November 2020

Elixir News

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

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Hi, everyone.

The next time you hear from us will be in the new year. On behalf of everyone at Elixir, we wish you happy holidays! May the year 2021 bring us all health, happiness, and prosperity!

We expected the upward movement of the capital markets after the US presidential election and have positioned our portfolios accordingly. That said, the percentage of increase, driven by strong speculation, was shockingly high.

The US stock market rose by 10.88%, which was its third-best month in terms of percentage increase since 2000. In the FX market, strong confidence pushed up the price of risky currencies. Compared to the US dollar, the Canadian dollar soared 2.44%. Other increases included the New Zealand dollar (6.12%), Mexico Peso (4.88%), Australian dollar (4.54%), Russian Rubble (4%), and Euro (2.41%).

We saw green everywhere in the commodities market in November, except for gold (-5.41%) and silver (-4.27). At 26.88%, oil saw its third monthly highest percentage increase over the last 20 years. Copper climbed 12.6%, and corn and soybeans surged 5.33% and 10.58%, respectively. Among all commodities, cocoa was the absolute stunner, with a 31.18% jump in price and no material news concerning its supply and demand. Coffee did excellent with a 15.61% rise, too. We expected the rise of cocoa and coffee prices and shared this in our October newsletter.

Perhaps the most interesting observation in November (expected and shared in our October update) was that the 30-year US treasury bonds also increased by 1.55%. In a normal and healthy market, safe assets, such as government bonds, should go in the opposite direction of risk assets. Investors are buying everything. The market can't sustain such one-sided buying pressure.

In the market observation section, we will discuss the consequences of this extreme speculation. Additionally, we will talk about the fact that China is now offering debt at a negative interest rate and that the Dow Jones went over 30,000. Our feature article is about home. We've always focused on analyzing the US economy and the US markets. However, the situation in Canada is becoming very concerning. As we head into the new year, we want to dedicate our feature article to sharing our research and thoughts about the Canadian economy and fiscal spending (current and future) and its impact on our loonie in 2021 and for the next few years.

We hope you find this newsletter insightful. Again, keep safe and keep well. Despite all the challenges and struggles in 2020, we are resilient, and we survived. The year 2021 will be a great one for Elixir and all of us. We will always be here. Give us a call or send us an email if you have any questions about Elixir or if you just want to talk about the market.

Warmest regards,
Bill and Eve McNarland

Elixir Technology Inc.
elixiroftechnology.com

In the introduction, we summarized the extreme speculation that drove the asset price increase in November. The upward trend is continuing in December.

Economist and scientific researcher Dr. John Hussman said that this extreme speculation adds risks to market blow off and that a drop in risk assets is approaching. In his recent report, published through Hussman Strategic Advisors, he stated that the capital market has shown this extreme speculation four times since the mid-'90s. Every time, the market would crash within months and then remain at a low level for the next few years.

China borrows at negative rates for the first time.

Just when we thought the negative debt party could not get any more extreme, on November 18, the Chinese government issued €4 billion in debt and split it between 5-, 10-, and 15-year bonds. The 5-year bonds were sold at -0.152%, while the 10- and 15-year securities were sold with positive yields of 0.318% and 0.664%, respectively. The demand for these Chinese low- and negative-rate bonds was €16 billion.

Investors speculate that the European Central Bank is aggressively buying foreign government debt, signaling that the European bond rates will be even more negative in terms of bondholders earning a profit in the future. Therefore, investors are jumping on the Chinese bond wagon even though the rates are low and negative.

For China, it works well. Issuing bonds in Euros is a small step to being less dependent on the US dollar.

Moody's is projecting that China's public sector debt, including borrowing from governments and state-owned enterprises, will increase to 185-190% of its GDP in 2020-2021, up from 167% in 2019.

What investors should be thinking about is that China is now on a path of extreme debt, similar to first-world countries like Canada and the US. A severe debt-to-GDP level will cause instabilities and risks for the future.

Dow Jones Industrial Average rose above 30,000

The Dow Jones rose above 30,000 for the first time in history. Some investors may find these records encouraging, but history tells us that "record-breaking in a roll" in the stock market eventually leads to falling prices.

I went back to Dow Jones data starting in 1920. Over the last 100 years, the index saw 10 streaks of record-breaking periods. The most prolonged period was from 1989 to 2000, when the Dow Jones broke its record 310 times and the accumulative return for the period was 221%. The second-longest period in history was between 1924 and 1929. The index saw 214 new highs during this period and earned 168% in accumulative return. On average, excluding the 1989-to-2000 period and the streak we are currently in, the winning streaks historically lasted about 3.25 years, breaking records 41 times with an accumulative return of about 39%.

