May 2020

Elixir News

CREATING INCOME FOR EVERYDAY PEOPLE BY USING TECHNOLOGY
TO HARVEST VOLATILITY.

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Hi, everyone.

Before May 2020, despite his 1.5 million Twitter followers, you might not have heard of Barstool Sports blog founder and self-proclaimed pizza connoisseur, Dave Portnoy. Things changed for Dave after his Buffett and stock comments went viral and were picked up by credible mainstream media, such as The Wall Street Journal and Bloomberg.

It's safe to say that Dave shocked every intelligent human being on earth in early June when he made public statements such as, "I'm sure Warren Buffett is a great guy, but when it comes to stocks, he's washed up. I'm the new captain now." And, further mocking the legend's famous investment advice, "I tell people there are two rules to investing: Stocks only go up, and if you have any problems, see rule No. 1."

Dave isn't hiding the fact that he started day trading only about a month ago. With his larger-than-life confidence and a well-followed Twitter account, Dave is leading an army of 20-year-old newbie day traders and buying up just about anything on the stock market[1]. It's hard to believe, but these retail investors/gamblers were, indeed, responsible for the seemingly endless stock market rally.

Ironically, but not unsurprisingly, Dave's "stocks only go up" theory was short-lived. If you're interested, watch this video[2] to see his emotional reaction when the market went down, and he lost nearly $700,000 in a single day on June 11.

I thought that starting this newsletter with Dave was appropriate, as the newsletter's main goal this month is to make sense of the market rally. We will share our research into the three factors backing these rally supporters' optimism and the seven factors supporting our belief that the market will turn.

Another popular topic these days is US-China relations. People are speculating about different financial weapons that the two countries could deploy if tension continues to build. Can these tools be feasibly used? How bad would the impact be for the country that is under attack? This newsletter will attempt to answer these questions.

The newsletter also contains our May performance review. In our April update, we said 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." We were right. Our May realized trading revenue on trading assets ended at a modest 1.61% (0.83% on total bonds and preferred shares outstanding). In this newsletter, we will briefly explain what we did and did not do out of caution in May.

We hope that you find this newsletter insightful. For shareholders, we look forward to seeing you online at the AGM.

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

May was a bizarre month. On the one hand, the North American economy improved only a little. We remain in the worst economic shape since the Great Depression. On the other hand, risky assets, such as FX, commodities, and stocks, all increased in value. The stock market was like the NASA astronauts being lifted off on a Falcon 9 rocket[3]. On June 8, the S&P 500 returned to the level, i.e., 3232.39, where it had been at the beginning of 2020. The index was only 154 points short of breaking its highest-ever record of 3386.15, established on February 19, 2020.

Elixir's trading portfolio has been net-short since April. We expected the sucker's rally to happen, but we also firmly believe that asset prices will fall back to reflect our real economic situation.

The biggest challenge for a net-short portfolio in a market rally is managing liquidity. We were cautious and ensured that we had lots of liquidity room for the value of assets to increase. My analytical mind did not believe that the stock market's return to the 3200 level was possible, yet I saw myself leaving much more room for liquidity.

I want everyone to know that we are well-capitalized. We are not anywhere close to the possibility of a "short squeeze" sell-off and we can wait for the market to correct itself. The only downside of being this conservative is that our return for May was modest. In May, we earned some profits from selling insurance on the few market down days, but we will not see significant revenue until the market substantially reverses its course. Preserving wealth has always been Elixir's number-one mandate. Especially when the market is acting extremely irrationally, maintaining adequate liquidity is much more important than chasing profit.

Looking ahead, volatility started to pick up in the second week of June. The return of the up-and-down movements certainly works in our favor. We are making some returns but, again, whether June will be an above-expectation month or another modest flat month will depend on the occurrence of a substantial market correction. We will not buy new assets for the portfolio until we encounter opportunities that have real value and that are underpriced. This will take a while. Patience is our key to success in the long run.

In May, optimism and confidence filled the stock market. Stock prices went up, up, and up some more. And we're talking about more than the Nasdaq-listed tech stocks; companies that had announced bankruptcy, such as Hertz and Chesapeake, also saw a boost in their stock prices! Let's get straight to it. First, we will share our research into this optimism. Then we will flip the coin to discuss our view.

Zoom in on the Optimism Supporting the Market Rally Since the March Big Crush

WHO IS BUYING AND DRIVING THE MARKET UP?

Offering no-fee trading and the ability to buy fractional shares enabled online brokers to eliminate the entry barriers that retail investors face in terms of trading stocks. Investors can buy as little as 0.01% of popular stocks like Facebook and Google.

For this reason, major online brokers – Charles Schwab, TD Ameritrade, E*TRADE, and Robinhood Markets – all reported significant new account growth in the first quarter, even though the stock market had experienced a severe market crash and a terrible first quarter. According to The Wall Street Journal[4] and Yahoo Finance[5], Robinhood signed up an additional three million retail investors during the first four months of 2020. Fidelity Investments added 1.2 million retail brokerage accounts between March and May. TD Ameritrade saw 426,000 new users in March alone and is averaging 3.5 million client trades a day so far in June. This is over four times higher than its June 2019 numbers!

Millennials and Gen Z accounted for most of the new trading account growth at these online brokers. The pandemic hit these two age groups the hardest. A typical profile would be: out of a job, collecting stimulus checks, bored, emotional, and looking for ways to make quick money or get an adrenaline rush. This demographic is particularly responsive to Dave Portnoy's gambling style of trading.

WHY ARE THESE NEWBIE TRADERS OPTIMISTIC?

The extreme enthusiasm for asset prices stemmed from the partial reopening of the US and global economies. Because the US GDP reporting comes out only once a quarter, the leading indicator of financial health on which investors rely is the employment reports.

The June 5 US employment report caused a wild, bullish price increase in most FX, commodities, and equities. With 2.5 million jobs created in 30 days, the report gave the impression that the US economy was quickly bouncing back. President Trump promptly took credit for the economic rebound, describing it as "not a V-shape recovery but a rocket ship.[6]"

Secondly, the market has been taken over by arrogant and ignorant gamblers like Dave Portnoy. The capital market is a platform that facilitates the flow of capital to efficiently generate the most value. Although there are speculators that could cause market inefficiency and temporarily cause stock valuations to disconnect from the health of the economy, the capital market is not a casino. Unfortunately, Millennial and Gen Z retail investors are treating the capital market like a casino. They have no analytical reasoning with which to back the stocks they buy. They think that the market hit bottom in March, and their buying decisions are largely driven by fear of missing out. They don't consider the fact that the stock market was extremely overvalued before the crash and they firmly believe that the market will return to its record highs.

Individually, these newbie retail investors may not have much buying power; many of them even used a portion of their stimulus checks to buy fractional shares. But there are a lot of them—enough to keep the madness going. On June 9, CNBC's Jim Cramer commented that he had never seen so many games played with stocks in his career[7].

WHAT ARE THEY BUYING?

Some may feel that my take on Millennial and Gen Z retail investors is too harsh. Well, let's look at some of their stock choices.

Hertz filed for bankruptcy on May 24[8]. After the company paid back part of the principal to its creditors, nothing is left for shareholders.

After the news release, Hertz's stock fell 98% from its 52-week high (reached in February 2020) to 41 cents per share. Carl Icahn sold out his entire holdings at an average price of 72 cents per share and lost USD 1.6 billion[9]. Then retail investors came in with their small capital over the next two weeks. Miraculously, Hertz's stock rose by a jaw-dropping 1429% to $5.86 per share!

