April 2020

Elixir News

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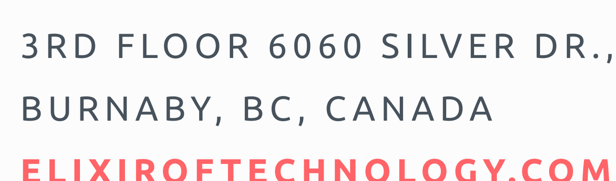

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Hi, everyone.

On April 21, billionaire investor Howard Marks said on CNBC, "[Today], we're only down 15% from the all-time high of February 19, [but] it seems to me the world is more than 15% screwed up … It took seven years to get back to the 2000 highs in 2007. It took five-and-a-half years to get back to the 2007 highs in late 2012. So, is it appropriate that, given all the bad news in the world today, we should get back to the highs in only three months? That seems inappropriately positive."

It is reasonable to assume that Howard's comments mirror the opinion of the smart money in the world during the current stock market rally. Since the beginning of May, it has become clear that the dumb money is starting to run out. The rally could end soon.

For those who are not familiar with Howard Marks, the 74-year-old co-founded Oaktree Capital Management, a US asset management firm that handles roughly $120 billion in assets. Warren Buffett once said, "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something."

Many investors have approached me, asking how to make sense of this US stock market rally and when (or if) the market will turn around. In this newsletter, we will provide an in-depth update and describe our outlook on the US GDP, unemployment, the bond market, major commodities, the FX market, the real estate market and the stock market. We hope that you will find the piece on how crude oil went negative, and the comments on the stock market rally, to be particularly insightful.

Before we dive into the details, we would like to provide a brief update about our April performance. Despite the market rally and our portfolio being short-titled, we earned a realized revenue of 4.63% on trading assets (2.76% on total bonds and preferred shares outstanding). Looking forward, I remain confident that we will perform strongly over the coming months. I would caution that strong returns will come when things start falling apart. We believe that this time is coming soon, though the returns for May might be flat. This means we may have to be patient a little longer.

Again, Eve and I are always available to answer any questions you may have. We are reachable by email or phone. We hope that you and your family are keeping well. As governments around the world start to reopen, we ask that you remain vigilant and take care.

Sincerely,
Bill and Eve McNarland
Elixir Technology Inc.
6060 Silver Dr., Burnaby, BC

The tradeable assets—whether they are stocks, government and corporate bonds, commodities, currencies or real estate—all correlate with the economy. Some of these assets (like commodities) are more tightly connected, while others (like the stock market) seem to be inversely correlated at times. Investors must understand that this inverse correlation is always temporary and is synthetically fueled by our biased and subjective emotions, as well as other financial strategies. Regardless of how "out of line" the stock market is from the economy, it will always go back in line. It is prudent, then, to understand the future of the economy and place our trade positions accordingly.

A Macro-Economic Update: GDP and Unemployment

When our last newsletter was released, the consensus was that the US GDP would experience a 3.5% drop [1] in the first quarter. We also quoted that "Moody Analytics said the [GDP] drop could be 29%, while James Bullard believes that the decline could be as much as 50% [in 2020]." Our model suggested that the 2020 US GDP would fall between 28% and 61%.

On April 29, the U.S. Bureau of Economic Analysis (BEA) released its advance estimate, indicating that the first-quarter 2020 GDP would be -4.8%. [2] Some may wonder how we should make sense of this information.

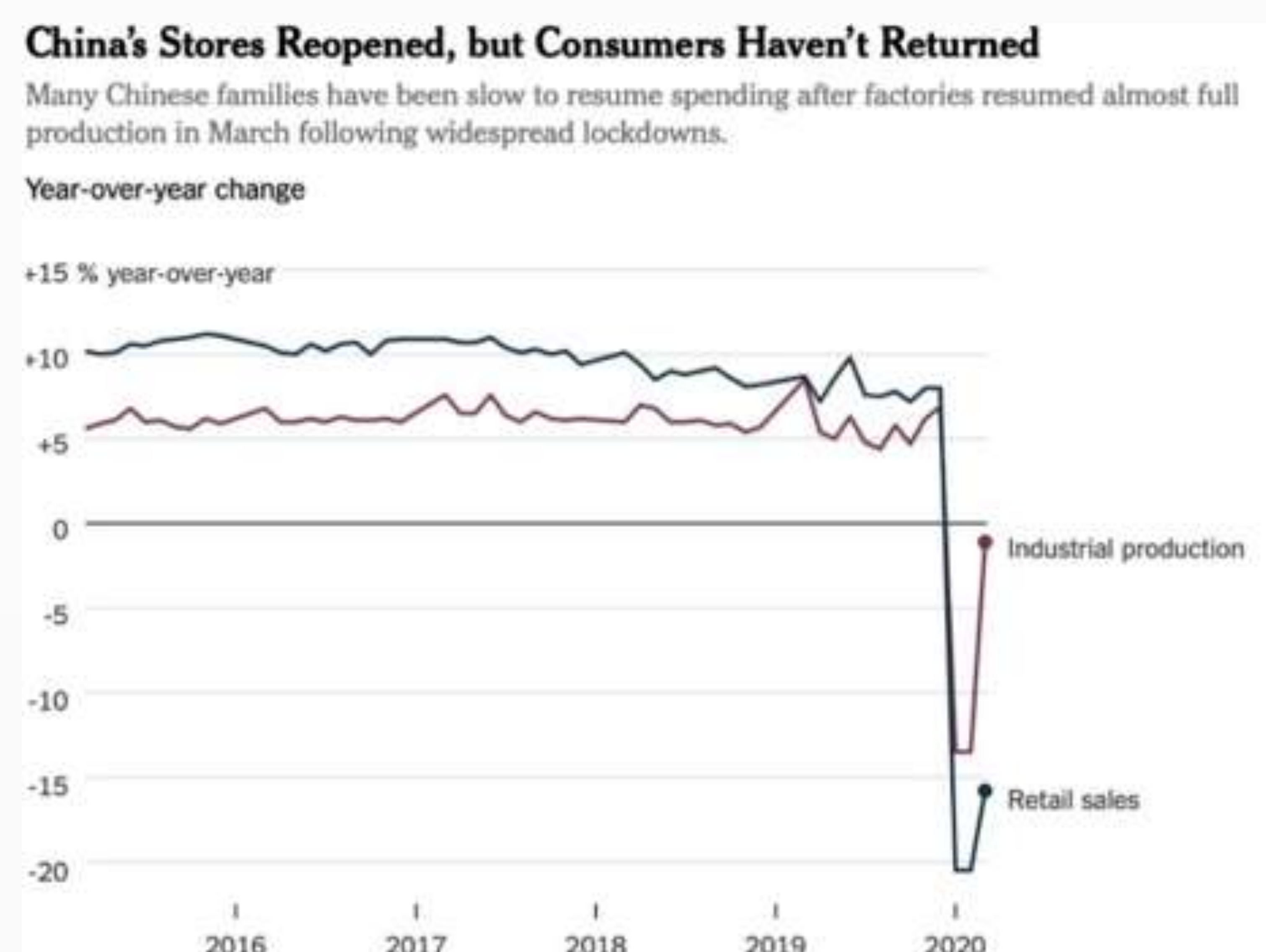
First, we must understand that although the GDP growth rate is reported quarterly, the BEA annualizes it and reports the GDP for the year. It does this to remove the effect of seasons. It is safe to assume that January and February GDP outputs were at a level similar to that of the 12-month average of 2019. After calculations, the annualized 2020 GDP based on March output is around -19%. However, we must remember that the effects of COVID-19 did not fully emerge until the last two weeks of March. This was because the national social distancing guidelines were not announced until March 16, 2020. [3] On the same date, California became the first and only state to issue stay-at-home and non-essential-business-closure orders. [4] The late-closing states did not implement their stay-at-home orders until ten days later, on March 26. This leads us to believe that the real GDP drop in March, driven by COVID-19, was much worse than -19%. We know that the two weeks of closure has already deeply dented the U.S. economy; going forward, if the situation remains the same as that of March, we could say that the U.S. 2020 GDP would dip under the -20% level.