Since 2013, the Dow Jones has been on a rising path. Eight years later, the index hit a record high of 30,000 on November 24, 2020. Over the last eight years, the Dow Jones broke the record 240 times, and its accumulated return is 268%!

By all standards, whether we compare our current up streak to the hottest time in history (1989 to 2000) or the historical average, we are in an unprecedented time. With the Dow Jones achieving new records while the coronavirus severely challenges the world economy, a reversal must be nearby.

Feature Article: **Canada's Fiscal and Economic Situation and Its Impact on the Loonie**

At Elixir, we focus most of our research and analysis on the US. This is because our investment portfolio is largely influenced by the US economy and the US dollar. That said, we also closely monitor economic developments at home, particularly the price trend in the Canadian dollar, for both Elixir and our own personal investment planning.

Frankly, based on the current information at hand, the economic situation at home is not looking good. In this last update before the new year, we share our domestic research and views to help our investors see the high devaluing risks that will be hovering over the loonie in 2021.

On November 30, Canada's Department of Finance released its Fall Economic Statement [1] to all Canadians. We will start by breaking down this official statement so that our readers will understand our current economic situation and what our government's proposed plan means for Canadians. Subsequently, we will look at historical fiscal spending since World War II and how fiscal spending policies affected the Canadian dollar. After a review of history, we will talk about our expectations for the loonie in 2021. We will keep this section brief because, in the next newsletter, we plan to provide a 2021 outlook on all asset classes. Lastly, we will discuss how the change to the Canadian dollar will impact Elixir and Canadians.

Fact-Checking the Fall Economic Statement

Two days after the statement's release, economist Jack Mintz published his commentary in the Financial Post with the following opening paragraph: "I was hoping our new minister of finance, once a fine journalist, might produce a fall fiscal statement written clearly and to the point. Instead, we are treated to 237 pages of repetitive back-slapping and cliché-laden phrases that few will bother to read. [2]" After reading the lengthy statement, we agree with Mintz that Canadians really won't miss much from simply reading the less-than-a-thousand-words press release.

We expected the government to sugarcoat the current economic situation and be light on a future plan, but we weren't expecting the finance minister to mislead the public. If you have time to read only the press release, you will find the finance minister's message to be clear and reassuring: Before entering the pandemic, Canada was economically strong compared to its G7 peers. We shall remain in this position of strength for future generations.

First, let's do a simple fact check on her messages in the press release.

