

Speculations to Financial Short Selling in Economic Way

Cailing Piao

Liaoning Province Shiyuan High School Hunnan Diyi Middle School
Shenyang, China
724793748@qq.com

ABSTRACT

The principle of short-selling is accessible, but to master the timings to short is tricky than ever. Referring to the historical examples such as the 2008 financial crisis, Soros's short selling on Britain Pound, and MuddyWatersResearch's report shorting on Lucking coffee, this essay presents five conditions to short whilst offering correspondent investment advice in combination with the economy. At the end of the paper, there would also be the discussion on weighing the advantages and disadvantages to short for an economy and economic agents.

Keywords: *short selling, 2008 financial crisis, Soros's shorting Pound, short of Lucking coffee's, economic affects of short selling*

1. INTRODUCTION

The outbreak of covid-19 prompts a bear market pouring out money for the short-sellers as the demand for objects such as airlines slumped with more people killing time indoors for the quarantine. As thus the changes in the market always exist, yet it does not completely unpredictable. This essay would list out five appropriate timings to short to readers and sum up the effects of short selling on an economy.

Borrowing assets and selling it when the value is high then returning the assets with a lower market price when the value of it decreases is the principle of short selling. In brief, it is pocketing the price difference therefore the greater fall in the price of assets more profitable the short becomes. Naturally, the interest rate ought to be paid for the assets lender which becomes the cost of the short selling. And if the stock market witnesses an upward trend, that will be the risk of the short-selling as asset borrower still needs to return the assets. Even so, if investors could seize the right timing, it will bring an impressive amount of fortune.

2. SHORT SELLING BASED ON OBSERVING THE POLITICAL CHANGES

Back in 1992 American stock investor George Soros earned a profit of 1 billion dollars by shorting Britain Pound as he found the economic policy loophole combined with the world situation. According to the impossible trinity, among the control to exchange rate, monetary policy, and capital mobility a country can only achieve two out of three. After the second war European community members built a system of ERM(Exchange rate mechanism) to keep the exchange rate pegged to Deutsche Mark for a common benefit. Britain's entry into this mechanism meant it could not give up control of the exchange rate. For the further revival, Britain signed the "Maastricht Treaty", the one that helped form the European Union, and in which the content involving the agreement on free mobility of British capital. As a result, in the trinity, Britain had to waive its control over deciding own monetary policy.[1]

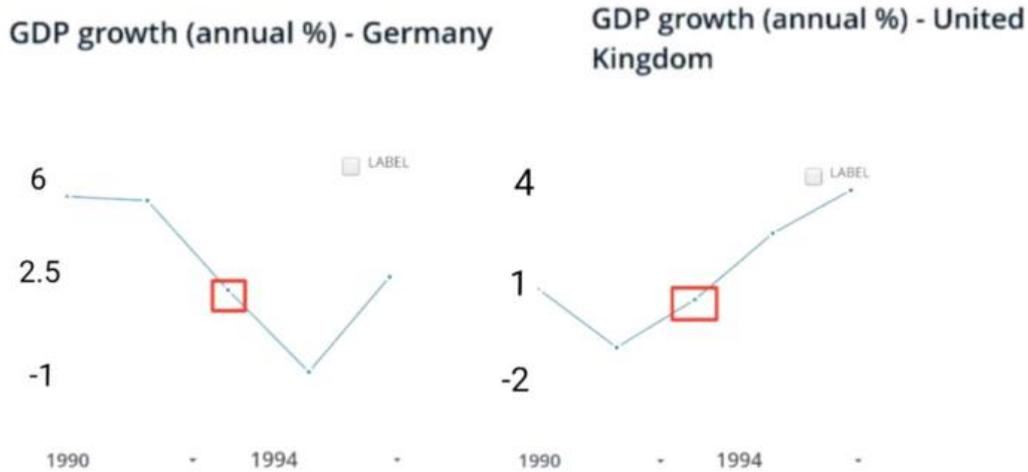


Figure 1. The comparison between the annual GDP growth of Germany and of Britain in 1992

During this phase, German government was busy increasing the interest rate to lowering inflation. Inversely Britain was in a recession. On the basis of data presented by the World Bank, the GDP annual growth of Germany was 2 percent whilst only 0.5 percent in Britain.[2]The restriction of the fixed exchange rate forced Britain to maintain its high-interest rate, which further suppressed the consumption and investment of Britain leading to a weaker economy. In this sense Pound was overvalued with a high exchange rate but low actual economic growth of Britain. Under the situation of no monetary policy could be utilized as once expansionary policy introduced it would cut the interest rate further lowering the exchange rate, which was apparently contradicted to the ERM. By spotting the paradox between high valued Pound and a floundering economy Soros successfully shorted Britain Pound.