Undoubtedly, April is worse than March.

That said, with more states reopening their economies in May, there seems to be a strong sentiment towards a quick bounce back of the economy, reflected by the up-trending stock market. We will have a more accurate assessment of GDP outlook when the April GDP estimate is released on May 28. In the meantime, there are unignorable clues outside the US that could offer insights into the future. Let's take a close look at China—a country that is ahead of everyone else in terms of getting into—and out of—the COVID-19 pandemic.

A look at China's Reopening

China shut down Wuhan on January 23. When the city reopened on April 8, the country's nationwide lockdown was officially lifted. We can learn a lot from China's path towards economic recovery over the past 30 days. According to the country's National Bureau of Statistics (chart below), while manufacturing capacity bounced back quickly, retail consumption has not shown a significant rally. Certainly, it is far from its pre-pandemic level.



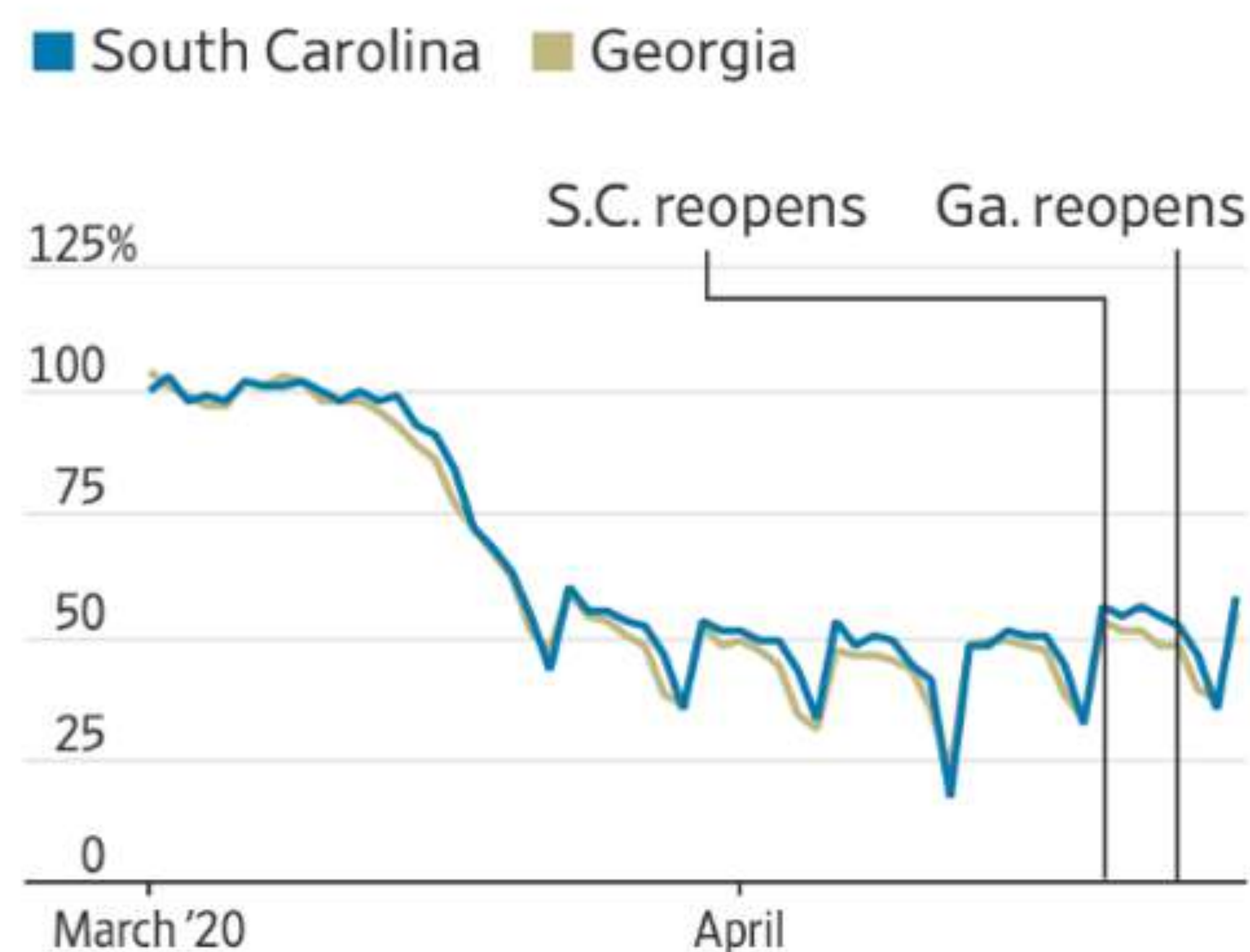
BY THE NEW YORK TIMES | SOURCE: CHINA'S NATIONAL BUREAU OF STATISTICS, VIA CEIC DATA