On June 8, retail investors who made good money off trading Hertz's bankruptcy got so excited about the Chesapeake Energy bankruptcy rumour that they pushed up the price of Chesapeake stock by 182% in one day[10]! As a businessperson (not even as a trained analyst), I find it incomprehensible that investors were excited and rushing to buy companies going bankrupt.

Bankrupt companies are not the only focus of Millennial and Gen Z investors, who are also diversifying their portfolios by taking a long position in financially challenged travel companies. Bloomberg compiled the following chart to demonstrate retail investors' favorite equities.

Retail Favourites

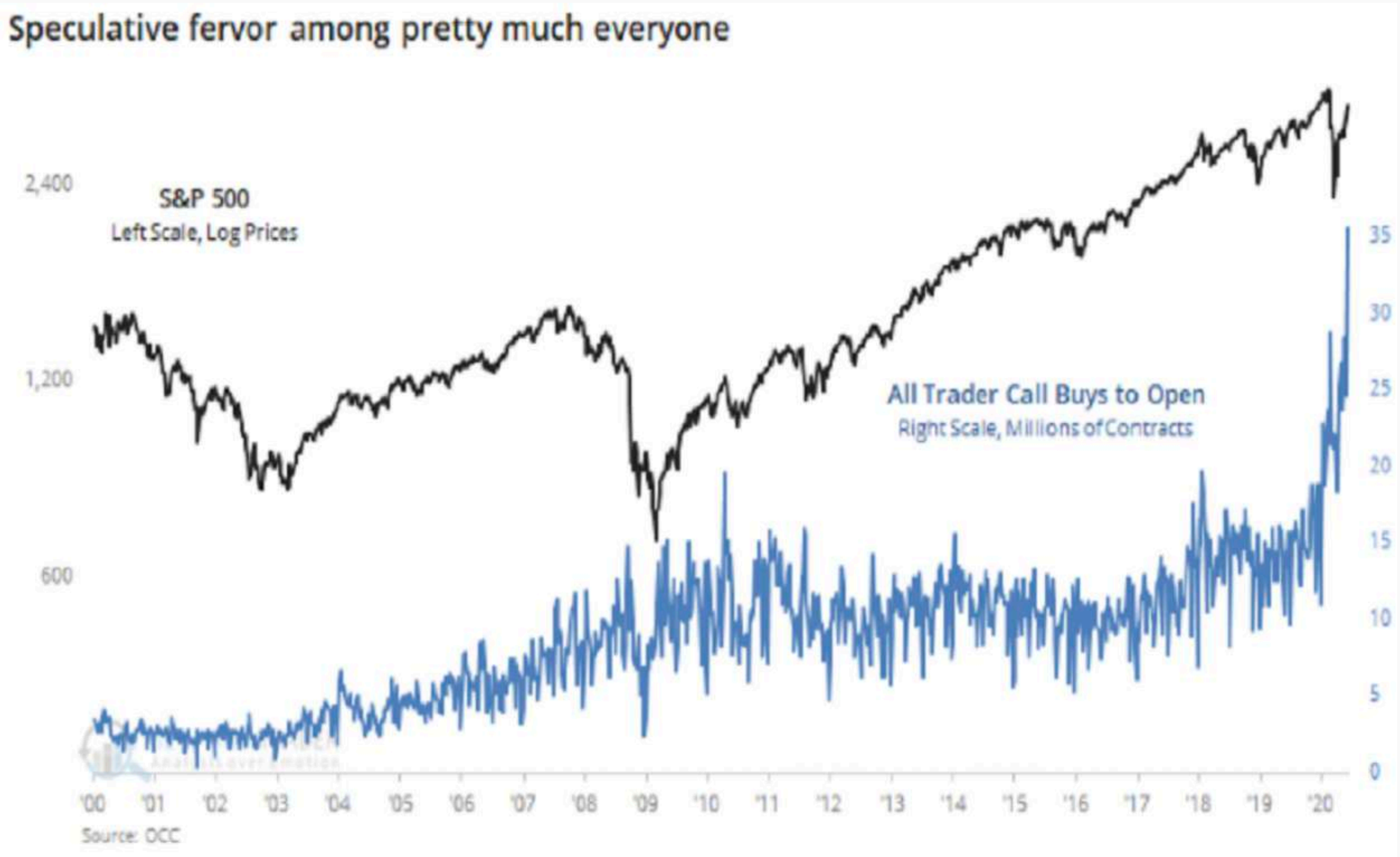
Stocks that have seen the largest increase in interest on Robinhood over the last month that are also in the Russell 3000

COMPANY	PERF. SINCE 5/8	PERF. BETWEEN 2/19-3/23
American Airlines	100 %	−64 %
Hertz	69	−66
Delta	63	−62
Spirit Airlines	142	−76
MGM Resorts International	52	−71
Invesco Mortgage Capital	151	− 71
United Airlines	92	−67
Boeing	73	−69
Carnival	75	−72
Norwegian Cruise Line holdings	116	−81
Average	93	−70

SOURCE: Robintrack, Bloomberg. Data through 6/8/2020

Sadly, these investors are not done making absurd investment choices. Those who felt that buying stocks wasn't exciting enough ultimately turned their attention to buying call options. Call options are leveraged bets that speculate the stock market will increase in value over a short period of time.

The following chart demonstrates that the level of bullish optimism has never been this high in the options market. During the first week of June, 35.6 million new call option contracts opened to bet on the upward increase of the S&P 500. The last peak of call options was on February 18, with 28.7 million contracts placed[11]—and we all remember what happened in March.



WHAT IS ELIXIR DOING (NOT DOING)?

Some may wonder why Elixir is not shorting companies like Hertz and Chesapeake Energy. As discussed a few times in the past, good ideas are not always actionable. In an irrational market (such as the current one), it is hard to determine how high the stock price will go. Second, it is hard to borrow shares. Even if you managed to acquire some, the possibility would exist that the exchange could turn off the option to short. If that were to happen, you could be forced out and take a loss. Third, the cost of financing is sky-high. In the case of Hertz, a short seller would have to pay a 200% annual financing fee, charged daily. It's too risky to short individual stocks when the market is irrational. One of Buffett's famous investment advice is to be "fearful when others are greedy." This advice has been ringing in my ears almost every day.

The Flip Side of the Coin: We Remain Optimistic that the Market will Turn Hard

We are still positively bearish on the US and global economies and the capital markets. The following seven factors support our view.

