September 2020

Elixir News

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

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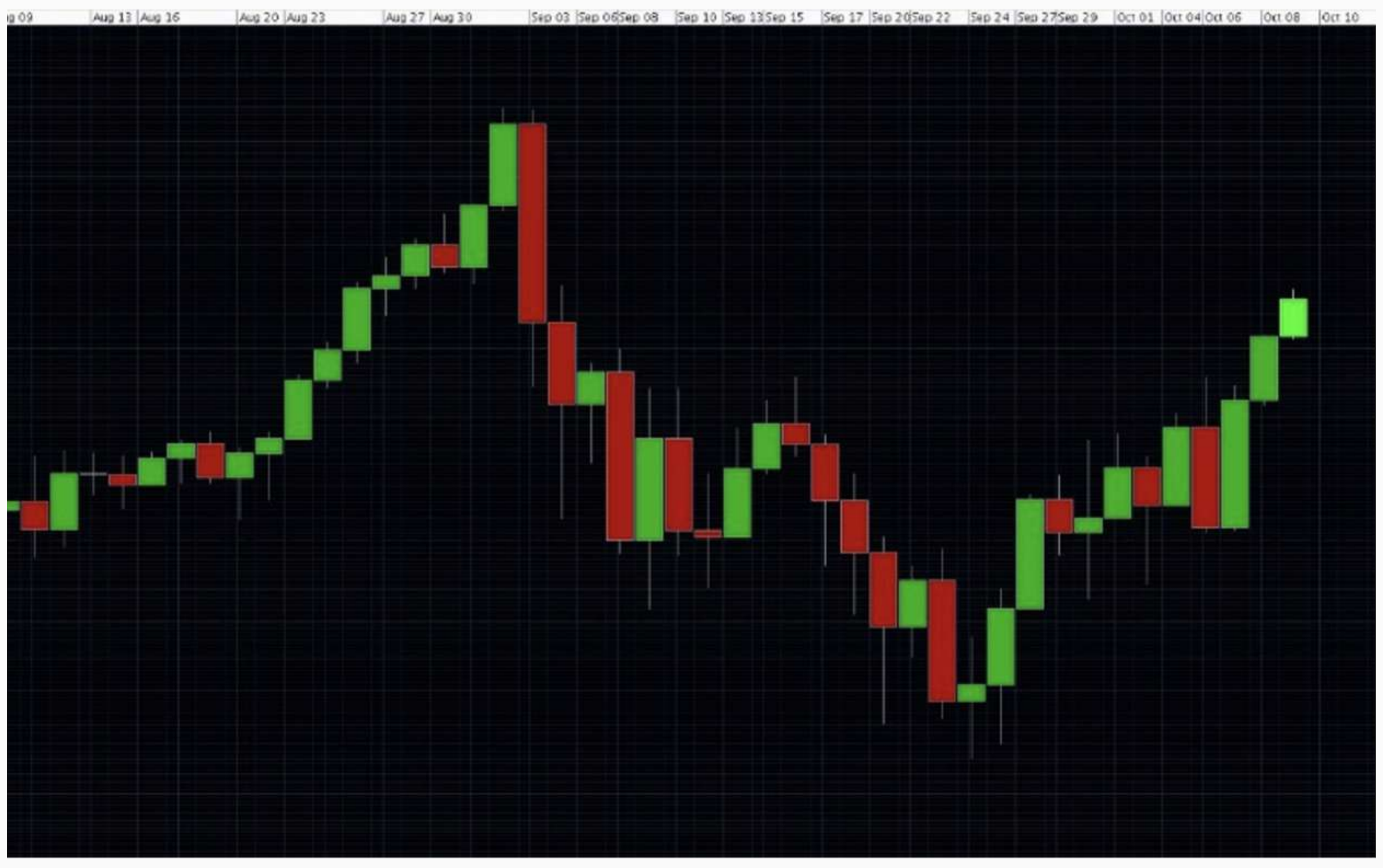
Hi, everyone.