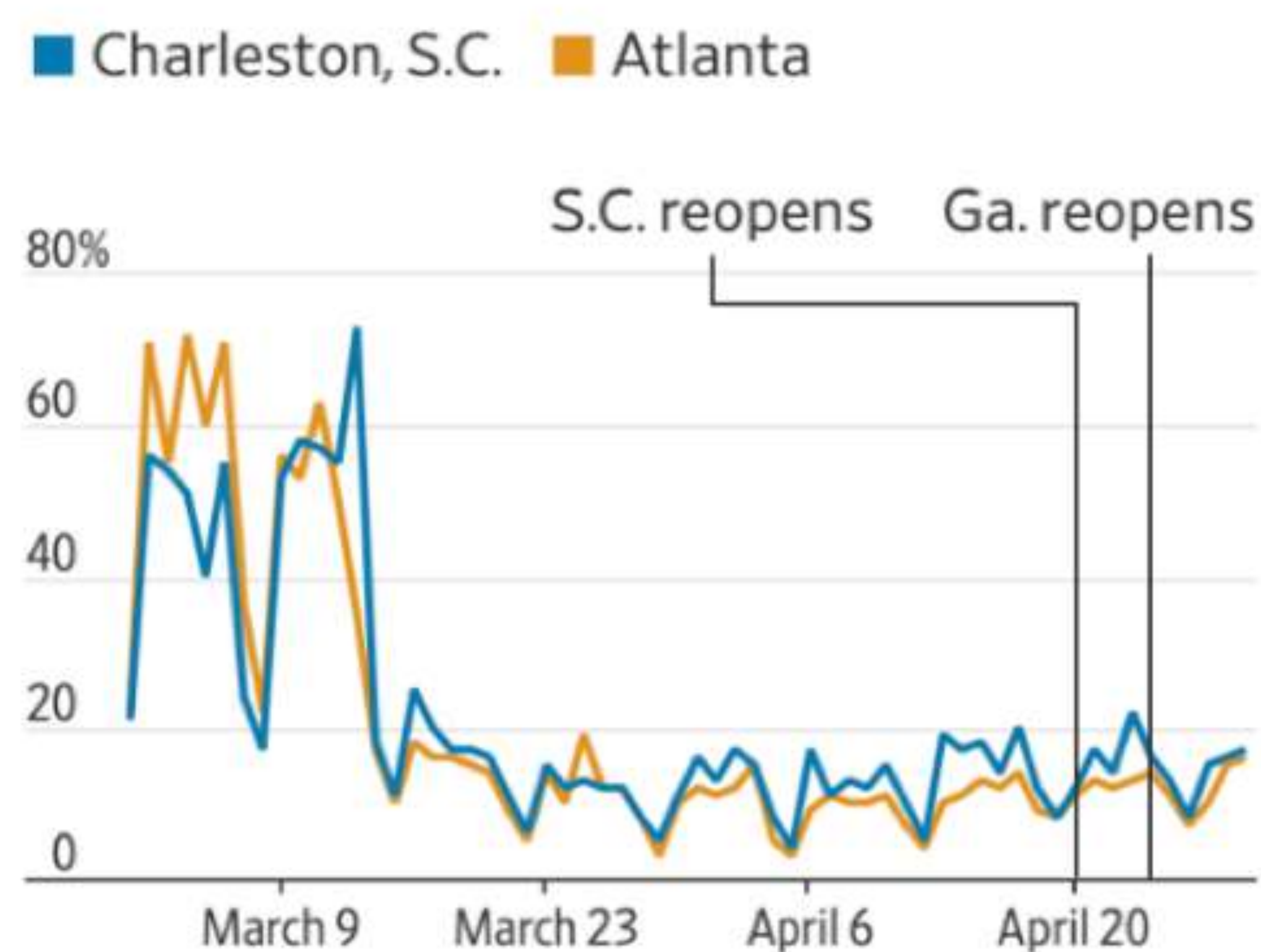
People are being cautious with their money and holding off on spending. This is clearly reflected in the slow recovery of the tourism and entertainment industry. Casinos in Macau were shut down for only a couple of weeks in February. In April, the visitor traffic was still almost nil, and gambling revenue was down 97% as compared to the same month in 2019.[5] On May 5, data of May-long-holiday, released by the Ministry of Culture and Tourism of China, suggested that the volume of domestic tourism was only 59% that of last year's level and that related revenue dropped nearly 60%.[6] International tourism remains unopened. Shanghai Disney World finally announced its opening on May 11, but at a capacity of only 30%.[7] Those who are interested in reading more about the behavioral changes of Chinese consumers can find two excellent articles about this topic in the New York Times[8] and the Wall Street Journal.[9]

It is important to note that China is one of the few countries that seemed to have the pandemic under control before reopening its economy. While the country is no longer in strict lockdown, social distancing restrictions are still in place. The nation has abundant masks and robust testing and tracking capabilities. It has also set up disinfecting sites that one must go through before entering indoor public areas, such as shopping malls. Additionally, the country's citizens follow government guidelines one hundred percent. It is reasonable to assume that countries that open without China's resources will not only be highly likely to experience a second wave of COVID-19 but will also see a slower economic recovery.

Early Reopening Status: The United States

Now let's take a look at the current situation in the United States. Georgia and South Carolina are two of the first US states to widely reopen. The following charts indicate that people are not quickly returning to their normal lifestyles, based on the results of academic studies involving small business activities and vehicle traffic volume in the two states.[10] On May 7, The Atlanta Federal Reserve President, Raphael Bostic, said, "Preliminary data we have, looking at cell phone numbers, suggest that movement has not gone up appreciably … Whether having an open economic policy is going to translate into economic activity — we are going to learn this in the next couple of weeks."





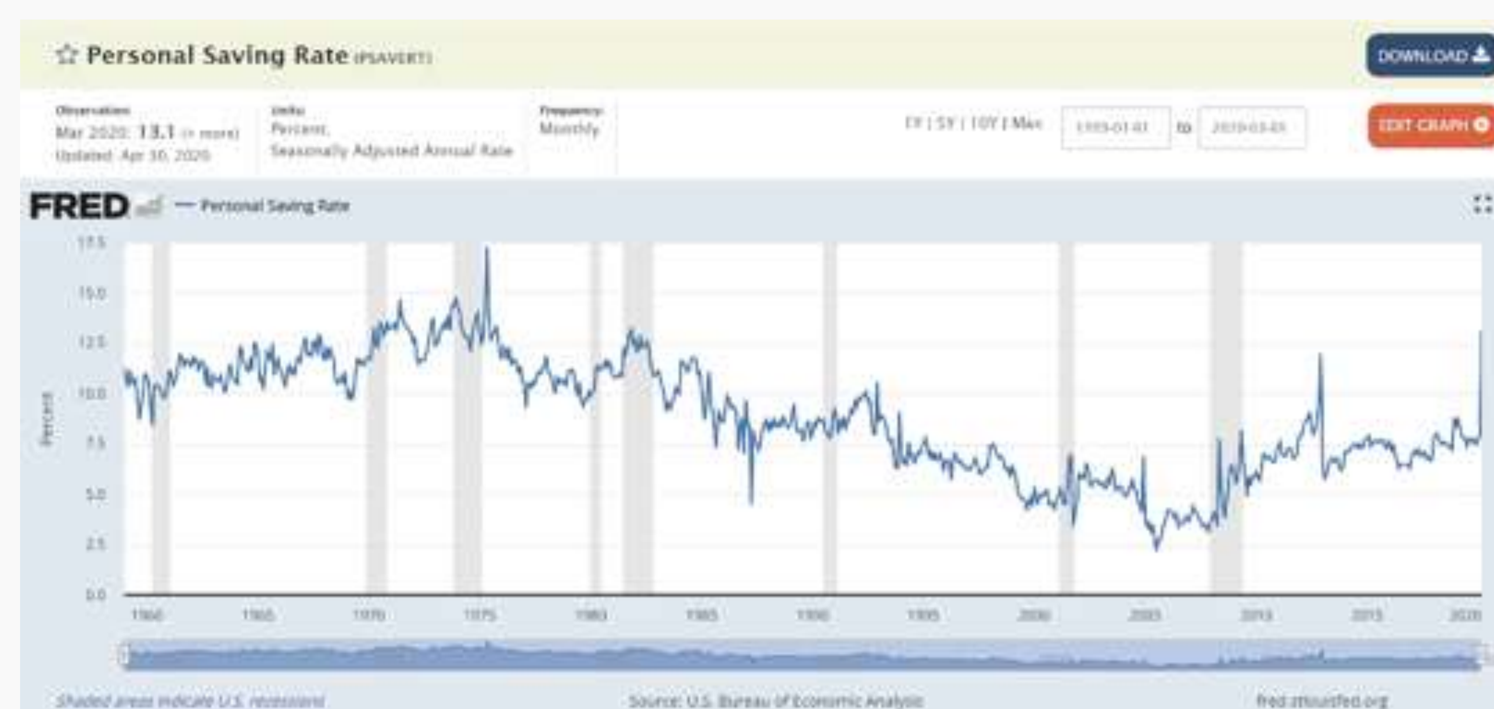
While the desire to reopen the economy is perceived as being a popular sentiment, as evidenced by the protests against stay-at-home orders, which have gotten much airtime in the past couple of weeks, a recent survey conducted by the Public Broadcasting Service (PBS) suggested that most Americans feel "returning to normal" without adequate virus testing is a bad idea.[11]