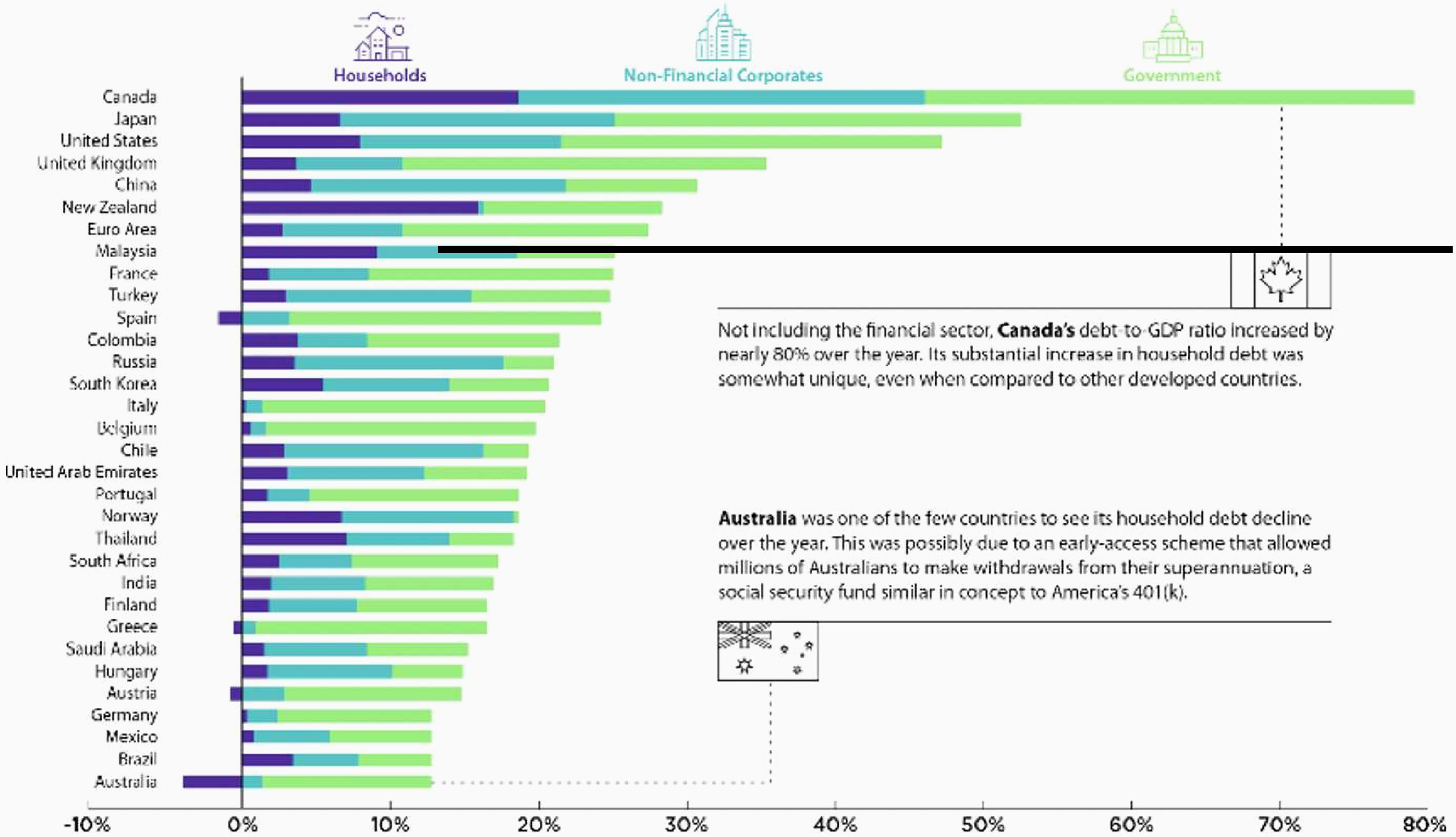
"Canada entered the pandemic in a position of strength, with the lowest debt-to-GDP ratio among G7 peers, a position it still retains."

*- The Honourable **Chrystia Freeland,***
Deputy Prime Minister and Minister of Finance

According to Trading Economics [3], Canada's debt-to-GDP in 2019 was at 89%. Germany and the UK performed better, at 60% and 81%, respectively. Outside of the G7 countries, the debt-to-GDP ratios of Russia, Australia, and Mexico were 12%, 45%, and 46%. If we sort the 173 countries covered under Trading Economics in order of highest debt-to-GDP ratio in 2019, Canada ranks 22.

Based on the newest data compiled by Visual Capitalist [4], excluding the financial sector, our debt-to-GDP ratio soared by nearly 80% in the first nine months of 2020. Canada is officially number 1 in debt-to-GDP growth in the world. So, no. The finance minister's statement is false.

CHANGE IN DEBT-TO-GDP
(Q42019-Q32020)



"Nearly 80 per cent of the jobs lost at the start of this crisis have been recouped and bankruptcies are well below levels prior to this pandemic."