As expected, September was a volatile month. After the S&P 500 reached its all-time high on September 2nd, it has been on a choppy way down. The following candle chart shows the daily movement of the S&P 500 from the beginning of August to the first week of October. As you can see, volatility was much stronger in September as compared to August. We were able to profit off this drop through portfolio insurance and have been trading more actively in this volatile environment.



In the last newsletter, we commented that four areas of uncertainty will keep volatility at a high level this fall and winter. Under the economic outlook and market observation section, we will provide a summary update on this topic. We will discuss the current employment situation in the US, the current and future earning quality of American companies, the margin debt in China, and what will happen to the market amid the US's contentious federal election. Subsequently, we will have a sequel article about the great bear market rally of 2020. To us, understanding the mechanism driving the great bear market rally is critical to designing future trading plans for our portfolio. We share our findings so that our investors remain in the loop of our thinking.

We hope that you find good information in this newsletter. Please feel free to reach out.

Sincerely,
Bill and Eve McNarland

Elixir Technology Inc.
elixiroftechnology.com

Economic Outlook and Market Observation

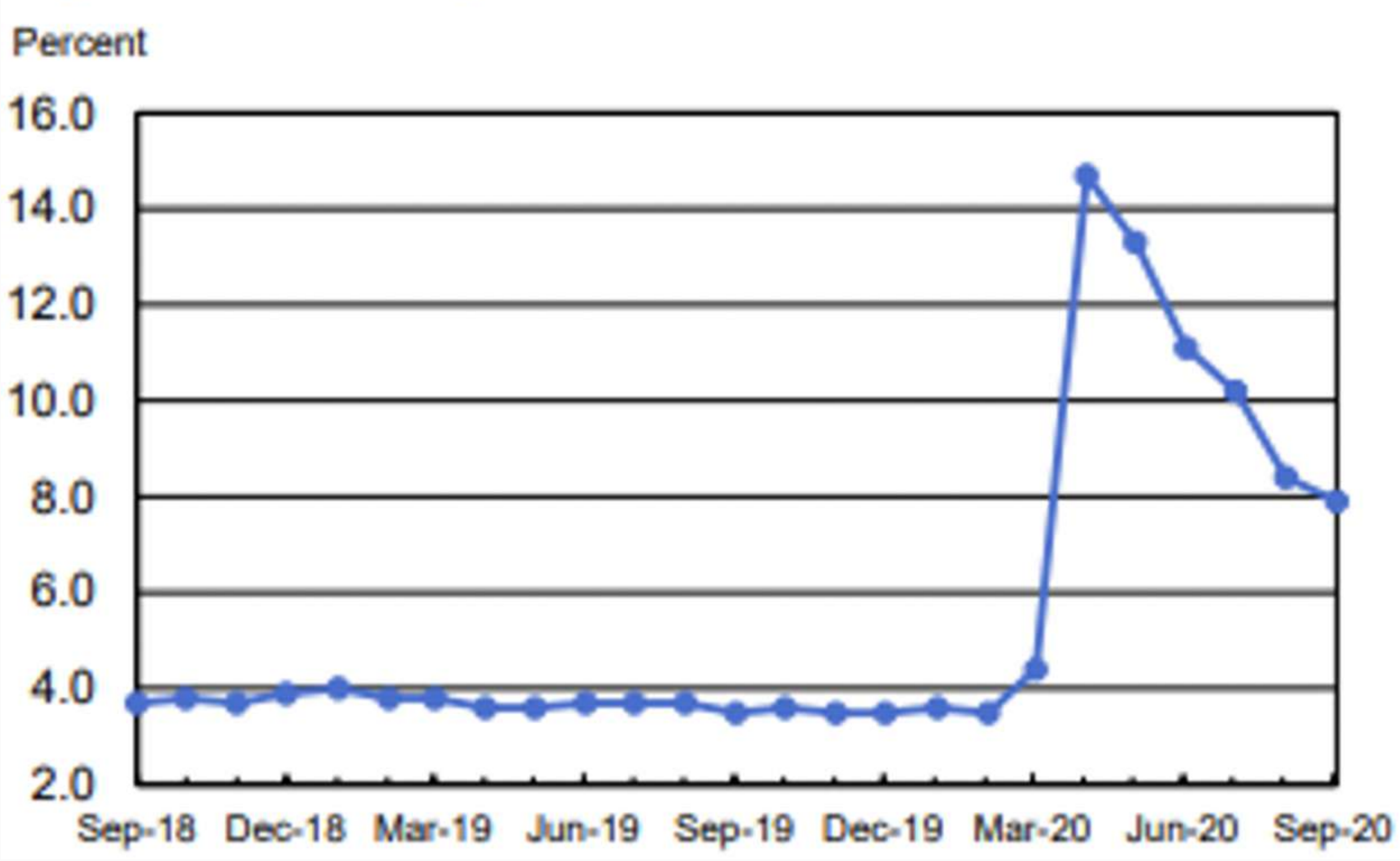
I often hear people say that gold and silver are bulletproof investments during market turmoil. However, the reality is much different. These commodities dropped in value during the 2008 and March 2020 market selloffs. More recently, while the S&P 500 was down -4.13% in September, GLD ETF (Gold) performed worse than stocks, declining -4.17%. SLV ETF's (Silver) 30-day performance was too tragic to even comprehend; it went down -17.5%. We expected that bonds would do better when stocks are selling off—a belief supported by the fact that the iShares 7-10 Year Bond ETF showed only a slight -0.27% decrease. That said, bonds were not able to provide protection. The only asset classes that increased in value in September were the traditional safe-haven assets, such as the US Dollar, Japanese Yen, and Swiss Franc, with a September performance of up 2.10%, 0.16%, and 2.48% against the Canadian dollar, respectively.