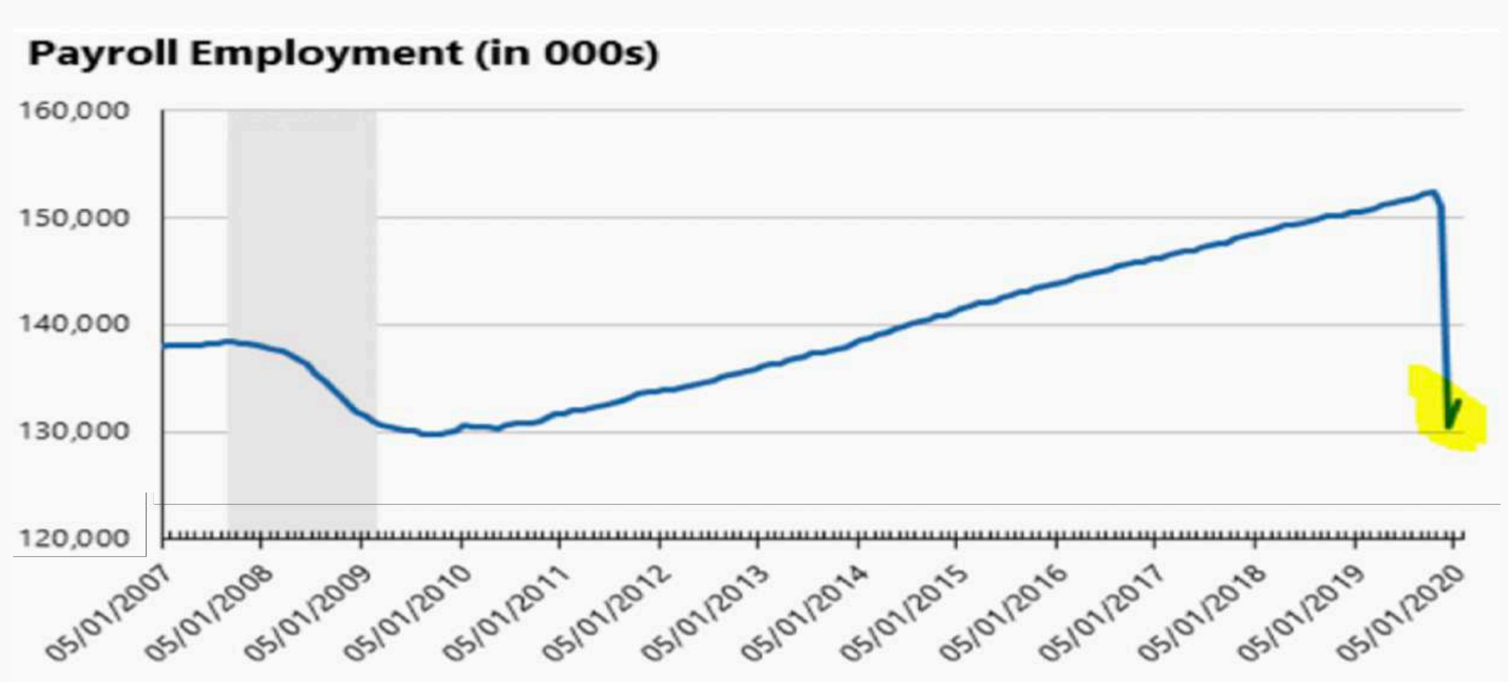
1 US EMPLOYMENT IS NOT IMPROVING. THE OFFICIAL MAY UNEMPLOYMENT NUMBER SHOULD NOT BE TAKEN AT FACE VALUE.

On June 5, the US Bureau of Labor Statistics reported that total nonfarm payroll employment rose by 2.5 million in May and that the unemployment rate declined to 13.3 percent[12].

We were not the only group surprised by this news release. As Bloomberg put it, "… a median projection for a loss of 7.5 million jobs. Of the 78 economists surveyed by Bloomberg, the most optimistic forecast called for an 800,000 decline. Their estimates also expected the unemployment rate to approach 20% -- the highest since the Great Depression in the 1930s -- when in fact it declined to 13.3%.[13]"

Closer examination reveals that this set of unemployment data is, again, miscalculated, just like the last one. The real unemployment situation in the US does not support a V-shaped recovery and is far from being a rocket ship. The following analysis is based on research and insights from Rosenberg Research[14], Bloomberg[15], The Guardian[16], Jared Bernstein[17], and economist Paul Kruger[18].

- The "2.5 million jobs created" claim was not an accurate statement, and even if it were, the number is still minimal compared to the total job losses that the US suffered since the start of the pandemic. Former Chief Economist in the Obama administration, Jared Bernstein, put the cumulative job loss numbers into a chart. As you can see, the 2.5 million jobs added is insignificant.



- In our last newsletter, we talked about the misclassification of "temporary worker" in April's report. The May report did not fix this misclassification. The unemployment rate should be 5% higher, at 18.3%.

- The job report showed that 21 million Americans are unemployed, but the weekly jobless claims report said that 30 million are claiming continuing unemployment benefits in all programs. Approximately 6.7 million Americans were "not in the labour force" in May. The unemployment report should have included these people, but it didn't. I won't go into a detailed explanation of this, but the real unemployment number for May should be around 19%.

- The report claimed that 85% of job categories improved in May, which is not accurate. Only eight types of businesses showed improvement. They are restaurants, dentists, clothing stores, general merchandise stores, specialty contractors, auto dealers, personal and laundry services, and repair and maintenance services[19]. Strong employment growth is broad-based. This was not the case with the US in May.

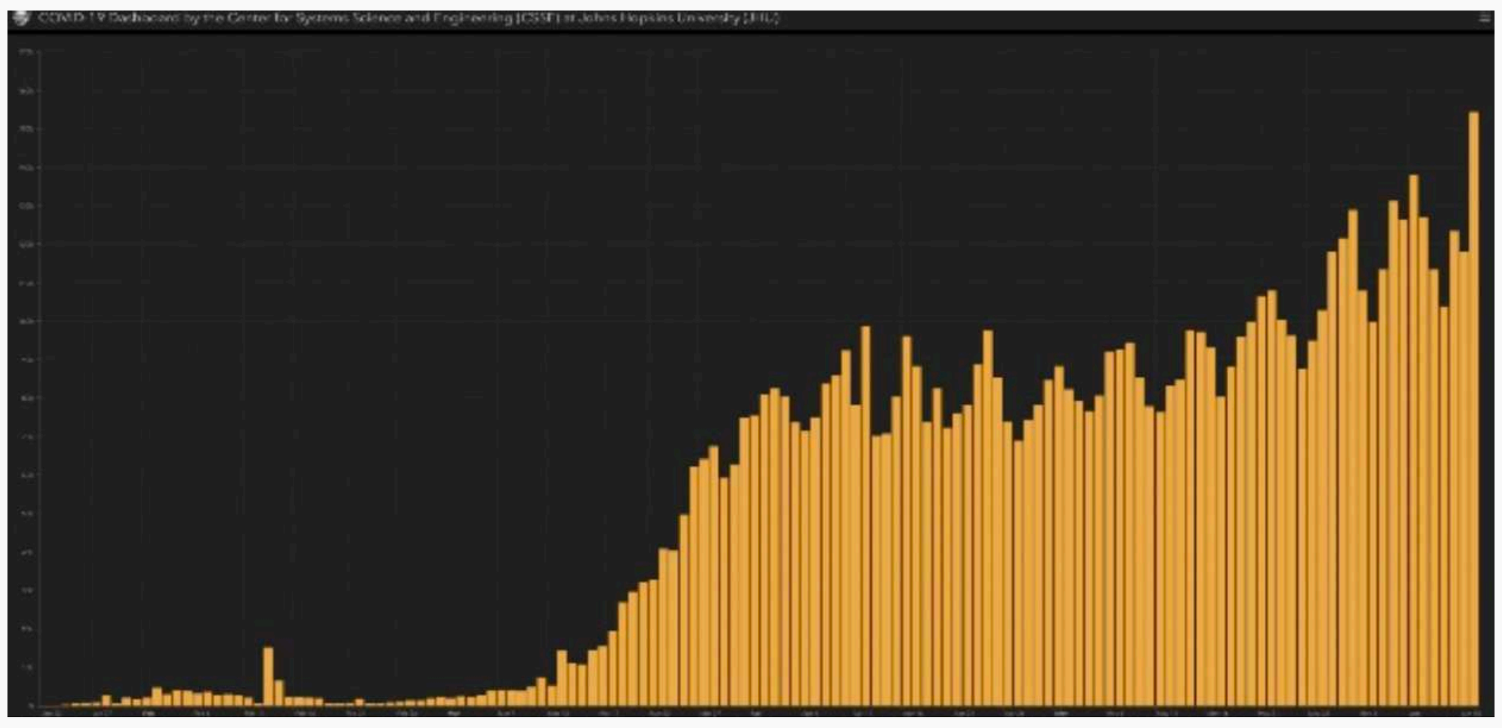
The reported job numbers are significantly off. The real unemployment number is much closer to the 20% level that the 78 economists estimated. The Organization for Economic Co-Operation and Development (OCED) estimates that unemployment will hover around 10% even after 18 months. It will take years for employment to return to its January 2020 peak. One in five Americans is currently jobless. How can anyone build a solid argument that the current high stock prices are sustainable based on this number? The market has to turn.