*- The Honourable **Chrystia Freeland,***
Minister of Everything

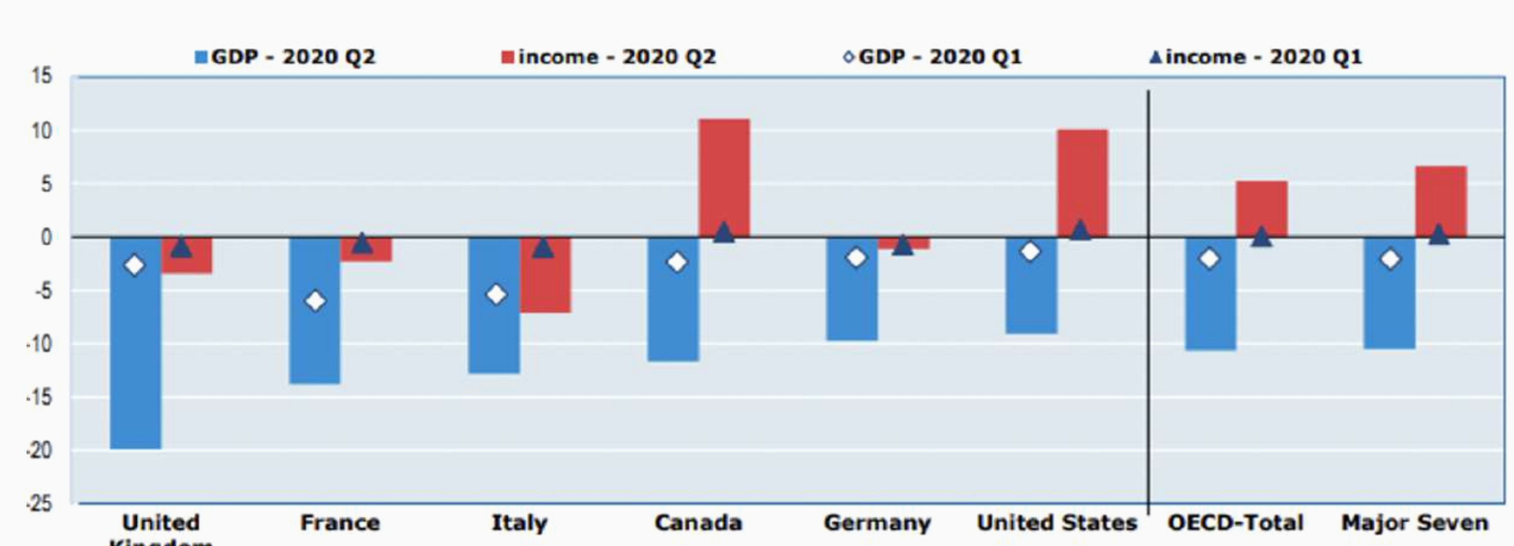
It's true that we didn't see a spike in delinquencies due to government income support and payment deferrals, and there were 45% fewer consumer bankruptcies in the second quarter compared to the same period in 2019 [5]. However, in November, our unemployment rate was at 8.5%, which is still 152% higher than February's (pre-pandemic) level of 5.6% [6].

Another profound piece of economic data is that while our GDP declined 11.7% in the second quarter, our real household income increased 11% compared to household income in the pre-pandemic first quarter of 2020! The generous $500/week CERB payments and the Canada Emergency Wage Subsidy not only allowed Canadian households to survive, but also made Canadians richer during the pandemic! What about the other G7 countries? Well, the US experienced a 10.1% growth in household income with a -9.10% decline in GDP, and Germany saw its household income decrease by -1.2% while its GDP was 2% better than that of Canada. The household income and GDP data were published in the OECD's Economic Well-Being Quarterly Report on November 12 [7].

It should be noted that the OECD uses "purchasing power parities" (PPPs) to level the field for currency conversion, thereby making its GDP estimates more relevant than what the World Bank produces.

REAL HOUSEHOLD INCOME PER CAPITA AND REAL GPD PER CAPITA

Percentage change on the prvious quarter, seasonally adjusted data



While Canada is leading household income growth during the pandemic, we also saw a tremendous increase in household savings rate: 28.2% in the second quarter, which is the highest savings rate since 1961. The spike is enormous considering that the average rate over the five years preceding COVID was only about 3% [8].

When asked how to unlock the "pre-loaded" savings to grow the economy, Jack Mintz said not to count on it. He explained that with the $124 billion in federal and provincial tax deferrals and $87 billion in credit support ending, as well as a tax due on CERB, Canadians are saving their money to pay off their debt and taxes.

David Rosenberg added, "The whole question itself, in my opinion, is offensive … After the biggest housing market spree of all time, you're going to have a tough time convincing me that there's a lot of pent-up demand in Canada on the consumption side. That's where the focus would be, to siphon off the savings into conspicuous consumption with no domestic economic multiplier, borders on the ridiculous.[9]"

Having said all this, it's easy to conclude that the Canadian economy is far from being in a position of strength like our finance minister claimed in her Fall Economic Statement. The better-than-expected economic data this year is attributed only to the massive life support from Ottawa. Most people and businesses haven't yet felt the real economic impact of the coronavirus. We agree that the quick and generous financial aid helped stabilize the economy in 2020 but way too early to consider that it would also help the economy recover. Why? Because the second wave of the virus is here, and many provinces are back in lockdown/restrictions. Let's worry about whether our economy can survive through the winter. While the vaccine offers some hope, it probably won't bring life back to normal until the fall of 2021. It is safe to assume that being the leftist member of the G7, our government will keep the fiscal aid tap running in 2021.

Now, let's look at the flip side of the aggressive fiscal spending. In February 2020, the federal government reported a deficit of $21.8 billion for 2019. The first estimate for the 2020 deficit came out in July, and the number was $343.2 billion. The government later renewed its assessment and, in the Fall Economic Statement, increased the number to the $381.6 and $398.7 billion range. We won't know the exact 2020 federal deficit until February, but let's pick a medium number, a $390 billion deficit for 2020. That is nearly an 1800% increase compared to 2019!