As mentioned in the August newsletter, we expected strong market turbulence in September, stemming from expiring call options and uncertainties with US politics, economic recoveries, and ongoing COVID concerns. In this section, we will continue to provide data supporting our belief that volatility driven by uncertainties will remain strong in the last quarter of 2020.

1 SECOND WAVE OF JOB LOSSES

In its October 2nd news release, the US Bureau of Labor Statistics reported that total nonfarm payroll employment rose by 661,000 in September and that the unemployment rate declined to 7.9% [1] The following chart in the news release also indicates an improving US unemployment rate since the pandemic hit in March.

Chart 1. Unemployment rate, seasonally adjusted, September 2018 – September 2020



Despite the positive trend, layoff announcements since late August have been on the rise. The following summary chart contains a compilation of the downsizing news from 21 notable companies. One easy observation drawn from the chart is that keeping people on payroll is no longer a challenge limited to travel-and-hospitality-related businesses. Many industries are now letting go of their employees. While terminating staff isn't a cheap process, companies would rather pay the expensive severance packages than keep employees on a furlough basis or a reduced pay arrangement. This clearly demonstrates that business decision-makers are not confident about the future and agree with the US Federal Reserve that the economic recovery in the US will take a long time.

Bear in mind that this process—from people officially getting terminated to running out of severance pay to applying for unemployment benefits—can sometimes take weeks or months. So, this new round of layoffs will not manifest in the unemployment numbers for a while and certainly was not included in the September unemployment report.

As mentioned in the past, lower employment places downward pressure on consumer confidence and consumer spending, which leads to a lower GDP and company earnings and, eventually, causes asset pricing to drop. Based on the US current unemployment standpoint, we remain confident that the future of asset pricing has much room to fall.