2 THERE IS NO EVIDENCE TO SUPPORT A V-SHAPED RECOVERY IN GDP.

While we won't see the Q2/20 GDP reporting until July, the Dallas Federal Reserve Bank Mobility and Engagement index offered clues as to where the US is in terms of its current economic vitality. The Mobility and Engagement index tracks how long and how far people travel from their homes each day based on cell phone location data. The last report was dated the week of May 30. It showed that people were still moving around 57% less than they were last year[20]. Lack of movement and engagement typically leads to less economic activity.

3 THE INCREASING NUMBER OF COVID-19 CASES DUE TO PREMATURE REOPENING & PROTESTS COULD FURTHER DRAG DOWN THE GDP.

I won't go into detail on this point, as I'm sure that our readers are just as current as I am on the news and are as concerned as I am about how our neighbouring country is dealing with the Covid-19 pandemic. The too-soon reopening of the economy and the ongoing intense protests are surely not helping to flatten the curve. The following chart shows that the rate of new cases is still stubbornly high globally, particularly in the US[21]. Will there be a second shutdown of the economy?

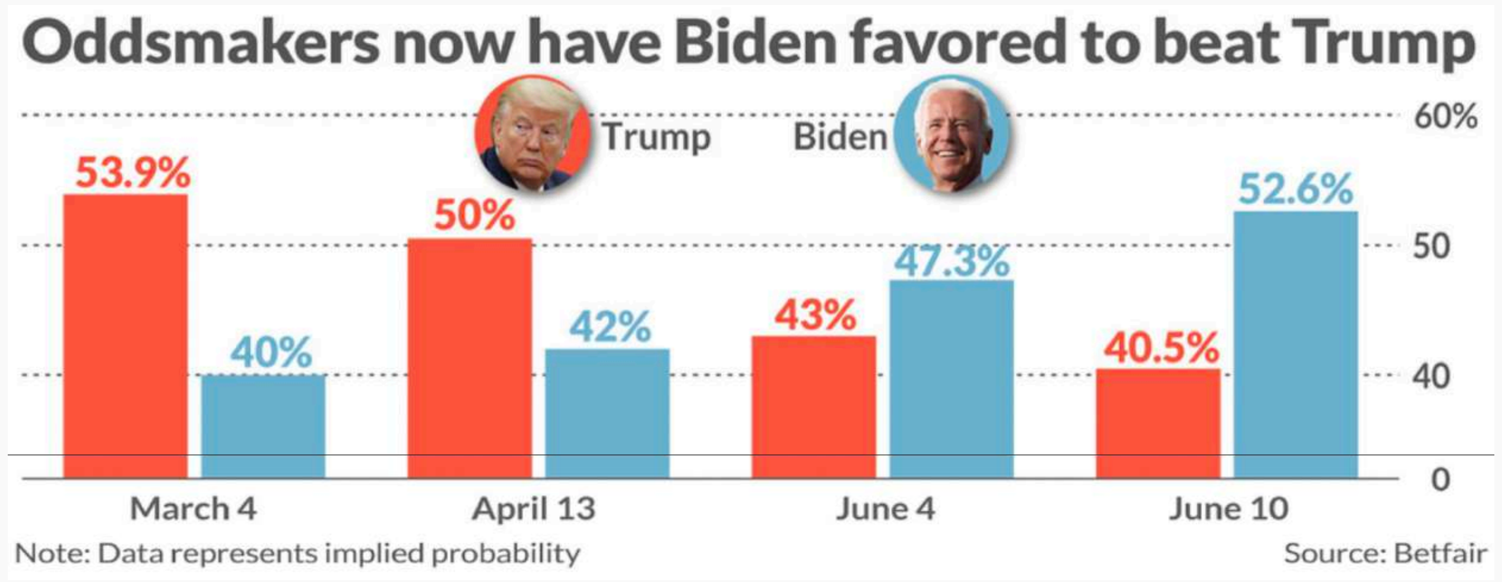


On June 11, Treasury Secretary Steve Mnuchin said that there was zero chance of this[22]—but who knows? I've seen too many impossible things become possible in 2020. Even if the US doesn't close down again, I think that people will voluntarily practice stay-at-home as much as possible regardless of what their political leaders tell them. It's safe to assume that Covid-19 will continue to challenge the US economy.

4 DEEP DEFICIT AND THE EQUALITY MOVEMENT COULD FORCE THE US TO RAISE TAXES.

A large deficit could lead to increased taxes in the US. This happened during the Great Depression. From 1929 to 1939, rates for the US corporate income tax increased from 11% to 19%; capital gain rates rose from 12.5% to 22.5%, while the top-bracket personal income tax rates increased from 24% to 63%[23]!

Adding to this, the worsening gap between rich and poor in the US may compel political leaders to raise taxes on rich individuals and corporations. At the current time, the US Democratic leader Joe Biden is significantly leading in the November 2020 election polls[24]. There seems to be a real possibility that the Democrats could take both the House and the Senate.



We may see taxes go up substantially in the US. From a market perspective, a tax increase reduces companies' net income. Therefore, it is considered a tremendous risk and typically results in selloffs and lower asset prices.

5 THE FISCAL STIMULUS IS RUNNING OUT.

Paul Krugman, ranked as the most influential economist in the world by Focus Economics, is concerned about the ending of the fiscal stimulus in many countries[25]. Take the US as an example: The unemployment and stimulus checks will cease at the end of July. The Paycheck Protection Program (PPP) has stopped disbursing funds. The PPP offers small business loans that can be converted into grants if they are used to maintain payroll. Krugman thinks that the latest "positive" job report will not enable an agreement in Congress to pass more stimulus. He believes that when the fiscal stimulus stops, more layoffs will happen[26]. The capital market also likes fiscal stimulus. Thus, when the tap turns off, the market will react negatively.

6 FIRST-WORLD COUNTRIES' CREDIT RATING IS STARTING TO SHOW A NEGATIVE TREND.

As countries take on considerable deficits to pay for fiscal stimulus related to Covid-19, bond rating agencies are starting to evaluate the need to downgrade these countries' credit ratings. Japan became the first developed county to have an outlook on its debt lowered by S&P. On June 9, the agency said, "The Covid-19 outbreak has set back Japan's fiscal stabilization process, but we expect that to get back on track in the next two to three years as the economy recovers.[27]" I remember the extreme volatility in the capital market when S&P lowered the outlook on the US and several European countries in August 2011[28].