"Canada's debt is affordable now, and will be for future generations. In fact, federal debt-servicing costs, relative to the size of Canada's economy, are at a 100-year low."

*- The Honourable **Chrystia Freeland,***
Minister of Everything

Our finance minister must have a crystal ball, as she sounds 100% confident that the debt-servicing cost will remain affordable for future generations. What she is saying is that my pre-teen kids will never see interest rates go up in their lifetimes.

I've always thought that people—especially politicians—have short-term memories.

Canadians got out of budget deficits in the mid-'80s without increasing taxes and enjoyed 11 years of a budget surplus for the following four reasons. First, Canada's interest rate fell from 22% in 1982 to 0.25% in 2008. Second, commodities prices went up. Third, the government is spending responsibly and within its means. Lastly, we had strong economic growth. Today, the interest rate is already at its historical low of 0.25%. Basically, we won't get to enjoy the benefits of a falling interest rate and our minister of finance is downplaying the risks of an interest rate increase.

So, what is our government's economic growth plan for the next three years? The Fall Economic Statement revealed the government's plan for growing more tax revenue by limiting stock option deductions and collecting GST/HST from foreign digital providers, such as Netflix and Amazon.

The statement also contains significant pandemic-related and non-pandemic-related spending measures:

1. Extending the Canada Emergency Wage Subsidy and increasing the maximum rate to 75 per cent from December 20, 2020 to March 13, 2021.
2. Extending the current rates of the Canada Emergency Rent Subsidy and Lockdown Support until March 13, 2021.
3. Establishing new $1 billion Safe Long-term Care Funds.
4. Providing temporary support of up to $1,200 in 2021 for each child under the age of six for families entitled to the Canada Child Benefit.
5. Planting 2 billion trees.
6. Establishing a "Highly Affected Sectors Credit Availability Program" for industries like tourism, hospitality, entertainment, and airlines.
7. Investing in Canada-wide Early Learning and Child Care System, "Green Projects" and initiatives to address systemic racism.

Additionally, the government continues to negotiate for the National Canada Pharmacare Act and more funding to provinces for pandemic-related health care costs.

"Once the virus is under control, the Government of Canada will invest in a growth plan of roughly three to four per cent of GDP, between up to $70 and $100 billion, over three years, to jumpstart our recovery."

*- The Honourable **Chrystia Freeland,***
Minister of Everything

According to a CBC News investigation, Ottawa already made $240 billion in payments and transfers to individuals, businesses, organizations, and government entities from March to November. Over these eight months, the Canada emergency wage subsidy (CEWS) cost the federal government $49.27 billion [10]. Based on average monthly spending of $6 billion, the extension of CEWS for three months alone could cost $18 billion for Ottawa. Our finance minister expects us to believe that $100 billion over the next three years could cover the cost of everything on her wish list?

The second thing to consider about this list is whether this spending could yield real economic growth. Rarely do I pay attention to our prime minister's address on television. During the odd times when I gave him an ear, I heard him saying, "We are going to invest…" In my opinion, our prime minister often misuses the word "invest." An investment requires a return. From a GDP standpoint, when we deploy capital into something, we can call it "an investment" only when there is a strong case for productivity payback or return. Perhaps investing in childcare, green projects, and initiatives to address systemic racism could create a - productivity return down the road, but is the next few years the best time to spend money that we don't have on these initiatives? Especially considering that we may already have a $400 billion deficit in 2020 and that our debt-to-GDP ratio is the fastest-growing one in the world?

Thirdly, the Canada-wide Early Learning and Child Care System is a permanent structural change to our fiscal spending. Once it is in place, it's impossible to terminate. A good example is our universal health care. Canadians pay a high income tax largely because of our universal health care system.