INDUSTRY	COMPANY NAME	ANNOUNCEMENT
Aerospace, Defense	Boeing	Initiating second round of layoffs of an unspecified number of employees in addition to the 19,000 layoffs in July 2020 [2]
	Raytheon Technologies	Cutting 15,000 jobs [3]
Automotive	Ford	Trimming 1,400 salaried employees in the US in addition to 7,000 salaried workers eliminated last year in Europe [4]
Beverage	Coca-Cola	Offering initial voluntary-separation packages to about 4,000 employees in the US, Canada, and Puerto Rico [5]
Cloud computing software	Salesforce	Eliminating 1,000 employees even though it had record sales in Q2 2020 [6]
Computer hardware/Software	Dell Computer	Starting to lay off an unspecified number of employees [7]
Financial services	Goldman Sachs	Letting go of about 1% of its workforce (roughly 400 positions) [8]
	Citibank	Laying off approximately 2,000 employees globally [9]
	Wells Fargo	Planning to cut up to 20% to 25% of its workforce, between 50,000 to 65,0000 people [10]
	Allstate (Insurance)	Terminating 3,800 jobs [11]
Mass media entertainment	Disney	Letting go of 28,000 staff in the US [12]
	Regal Cinemas	Closing all 543 theaters on October 8. Estimated layoffs in the US and UK to be around 45,000 according to CNN [13]
Oil and gas	Royal Dutch Shell	Laying off 9,000 jobs globally [14]
	Suncor Energy	Cutting 15% of its 13,000-person workforce in the next six months [15]
Retail	Kohl's	Trimming up to 15% of its 122,000 employees in the US [16]
	Ralph Lauren (Fashion)	Terminating 15% of its global staff, about 3,700 workers out of approximately 25,000 effected [17]
Hospitality	MGM Resorts International	Sending separation letters to 18,000 US employees who were furloughed during the coronavirus pandemic, making their job cuts permanent for now [18]
Scheduled air transportation	American Airlines	Furloughing 19,000 employees [19]
	Delta	Laying off 1,941 pilots in October [20]
	United Airlines	Furloughing 13,000 employees [21]
	Lufthansa	Unspecific number of layoffs but identified that 22,000 full-time employees are considered surplus due to fleet reduction [22]

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2 COMPANIES' POOR EARNING QUALITY

In the early '90s, 60 US companies were on the AAA credit rating list. Today, only Microsoft and Johnson & Johnson still have that prestige status [23]. We've commented that, over the last 10 years, many companies have been taking on too much low-cost debt at an accelerated speed to artificially boost their earnings. Well, this high debt ratio has cost 58 companies their AAA credit rating.

This situation reflects the severity of high leverage in American companies over the last three decades. Leverage (debt) on a company's balance sheet is just like trading with leverage. While leverage can amplify small gains, it can also make losses much worse. In the past, through leverage, companies were able to turn small revenue increases into large earnings. When revenue slows or becomes stagnant, high leverage makes problems and losses much worse.

What causes revenue to slow down? When debt is supporting income, and a company is no longer able to raise more debt, revenue will naturally slow down. At the beginning of 2020, many companies may have felt that they were still in a good position regarding leverage. However, the pandemic and the economic shut-down certainly made many of them nervous about the catastrophic risks that heavy debt could quickly bring to the boardroom table. Therefore, we are starting to see widespread layoffs, even in companies that reported an excellent second quarter. These companies are trying to be proactive in risk management by actively lowering their cost of business. They are preserving their "food packet" for the long "battle" ahead.

We remain concerned about US companies' prosperity and still believe that the current valuation is too high based on companies' poor-quality earnings. Eventually, and in the long tun, these poor-quality earnings will not sustain the high valuations, and we will see significant corrections.

Leading asset managers and financial analysts share our view. In his interview with CNBC on September 16th, Blackstone's Executive Vice Chairman, Tony James, said that equity appreciation could face a lost decade of 'anemic' stock returns as companies struggle to grow their earnings [24]. Yardeni's renewed research report, released on September 24th, also supports our view. In its report, Yardeni Research estimated that S&P 500 companies would produce $166 per share in earnings in 2021 [25]. This renewed estimate is 20% lower than its January assessment of $200 per share in earnings next year. Based on this change in estimates, the S&P 500 companies' value should have dropped by 20% since the beginning of the year.