Additionally, over half of New York tri-state residents said that lifting restrictions on businesses would not be safe until at least a few months (or more) have passed, according to a poll released by Quinnipiac University on May 6.[12]

Poll: Do you think it is a good idea or a bad idea to do each of the following without further testing for the coronavirus: PBS NEWS HOUR

	Good idea	Bad idea	Unsure
Have students return to schools?	14%	85%	1%
Have people return to work?	32%	65%	3%
Allow large groups of people to attend sporting events?	8%	91%	1%
Open restaurants for people to eat in them?	19%	80%	1%

In our March newsletter, we explained that, during times of uncertainty, people typically save instead of spend. Additionally, we warned that an increase in savings would damage the economy. Now we have an update from the St. Louis Federal Reserve Economic Department. The following chart shows that the savings rate increased by 59% in the first three months of the year. The current savings rate is the highest since November 1981, when extreme uncertainty was caused by the highest overnight interest rate of 14%.[13]



Lack of future confidence drives consumers to save instead of spend. In the US, consumer confidence saw its most significant drop at 86.9 in April—the largest decline since the Consumer Confidence Index's benchmark of 100 was established in 1985.[14] Lack of confidence is not limited to American and Chinese consumers. The UK[15] and Japan[16] also reported historically low consumer confidence data in April. The US March consumer spending report showed a -7.5% drop.[17] April's data will be available on May 29.

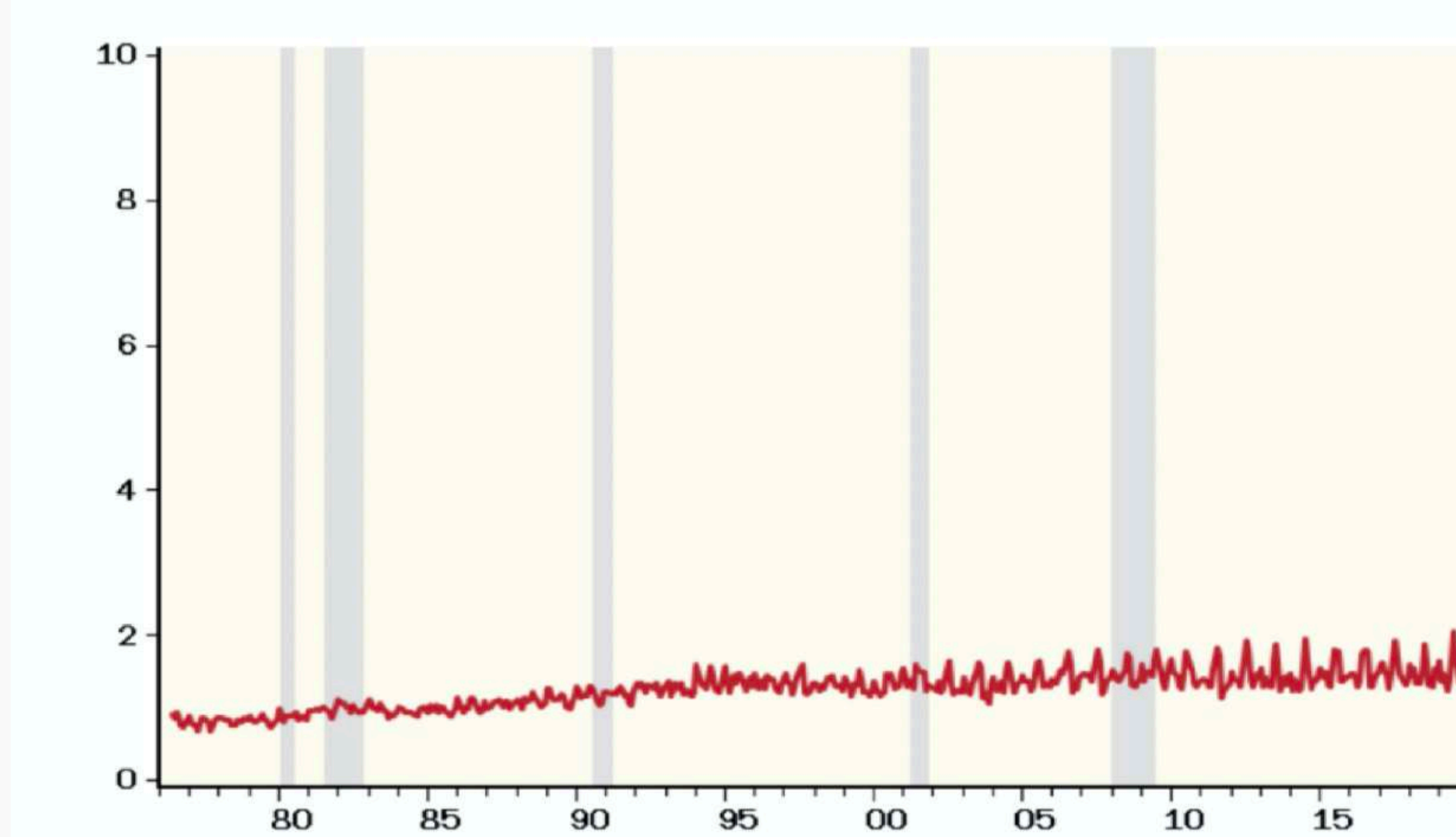
So far, Americans' post-opening behaviours seem to follow a similar pattern to that of the Chinese. Most people are in no rush to return to their pre-pandemic lives. They are saving and not spending. In addition, they believe that the decision to reopen is premature and will likely impede economic recovery.