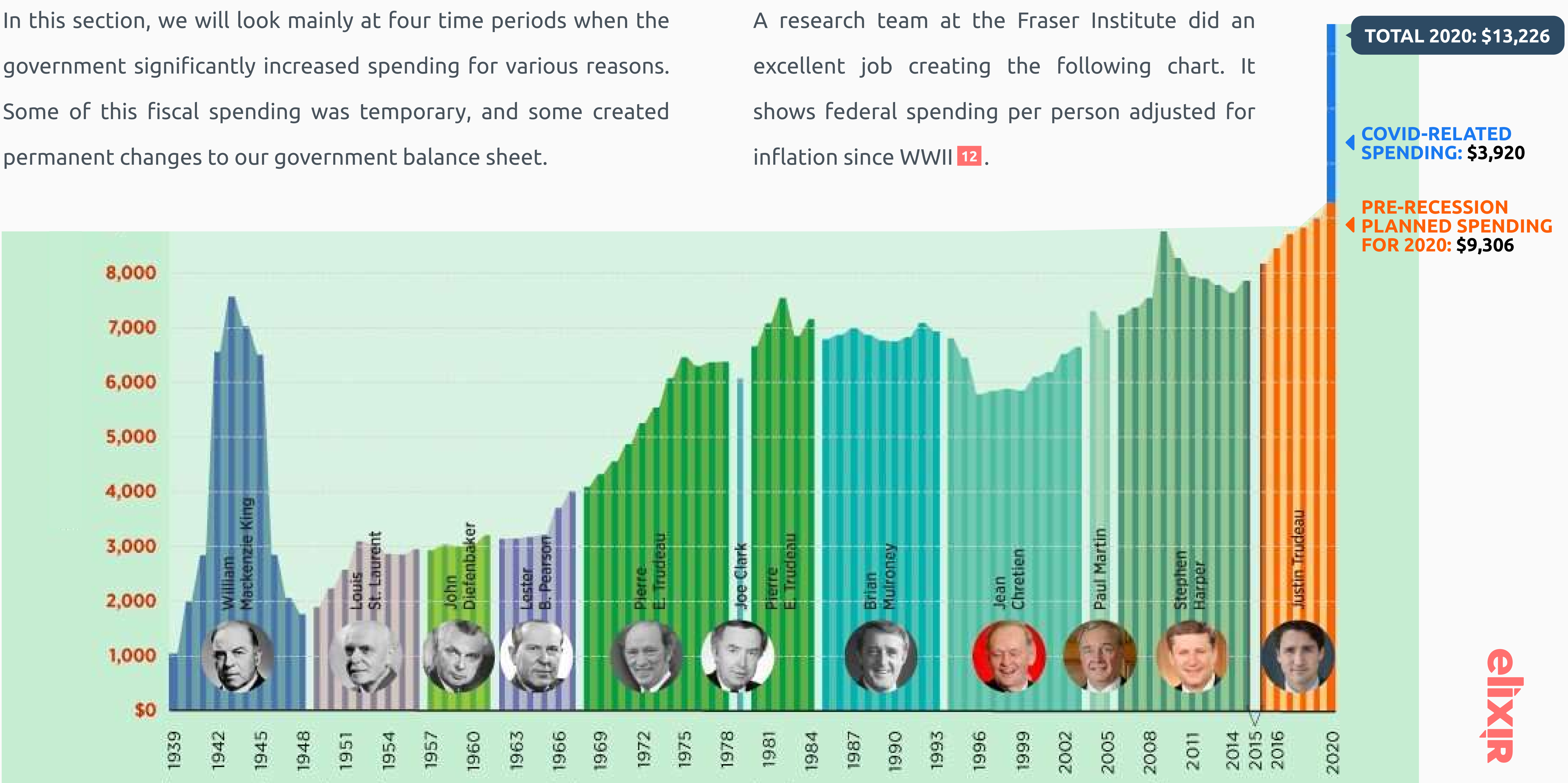
At this point, you likely agree with us that our current economic situation in Canada is very concerning and that, with the future spending plan disclosed in November, our federal deficit could stay at a very high level for years to come. The next question is: How would a material increase in fiscal spending affect our quality of life (how long we have to work for the government before we get to work for ourselves and our family) and to the loonie? As always, we start with a review of history.

A look back in history: Government spending and the loonie

In this section, we will look mainly at four time periods when the government significantly increased spending for various reasons. Some of this fiscal spending was temporary, and some created permanent changes to our government balance sheet.

We won't include a discussion of the loonie until our currency became freely tradable in May 1970. It should note that the Globe and Mail provided the historical data on the Canadian dollar in this article [11].

A research team at the Fraser Institute did an excellent job creating the following chart. It shows federal spending per person adjusted for inflation since WWII [12].