Therefrom the alteration of policy and world trends is often responsible for the depreciation of a product. When an object is seemingly not valued as much as its price, it would eventually lose out its present price when all investors start to believe so. Even though the value of a

product is not worth decreasing too much, it will still be depreciated from appearing to lose value to lose actual value. For Soros, his wisdom was to incite other investors, as using one person’s ability to short a currency is almost impossible. Making other investors believed in the future depreciation of the Pound, they would use Pound to exchange Deutsche Mark, and with the supply of Pound increased the value of Britain’s currency further dropped. This could be explained by the herd effect which presents people are prone to believe on the side of the majority as it is more reliable.

According to the report The UK plans to ban sales of diesel and petrol cars from 2030.[3]A slew of other countries and areas introduced policies that are environmentally friendly as well. For example, France levies more highly on high-polluting cars and Ursula von der Leyon, the European Commission President, lifted the European Union’s 2030 emission reduction target to 55% in an official manner.[4]This presents the tendency of the world is becoming greener and the encroaching new and renewable energies such as electricity, solar, and wind are replacing the utilization of crude oil.

Year	Average Closing Price	Year Open	Year High	Year Low	Year Close	Annual % Change
2020	\$38.80	\$61.17	\$63.27	\$11.26	\$41.47	-32.17%
2019	\$56.99	\$46.31	\$66.24	\$46.31	\$61.14	35.42%
2018	\$65.23	\$60.37	\$77.41	\$44.48	\$45.15	-25.32%
2017	\$50.80	\$52.36	\$60.46	\$42.48	\$60.46	12.48%
2016	\$43.29	\$36.81	\$54.01	\$26.19	\$53.75	44.76%
2015	\$48.66	\$52.72	\$61.36	\$34.55	\$37.13	-30.53%
2014	\$93.17	\$95.14	\$107.95	\$53.45	\$53.45	-45.55%
2013	\$97.98	\$93.14	\$110.62	\$86.65	\$98.17	6.90%
2012	\$94.05	\$102.96	\$109.39	\$77.72	\$91.83	-7.08%
2011	\$94.88	\$91.59	\$113.39	\$75.40	\$98.83	8.15%

Figure 2. The price of crude oil from 2011 to 2020

The data extracted from the Macrotrends[5] illustrate the fluctuation of crude oil. As a whole, the price of crude oil dropped 56.08 dollars per barrel. It is projected to decrease further in a long-term way at least it is hard to rebound to the original price. Demand and share of oil are likely to be replaced by the electronic vehicle. Recently with the improvement in the epidemic situation and the possibility of vaccine introduction, the demand for oil increased. Yet for the long-term fashion oil use would plummet.

3. SHORT SELLING BASED ON OBSERVING THE HIGH RISK HIDDEN

Apart from observing the value of a product, the risk is another tool useful to estimate the value of assets. When the risk of an asset is hidden or underestimated there will be a significant decrease in the price of assets as a result of panic selling when the actual risk is disclosed to the investors. In 2008 the fuse of the financial crisis was lit by the high but vague risk. With contracts of debt passing through rating agencies through being divided to bonds through institutions that sell the bonds and through being packed to other bonds over and over again, their risk was exponentially soaring. In which it was a domino that the system would collapse terrifyingly due to excessive subprime mortgages with a mounting number of defaults. The system was supported only under the condition of maintaining an increase in house prices. With the rise in the interest rate and decrease of house prices, the bubble was eventually burst. The USA in 2008 failed to stop the swell of the bubble in the housing market and prevent the catastrophe led by intricate risk hidden in the complicated financial

derivatives. This partly contributed to risk zoomed in as a result of moral hazards from credits, rating agencies, and other institutions.[6]

In contemporary society, the shadow of the 2008 financial crisis still exists. Money management applications such as Ant Financial in China were stopped to open to the public by the government because of its high hidden risk. It prepared the principal of 3 billion to lend out then making them bonds to borrow money from the banks as mortgages. After lending out the bank money they will cycle the process again. It was successfully swelling to 300 billion which was 100 times comparing to the principal. Obviously, this online lending contains high risk as it does not need high credit to lend the money but with higher interest. People with low credit are likely to break the agreement and it copies the mode of the 2008 financial crisis. Its high potential risk spotted by the government timely and stopped before the decrease of stock and lurking financial crisis. As if the lenders do not pay back the money, consequences will be endured by the banks and citizens, where banks fail to get back the money and citizens suffer from crowding-out. Some P2P(peer-to-peer) lending companies are also conceived with high risk. It uses investors' money to invest in other financial derivatives but not only works as a broker. Designing a capital pool and conducting rigid payment for improving its competitiveness in the financial market will make the system lose out with the decreasing investors. This is similar to the function of the Ponzi scheme. Once the money injecting is smaller than money outputting the system collapses.