Some may argue that the US's massive fiscal package is one advantage that the nation has over other countries; however, as we discussed in the previous newsletter, the effectiveness of stimulating the economy is limited. One reason is that, in our opinion, this money will go into savings. Another reason is that the lending program is exceptionally inefficient at allocating funds to the right businesses. More than 341 publicly traded companies received loans[18] though they had access to other financing options in the public markets. On the other hand, the Federal Reserve Bank of New York said, on May 6, "In New York, the epicenter of the coronavirus in the United States, less than 20 percent of small businesses have been approved to receive PPP loans."[19]

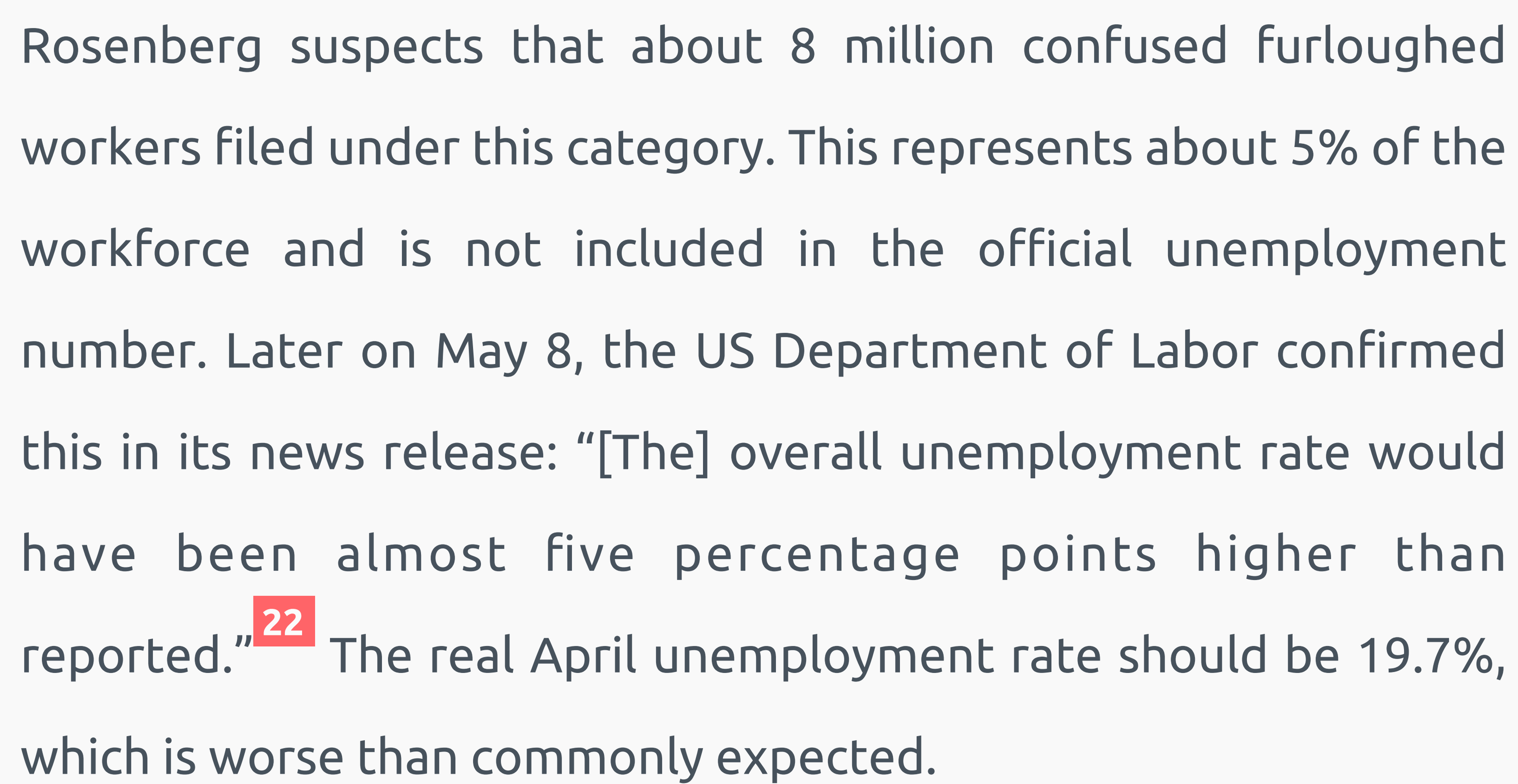
Real Unemployment Rate is Worse than Expected

Domestic consumption drives nearly 70% of the US GDP[20], and healthy consumption ultimately relies on people who are employed and who have income to spend. The April unemployment rate was 14.7%. Although 14.7% seems like a remarkably high number, I was expecting it to be closer to 16% or 17% based on the weekly job loss claims. In his NBC interview the day before the data was officially released, Neel Kashkari, president of the Federal Reserve Bank of Minneapolis, stated similar views. Kashkari further predicted that the real unemployment number could reach 23% or 24% in June.[21]

Does this mean that the unemployment rate in April was better than people expected? David Rosenberg did some in-depth research and concluded that the reported unemployment rate was significantly understated. His suspicion stemmed from one category of the unemployment application: "With a Job, Not at Work: Other Reasons" experienced a massive spike in April, as shown in the following chart.



SHADED REGIONS REPRESENT PERIODS OF US RECESSION
SOURCE: HAVAR ANALYTICS, ROSENBERG RESEARCH



Rosenberg suspects that about 8 million confused furloughed workers filed under this category. This represents about 5% of the workforce and is not included in the official unemployment number. Later on May 8, the US Department of Labor confirmed this in its news release: "[The] overall unemployment rate would have been almost five percentage points higher than reported."[22] The real April unemployment rate should be 19.7%, which is worse than commonly expected.

In an interview with Fox News on May 10, Treasury Secretary Steven Mnuchin said that the US unemployment rate could hit 25%. However, his prediction is based on his firm belief that the reopening will be carried out flawlessly with no risk of a second wave of the virus and a possible re-lockdown. Our model suggests that the US unemployment rate will be worse than 25%. To put this into perspective, only 9.9% of Americans lost their jobs in 2009, while 24.9% reported being unemployed during the peak of the Great Depression.

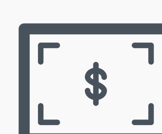
In addition to the increasing job losses, many "furloughed workers" may lose their jobs permanently. "Furloughed workers" is a typical American term. "Furloughed" describes mandatory suspension from work without pay, though the employee keeps their healthcare benefits through their employer. In Canada, these people would be considered temporary layoffs. A new report from the Becker Friedman Institute at the University of Chicago predicts that 42% of the recent layoffs from the pandemic will result in permanent job loss.[23]

From an unemployment standpoint, things in the US will get a lot worse before they get better, and the road to recovery may be an awfully long one. High unemployment would create a cascading effect that would ripple through the economy. Historically, high unemployment will cause inflation and interest rates to stay low. That said, we were already in a low-interest rate and low-inflation environment before the pandemic, which led us to ponder the likelihood of deflation, stagflation or inflation. To articulate each possibility, a long article will be necessary. Therefore, we will leave this topic to future newsletters.