Yet, as of the time of this writing, the price of the S&P 500 has increased by 6% since January 2020. Eventually, stock prices must match the company's underlying earnings. Based on Yardeni's forecast in January and September, the stock market should still have about 26% to drop.

3 MARGIN DEBT IN CHINA

According to Rosenberg Research, margin debt in China increased by 47.7% between September 2019 and September 2020. What does this mean? It means that investors in China have increased their margin for trading by almost 50%! With this aggressive margin level, the market does not have to drop much to force these investors to sell. The scattered force selling would quickly amplify the selling pressure on the market as a whole. The last time margin debt increased to this level was in 2015, and within 30 days, the Chinese stock market crashed by 40%.

If history repeats itself, it will be only a matter of time before we see a 2015-like drop in the Chinese stock market. When the Chinese stock market drops severely, volatility occurs in the US stock market. Although US stocks' enthusiasm cooled a bit in September, other major markets' speculations remain high.

CHART 33: Margin Debt in China

Source: Bloomberg, Rosenberg Research

4 CONTENTIOUS ELECTIONS: BAD FOR ASSET PRICING

We are not here to predict the results of the US election. However, one thing is certain: Contentious elections are not good for asset pricing. This US election reminds me of the 2000 election, when the Republican candidate George W. Bush was fighting for the title of Commander in Chief against Democratic Vice President Al Gore. Back in 2000, because of the dispute over close voting results in Florida, the Supreme Court had to step in, and it took the nine justices 36 days to determine the outcome of that election.

From September 1st to December 1st, 2000, the S&P 500 dropped 14%, marking the beginning of a long and challenging bear market. The following chart shows the S&P 500 performance between 2000 and 2003.

With the current concerns regarding mail-in voting, the possibility of disputes is much higher in the 2020 election as compared to 2000, when only one state was the topic of debate. The delay could cause extreme volatility in the market until the election result is finalized and accepted by the American people.

S&P 500 Performance between 2000 & 2003

Final Remarks

Volatility is the up-and-down movement in the market. Although these renewed observations seem to create downward pressure in the market, we cannot ignore the possibility of good news in the last quarter of 2020, which would cause the stock market to go up. This could be a second and third round of stimulus packages or a medical breakthrough regarding a cure for COVID-19. Also, we can't ignore the fact that "fear of missing out" would entice retail investors to buy in after a round of selloffs, causing stock prices to temporarily rebound. A volatile market is perfect for Elixir. We are certainly excited as we head into the last quarter of 2020.

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Making Sense of the Greatest Bear Market Rally

Retail Traders Become More Influential in Setting the Stock Market's Trend

IMAGE COURTESY: csinvesting.org

In 2020, the capital market made history. After the US market-wide circuit breaker was triggered four times and the S&P dropped over 34% in March, we witnessed the strongest bear market rally in history—the S&P 500 not only recovered to its February 19th peak after only four months, but the index also beat the February record by over 5%, closing at 3580.84 on September 2nd. As of October 8th, the S&P500 was 6.7% higher than it was on December 31st, 2019, though millions of Americans have been hit hard and have continuously faced pandemic-related challenges since March.

As the person responsible for Elixir's investment strategies, I have been researching the mechanism driving the great bear market rally. This knowledge is critical to designing trading plans for our portfolio.

1 What makes this great rebound so extraordinary and unique?

Typically, a healthy market has volatility. The market will go up for a few days or weeks, and then will give back half or more of its gains over a few days or weeks. Investors' fear level would drive the intensity of the volatility, depending on the cycle the market is in; the general moving trend is either up or down. Typically, a bear market has much higher volatility. Yet, despite all the risks and uncertainties, after the March selloff, the market was traveling linearly to the top, with only a few days of retracement in June.