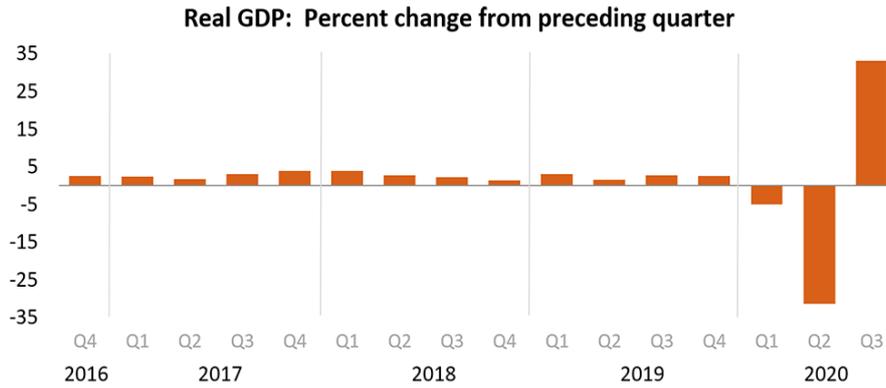


Figure 3. The real GDP growth of the US from 2016 Q4 to 2020 Q3

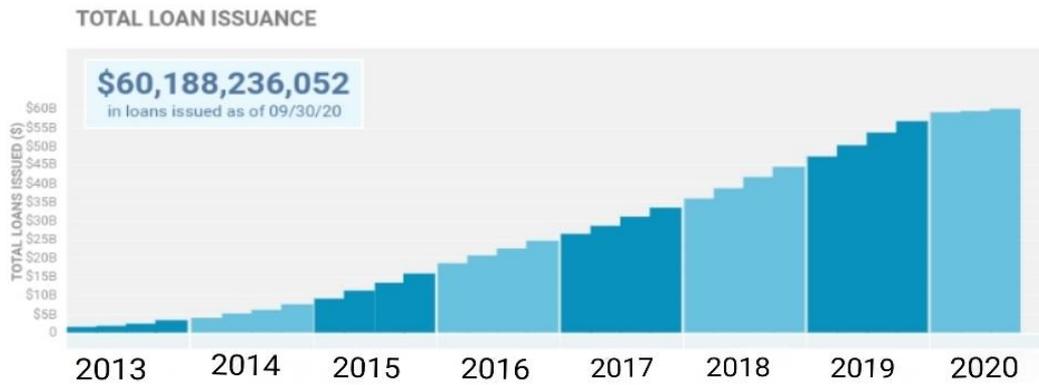


Figure 4. Total loan issuance of LendingClub from 2013 to 2020 Q3

Form the figures, with the recession in 2020 the growth of lending in the LendingClub, a big recognized American P2P lending company, has decreased unprecedentedly.[7]This might cause no effect to the big P2P firms as they stick to being merely a proper broker or they have sufficient money in the capital pool. Whereas, the small ones are likely to go bankrupt with shrinkage in the money to pay the investors with the fall of lenders.

4. SHORT SELLING WHEN THE INVESTORS HAVE LOW CONFIDENCE

Thirdly, low confidence in the market could also make the value of assets fall straight. For example, on 17 November because of a decrease in drug store shares and a disappointing economy, the Dow Jones Industrial Average dropped 167,09 points and the S&P 500 dropped 0.5%.In the period of the pandemic, the stock’s price is falling excessively fast that it was forced to shutdown in America. In March 2020, the stock of America was shut down four times even Warren Buffett was surprised. Yet the confidence of investors fluctuates every now and then leading to the change in demand on the stock giving rise to the undulation of the stock prices.

5. EXTERNAL PROBLEMS FOR FIRMS DEPRECIATE THE ASSETS

Fourthly, external problems which are factors outside the firms led to its depreciation such as an increase in the cost of labor and materials or the bad reputation aiming at one particular market. This is because when variable costs increase it might naturally drive the rise of product prices. With the cut in demand for the goods especially for the elastic goods, investors would lose confidence in the firm therefore demand for this particular firm’s stock price would decrease. On the other hand, a bad reputation in the market would likewise cut the demand for the relative firms’ stock price. To offer an example, when the reports of the unhealthiness of E-cigarettes were inundated in the news, the prices of the stock of E-cig firms declined in 2019.

6. INTERNAL PROBLEMS FOR FIRMS DEPRECIATE THE ASSETS

Finally, internal problems of the firms such as changes in the leaders, false information disclosure, and a bad reputation internally would cut the price of stocks.

