The Fed downplays inflation while GameStop captures the world's attention

Weekly Market Compass: Market speculation hit a new level this week with GameStop, and the Fed threw cold water on inflation concerns.

Feb 1, 2021 | Kristina Hooper, Chief Global Market Strategist

The Federal Reserve (Fed) met last week and, as I expected, Fed Chair Jay Powell reassured markets that it doesn't have a trigger finger when it comes to inflation. In his press conference following the meeting, Powell showed concern that the economic recovery had moderated and stressed that it was more dangerous to do too little than to do too much to support the economy (a sentiment echoed by US Treasury Secretary Janet Yellen last week as well). He underscored that the Fed will not tighten monetary policy any time soon. For income investors, the key takeaway is that we find ourselves mired in a yield-scarce environment for a variety of income-producing asset classes for what is likely to be some time to come.

Powell throws cold water on inflation concerns

Powell said he expects inflation to rise as a result of base effects – distorted comparisons to abnormally low year-ago numbers – but that the Fed will assume it is transitory and will not react to it. "As we lap the very low inflation readings of March and April of last year, we'll see measured 12-month inflation move up a few tenths," Powell said. "... That's a transient thing that we think will pass."

He also stressed that the Fed would not react to a rise in inflation once vaccines are broadly distributed and the economy rebounds more robustly: "There's also the possibility ... that as the economy fully re-opens, there'll be a burst of spending because people will be enthusiastic that the pandemic is over, potentially, and that that could also create some upward pressure on inflation," Powell said. "Now, again, we would see that as something likely to be transient and not to be very large. So the way we would react is we're going to be patient."

Powell went one step further and threw cold water on concerns that there will be a significant and sustainable rise in inflation. He explained that while inflation dynamics evolve over time, they "don't change rapidly." He stressed that there has been significant disinflationary pressure for several decades and so it is very unlikely that a "troubling" level of inflation would emerge. And if we consider the key factors that drive higher levels of inflation, at the top of the list is a rise in unit labor costs. However, there is a large amount of slack still in the labor market, suggesting that will not happen any time soon. In other words, I expect the fed funds rate to stay put for at least 2021. And while the 10-year US Treasury yield rose significantly early in January, it has since fallen slightly, and is still at a relatively low 1.07%.[1]

Time to consider dividends for income?

As I mentioned at the outset, we find ourselves mired in a yield-scarce environment for a variety of income-producing asset classes for what is likely to be some time to come. And so in my view, this is a time for investors to consider dividend-paying stocks in order to augment income from traditional sources. Here are just a few other reasons to consider dividend-paying stocks:

- Corporate earnings and cash flow have improved, so I believe the major dividend cuts we saw last year are over. We have actually seen some dividend increases in this environment.
- Dividends tend to force discipline on companies that pay them because they are a major cash commitment; that can mean that companies are more selective in the projects that they do take on. That can result in a higher return on equity.
- Dividend-paying stocks tend to exhibit substantially less volatility than non-dividend-paying stocks.[2] That's because investors are less likely to sell stocks that pay dividends in difficult times because they are still receiving dividend income.

Market speculation hits a new level with GameStop

Low yields on traditional sources of income is just one of the effects – a necessary evil – of very accommodative monetary policy. Another effect is market speculation, which has been top of mind for investors this week given what is happening with GameStop.

So, what happened?

GameStop has been experiencing challenges given its "Old Economy" business model – operating video game stores typically located within shopping malls. But for more than a year, a small but devoted group of investors bought GameStop stock and call options and talked it up on social media sites such as Reddit. This caused its fan base – and retail investor base – to grow. Excitement also built around other stocks currently facing headwinds, such as AMC, Blackberry, and others.

Then, these investors noticed that many hedge funds had shorted GameStop's stock – meaning that their positions would profit if the stock price fell. This is a common tactic in the hedge fund world for turning profits; however, it can backfire if the stock price goes up. Small investors spread the word over social media, bought up GameStop stock, and pushed the stock price higher in order to create a "short squeeze" on hedge funds. In other words, these hedge funds were compelled to buy the stock in order to cover their short positions before their losses grew further, and that added buying activity compounded the stock's meteoric rise.

So far, small investors have driven up GameStop from a market capitalization of less than $1 billion in the summer of 2020 to more than $22 billion currently.[3] Because of the volatility in GameStop and other stocks, some trading platforms have limited retail traders' ability to trade, a move that has been very controversial. Volatility in the overall stock market last week was partially blamed on the speculative behavior involving these stocks.

Is further volatility ahead?

There is concern that this level of speculation in markets could create more volatility and instability, and suggests that markets are frothy. After all, it's not just a handful of stocks with challenging business models that have been bid up dramatically – it's also cryptocurrencies such as bitcoin. I think we need to recognize that extremely accommodative monetary policy can often create unintended consequences such as froth and speculation in some small corners of the investing universe. It's happened before and it is likely to happen again.

We have to keep in mind that in general, stock market fundamentals are solid. Earnings season has been good thus far with 82% of S&P 500 Index companies that have reported delivering a positive earnings per share surprise, and 76% that have reported delivering a positive revenue surprise.[4] Vaccines are starting to be distributed in a number of countries and, while there will likely be some speed bumps along the way, we expect a strong economic rebound once they are broadly available. In my view, investors should not get distracted from focusing on their financial goals by worrying about what is going on in small portions of the investing universe, even if at times it can create broader volatility.

Source

[1]Source: Bloomberg L.P., as of Jan. 29, 2021

[2]Source: Ned Davis Research, Inc. Based on the historical beta for dividend growers and initiators (0.92) compared with the beta for non-dividend payers (1.14) in the S&P 500 Index. Measured over rolling 10-year periods using monthly data, with the first 10-year period beginning March 31, 1982, to Dec. 31, 2019. Beta is a measure of the volatility or systematic risk of a security or a portfolio in comparison to the market as a whole. Dividend growers and initiators represent all dividend-paying socks of the S&P 500 Index that raised their existing dividend or initiated a new dividend, recategorized monthly. An investment cannot be made directly into an index. Past performance cannot guarantee comparable future results.

[3]Source: Bloomberg L.P., as of Jan. 29, 2021

[4]Source: FactSet Earnings Insight as of Jan. 29, 2021