For some of our readers, this second point could be unfamiliar knowledge. Most of the capital in the market does not actively engage in trading daily. This is because most institutional groups have a "buy-and-hold, no short and minimum cash" mandate. Only a relatively small portion of capital from hedge funds and retail investors is trading actively and moving the price of assets every day.

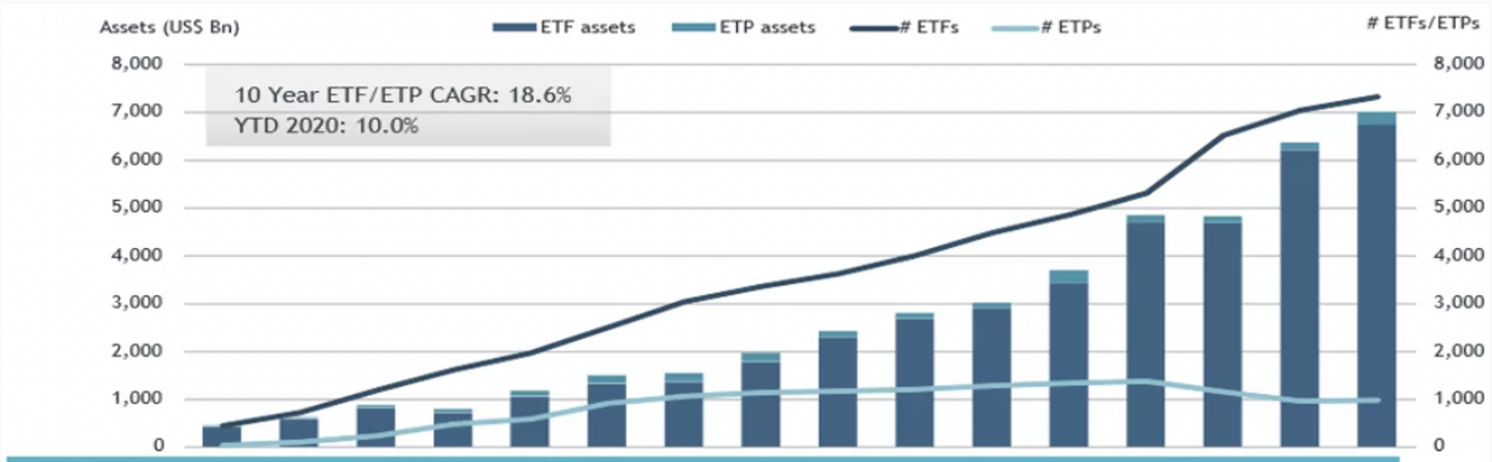
Historically speaking, within this "engaged money", Stephen Briese, the world's foremost authority on interpreting the CFTC's Commitments of Traders Report, estimates that retail investors influence about 15% of asset pricing[26]. In 2020, most experienced institutional investors did not add more capital and participate in the great rally. To them, there is too much risk from uncertainties in a bear market. Primarily, retail traders supported the great rally.

2 Why and how did retail traders gain their influence over the stock market?

For months, it was hypothesized that retail investors were the driving force behind the extraordinary rally, as researchers were still compiling data to prove it. Most of us can't ignore the fact that the number of retail traders has increased significantly since March. For the first time in history, it was easy to become a retail day trader. It was easy to open an account at online brokers like Robinhood and Charles Schwab. Accounts could be opened within a couple of days, and it was easy to instantly fund the trading account through online banking. Most online brokers eliminated fees, which created an additional incentive for people to try out trading. Due to the COVID pandemic, people had either lost their jobs or were working from home. With a low barrier to entry, low cost, and minimal time investment, the environment was perfect for creating newbie day traders, who brought very engaged new money into the market.