1939 to 1945

Increased spending to fight the war

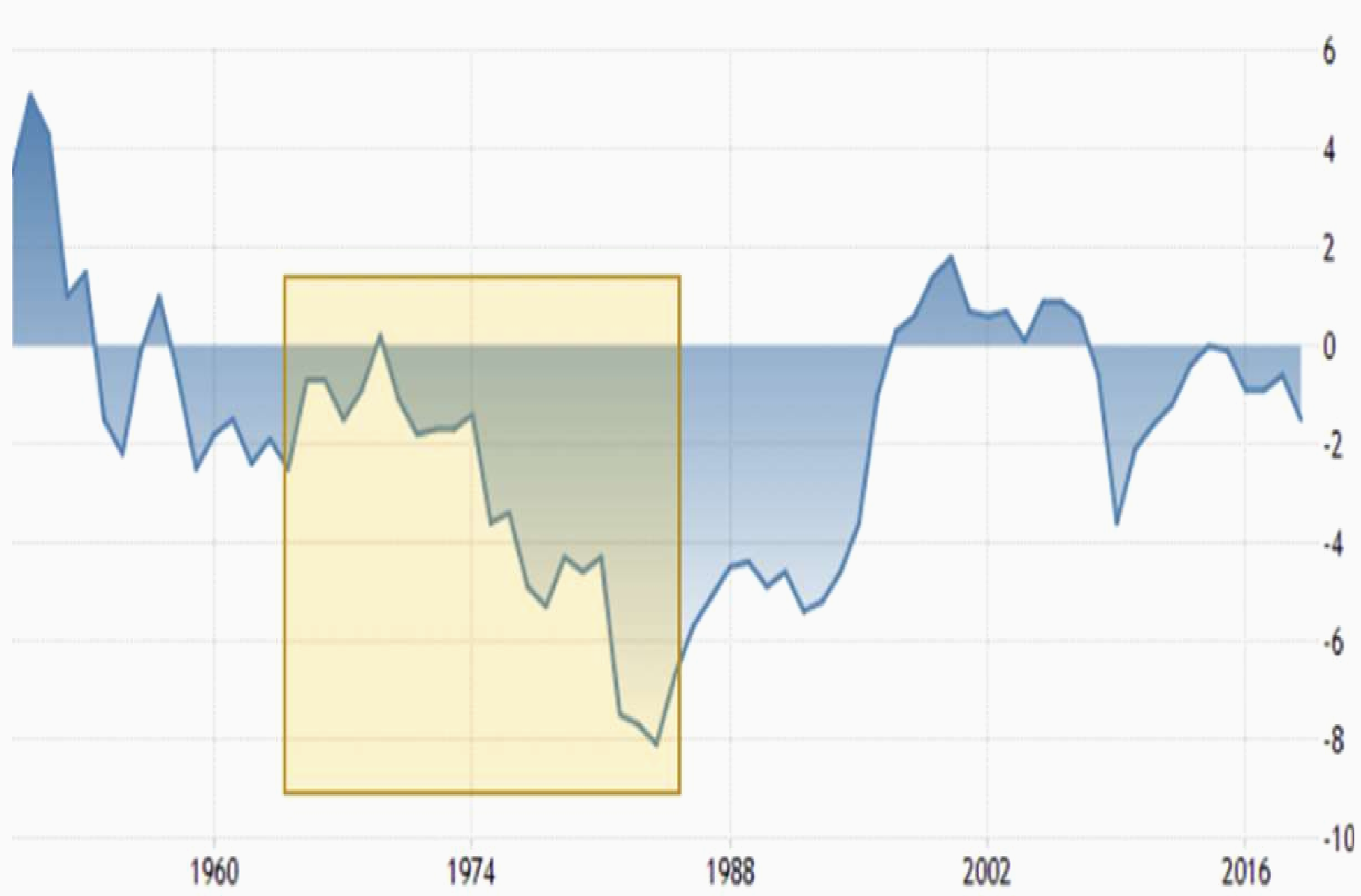
During this period, federal spending skyrocketed under the leadership of Prime Minister Mackenzie King. The increased spending was directly related to the war; it did not supplement the incomes of people affected by the war. This may be a surprise to many Canadians, as in 2020, a large chunk of government spending is supplementing the incomes of people affected by the virus.

In 1946, after the war, spending quickly declined, but taxes rose to extreme levels to help pay for wartime spending. Corporate tax rates increased to as high as 80%, and the practice of employers remitting income tax on behalf of employees became mandatory[13]. Extreme high taxes, while painful at the time, allowed deficits from WWII to be temporary and did not create structure changes for Canadians.

1965 to 1984

Increased spending to fund social programs

Prime Minister Lester Bowles Pearson, succeed by Prime Minister Pierre Trudeau, focused on establishing social programs. Under Pearson, Canada adopted universal health care, the Canada Pension Plan, and the student loans program. To pay for these social programs, the capital gain tax was introduced. The idea behind the capital gain tax was to transfer wealth from the rich to the poor. As you can see in the following chart, spending on these social programs became a structural issue on our government's balance sheet. Running deficits were the norm for 19 years, with only one year in the surplus.