Our offline tracking results of tracking 981 store-days from 2019 4Q showed 263 items per store per day only:



Figure 5. Comparison between the fake and actual data of Luckin Coffee’s items sold per store per day

Luckin coffee would be an example that was shorted as its fake information presented to the public. On 1st February, MuddyWatersResearch tweeted with an anonymous report [8] to short the Luckin coffee for its fake information on presenting the business performance. This research is supported by 11260 hours of store traffic videos that convinced investors and netizens significantly. From the chart in 2019 Q4, the predicted actual annual items sold per store per day is 263, which is dramatically smaller than 495, and the datum is provided by the official report of Luckin Coffee. The short report shows some other loopholes of Luckin Coffee’s running mode and false information laid bare to the public and investors. For instance, its financial fraud on the costs of advertising was 150% higher than its actual expenditure in Q3 2019. This is because for making the data more reliable Luckin coffee bragged on its profit whilst increasing its expending. According to the short report, Luckin coffee exaggerated its profit on 19Q3 for nearly 400 million RMB.

7. ECONOMIC ANALYSIS ON THE SHORT SELLING

Nevertheless, there are disadvantages for the mechanism of the short selling on account of its likelihood of damaging an economy. The long-term way of the gloomy stock market led by short sellings would make the firms harder to finance the funds to invest more to enlarge their scales. Especially for the start-ups there rise would be difficult than ever. There is also a chance to jeopardize the existing big companies. In the 2008 financial crisis because of the short and provide of CDS(Credit Default Swaps), AIG, an insurance underwriter company, needed over 150 billion dollars to be saved by the government. Other big scaled investment banks such as Lehman Brothers announced bankruptcy. In like manner, Luckin coffee is out of the stock market. With the decrease of investment, it would drag down the GDP of an economy as the fall of aggregate demand in the short run, and also likely it would decrease the efficiency of the firm then leading to a further decline in the economy in the long run.

For the consumers, they might confront fewer choices or lower quality on the products as the short-selling leads to the strike or bankruptcy of the firm.

Moreover, short selling has its contribution to the economy in a positive light. After Soros shorted Britain’s Pound since the day called the Black Wednesday Britain showed stable economic growth because it offered Britain a clearer head making it retreat from ERM. In addition, Luckin Coffee is working more efficiently in the transaction on the over-the-counter market that its stock price showed a noticeable rise. The example of companies shorted would work as a warning to the others as well, and the short-selling would also make an economy or a firm to adjust its mistakes in a faster manner. As a result, consumers are able to attain higher quality goods with the rise of efficiency of the firms and the retreat of other inefficient companies.

8. CONCLUSION

Because the policies are adjusted over and over again and the government is reflecting on the historical mistakes the opportunity to short on an entire market such as housing is nearly impossible. Although housing prices in an array of countries are abnormally surging as a result of low-interest rates during the pandemic, which shows a sign of a bubble, the governments and investors are more incentives on the situation where could not be seen in 2008. Yet the unpredictable events as a pandemic or political changes would still intervene in the stock market showing the sign of shorting chance. For the active investors observing a firm’s performance is imperative such as the sales. Investors could even research a brand’s value and public praise in the flesh by statically analyzing the actual customers in the store or appraisal of the firm from the internet and people around.

In summary, there are five main timings to short which would be when there are political changes, underestimated risks, low market confidence, external and internal firm problems. Although the consequence of shorting would be enormous, the faults of operation would expose to the public on all accounts in the end.

Hence, short selling is a catalyst to prompt the occurrence of the consequence of the mistakes ranging from a firm to a country. In return, it offers higher efficiency and a promising future.

ACKNOWLEDGMENT

First and foremost, I would like to sincerely appreciate the help from my teachers who offered me guidance on the process of writing the essay. Furthermore, I would also like to show the gratitude towards my friends who provide with suggestions enlightening me to complete the thesis more appropriately.

REFERENCES

- [1] The Economics Review. (2018) How Soros Broke the British Pound. theeconreview.com
- [2] The World Bank. data.worldbank.org
- [3] A. Frangoul. (2020) The UK plans to ban sales of diesel and petrol cars from 2030. www.cnn.com
- [4] I. Todorovic (2020) Von der Leyen targets 55% greenhouse gas emissions cut in the EU by 2030. balkangreenenergynews.com
- [5] Macrotrends. www.macrotrends.net
- [6] L, Michael (2010) The Big Short: Inside the Doomsday Machine. W.W.Norton&Company, New York City.
- [7] Lending Club. Total Loan Issuance. LendingClub.com
- [8] Anonymous. (2020) Luckin Coffee Fraud and Fundamentally Broken Business. <https://mobile.twitter.com/muddywatersre/status/1223274746017722371>