7 IF HISTORY REPEATS ITSELF, THE STOCK MARKET STILL HAS A LONG WAY TO FALL.

The historical trading data of the Dow Jones Index goes back 100 years. The following chart shows how the index reacted to the Great Depression and went from its record peak price of 380 in August 1929 to its record bottom price of 43 in June 1932. As you can see, the decline was not a straight line. Let's say "a drop and a rally" is one round. From the peak to the bottom, stretched over 35 months, the Dow Jones Index went through six and a half rounds of "drops and rallies" and lost 89% of its value. The average length of a round is about five months. Where are we today? It seems like we are just finishing our first round. The worst is yet to come.

Conclusion:

The current market rally is completely disconnected from the true value of assets and our economic reality. Although unsustainable, the rally may still be around for a while as optimistic retail investors try hard to keep it going. The market will turn but this may take some time. We anticipated these drops and rallies. For now, we wait patiently for the market to reverse and we look forward to a time when we can actively trade valuable assets at a low price.

A closer look at the **financial weapons** of the US and China

US-China relations have been a hot topic in recent years. While July 8, 2018, marked the official start of the US-China trade war[29], the first sign of this event dated back to September 2011, when Trump (now President Trump) tweeted, "China is neither an ally or a friend — they want to beat us and own our country.[30]" Since the trade war started, we have seen instability and volatility in all asset classes, including bonds, stocks, FX, commodities, and metals.

Just as the world thought that the trade negotiation was on a promising path, the Covid-19 pandemic created a new round of uncertainties over the relationship between the two countries. Speculation of a second US-China trade war is brewing in the market.

This time, in addition to tariffs, the media is saturated with rumors of the various financial weapons that both countries could deploy.

Any tension and conflict between the world's two largest economies could shake the market. Therefore, we spent some time analyzing each of these popular weapons. Our goal was to answer two simple questions. One, can the weapon be used? Second, if the weapon were used, how bad would the impact be for the country that is under attack?

In this article, we will first discuss the following five US weapons. Then we will share our findings regarding the three popular firearms that speculators believe the Chinese could use.

The United States of America

#1: The US could prohibit China from using the SWIFT global payment system.

#2: The US could cut off China from using Mastercard, Visa, and American Express.

#3: The US could delist Chinese companies from its stock exchanges.

#4: The US could cancel the Hong Kong Policy Act of 1992.

#5: The US could default on its bonds owned by China.

VS

People's Republic of China

#1: China could sell off all its US treasury bonds.

#2: China could devalue the RMB.

#3: China's Belt and Road Initiative could cause economic difficulties for the US.

THE UNITED STATES OF AMERICA

WEAPON #1:

The US could prohibit China from using the SWIFT global payment system.

A popular idea is that the US could cut China off from using the global payment system[31]. This would create enormous challenges in terms of China's ability to engage in international trade. Is this idea realistic?

After 9/11, the US government established the Terrorist Finance Tracking Program (TFTP). The Society for Worldwide Interbank Financial Telecommunication (SWIFT) received subpoenas from the US Treasury to provide the financial and banking details of suspected terrorists and to cut off banking to countries or individuals that the US perceived as a terrorist threat.

For those who are not familiar with SWIFT, the organization provides a network that enables financial institutions worldwide to easily send and receive money globally. For example, Bank of Montreal (BMO) is identified as "BOFMCAM2" in the SWIFT Code system, through which anyone in the world can quickly wire money to BMO.

While the US could prohibit China from using SWIFT, the trick is that the Americans must get the European Union (EU) to agree on a joint action. SWIFT is a not-for-profit organization based in Belgium. Therefore, it must comply with European laws. The US government has no authority or control over it[32]. Since 9/11, the US has placed financial sanctions on Cuba, Iran, North Korea, Syria, Russia, Venezuela, Belarus, Burundi, Congo, Iraq, Lebanon, Libya, Nicaragua, Somalia, South Sudan, Yemen, and Zimbabwe. Among these countries, SWIFT refused its service only to North Korea and Iran. In the case of North Korea, this was because the country failed to meet SWIFT's operating criteria[33], while for Iran, the disconnecting action was a response to the EU's sanctions demand. The US tried, without success, to cut off Russia from SWIFT service after its 2014 invasion of Crimea[34].

Based on our observation, the EU seems to have a limited interest in imposing sanctions on China. Therefore, unless the US has the EU on board, it would be highly unlikely for the SWIFT organization to consider cutting off its service to China's financial institutions.

WEAPON #2:

The US could cut off China from using Mastercard, Visa, and American Express.

While the US does not have power over SWIFT, it could order American credit card companies to terminate their services in certain countries. They have done this to Burma, Iran, Sudan, Syria, Russia, and North Korea. When the US imposed sanctions on Russia in March 2014, Visa and Mastercard swiftly blocked credit card services to many Russian banks[35]. This ban was difficult for the country, as these credit cards were widely used domestically.

However, China is in a much better position than Russia. For years, American credit card companies have been lobbying the Chinese government to allow them to tap into the massive USD 27 trillion payments market, without success[36]. Approval to begin formal preparations for setting up a bank card clearing institution in China was granted only in February 2020[37]. This marked a significant step towards American credit card companies being allowed to have a slice of the pie. Although the regulatory path is clearing up, American credit card companies still face fierce competition, as local players, such as WeChat Pay and Alipay, dominate the Chinese domestic payments market[38].

The growing worldwide acceptance of China UnionPay also makes traveling outside of China less dependent on Mastercard, Visa, and American Express. Take Canada as an example. Chinese UnionPay cardholders can withdraw cash from CIBC, Scotiabank, BMO, RBC, and TD Bank ATMs and use their cards at more than 10,000 locations throughout Canada. Although Chinese tourists may still encounter inconveniences while travelling overseas, the need for American-based credit cards will decrease over time.

As evidenced, in the current circumstances, terminating American-based credit card services to Chinese citizens would have a limited impact on China. In fact, the decision could backfire on the US. For example, as a solution to the 2014 sanctions on banking, the Russians quickly launched a competing national payment system, "Mir," in December 2015. According to GlobalData, more than 40 million Mir debit cards and 1.3 million credit cards were in circulation in 2018. Although Visa and Mastercard still have a strong presence in Russia, their cumulative market share has been shrinking[39]. If the US insists on disallowing Mastercard, Visa, and American Express to do business in China, these companies will undoubtedly lose out on a significant market for revenue growth.

WEAPON #3:

The US could delist Chinese companies on its stock exchanges.

Last month (May 2020), the US Senate passed a bill that could delist Chinese companies from American stock exchanges[40]. Yes. Unlike previous ideas, this one is already in motion. But how significant would the actual impact be on Chinese companies and China itself?

Overall, Chinese companies raise a small amount of capital through IPOs. The money raised in the US stock market accounts for only an insignificant portion. According to PwC[41] and Renaissance Capital[42], more than 400 Chinese companies IPOed in China and raised about USD 77.9 billion in 2019. Adding to that, Chinese companies raised an additional USD 133.6 billion from domestic private equity funds in the pre-IPO round. In 2019, only 25 Chinese companies IPOed in the US and raised only USD 3.8 billion. As you can see, Chinese companies' fundraising in the US IPO market represents only 1.8% of its total capital intake in 2019.

We believe that credibility enhancement is the main motivation for Chinese companies to list on the US stock market. It's a "face" project that will help their brands in the domestic and global markets. There is a great movie—called "American Dreams in China[43]"—about Chinese entrepreneurs taking their English-language school public in the US. The movie is based on a true story and I highly recommend it.