In summary, the newest data and observations confirmed that our thesis from the March newsletter is on track. We suspect that the May data will point to further deterioration in GDP and employment.

The US Bond Market

The issuing country's tax revenue backs government bonds. Therefore, the bonds' value is correlated with that country's economic vitality. Typically, when investors are worried about a country's economic future, they sell off their bond holdings and find safer investments elsewhere or hold cash. For example, in a previous newsletter, we commented on Argentina's century bond (initially offered in 2017), which lost 60% of its value during the summer of 2019 due to an unforeseen change in political leadership. We learnt that in April 2020, the perceived COVID-19-related loss in its economic output drove the bond's value down further, to 30 cents on the dollar.[24]

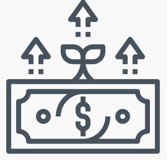


The US Government Bonds

> The US bond is unique among other government bonds. The decision to buy US bonds does not depend entirely on the country's future economic positions; it also stems from the fact that people need US dollars to engage in international trades. This is why countries such as China hold so much US debt. It is reasonable to say that as long as the US dollar maintains its dominance in trades, US bonds will be considered safe investment options.

The bond market is much more rational and disciplined than the stock market. While the investment decisions of a stock investor can stem from imperfections in human psychology, such as the urge to follow popular sentiment (herd mentality) and the "fear of missing out," a bond investor makes their investment decisions based strictly on their assessment of a country's ability to service its debt and the direction of its interest rate.

Thus, in times of challenges, the fabricated illusion of confidence created by stock investors is often short-lived. In light of this fact, the bond market is often seen as a true reflection of real confidence and serves as a "forecast" for the future movement of the stock market. For example, during the bear market rally of December 2008 to February 2009, the 10-year US bond high yield prewarned investors that the worst was yet to come. Sure enough, the stock market hit a new low in March 2009.



Bond Pricing and Bond Yields

Understanding the pricing of bonds is rather complicated because the term to maturity changes every day. Instead, people quote the 10- and 30-year bonds' yield from the futures markets. The pricing of the bonds and the returns are inversely correlated. This means that when the 10-year bond yield increases, the price of the 10-year bond decreases.

After the most severe stock market crash in March (a sharp 35% drop within weeks), we witnessed a strong stock market rally of over 60% in April. At the end, we will comment on how to make sense of this rally. However, first let us discuss how the bond market reacted during the same period.

In October 2018, the US 10-year Treasury yield was at a high point of 3.26%. This high yield stemmed from strong confidence among investors, who, consequently, had fewer bond holdings in their portfolios. Subsequently, the return decreased and remained at a 2% level for most of 2019. Then, in February 2020, it declined further to 1.68%. This drop in yield indicates that the bond investors became more fearful as we approached the beginning of the new year.

In March 2020, anxiety over the future reached a maximum level. As a result, the average yield for March dropped to 0.66%. April's average was 0.64%, while the May average is 0.71%. The bond market's behaviour is telling us that bond investors are keeping their US 10-year bonds. As a collective group of the most sophisticated and disciplined investors, they still believe that the economic future is filled with tremendous risks and uncertainties. In the eyes of the "big boys and girls" in the market, the extreme confidence in the stock market is far-fetched.

Major Commodities

In April and the beginning of May, similar to the bond market, the prices of most commodities did not experience a significant price rally. The prices of sugar, oil and corn declined further from their March levels. In simple terms, this tells us that global demand for commodities is low, which confirms the fact that economic activities worldwide have slowed down.

April 20, 2020: A Historic Day for Crude Oil

WTI Oil going negative would undoubtedly be written in the history books. On April 20, at one point in the day, the West Texas Intermediate May futures contract was changing hands at -$37.63 price per barrel. People were stunned and some investors asked us to provide insight. To understand what happened to the WTI May futures contract in April, we must clarify a few things about oil trading.

First, only three instruments are available for retail investors in crude oil trading: futures contracts, contracts for difference and ETFs. Most futures contracts for commodities must be closed before they expire; otherwise, the buyer would have to take physical delivery of the product. For example, if I buy one futures contract for oil with an expiry date of May 1, I agree to take delivery of 1000 barrels of oil on May 1. If I were speculating and neither planning nor able to take delivery, I would have to sell my contract before it expired.

Second, oil refineries constitute the only commercial buyer of oil. If oil refineries are not buying oil, and if I take delivery of oil, I will have to store it until the oil refineries bought it off me. Globally, oil refineries have been purchasing much less crude oil since the demand for gasoline and diesel decreased due to the health crisis paralyzing economic activities around the world.

Third, crude oil requires custom-built storage to ensure its quality. So, if the existing storage capacity runs out, the unavoidable physical delivery would force owners of the futures contracts to sell their contracts at any price available. On April 17, the Cushing storage hub was reported to be 77% full. Goldman Sachs estimated that storage would run out by the first week of May.[25] On April 20, a lack of storage in May forced investors to sell off. The extreme selling pressure quickly sent the WTI May futures contract below zero.

Now, what I am about to explain is important primarily to those investors who are considering buying oil at its bottom. My advice is to skip the "opportunity." This is because a successful execution is impossible.

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Here is an example. Today, I buy a one-year oil futures contract with an expiry date of June 1, 2021. I bought this contract at today's price of $35. In the meantime, the current front-month contract (expires June 1, 2020) is priced at $24. If oil's front-month price increases to $35 in a year, then I made zero dollars on my investment. If oil does not increase by 46% over the year, I lose money.

Typically, a commodity ETF has a monthly rollover. Let's say an oil ETF owns the August contract; it will have to switch to the September contract this month. The changeover would cause the oil ETF to lose 5% according to today's price (May 11). When the future price is higher, the product will continuously lose money. This negative effect is called contango and it is extremely dangerous for investors. Since April 20, oil prices increased 21%, though the largest oil ETF in the world (USO) decreased 34%! Many investors lost their shirts over this. We know this because the demand for USO increased 30 times since oil reached the bottom in April. This is an excellent example of a great thesis that fails due to execution.

Some people were also curious about how the "contract for difference" works. A contract for difference allows investors to buy at the current "spot" price, which people can't do with a futures contract. The downside is that investors must pay a financing fee. Currently, the largest custodian in this area is charging 259% annual interest (charged and compounded daily) to trade oil. Again, the devil is in the execution.

FX

Since I last wrote to you, the FX market also acted as the bond market. The risky currencies, such as the Canadian dollar, Australian dollar, Euro, New Zealand dollar and Mexican peso, are staying at their March levels. The FX market is behaving just as it did during the bear market rally from December 2008 to February 2009. This market further confirmed that things are not as positive as the stock market is forecasting.

Real Estate

In March's newsletter, we said that falling interest rates, easy mortgage availability, high-quality renters and extreme overconfidence supported the real estate boom of the last decade. We predicted that these advantages are disappearing and that, as a result, properties will fall in price.

