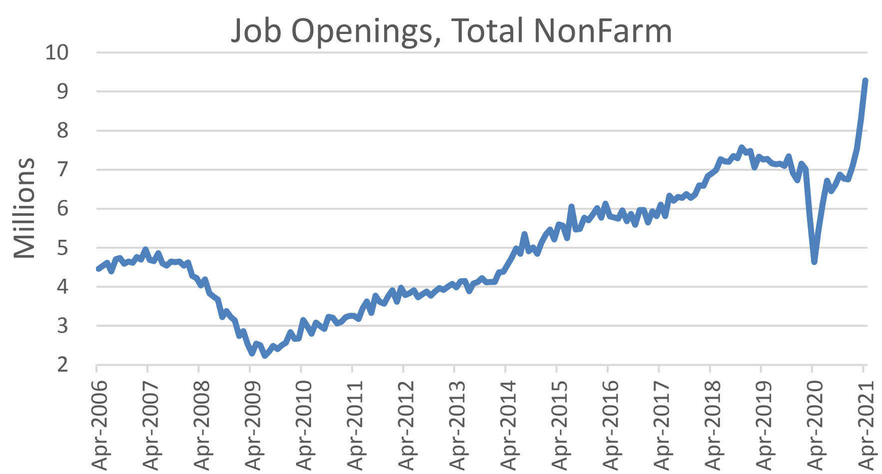
Economic and Capital Markets Commentary

The Consumer Strikes Back: What Surging Demand Means for the Economy and for Stocks

After a year of lockdown, U.S. households have begun to spend savings that accumulated during the pandemic. As a result, consumer demand for goods and services, from automobiles to restaurant reservations to airline seats, has in many cases exceeded the available supply. This effect has been intensified by the decision of companies large and small to cut back on hiring and investment simply to survive the last 15 months. In response to this *demand shock*, businesses have been forced to ramp up practically overnight to meet the surge in spending.

Consequently, as shown below, the number of job openings employers are looking to fill now stands at an all-time high, even though the country is still nowhere near *full employment* as described by the Federal Reserve. (To put it simply, the Fed will not declare victory on the employment front until the unemployment rate, currently 5.8%, returns to pre-pandemic levels of 3.5 – 4.0%.)



Source: U.S. Bureau of Labor Statistics

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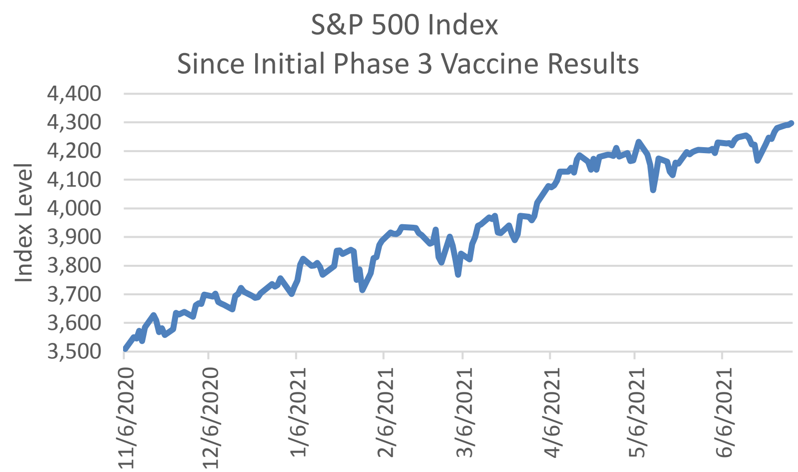
Making the Fed's job more difficult, the labor market is highly dynamic. That means that in the short-term, the employment numbers do not always account properly for workers who chose to retire, or were forced into retirement by COVID-19, or, on the other hand, those entering the workforce, such as high school and college graduates.

Meanwhile, the unleashing of household savings now taking place across the country in such a short period of time has already led to temporary (in our opinion) price increases in many consumer goods and services and, as discussed in our Second Quarter 2021 Commentary [link], raised concerns about longer-term inflation. It has also boosted year-to-date sales at many publicly traded companies.

With this backdrop, during the first few weeks of the second quarter, U.S. equity markets continued to grind slowly higher as economic activity picked up across the country. However, the momentum that carried the market following the first positive results from Phase 3 vaccine trials in November 2020 largely stalled in May and June (the S&P 500 Index did close the quarter at a record high).

