-year in June, is one example making headlines and causing some to question the Fed's forecast for 3.4% inflation this year. The problem is how the government measures home-price inflation, which does not reflect the price paid to purchase a home. Housing units are not included in the CPI measure as they are considered a capital good, not a consumption good. Comparable to why stock price changes are not included in CPI, purchasing a home is treated as an investment since over the long run, one can expect home prices to increase and eventually capture a profit upon sale. In addition, homes provide shelter and are not strictly an investment, making it challenging to measure the inflation impact. The CPI measures price changes for an owner-occupied unit through an implied rent figure by asking homeowners how much they believe monthly rent for their homes would be. For a typical homeowner who did not buy a home or refinance a mortgage during the past year, their housing costs are probably little changed. For example, someone with a fixed-rate mortgage is paying the same monthly amount as the prior year even though the value of their home increased more than 20%. The rationale makes sense but is not an accurate reflection of the inflation experienced by new home buyers and those upgrading to larger homes.

As it relates to your portfolio, stocks and bonds experience inflation differently. Fixed-rate bonds make regular payments to investors based on a fixed coupon rate over the bond's life. An increase in inflation makes the income investors receive less valuable. Goods purchased are more expensive while the amount of income remains the same. Additionally, if inflation picks up, the Fed may increase interest rates to prevent the economy from overheating. Bond prices are inversely related to interest rates, so an increase in rates causes a decrease in bond prices. New bonds issued with higher coupon rates make prevailing bonds with lower coupon rates less valuable. Stocks, on the other hand, represent a good hedge against inflation. Companies can maintain profit margins by passing through price increases to customers and thereby growing the bottom line. Over the long run, stocks have outpaced inflation, although higher interest rates may cause near-term weakness as investors become acquainted with the new rates. Ideally, in a balanced portfolio, the inflation impacts from stocks and bonds are a wash, and the underlying fundamentals for each asset class drive portfolio returns.

Not So Fast

Last year we experienced a bear market and a recession, so now we are due for another decade-long bull market. Right? Wrong. History books need to include an asterisk next to both of those claims. The bear market lasted less than one month, and the recession endured only two months. Since 1929, the average duration of bear markets and recessions is 22 months and 13 months, respectively. The episode markets experienced in the spring of 2020 was a sideshow. Often, market drawdowns allow a valuation reset. Prices at times become detached from the fundamental factors they stand for, and bear markets provide for a reflection period to bring the relationship back in line. In the nine bear markets since 1950, one year following the end of each drawdown, the Cyclically Adjusted Price-to-Earnings (CAPE) ratio on average was 19.6% lower than at the start. One year following the March 2020 speed bump, the CAPE was 14% higher. The CAPE ratio is a valuation metric that divides the S&P 500s price by the 10-year average inflation-adjusted earnings.

Several factors are at play, including easy money and soon-to-be-expensive money. Zero percent interest rates and asset purchase programs have lowered borrowing costs and improved access to financing for individuals and businesses alike. Moreover, the federal government's unprecedented pandemic response put trillions of dollars in consumer's pockets through direct payments, small business payroll grants, and additional unemployment assistance. Aided by the actions, expectations call for corporate earnings to reach all-time highs this year. On the other side of the coin, taxpayers are funding this growth through an implicit borrowing arrangement with the federal government. The stimulus payments individuals received over the past year will be returned to the government through higher future taxes. And the cost to taxpayers is setting up to be a double whammy. Not only will elevated tax rates manifest in reduced discretionary income, but above-average inflation will further suppress purchasing power. The federal aid was intended to hold people over by making up for lost income resulting from pandemic-related economic disruptions, not to help household net worth surge to record levels and pad corporate profits. Record earnings may well come to fruition this year, but it is not sustainable, and future suppressed consumer spending will serve as a tax on business profits. The boost from the stimulus will fade, and the economy will return to the slow growth posture where we began the decade. The market is supremely overvalued and as valuations continue to rise, so does the risk of the market delivering a disappointing decade for investors.

Moral Hazard

We are in a unique time. From an unprecedented response of the federal government to speculation and risk-taking beyond belief, no one has seen the ending to this particular movie before. The actors and set of rules this time around are equally unparalleled to boot. Colorful characters using social media can influence markets quickly and effectively with a simple post. Online profiles can craft any narrative giving off the impression of some level of expertise or success, causing those consuming the content to fall into the trap of the fear of missing out.

Two events, in particular, depict just how flagrant the behavior has become. Theater chain AMC was on its way out of business due to evolving consumer preferences until a garage band group of traders realized they could work together to bid up the stock's price. By doing this, the company could now raise enough cash to stay afloat by selling their stock at inflated prices to those very people. Regulators astray, the traders successfully manipulated the proper functioning of capital markets. Just as problematic, a cryptocurrency called dogecoin, which by design has an unlimited supply and the founders created as a joke in 2013, is now one of the top ten largest by market capitalization. Benefiting from celebrity endorsements, traders bid up the price more than 4,000% this year through June because they think it is funny.

The level of irresponsible behavior today is alarming, and sadly the examples discussed have plenty of company. The stimulus checks supplied much-needed cash to many people but also resulted in the coffers overflowing for others. For those in the latter predicament, this created a moral hazard. People are much more willing to make aggressive wagers or engage in reckless activities when they did not have to work for the money. As Warren Buffett wisely quipped, "nothing sedates rationality like large doses of effortless money." Unfortunately, this is the world in which we live. Although influenced by extraordinary factors like a 100-year pandemic, we are in an unusual period, with a unique set of actors and an unconventional set of rules. When you put it all together, this is beginning to resemble an off-the-wall comedy, not something necessarily desired of financial markets.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization.

Sources: Committee for a Responsible Federal Budget, J.P. Morgan Asset Management, NBER, University of Michigan, University of Nevada Las Vegas, YCharts.