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FROM THE DESK OF DARRELL L. CRONK

State of the Markets

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Darrell L. Cronk is the president of Wells Fargo Investment Institute, which is focused on delivering the highest quality investment expertise and advice to help investors manage risk and succeed financially.
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An object in motion…

"The irrationality of a thing is no argument against it but rather a condition of it." — Friedrich Nietzsche

It would be nice to believe that markets are always steadily efficient, acting appropriately as a discounting mechanism. The purpose of markets is to allow prices to be discovered, and that requires a large pool of buyers and sellers to participate. At various stages of an economic cycle, different shifts of human behavior occur that can lead to prices fluctuating well above and below their fair value. Equally, there are no set rules that determine which group of investors — institutional, foreign, retail, etc. — should dominate the setting of prices at any time.

What happened

In an almost David-versus-Goliath-type battle this past week, retail investors — supported by liquidity and social media — swarmed popular hedge fund short positions, creating what Wall Street calls a "short squeeze" on a number of stocks with high short-interest ratios, inducing unprecedented volatility. Last week witnessed a 62% spike in the CBOE Volatility Index (VIX), a commonly followed measure of stock market volatility, the second largest single-day spike in a decade. This appears to be a vocal army of retail traders bringing a populist fight to the markets through targeted buying in selective single stocks, forcing prices to inconceivable levels relative to their fundamental outlook. As a result, some of the most heavily shorted and levered stocks have sharply risen — the common thread for these stocks is both consumer brand awareness and intuitive understanding of the product by retail investors.

Retail participation has been on the rise steadily over the past several years with the acceleration of secular trends: declines in online trading fees/commissions, better technology creating retail ease of use for trading platforms, and demographic shifts as Millennials enter their prime earning years. New internet platforms are facilitating the education and recruitment of new investors. Social media is spreading new trade ideas with higher velocity in chat rooms and trending news sites are flagging abnormal trading activity, high volume, or extreme single-day price moves.

Why this happened

So why did this trend explode onto the scene in late January with a few select stocks as the battlefront? Frankly, this phenomenon has been growing for some time below the surface, as this democratization of information has purposeful traders sparking popular sentiment against short sellers betting that financially struggling companies' stocks will falter. Younger retail cohorts appear more comfortable wielding leverage, owning single stocks versus passive products like exchange-traded funds (ETFs) and mutual funds, and using capital to take moral stands supporting companies deemed under attack. Elevated New York Stock Exchange (NYSE) margin balances, strong retail derivatives purchase levels, and recent social media posts confirm these trends.

It is important to note that, as many other themes, COVID-19 intensified and accelerated this underlying retail investment trend. Multiple rounds of stimulus, excess savings, low consumer debt service ratios, and rising home equity levels are all contributing factors, and the scarcity of substitutes to spend cash on has resulted in higher-than-usual retail stock market participation. The latest U.S. savings rate remains at an elevated 13%, down from its March 2020 all-time record of 34%. The pandemic's unusual influence has discretionary spending by consumers down 30%–50% year over year on transportation services, recreational services, food services, and gasoline/energy spending. This additional disposable income, along with extra time as people work from home, is a key catalyst in rising retail stock market participation.

The future

History has proven time and again that while irrational market behavior can persist for short periods of time, over the intermediate to long run, markets have returned to rationality and fundamentals. That said, it would be wrong to ignore this changing trend in democratization of financial markets, where the power of social media platforms creates both opportunity and risk.

This latest trend has its roots in an outcry — or dare we say even a demand — for an equitable ecosystem between Wall Street and Main Street. We wrote about this theme of convergence in our 2021 Outlook, even if we weren't fully able to predict the tool set used to pressure this gap. Often, ground-shaking events such as a global pandemic have rippling repercussions. This latest trend, backed by the power of social media, will require investors to expand their investment toolkit to include fundamentals, market insight, and community sentiment.

Risk Considerations

Past performance is no guarantee of future results. All investing involves risk, including the loss of principal. Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.

Definitions

CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

An index is unmanaged and not available for direct investment.

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