Does this mean the economy is no longer improving? Quite the opposite. Nearly every statistic we have viewed points to increased economic activity, albeit in fits and starts, which is to be expected after such a significant downturn in activity. Indeed, over 80% of companies reported first quarter earnings above Wall Street estimates, far above the historical average of 65%.



Source: Bloomberg

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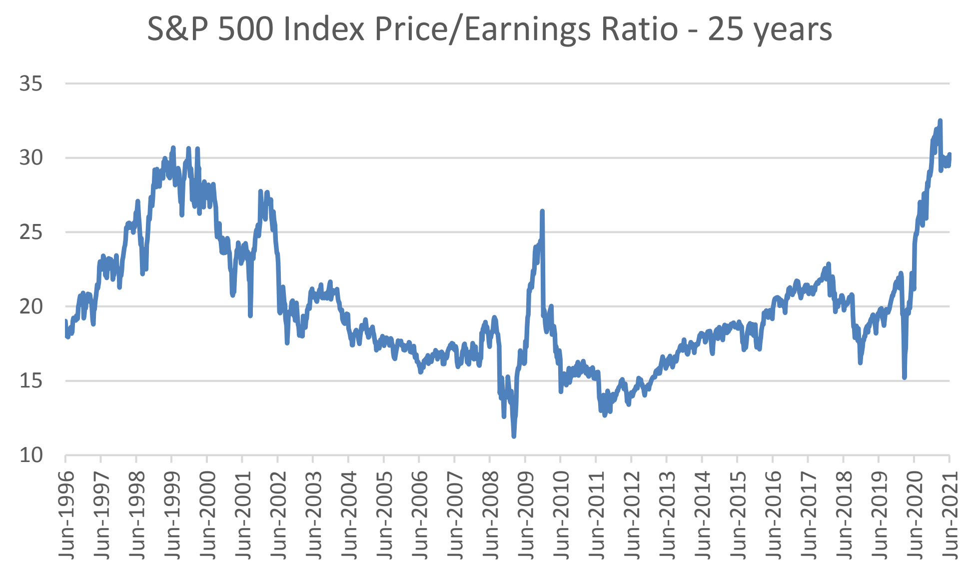
When markets stall or move sideways during a period of strong earnings, it typically has more to do with previously elevated stock prices and investors' lofty expectations than underlying economic fundamentals. In such a situation, stock prices may trade for a time in a narrow range, making little headway until the underlying corporate earnings catch up to the prices being paid for those earnings.

This effect can often be seen by tracing valuation multiples, such as the price-to-earnings (P/E) ratio, which measures the price investors are paying for the earnings of a company or collection of companies as represented by an index. P/E ratios are frequently cited as a quick measure of whether the market is cheap or expensive. As shown below, the P/E ratio of the S&P 500 Index entering the second quarter was extremely elevated relative to history. In fact, the last time investors paid this much for earnings was during the Tech Bubble in the late '90s.



Source: Bloomberg

It is worth remembering, however, that COVID caused aggregate corporate earnings to decline dramatically last year. This, rather than a run-up in stock prices, elevated the price-to-earnings ratio of the index. If the market does not move markedly higher as positive earnings continue to roll in, P/E ratios should return to more normal levels. In short, the profitability of companies will catch up with the price investors have been paying for them.

Inflation expectations, the Federal Reserve, and COVID variants may continue to command front page headlines this summer. At Mitchell Sinkler & Starr, however, we will continue to focus on consumer spending, hiring, and the ability of companies to adapt and adjust to meet consumer demand. These factors will drive earnings, and over the long-term, earnings drive stock prices.

Note that at the end of this Commentary we have included our third Investment Insights column. This quarter we discuss “meme stocks” and the irrational price movements of two companies that were flirting with bankruptcy less than a year ago.