WEAPON #4:

The US could cancel the Hong Kong Policy Act of 1992.

It wouldn't be appropriate to talk about US-China relations without talking about Hong Kong. The city holds a special place in my heart, as it was my first introduction to Asia back in 1998. Two decades later, I have visited the city almost every year and witnessed the changes that have taken place throughout that time.

On May 29, President Trump announced that he would start taking action to revoke Hong Kong's favored trade status with the US[44]. If this happens, what impact would it have on Hong Kong and China?

Currently, under the Hong Kong Policy Act of 1992[45], there are no tariffs on the majority of goods trading between Hong Kong and the US back in 1992, Hong Kong was an essential trade bridge between mainland China and the rest of the world. At the time, trade as a percentage of GDP between Hong Kong and the US was significant. The city accounted for 18% of China's GDP[46].

Fast forward 28 years. Hong Kong's trade role between mainland China and the US has become much less significant. In his interview with the South China Morning Post shortly after Trump's announcement, Paul Chan, the Hong Kong Financial Secretary, said that the US accounted for less than 0.1% of the city's overall exports. He emphasized that the city would continue to strengthen its trade ties with Europe and Japan. Meanwhile, Hong Kong's contribution to China's GDP has shrunk to less than 3%[47]. So, from a trade perspective, the damage that the US is hoping to inflict on China by stripping away Hong Kong's preferred trade status will be very minimal.

In addition to trade, the Hong Kong Policy Act of 1992 allows the city to import sensitive technology, such as military weapons, from the US. It is speculated that most of these sensitive technologies end up in mainland China. Canceling the Act would close the loophole for China to import these restricted goods. That said, these sensitive imports make up only about 5% of Hong Kong's overall imports[48].

Lastly, the potential sanctions could include freezing certain Hong Kong citizens' assets in the US and denying Hong Kong passport holders entry into the US. While the US government has the authority to do this, the overall economic impact on China and Hong Kong would be limited.

Our view is that the use of Hong Kong to hurt China would have been an effective strategy 30 years ago. Today, not so much.

WEAPON #5:

The US could default on its bonds owned by China.

Perhaps the most prevalent idea being reported by media outlets is that the US could default on its bonds owned by the Chinese government. Leading Republicans, such as Senator Lindsey Graham, have proposed that the US should default on its bonds owned by China to pay for the costs of the Covid-19 pandemic[49]. A quick background check reveals that, unsurprisingly, Senator Graham has no work experience or education in securities law, finance, or economics. Let's take a look at the feasibility of his recommendation.

Bonds and stocks in the public market are commonly held under a "street name," For example, Elixir currently owns some Walgreen Boots Alliance stock (WBA). WBA is unaware that we are one of its shareholders because our shares are registered under our custodian, Interactive Brokers (IB).

When WBA pays a dividend, splits stock, sends out shareholder material, or takes other corporate actions that involve shareholders, the company contacts IB. Our custodian then cross-references its records and passes on the dividends or information to WBA shareholders who are registered under their "street names." It's challenging for an issuer, whether WBA or the US government, to identify who owns its shares or bonds. The Chinese government likely holds its US treasury bonds in many different custodians and brokers worldwide. It would be almost impossible for the US government to accurately pinpoint all of China's bond holdings.

More importantly, under fairness rules, an issuer—whether it is a company or a government—cannot target default on one specific bondholder while not doing so with the others who invested under the same class. If such an action is inevitable, the issuer must default an entire class of bond. It's reasonable to assume that the Chinese government has bought into many classes of US treasury bonds over the years. Therefore, even if the US government could identify the owners of its debts, it is legally impossible to default only on China's holdings.

Finally, is it in the best interest of the US to default on its debt? The answer is an obvious no. The immediate consequences would be devastating to the United States. The action would lower the country's credit rating, which would impact its ability to raise capital by selling treasury bonds. Institutional investors, such as insurance companies and pension funds, have strict investment policies that forbid them from buying or holding bonds of issuers in default. Also, when the US defaults on its obligations, it sends out a strong signal of uncertainty. Fear would force many investors to sell their US bond holdings. As a result, the prices of US treasury bonds would decline while the bond yield would go up.

Government bond yields are a baseline for setting lending rates and interest rates. Many US companies, and much consumer debt, are on a variable rate term instead of a fixed-rate arrangement. As the lending rates go up, so does the cost to service their debt. From a company's standpoint, the stock market would view rising costs as risky. Investors would react by selling off their holdings, and we would subsequently see high volatility in the marketplace. The US government would face the same problem. Raising interest rates would add to the cost of its new and renewing debt. An increased cost of debt would drag the country into deeper deficits, eventually forcing it to raise taxes on its citizens.

As you can see, the idea that the US could default on its bonds owned by China is ill-considered. I'm confident that the US would not go ahead with this self-destructing strategy.

PEOPLE'S REPUBLIC OF CHINA

WEAPON #1:

China could sell off all its US treasury bonds.

On the other hand, could China sell off all its US treasury bonds? Yes. But would this have a material negative impact on the US? As of June 3, the US government had issued $25.9 trillion in debt. A May 15 report from the US Treasury Department indicated that China owns only about $1.08 trillion in US treasury bonds, which accounts for 4.17% of US government debt[50]. This data may be a surprise to many, but China's position in US treasury bonds is small.

From March to June, the US government raised $2.5 trillion in bonds. It was impressive that the country could raise record-level bond capital within such a short time without causing interest rates to rise uncontrollably. In the short term, with its superpower of "money printing," the US Federal Reserve should have no problem repurchasing bonds (if China decides to sell) while keeping its monetary policy stable.

In the long term, however, a terrifying reality could come to the forefront. Can the US continue its rapid deficit growth without losing its current top-tier credit rating? Eventually, money printing and increasing money supply will make the US government debt less desirable and trigger massive selloffs, leading to higher interest rates and inflation.

In conclusion, if China were to dump its $1.08 trillion in US debt soon, the impact on the US would be immaterial. However, doing so at the right time, when the selling pressure is starting, could add fuel to the fire. We receive data from first world countries' regular bond auctions each week. The "bid to cover ratio" in the data indicates the strength of demand for a country's bonds. Currently, the demand for all first world countries' debt is solid. That said, things could change. Therefore, we are keeping a close eye on this.

