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Welcome Back to Fundamentals and Risk Management

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The Fed and US government pumped massive liquidity into the economy and markets during the Great Recession and again after Covid-19 hit. The tide came in and lifted all boats for well over a decade. With the market in full "risk-on" mode for much of this period, many overvalued stocks as well as speculative equities (e.g. low-quality "meme" stocks) did very well riding abundant liquidity.

The liquidity-fueled party is now over. As the Fed belatedly withdraws this excessive liquidity by hiking interest rates and embarking on quantitative tightening, stocks have entered a deep bear market and bonds continue to be hit very hard. So far, the market is off to one of the worst starts to a calendar year. While supply chains have improved some, Russia's horrific invasion of Ukraine continues, and the bond market has raced ahead of the Fed in pushing rates up and draining liquidity from the system. The Fed is now playing catch-up. As the tide goes out, almost all assets are getting hit hard. What is happening now is the ***opposite*** of what prevailed during the decade when the Fed pumped the system full of liquidity.

The current declines of the stock and bond markets are painful, but temporary. Bear markets have always been transitory, and on average are much shorter in duration than bull markets. In hindsight, the Fed pumped too much liquidity into the markets and distorted asset pricing. Draining excessive liquidity exacts pain in the short run, but is positive in the medium and long run. It brings about a long overdue adjustment away from a market environment in which most assets, good or bad, rise due to massive liquidity. ***This means markets and investors will again be re-introduced to the concept of risk management and the importance of making fundamental distinctions between high-quality and low-quality assets. This should reward those who do fundamental research and are valuation driven. Capital markets will once again be more efficient and effective in funding only those businesses that deserve money, rather than chase dreams, concepts, exciting stories, and fads***.

The direction of the market on the way up and now on the way down has been influenced greatly by ETFs and quantitative-based investment vehicles that have dominated daily market trading over the past decade. These vehicles do not discriminate among different companies. ETFs buy/sell ***baskets*** of stocks, while quantitative investing often executes algos that key off certain "factors" such as momentum, key words, headlines, macroeconomic developments etc. Most of these vehicles are valuation agnostic. With the massive liquidity that the Fed and government injected into the system over the past decade, many of these vehicles did well despite being agnostic about valuations. This lack of risk management did not hurt; on the contrary embracing full-on risk and throwing caution to the wind during that period did very well as good, bad and ugly assets all appreciated. This created a false sense of infallibility; but now most of these assets have been decimated by this bear market.

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As we transition from a system pumped full of liquidity to one that is rapidly draining liquidity, ETFs and quantitative-based investment vehicles are selling indiscriminately. If one retailer mentions supply chain disruptions, an ETF investor that owns a basket of retail stocks may sell the ETF, and by extension every single retail stock (regardless of relative merit) making up that basket. Likewise, a quant using an algo that searches for the words "supply chain disruptions" would automatically trigger a sell program for a group of retail stocks.

Overvalued and deeply flawed assets can keep going up a lot longer and higher than rationality would justify. Ample liquidity cures a lot of recklessness. This speculative wave lasted a very long time, but the music appears to have finally stopped. There were many bubbles during this go-go period, but 4 of the most extreme were crypto companies/cryptocurrencies, unprofitable technology companies with exciting stories, special purpose acquisition companies (aka SPACs), and so-called meme stocks. Below we discuss what has happened to these 4 areas of the market so far this year, now that we are transitioning back to fundamentals and risk management.

Crypto companies/cryptocurrencies

As of June 15, 2022, the price of bitcoin (the world's largest cryptocurrency by market capitalization) has dropped about 67% from its all-time high reached in November 2021. The price of ether (the second largest cryptocurrency by market capitalization after bitcoin) suffered an even more severe 74% loss. Most other cryptocurrencies also saw their prices plummet this year. The fallout in the crypto sector has not only wiped out ***more than $1 trillion in value over the past 6 months***, but it has also surfaced problems that have been largely ignored or missed in this decentralized and unregulated sector.

As one example, trouble has hit crypto lenders who offer staggeringly high yields to attract deposits. These crypto lenders may hold their reserves in other crypto assets, subjecting them to concentrated risk from the same asset class. Compounding the risks is the fact that there is no regulatory oversight or government-backed insurance for customer deposits.

On June 12, 2022, Celsius, a major crypto lender that was offering up to 18% yield to depositors, suspended customer account withdrawals. It had no choice but to take this action as customers pulled $2.5 billion from Celsius since March in reaction to plummeting crypto prices. Assets under Celsius's management in May was down to just half of what it was roughly 6 months earlier.[1] Customers reportedly had problems logging into their accounts or withdrawing their assets in the days leading up to the announcement barring withdrawals.

Celsius's suspension of customer withdrawals not only alarmed its depositors about losing their assets, it also fueled carnage across the entire crypto sector. On the Monday after Celsius's announcement, bitcoin and ether both dropped more than 15%. Celsius's digital token fell more than 20% the same day and more than 95% over the previous 12 months.

The volatility and riskiness of crypto assets shown by the Celsius debacle echo those relating to the collapse of the stablecoin TerraUSD just a month earlier. A stablecoin is a cryptocurrency that is pegged to a government-issued currency. Given that it is designed to provide a stable and predictable value, stablecoins are marketed as a safer type of crypto assets. However, a stablecoin's risk depends on whether it is backed by real assets, financial assets or algorithms. It's one thing to be backed by let's say 3-month Treasuries with no default or interest rate risk, and quite another to be backed by computer code that itself is based on another type of volatile cryptocurrencies. In TerraUSD's case, it had a 1:1 peg with the US dollar and was backed by an algorithm involving another cryptocurrency. In May 2022, heavy selling of TerraUSD broke the stablecoin's peg; its price eventually dropped to $0.01. The whole debacle fanned fear of contagion and added selling pressure across the entire crypto sector.