In the last newsletter[27], we commented that the remarkably high adaptation of the call options trading strategy also increased retail investors' influence on asset pricing. A $10,000 investment often controls $200,000 or more of the underlying stock. To hedge themselves against the call option contracts, market makers had no choice but to buy the underlying stock and, consequently, push up stock prices. You could say that retail investors indirectly pushed up the demand for stocks.

Then we have the more experienced retail traders who have also been changing their investment strategy. We are seeing an ongoing shift from mutual funds to ETFs. According to ETFGI, a leading independent global ETF and ETP research and consultancy firm based in the UK, ETF assets globally have been growing at over 18% every year [28]. Based on my research and calculations, mutual fund asset growth has been stagnant. The significance of this shift is that mutual fund investors typically hold their positions for an average of 15 to 17 months, while ETFs change hands an average of approximately every 12 days. When more investors are buying and selling ETFs, the ETF manager must buy or sell more underlying companies, which creates more trading volume indirectly from retail investors.



Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Aug-20
# ETFs	452	728	1,194	1,620	1,971	2,500	3,041	3,357	3,621	4,002	4,475	4,852	5,303	6,508	7,030	7,312
# ETFs/ETPs	482	828	1,424	2,095	2,552	3,414	4,099	4,492	4,785	5,202	5,755	6,186	6,672	7,661	7,989	8,287
ETF assets	417	579	806	716	1,041	1,313	1,355	1,771	2,283	2,674	2,898	3,423	4,690	4,683	6,193	6,734
ETF/ETP assets	426	603	856	774	1,157	1,478	1,526	1,951	2,402	2,787	2,997	3,552	4,839	4,815	6,363	7,000

Research academics recently confirmed these observations concerning retail investors gaining influence on asset pricing in the capital market. In their 101-page research journal, published on September 4th on SSRN, "In Search of the Origins of Financial Fluctuations: The Inelastic Market Hypothesis," researchers from Harvard and the University of Chicago concluded that retail investors' $1 investment in the stock market increased the market's aggregate value by about $5 from March to Aug 2020 [29]. In other words, retail investors have a five-times-higher influence on asset pricing in this great rally as compared to all times in the past.

3 Has retail traders' influence declined since the September peak in the market?

When the first set of call options contracts expired as worthless on September 18th, many retail investors got wiped out. It's too early to get the data at this point, which means we can't yet comment on whether retail traders' influence on the market is declining. However, we have some tools to monitor this going forward.

For example, we can look at data from retail investors' account openings and trading activity. Charles Schwab is a public company and provides data once a month. Another large retail-focused custodian, Robinhood, although not public, will be periodically releasing related reports. We will also be closely watching outstanding small option activities.

If asset pricing does not return to August highs, we suspect that more call options will expire as worthless on October 16th, November 20th, and December 18th. A fiscal stimulus is not likely to include generous funds for the unemployed, like it did last round. The US government recognized that the previous round of stimulus packages might have been too aggressive. We will closely monitor this situation, as overly generous free money could fund trading activity. Unemployment is an additional indicator to watch. As people return to work and get back to pre-pandemic life, retail traders will have less time to trade in the capital market.

4 What does this knowledge mean for Elixir's trading strategy?

Understanding the uniqueness of this great rally helps us adjust our trading strategies. Retail traders are the most speculative group of investors, especially the newbies. They get enthused quickly and are blindly confident. It's certainly good news that their influence finally peaked in August and the market rally seems to have cooled down since. Since mid-September, only limited new capital entered the market from this unique group of investors. This trend should remain unless the federal leadership agrees on another round of stimulus. That said, stocks' interests remain high, and some retail investors may be waiting for a dip to start purchasing again. We are not ruling out the possibility that we could see another substantial rally fueled by retail investors, though that risk has dropped from a high to medium level.

Going forward, we are adjusting our algorithms in three ways. First, we will wait longer to start participating in methods to profit against retail traders' direction. Second, our strategies take into account the fact that trends could last longer than they have in the past. Third, we use less capital so that we always have more capital to put into a trade that may be going further and longer than we expect.