This month, evidence started to play out in support of our thesis.

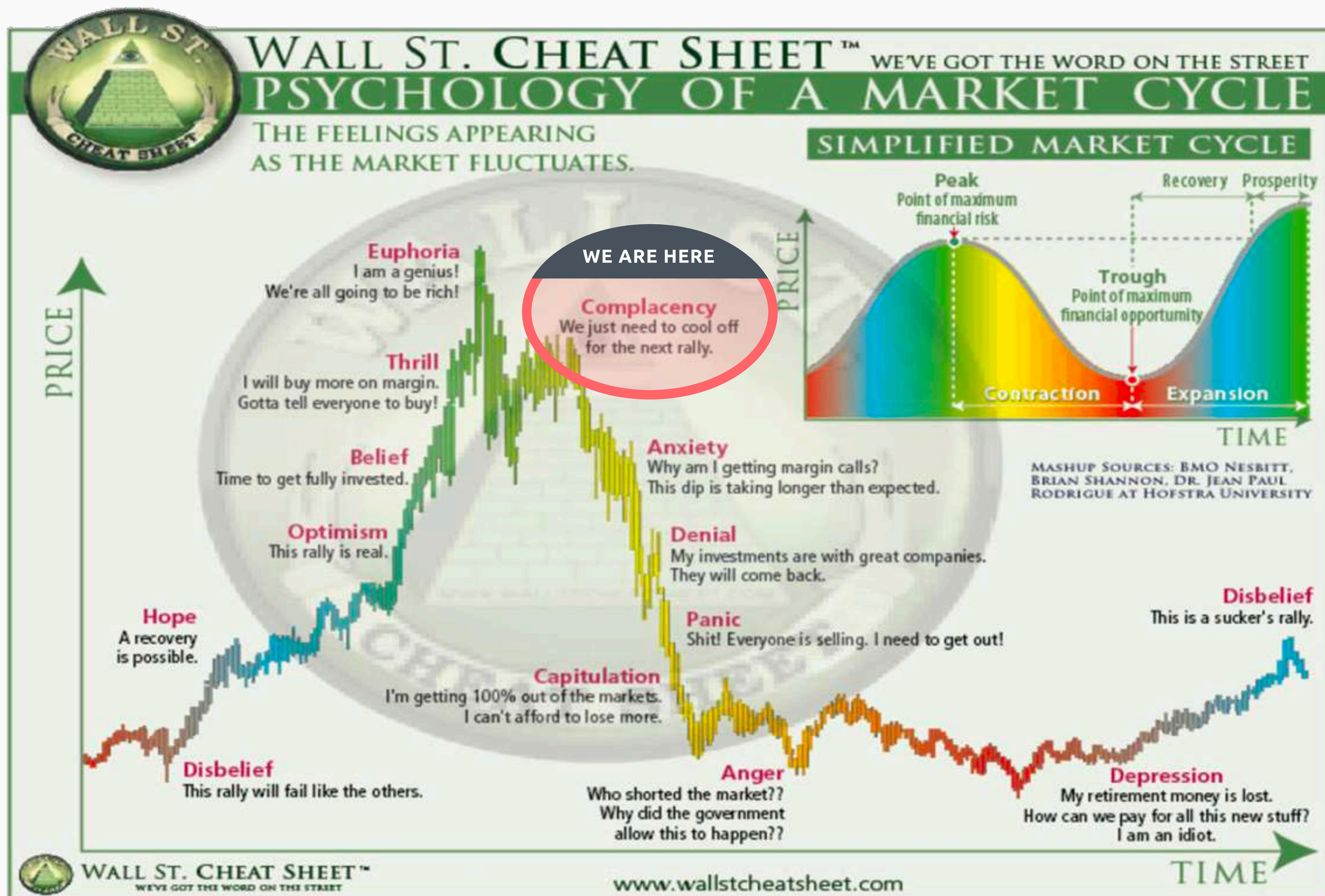
In Toronto, residential property prices have given back last year's price increase. The price in April 2020 was the same as the price in April 2019. Rent rates for two-bedroom apartments have fallen by 4.1%.[26] On the commercial side, through the Q1 earnings reports, we learnt that many public companies, including The Cheesecake Factory, Dave & Buster's, AMC Theatres and Gap, could not (or refused to) pay their rent.[27] Another challenging trend for commercial real estate is that, after the pandemic is over, businesses may choose "working at home" as a permanent option. For example, Bank of Montreal has said that it may allow up to 80% of its employees to have a blended home-office work arrangement after COVID-19 passes.[28] On May 12, Jack Dorsey, the CEO of Twitter, took one step further and announced that the company is allowing employees to permanently work from home, even after COVID-19 is behind us.[29]

The US Stock Market

S&P 500 DAILY CHART (JAN 23 - MAY 11, 2020)

In our last newsletter (released on April 15), we explained that, after a big crash, the stock market always rallies. It seems that the current rally has started losing steam, as the market has not been able to break through the high point it reached on April 29. As of the time of this writing on May 11, 49 days have passed since the market touched the bottom on March 23. The length of the rally is also reasonable, as it is within the historical average of 77 days. (The data goes back to the bear market rallies of the Great Depression.)

To be clear: Retail investors are always the biggest supporters of bear market rallies. They trade based on what they like to hear in the news and from the mouths of leadership. For example, if an investor subjectively thinks that the COVID-19 pandemic is the result of media sensation or believes that "we are over the hump of the virus," he will purposely look for news sources that support his view. He will also firmly believe that the economy can reopen quickly and that the market will swiftly return to its pre-crash level. These investors also tend to have strong faith in fiscal and monetary aid and are powerless when it comes to "fear of missing out." The following chart helps us better understand the psychology of a market cycle. After the month-long rally, we are near the end of the "complacency stage," where people believe things will cool off or improve.



When the unsophisticated investors run out of money, the market starts dropping again. Selling pressure quickly builds when the market begins to show a decline, which further pushes down the market's value. This sounds overly uncomplicated, but the truth is often not complicated.

Investors who want to successfully navigate the stock market must have an objective and realistic understanding of the challenges that most public companies are facing. The 2020 first-quarter earnings season provided a significant amount of current and forward-looking guidance. We divide the companies into two categories: those that are directly impacted by COVID-19 and those that are indirectly impacted by COVID-19.