Yet another problem is the perception held by some that it is virtually impossible to lose cryptocurrencies to theft because of its decentralized nature, encryption technology and secure password protected "wallets." Contrary to this perception, $3.2 billion in cryptocurrencies were stolen in 2021.[2] The most recent major crypto hack occurred in March 2022 when approximately $615 million cryptocurrencies were stolen from the gaming-focused blockchain platform Ronin Network.[3] Even though cryptocurrencies run on blockchain networks that offer transparency and enable tracking of the stolen cryptos, recovery is not guaranteed because the crypto world is decentralized and no authorities are officially tasked with helping with asset recovery. And even if a crypto exchange platform reimburses customers in the event of a hack, it may not necessarily provide full reimbursement.

Loss-producing technology companies

Many loss-producing technology companies that promised high profits far in the future rose like phoenixes in the midst of excessive liquidity. This was all quite reminiscent of the dot-com bubble in the early 2000s when fast-growing, but loss-producing companies with exciting stories to tell can keep tapping the capital markets at more and more insane valuations to fund their growth even if losses kept growing. With increasing interest rates, the era of free money is over and the music has stopped. Higher market interest rates mean higher discount rates used to value far-in-the-future profits and cash flow, which severely lowers the values of these loss-producing companies. To add injury to insult, higher rates also mean higher cost to access funds to feed the growth machine. Higher cost of both debt and equity financing will drastically stunt the growth of these companies.

According to The Wall Street Journal, loss-producing companies in the Nasdaq Composite Index fell 28% on average between September 30, 2021 and January 18, 2022, while their profitable counterparts only went down 0.7% on average over the same period.[4] These types of loss-producing companies have fallen a lot more since then. For example, shares of electronic signature software maker DocuSign soared during the pandemic due to adoption of remote and electronic agreements. The company has reported a loss in every quarter since it went public in May 2018, but its stock nevertheless reached an all-time high of $310.05 per share on September 3, 2021. DocuSign's stock price is currently at $60 per share, about 80% below its all-time high just 10 short months ago.

SPACs

When SPACs were all the rage in early 2021, we wrote about their benefits and potential pitfalls in the Spring 2021 issue of ***PDV Observations***. In that article, we pointed out that only a small minority of them will do well over time. With rising interest rates making many speculative assets less attractive, SPACs have been cancelling deals and many SPACs investors have been pulling their money out.

From early November 2021 to January 2022, at least 10 companies terminated SPAC deals, which is significantly more than the 13 terminations that occurred in the first 10 months of 2021, according to Dealogic.[5] SPACs also have been unable to find targets in a volatile and uncertain market environment, with too many SPACs looking for merger targets. Increasing regulatory scrutiny over the SPAC sector is also making deals less attractive. SPACs typically have to return funds to investors if deals are not completed within 2 years.

Performance of companies that merged with SPACs also has been poor. Share prices of many of the hottest companies that went public via SPACs were down 60% or more between early 2021 and early 2022.[6] In hindsight and away from the speculative frenzy and herd following, this is not surprising since many of the merged companies have inadequate financial results to support their once ridiculously high valuations. According to Audit Analytics back in May 2022, more than 10% of the companies that went public through SPACs between 2020 and 2021 have issued going-concern warnings in recent months.[7] This means they don't think they will make it. Investors have now soured on SPACs. As an example, before BuzzFeed went public via merging with a SPAC in December 2021, investors of the SPAC pulled about 94% of their funds.[8]

Meme stocks

Rising stock prices, low interest rates, stimulus checks, and low-cost trading applications like Robinhood brought about the meme stock phenomenon in 2021. Different assets, same liquidity-fueled speculation. Meme stocks are those that have a cultlike following by retail investors on social media platforms. Meme stocks tend to be issued by companies with poor fundamentals and have been heavily "shorted" by professional investors, who are betting on price depreciation because of the poor fundamentals. Shorting involves borrowing shares from the broker to sell, and eventually having to buy those shares back to return to the broker (hopefully at lower prices). A "short-squeeze" occurs when the stock price goes up rather than down, forcing the investor who shorted to buy back shares at higher prices. This buying in turn drives up the price even more. Last year, large numbers of retail "investors" on online message boards banded together to identify and buy meme stocks that were heavily shorted. This non-fundamental approach worked well for months as short-squeezes produced substantial gains for these "investors." It has been widely reported that some of these "investors" were using stimulus checks to fund their activity.

As the tide goes out and fundamentals matter again, many meme stocks have imploded. GameStop is one of the most widely known and traded meme stocks. According to a SEC report, the number of trading accounts for GameStop went up from less than 10,000 at the beginning of January 2021 to nearly 900,000 by January 27, 2021, with most of them being individual accounts.[9] GameStop stock has dropped more than 40% over the past 12 months. Shares of AMC, another popular meme stock, have plunged 78% over the same period.

To conclude, being very selective among assets will be as important as ever when liquidity is being aggressively drained out of the system. With prices crashing among the 4 asset categories above, one may be tempted to "buy the dip." Doing so is likely to end badly because the market is transitioning back to fundamentals and risk management.

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