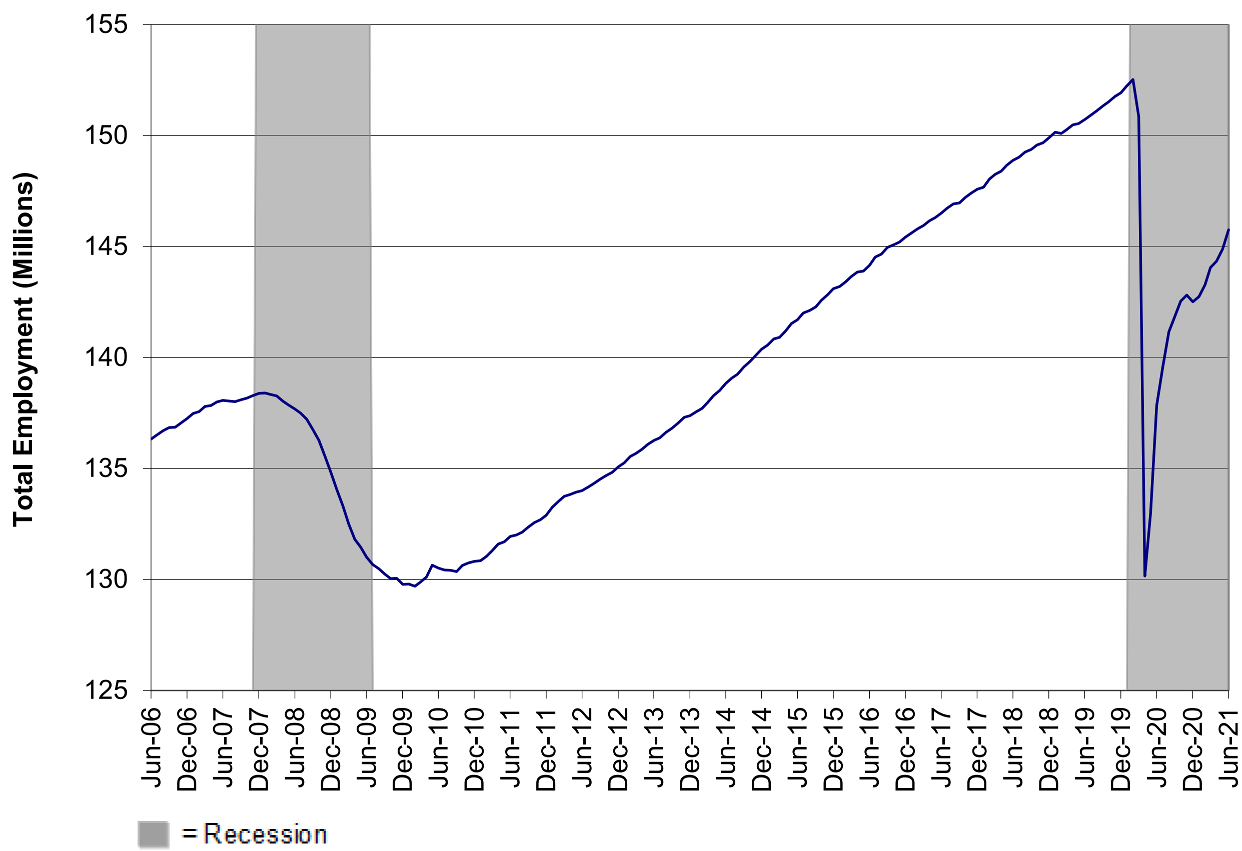
Economic and Capital Markets Data

	June 30, 2021	June 30, 2020	June 30, 2016
S&P 500 Index	4298	3100	2099
Price / Earnings Ratio	30.3	22.2	19.4
Dividend Yield	1.31%	1.95%	2.18%
Federal Funds Rate	0.25%	0.25%	0.50%
10-Year U.S. Treasury Yield	1.47%	0.66%	1.47%
Gold	1770	1781	1322
Oil (Brent)	73	41	50
GDP* (Annualized)	6.4%	-32.9%	2.1%
Unemployment	5.9%	11.1%	4.9%
Inflation (Annualized)	5.4%	0.6%	1.0%