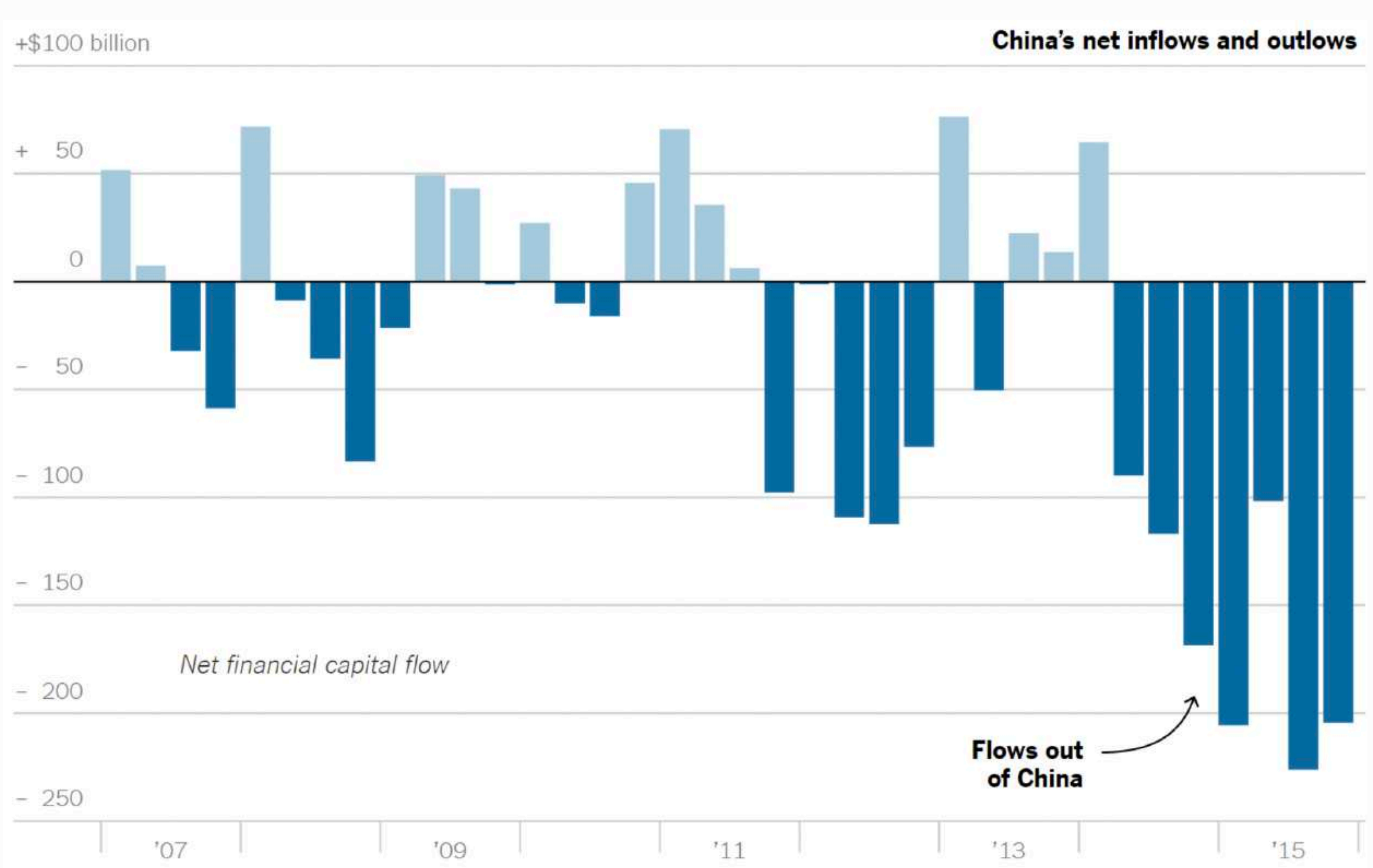
WEAPON #2:

China could devalue the RMB.

In August 2019, the Trump administration labeled China a currency manipulator. It is true that China controls the conversion price of RMB to USD[51]. US officials have expressed concern that China could artificially drop the value of the RMB to make its exports more competitive. For example, let's say a microwave from China costs USD 100 today.

Tomorrow, the RMB dropped by 10% in value; thus, the same microwave would cost only USD 90. Devaluing the RMB could offset the tariffs from other countries and create more demand for Chinese manufacturers.

However, such a tactic would have severe repercussions. In August 2015, China tried devaluing the RMB to avoid a recession. The result was disastrous. On August 9, 2015, the Chinese government authorized the RMB to decrease by 2% in a single day[52]. Unexpectedly, many Chinese people viewed this decision as a risk and ran to move their savings overseas. The outflow of capital was overwhelming[53].



To protect the value of its currency, the Chinese government had to sell 25% of its foreign currency reserve in the subsequent year[54]. Additionally, the country has been cracking down on illegal outflow of capital, and more strict rules for foreign transfers were introduced.

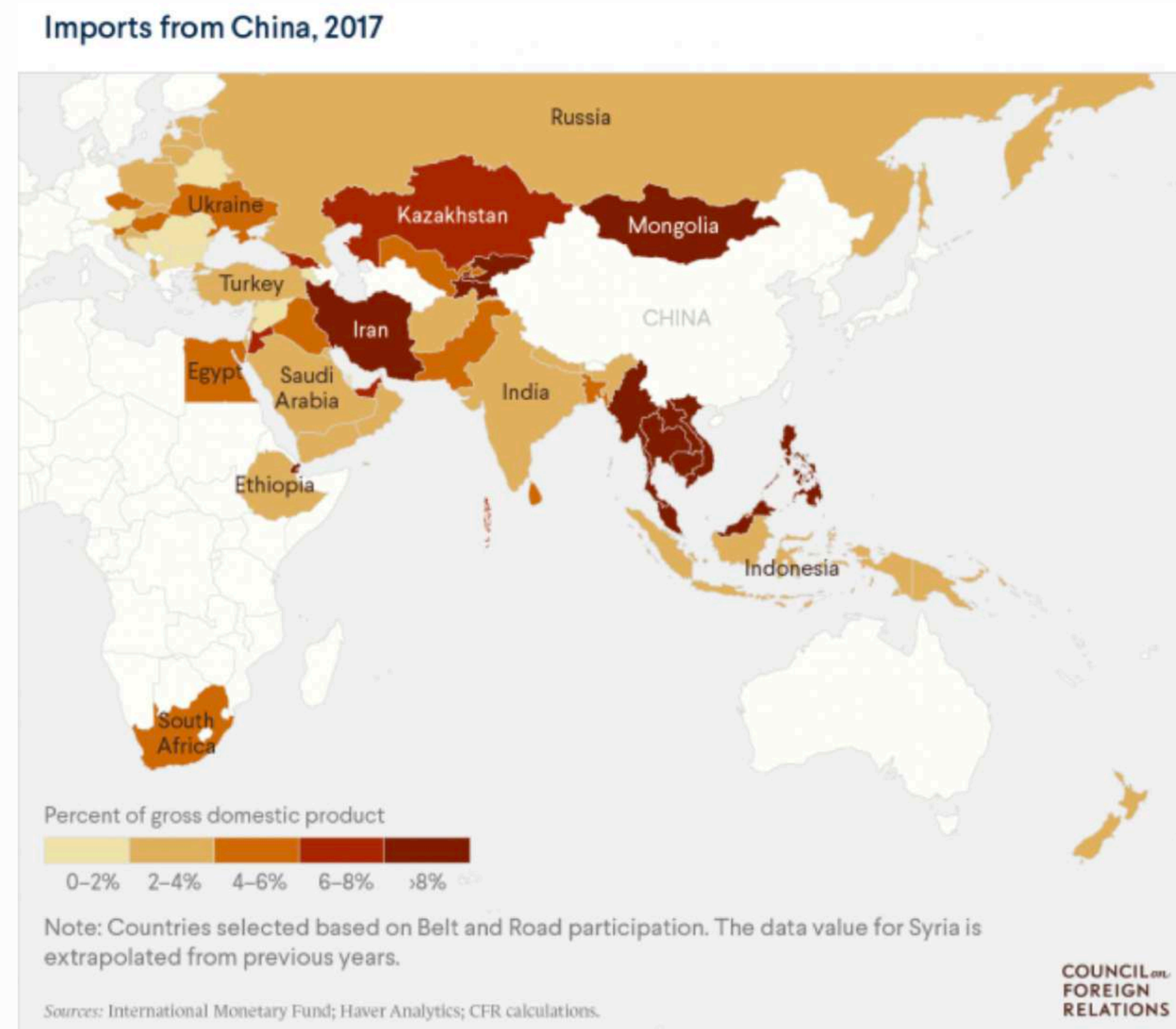
Based on our observation, China has been working very hard to support and stabilize the value of RMB over the last five years, which is the opposite of what the US government is insinuating.

