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Weekly Commentary

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Macro View

By Hubert Marleau

The Financial Times Unmasked the "Nasdaq Whale", Spelling a "Flash Crash"

Submitted September 6, 2020

What Happened In the Market Last Week Ending September 4, 2020 Was Weird:

On Friday, the S&P 500 closed at 3427 registering a loss of 4.3% in two days, for a weekly decline of 2.3%. Pullbacks happen all the time. It's part of the market. As a rule, pullbacks (-5%) are relatively frequent. On average, they occur about four to five times a year, but infrequently turn into corrections (-10%) and rarely into crashes (-20%). It appears that the Thursday-Friday pullback was a flash trade.

The Financial Times and Wall Street Journal reported that SoftBank invested in July and August billions of dollars in equity call options of several popular technology shares. Masayoshi Son publicly manifested in recent fillings, an interest in speculating in tech stocks via direct investments and derivative transactions. In this regard, he amassed a large sum of cash by selling his stake in various companies--enough to warp the market for options, especially if investors are frozen with indecision.

The Financial Times wrote that SoftBank is the "Nasdaq whale" that bought billions of dollars' worth of US equity derivatives in a series of trades that stoked the fevered rally in big tech stocks before the sharp pullback on Thursday and Friday. Goldman Sachs reported that the overall nominal value of calls traded on individual US stocks has averaged $335bn a day over the past few weeks. That is triple the rolling average between 2017 and 2019. The retail brokerage business played a part in the frenzy, but the size of the option purchases was far too big to be retail driven. Several market veterans said that the trades were among the biggest seen in twenty years. Nomura's Charlie McElligott revealed that these huge flows were larger than any single-name option market could

Macro View cont.

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take--including Apple. The price and volume of many tech call options were trading substantially above puts. Premiums on call options for tech stocks were at their highest levels in years. Given the usual summer trading lull, that kind of buying could no longer go unnoticed. The “Nasdaq Whale” was just too hungry.

The surge in the purchases of call options--derivatives that give the user the right to buy a stock at a pre-agreed price--forced trading banks who wrote the option contracts to buy, in order to cover the potential liability of having to deliver stocks, incentivized momentum players to participate in the run-up and coerced cynic traders to unwind their short positions. A perfect storm for a technical melt-up.

As rumors spread that there was a mysterious buyer out there devouring whatever was offered, a weird thing occurred on Monday, Tuesday and Wednesday--stock prices were rising and so was volatility and the FAAMG cohort was trading at an unprecedented 40% premium to its 200-day moving averages. Those conditions alerted the professional quants that the increase in volatility along with price, pointed to an unsustainable concentration of mammoth option trading activity in several tech stocks like Amazon, Zoom, Google, Tesla Adobe, Netflix, Facebook, Microsoft. They correctly judged that if they harpooned the “Nasdaq Whale”, they could make good money on such a trade. There is a limit as to how far the option market can move a $30 trillion market cap. It does not have the financial might to last forever.

On Wednesday, the S&P 500 closed at 3580 for a new all-time high--5.7% above the February 19 number. The economic prints continued to show that business was healing from the pandemic devastation, defying the pessimists and supporting risk-on sentiment. The NY Fed’s Weekly Economic Activity is showing rising momentum.

The ISM-manufacturing numbers were ebullient, giving proof that the recovery is definitely on track. The internals were outstanding. Production was unable to meet demand by a very wide margin due to a lack of industrial capacity. It depleted inventories. Given that new orders are the highest in more than 16 years and manufacturing executives are adding workers cautiously, producer prices are probably rising and productivity rates are certainly increasing, suggesting that earnings reports for Q/3 may end up being much better than generally expected.

Macro View cont.

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Meanwhile, the labour market is recovering as the lockdowns ebb. Although the present pace of hiring has dropped off, the labour market is rebounding in an encouraging fashion. So far, the economy has added 10.5 million jobs in the four months ended August, about half the loss resulting from government-ordered lockdowns. It should be noted that the number of unemployed individuals saying their layoff is temporary totaled around 6.2 million. Unfortunately, it leaves the labour market with about 4.0 million people seeking a job permanently out of work. Herein lies the problem. While I'm willing to bet that some additional relief is forthcoming before the end of September, the question is what will happen to these people. They will have to change their occupation to fill the digital, transportation, manufacturing and construction industries that are poised for an employment boom. There are anecdotal reports that a hiring binge has already started.

Q/3 GDP growth looks very good. Monthly GDP estimates from IHS Markit show that after disastrous declines of last March (-73.4%) and April (-47.5%), the economy bounced strongly in May (+71%), June (+95.4%) and July (+26.1%). Tack on July's gain to the bounce in the latter months of the second quarter, the GDP is estimated to be 7.3% above its second quarter level for an annualized GDP growth of 32.6%--that assumes that the economy was flat through August and will be flat in September. The Atlanta Fed's GDPNow model is predicting a 3/Q growth of 29.6%. Based on the likely event that some growth will be registered in those latter months, the bounce would be much bigger than the expected roll-over effect. Investors should take note that an annualized rate of 45% would get us back to Q/1 and 55% to Q/4 2019. Interestingly, the Q/3 GDP report will come out on October 29--five days before the November Presidential election.

The Thursday-Friday selloff went a long way to quell the irrational exuberance of SoftBank. The episode is not a harbinger of doom. BofA's Michael Harnett pointed out that "the bank's "Bull & Bear" indicator may not be in contrarian "buy" territory, but nowhere near euphoric." Certain segments of the market are perhaps overbought but many other ones certainly not overowned. Interestingly, while the pullback was taking place, the market price of copper, lumber, bond yields rose while that of gold, oil and the dollar remained stable and the yield curve widened. Nothing bearish here. It looks as if it was simply and justly a removal of froth in the tech sector.

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