* GDP Data as of 3/31/2021

U.S. Total Employment

Fifteen Years

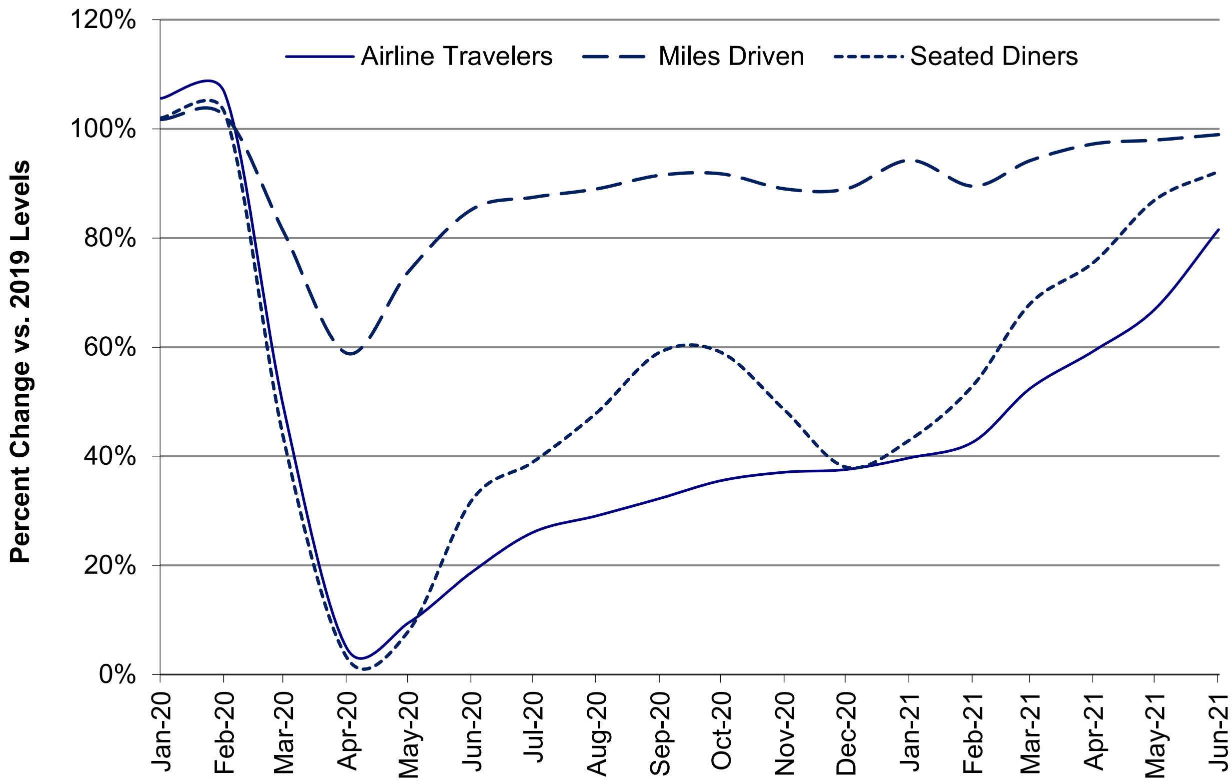


Employment continues to recover quickly, as lockdowns and restrictions have eased and demand for services has increased.