WEAPON #3:

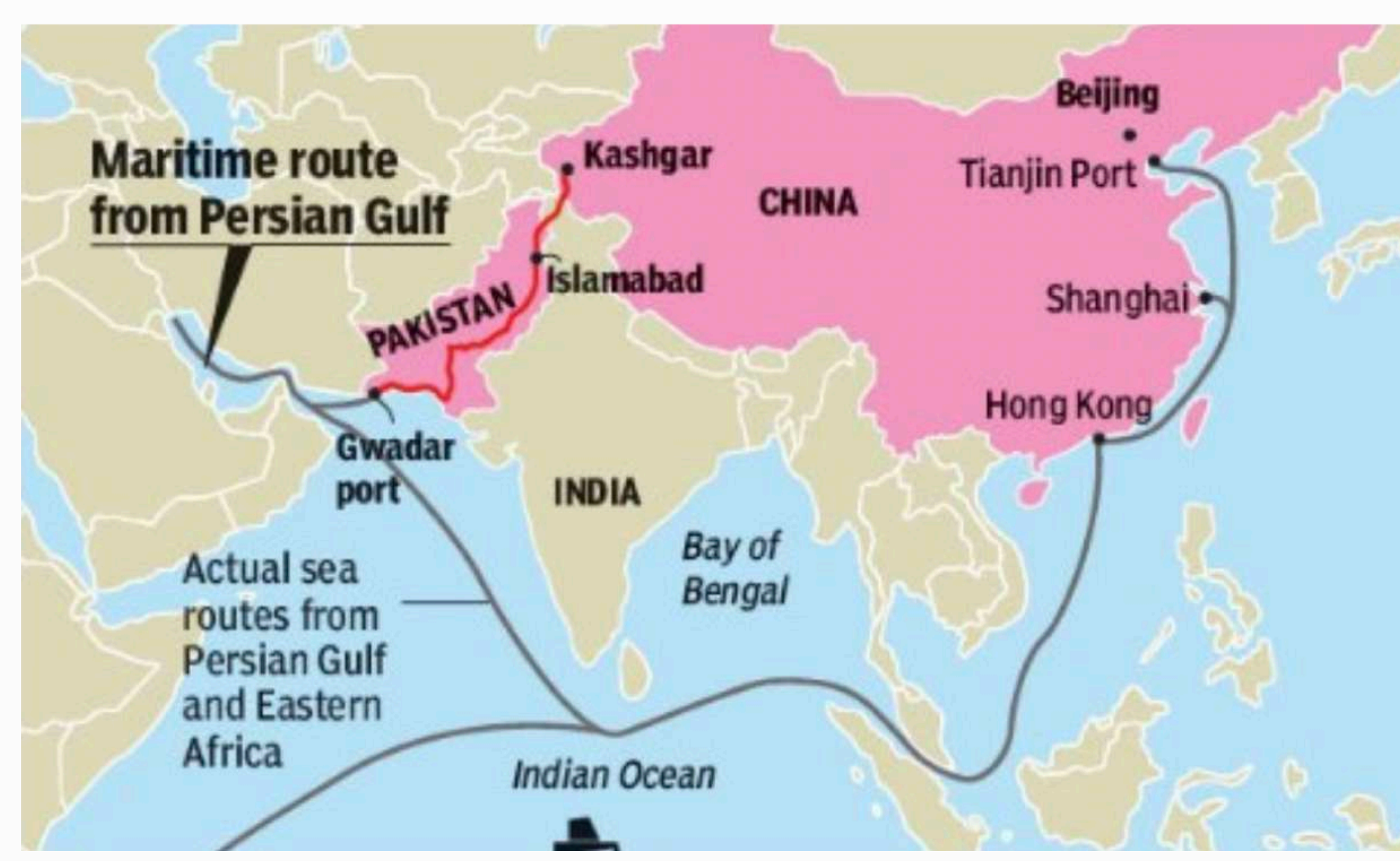
China's Belt and Road Initiative could cause economic difficulties for the US.

In 2013, the Chinese government launched the Belt and Road Initiative (BRI)[55]. The BRI is a global development strategy involving infrastructure development and investment in nearly 70 countries and international organizations.

Countries geographically close to China are growing fast, and there is still a lot of untapped room for trade with China to expand. The following chart from the International Monetary Fund shows imports from China as a percentage of GDP for those countries that are within the BRI. Iran, Mongolia, and Southeast Asian countries are the biggest buyers of Chinese goods. The value of Chinese imports is equivalent to about 8% of their GDP. To put this in perspective, though, US imports of Chinese goods are valued at over 15% of the US GDP[56].



China approaches every country differently. It invests in projects that would help trade. Take Pakistan as an example[57]. The Chinese spent billions on a mountain highway to connect its western province of Xin Jiang to the Pakistan port of Gwadar. This highway allows China to shorten the distance that goods travel to Europe by avoiding the long journey through the Strait of Malacca, Singapore, and the Indian Ocean.



In addition to obtaining benefits from international trade, the Chinese typically finance the projects through debt, which potentially allows China to exercise influence over its BRI trading partners. Pakistan has been one of the largest benefactors of China's investments under the BRI. In total, the country received USD 19 billion in infrastructure spending, of which approximately USD 4 billion is in loans; the rest is in the form of grants. Currently, China's influence remains limited, as the USD 4 billion in loans is still small compared to Pakistan's USD 19 billion in currency reserves.

Although the BRI is an excellent and ambitious strategy for China, countries along the Belt Road have pushed back. This is evidenced in China's outbound direct investment numbers (ODI) in countries participating in the BRI[58].

During the seven years between 2013 and 2019, the total ODI was about USD 200 billion, which is only a fraction of China's estimated total spending of USD 1 to 8 trillion when the program was launched in 2013[59].

Because the BRI promotes trade in Eurasia and potentially increases China's influence over the largest continental area on earth, it makes sense that the US sees the BRI as a threat. However, the BRI still has a long way to go and many problems to solve. We don't see it being a short-term threat to the US.

Conclusion:

As we suspected, the feasibility of the speculative financial weapons is limited, and the impact of the weapons the two countries could use is minimal. Based on our independent research, we conclude that the US would not be able to default on its bonds owned by China, and that while China could sell its US bond holdings, doing so in the near future would have an immaterial impact on the US. Delisting Chinese companies from American stock exchanges, although feasible, would not have much of an adverse effect on China's economy. The US threat to disconnect China from the use of international payment systems, including SWIFT and American-based credit cards, is not as easily achievable as people think.

The US could strip away Hong Kong's exclusive trade agreement, but this would, at present, not cause significant problems for China. China could devalue its currency, but doing so would not be in China's best interest. Lastly, China's Belt and Road Initiative is a long-term strategy, and while it poses no short-term threat to the US, it is slowly but surely turning the table of trade, which could threaten the US in the long run.

That is, if the US doesn't self-destruct first. As we mentioned earlier, money printing and an endless money supply don't go on forever without consequences—although the Modern Monetary Theory[60] (MMT) might disagree. The next newsletter will discuss the consequences of these monetary policies.