In terms of the effects of the health crisis, aviation is the worst-hit industry by far. Bankruptcies to date include UK's Flybe,[30] Australia's Virgin,[31] Alaska's RavnAir[32] and Colombia's Avianca.[33]

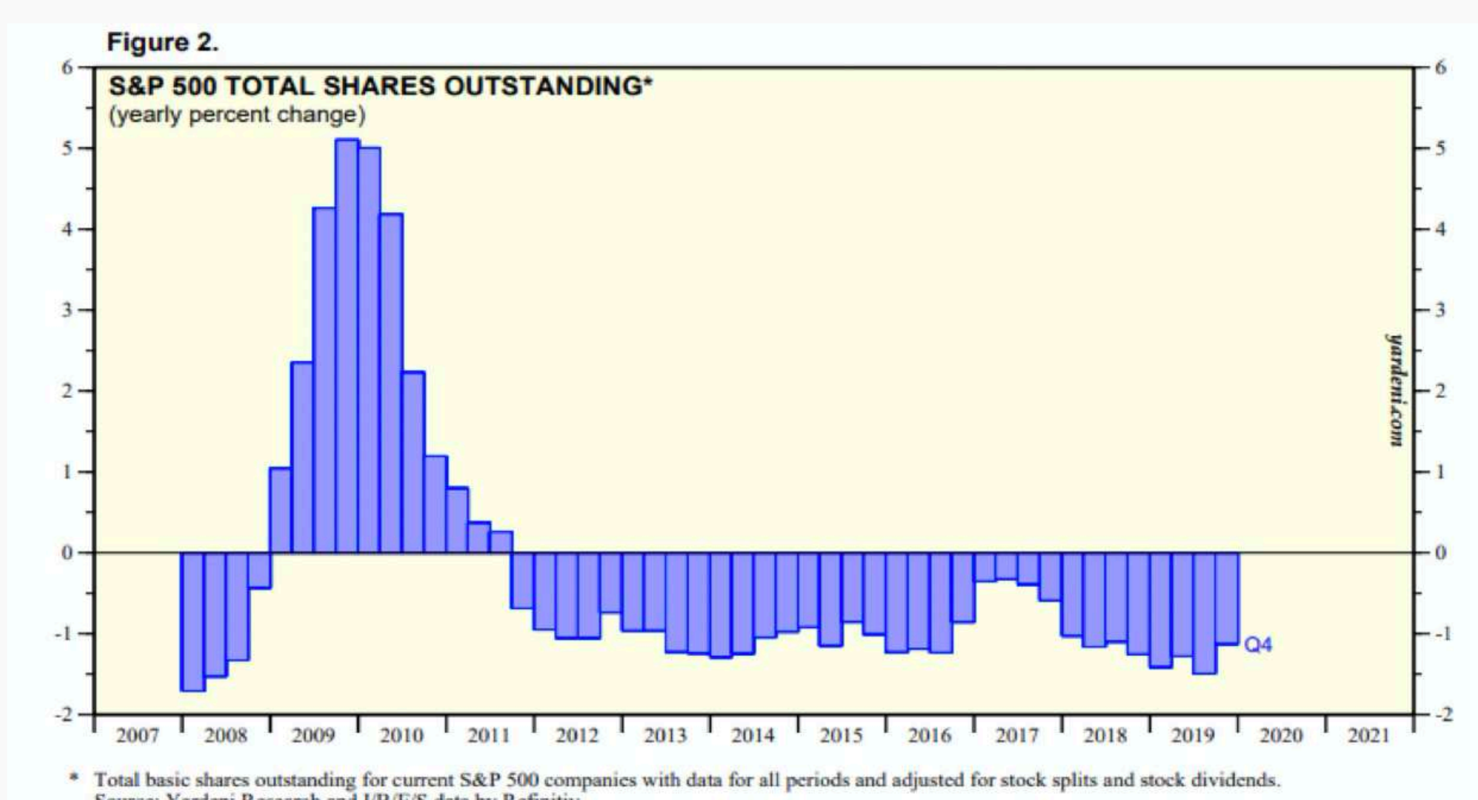
Based on debt ratings,[34] Delta Airlines has the most robust financial position among US airlines that fly internationally. The company has $10 billion in liquidity, including all credit lines, US government support and debt markets. It is trying hard to improve its situation so that it loses only $50 million a day by the end of Q2! If the company pulls it off, its current liquidity will allow it to stay in business for about 200 days. By contrast, CEO Ed Bastian is quoted in his outlook as saying, "Given the combined effects of the pandemic and associated financial impact on the global economy, we believe that it could be up to three years before we see a sustainable recovery."[35] With a three-year outlook for recovery and 200 days of liquidity, the future of the strongest American airline looks bleak.

No wonder Warren Buffett went against his lifelong value investing philosophy and sold off Berkshire Hathaway's entire airline portfolio.

This is the first time that Buffett has ever stepped outside of his buy-and-hold philosophy. Such a drastic decision means that the global travel industry is heading towards a devasting future.

Many people express the thesis about owning companies that will not be affected in an economic downturn. Typically, the argument is that we will always spend money on groceries but not on luxury goods. The reality doesn't support the thesis: Many stable companies are experiencing challenges, too. For example, Coca-Cola warned that sales had dropped by 25% in April, as bars and stadiums are closed.[36] Loblaws and Dollarama cautioned investors that increased costs and declining sales have negatively impacted their business and, therefore, they are unable to provide any forward-looking guidance.[37] Even the crowded Costco announced that its year-over-year sales were down -4.7% in April, and costs continue to rise.[38]

In addition to the first-quarter earnings reports that point to a downward-trending market, the suspension of share buybacks indicates that the market will soon be dropping. Typically, share buybacks are common in a bull market. The following chart demonstrates that stock buybacks were quite high a few years after the market tanked during the 2008 financial crisis. As we explained previously, companies do stock buybacks to artificially boost their stock prices.



While the data on exactly how many companies have suspended share buybacks is not yet available, many companies have announced, in their last earnings reports, that they have stopped the practice to preserve cashflow. When share buybacks stop in the market, equity prices have less support to rise as well.

One last fascinating and ominous development I want to share with you before we conclude this long market update is that, on May 6, 2020, the Canadian multinational e-commerce company Shopify Inc. topped Royal Bank of Canada (RBC) to become the most valuable company in our country![39]

Not counting Shopify, I have witnessed, in my career, only three insignificant companies that were valued higher than RBC. Each time, the valuation was short-lived, and two out of three times, massive market selloffs shortly followed. In July 2000, Nortel peaked RBC just before the 2001 bear market. The company declared bankruptcy in 2009. In October 2007, right before the start of the 2007-2009 bear market, RIM (Blackberry) became Canada's largest company. Today, the company is no longer relevant and has lost over 97% of its value. In July 2015, Valeant Pharmaceuticals surpassed RBC in value. However, after controversies over business practices, accounting and drug pricing, the company is currently trading at less than 10% of its peak price.

Another common theme among these three companies is that I was never able to articulate their value proposition. For those who are interested in learning about how wrong the popular opinion can be, I share a research report from the top-ranked technology analyst at the time, who was building the case that Nortel was undervalued the month when it reached its all-time high.[40]

I have no clue (or interest) in learning about Shopify's value proposition. I can only say, "Congrats! Shopify! And WATCH OUT!"

In summary, the April market rally is within expectation and is coming to an end. The stock market will soon experience its next round of decline. Our portfolio is short-titled and we are certainly prepared to make some good money when the market falls. For those investors who still believe that "this time it's different," I want to share the words of Sir John Templeton: "The four most dangerous words in investing are: 'this time it's different.'"