Source: Bloomberg

Economic Data Points

Eighteen Months

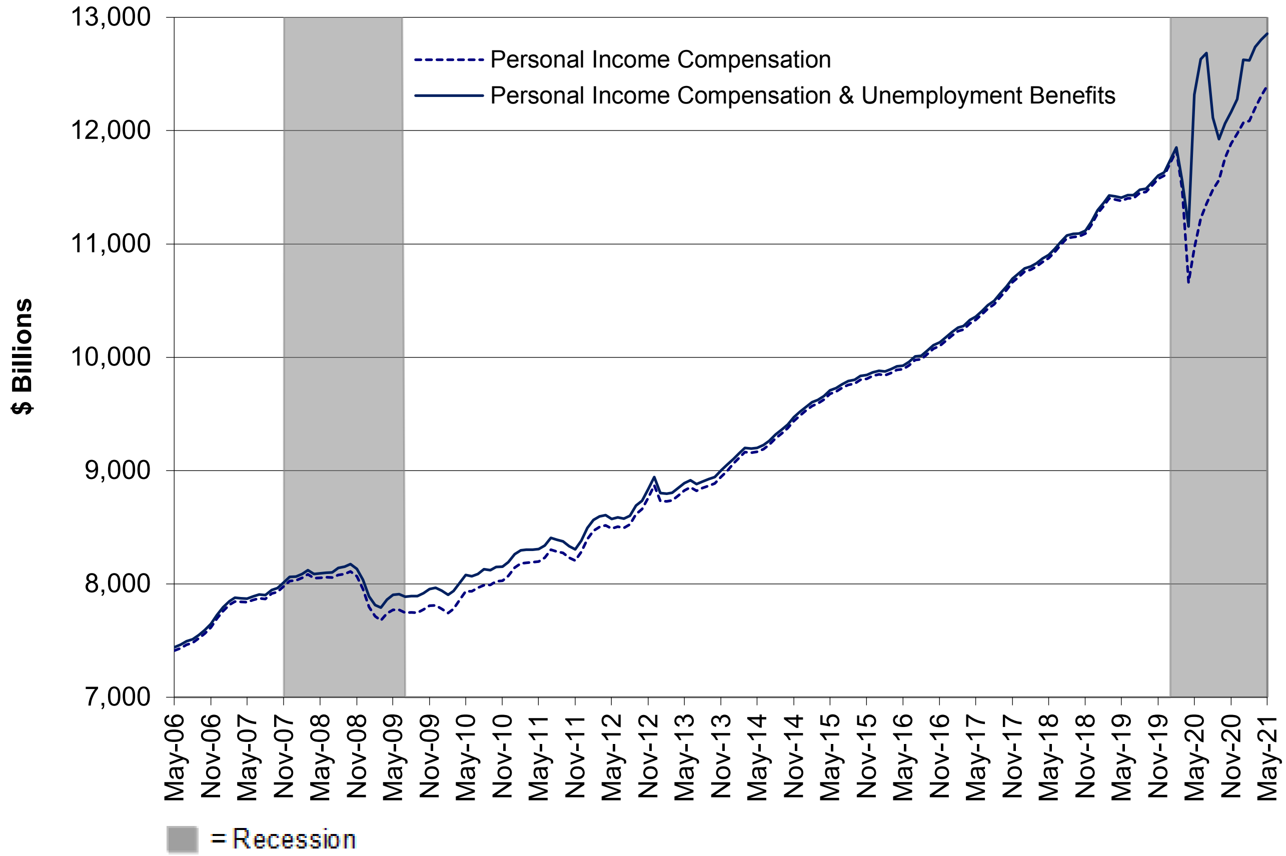


While economic activity continues to climb at a rapid pace, it may have been even higher if not for supply and labor shortages affecting many industries.

Source: TSA, Federal Highway Safety Administration, OpenTable

Total U.S. Monthly Compensation & Unemployment Benefits

Fifteen Years

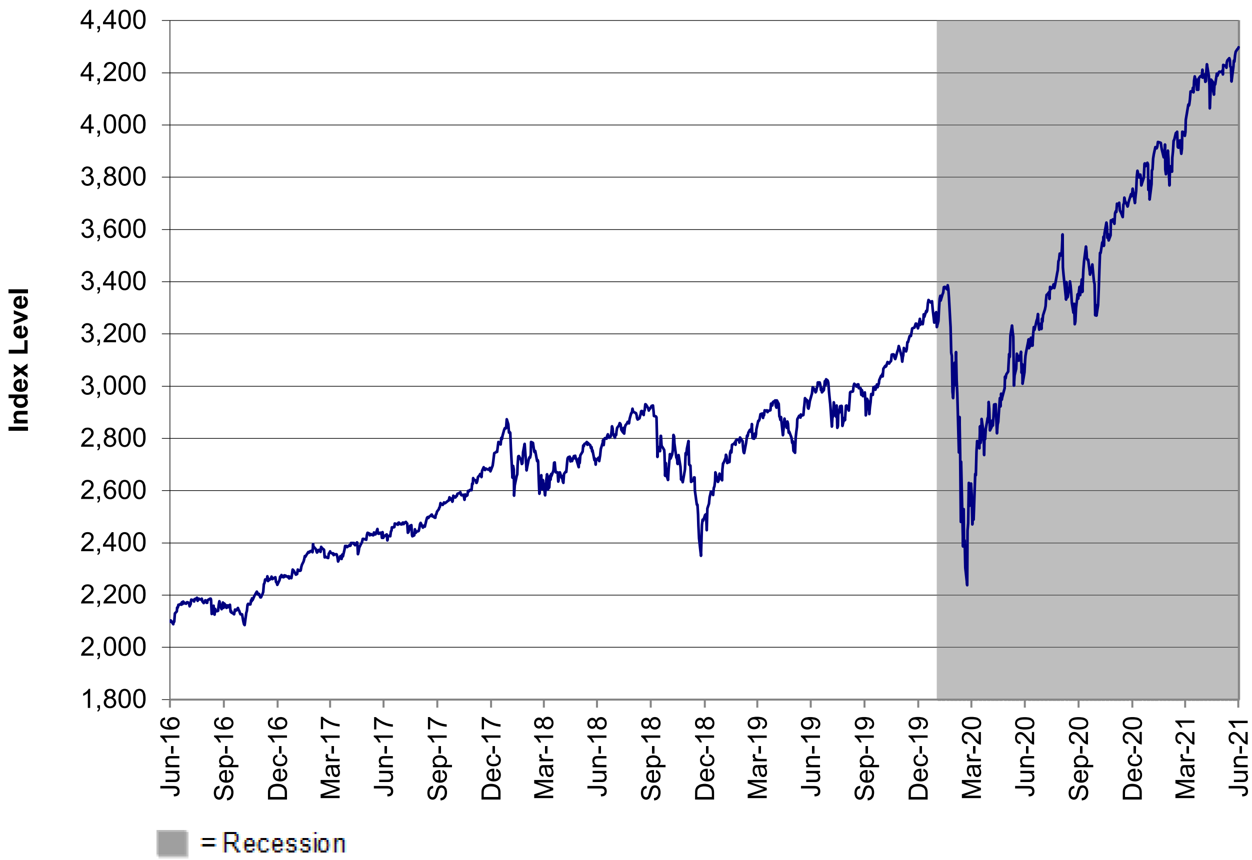


Fueled by government stimulus and unemployment benefits, total personal income jumped to a record high. Some states, however, have decided to end unemployment benefits early, citing possible labor shortages these benefits may cause.

Source: Bloomberg; Please note that this chart is as of May 1, 2021.

Standard & Poor's 500 Index

Five Years

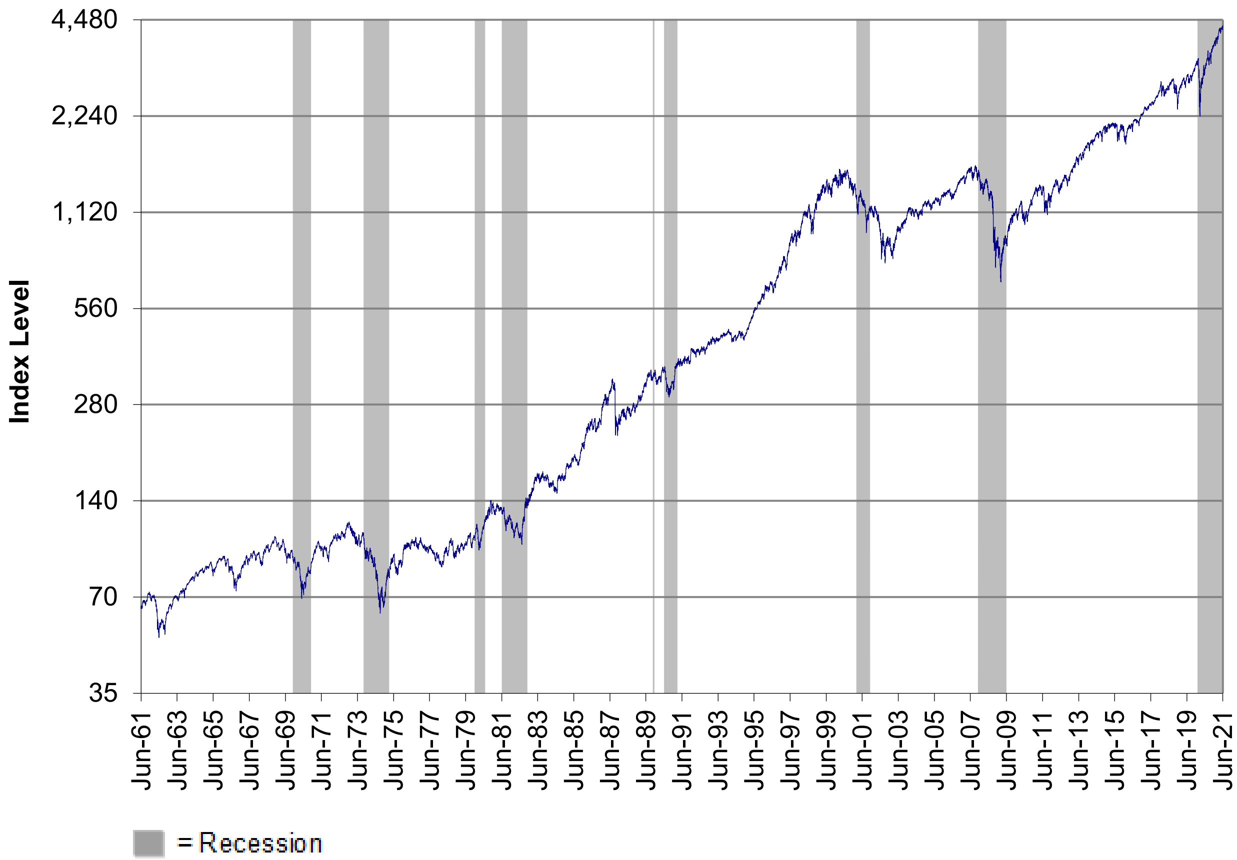


Strong first quarter earnings have supported the stock market's gains in the first half of the year.

Source: Bloomberg

Standard & Poor's 500 Index

Sixty Years



Over the long-term, stocks remain the only liquid asset class with the potential for growth in excess of inflation.

Source: Bloomberg; Please note that this chart is using a logarithmic scale.

Financial Market Data

Decade-by-Decade

S&P 500 Index	1960s	1970s	1980s	1990s	2000s	2010s
Opening Level	60	92	108	353	1469	1115
Closing Level	92	108	353	1469	1115	3231
Beginning Price / Earnings Ratio	17.6	15.1	7.4	14.7	29.3	19.4
Ending Price / Earnings Ratio	15.1	7.4	14.7	29.3	19.4	21.2
Earnings Growth	6.0%	9.1%	5.1%	7.6%	1.4%	10.2%
Total Return	7.8%	5.9%	17.5%	18.2%	-0.9%	13.6%
Price Appreciation	4.4%	1.6%	12.6%	15.3%	-2.7%	11.2%
Dividend Return	3.4%	4.3%	5.0%	2.9%	1.8%	2.3%
Avg 10-Year U.S. Treasury Yield	4.8%	7.4%	10.4%	6.5%	4.3%	2.5%

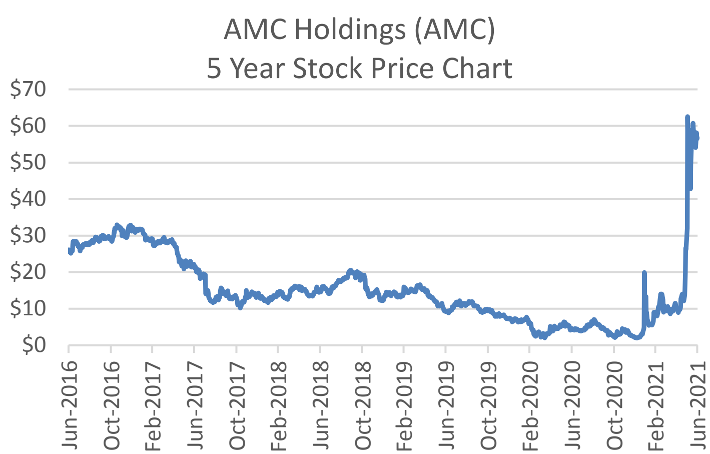
Returns for each decade are annualized.

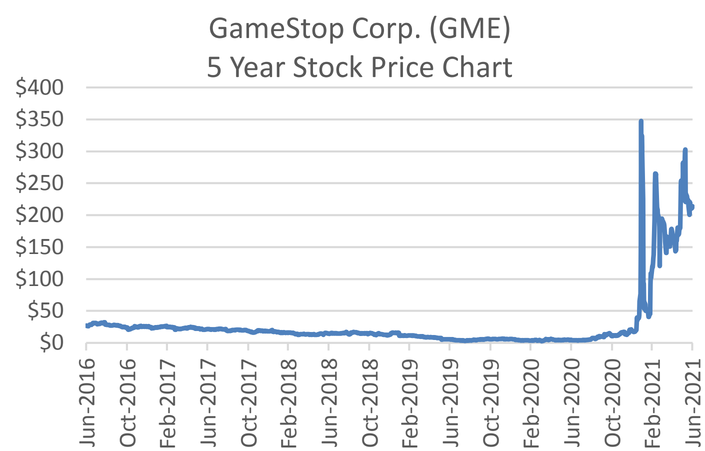
Investment Insights

A Bubble by Any Other Name: The Year of the "Meme Stock"

By the late summer of 2020, AMC Holdings (AMC) was a struggling movie theater chain brought one step closer to bankruptcy by COVID-19. Streaming services like Netflix had already resulted in fewer consumer trips to the cinema (and fewer sales of soda and popcorn), and then the pandemic completely shut AMC down. GameStop Corp. (GME) faced an equally dire situation. The nation's largest brick-and-mortar video game retailer, its main profit-making segment (reselling used consoles and games) had been declining for a decade as the gaming industry moved from physical copies of games to digital downloads of the latest hits such as Minecraft and Fortnite. Then, due to COVID, it too had to close its locations.

As pandemic-related restrictions eventually eased, the retail locations of both companies began to reopen. Other than this marginally bright bit of news, however, no new major potential earnings drivers emerged for either company. Yet despite that fact, any investor looking at the five-year stock chart of both AMC and GME (below) might reasonably conclude that both companies had reinvented themselves.





In reality neither company has made any significant move toward greater long-term profitability, yet both stocks have become retail investor favorites. What happened? The run-up in AMC and GME was driven by social media and the perceived *wisdom of the crowd*—or the Reddit mob. (Reddit is a social media website where individuals can connect and discuss a diverse range of topics.) In our opinion, neither stock price reflects the fundamental long-term prospects for either business. Instead, they represent a perceived battle between retail investors and Wall Street—perfect examples of so-called meme stocks.

As lockdowns have ended, AMC has reopened its doors and is showing movies again but finds itself increasingly in competition with studios streaming their movies directly to consumers. In addition, the company is saddled with debt. Its prior strategy of borrowing to buy other theater chains left it with a crippled balance sheet. (Too much debt limits any corporation's options during downturns). At least AMC was able to use the rapid stock price increase to issue more shares, which raised much needed cash and provided a temporary financial lifeline.

Meanwhile, GME replaced most of its management team and brought in the founder of online-pet food company Chewy as its new chairman. While there are potential new business lines the new team could pursue, profitability in new segments is hard to create from scratch.

Why now?

We might ask what changed in the world to spark the sudden, dramatic, and hard-to-justify turnarounds in the stock prices of these two companies. There are many possible catalysts for why this occurred in 2021—the pandemic, shutdowns, government stimulus. But we should note this type of investor behavior is not without precedent. While not nearly as organized, something similar got its start on the Yahoo message boards during the dot-com boom and bust in the late '90s.

Investment Insights

This time around, these are the conditions that came together to drive the phenomenon:

- When COVID-19 hit, the personal saving rate of Americans skyrocketed. Aside from online shopping, consumers quite literally could not spend money even if they wanted to. This led to a larger than normal amount of cash on the sidelines, which was also earning nothing in savings or money market accounts due to the Federal Reserve slashing interest rates.

- The U.S. stock market started to rebound in late-March 2020, at the same time that many young adults were stuck at home either unemployed (and receiving significant government stimulus payments) or working from home with increased savings. The rising stock market may have piqued their curiosity as stocks hit all-time highs repeatedly in the latter half of the year, despite a raging pandemic.

- Crowd behavior is amplified on the internet. Subscribers to the subreddit *WallStreetBets* (a specific group on Reddit) ballooned from 1 million when COVID-19 started to over 6 million by the end of 2020. Rapid stock appreciation, often seen as a quick way to make money, results in both the *fear of missing out* (FOMO) and a form of mob mentality driven by emotion. GME and AMC were highlighted online by several individuals as “deep value” stocks for several reasons, including the number of shares that were held short by hedge funds who had bet the price would decline. This was one way the movement became somewhat of a crusade against Wall Street.

- Finally, retail investors found they could now trade stocks for zero commission, removing one of the final friction points for day traders and other short-term speculators. Robinhood Financial, an online broker, targeted meme investors by offering zero commission stock and option trading. They also offered fractional share orders (the ability to buy less than one share of stock), a millennial-friendly cell phone app, and promotions for traders with little money to invest, all of which succeeded in attracting new, younger investors looking to get in on the action.

Investment Insights

Who’s in charge and what do they want?

It appears that retail traders are driving much of the price movement in AMC Holdings, GameStop, and other meme stocks. Using leverage through margin accounts (borrowing against the value of their account to buy even more shares), retail traders have become a much larger presence in the stock market over the past 12 months than they have in the past. While many post on message boards that they are trying to “stick it to the man” by showing Wall Street that they can keep these companies alive, most are likely trying to make a quick buck riding a wave of momentum.

On the other side of the trade, several hedge funds lost significant amounts of money betting these companies would fail, further emboldening the Reddit mob. At the same time, it is a guarantee that other institutional investors are finding ways to make money from the extreme volatility of the meme stocks as seen in the charts above.

How will this play out over the long-term?

In our opinion, the price of any meme stock will eventually revert to the underlying value of the business and its future potential earnings. Bubbles and manias have been well documented throughout history and we would simply add this to the list. We are concerned, however, that at the end of the day, if and when these stocks fall back closer to their fair value, it will be unprepared retail traders left holding the falling shares, not large institutions, hedge funds, or Wall Street.

For those that may be inclined to run with the meme crowd, we say “tread carefully.”