SOURCE: TRADINGECONOMICS.COM | DEPARTMENT OF FINANCE CANADA

On May 31, 1970, the Canadian dollar stopped being pegged to the US dollar. The two currencies hovered around par, eventually reaching a high of 1.04 CAD to 1.00 USD on April 25, 1974. Both countries fought inflation and economic challenges between 1970 and 1974.

During the 12 years between 1974 and 1986, the Canadian dollar devalued 34%. The fast-growing deficits from social program spending created significant downward pressure on the Canadian dollar. A secondary factor contributing to the fall of the loonie was the decline in the price of commodities. As fiscal spending stabilized in year 1988/1989 and the price of commodities recovered, the Canadian dollar increased 25% and by the end of 1989, the loonie was at 0.89 USD.

Over the next 12 years, the Canadian dollar was mostly flat until the federal government abandoned its early '90s spending cut and started increasing fiscal spending in 1998. The external environment wasn't friendly to the loonie either. Commodity prices had fallen, and the market was fearful with the default in Russia and various Latin American countries. As a result, the Canadian dollar began another downward trend, eventually stopping at 0.6198 USD in January 2002. Between 1998 and the beginning of 2002, the loonie lost 33% of its value.

The subsequent five years, from 2002 to 2007, were golden ones for the Canadian dollar. Canada enjoyed fiscal stability as tax revenue significantly increased due to rising oil prices, a strong economy, and the fact that Canada's debt rating returned to AAA. During this period, the loonie went up 77% and reached 1.10 USD on November 6, 2007!

2008 to 2009

Increased spending to fight the recession

In 2008, the world fell apart. During the fallout from the 2008 recession, the federal government, under the leadership of Prime Minister Stephen Harper, increased the deficit to fight the recession. As you can see in the following chart, this became partially structural, as spending could not return to the pre-2008 level.

The return of the federal deficit, the great recession, and falling commodity prices drove down the loonie by 31% over 18 months. As Canada and the world began recovering from the great recession in 2010, the Canadian dollar steadily regained its value, and eventually on par with the US dollar again in 2014.

2015 and 2019

Increased spending driven by conspicuous political initiatives

When Prime Minister Harper left Ottawa, the federal government had a balanced budget. Prime Minister Justin Trudeau took over in 2015. With no new notable social programs, the great prosperity continuing, and commodity pricing favoring Canadians, the federal government somehow went into deficit in 2015 and hasn't been able to balance its budget for four years. After four years of running deficits, I hope that our Prime Minister learnt the lesson that the budget won't balance itself, as he claimed when he first took office. Under Trudeau's leadership, running deficits became a norm again—and this was before COVID. Again, it baffles me how the Finance Minister could say that we entered the pandemic in a position of strength.

SOURCE: TRADINGECONOMICS.COM | DEPARTMENT OF FINANCE CANADA

With an increasing fiscal deficit, lower commodity prices, and the first debt downgrade in 2020, the Canadian dollar dropped to about 0.70 USD in 2019—a 30% decrease from its 2014 high.

Through history, we learnt the following. A 30% drop in the loonie to 62 cents on the dollar is not uncommon. High fiscal spending and deficit create downward pressure on the Canadian dollar. The price of commodities, weak economy, global and domestic instability, and debt rating downgrades also create downward volatility for the Canadian dollar. In addition, we learnt that our loonie could fall for a decade, but strong fiscal leadership and strong commodity prices can quickly restore its value.

What do we expect to happen to the value of the Canadian dollar?

Based on the influencers on the Canadian dollar, let's take a look at 2021.

1. Based on the current government's spending plans, there will be extremely high fiscal deficits from elevated levels of spending in 2020 and for the next three to four years.

2. OPEC expects the price of oil to remain at its current low level, as global demand will still be sluggish in 2021[14].

3. Fitch lowered Canada's credit rating to AA+ in June. We expect the other three main credit ratings to take action in 2021 as well[15].

4. We expect Canada to have sluggish GDP growth in 2021.

While each of these four influencers is working against the loonie, our biggest trading partner that has the world's most dominant reserve currency is reluctant to add more debt and deficit. Based on my calculations, Canada is growing its deficits 3.6 times faster than the US, relative to the size of our economies. In other words, the US is expected to be in better fiscal shape than Canada, which makes the loonie vulnerable

In conclusion, we expect the Canadian dollar to fall in value over the next five years or longer. We won't be surprised if the Canadian dollar revisits the 62-cent level.

How does a falling loonie effect Elixir?

Overall, the devaluation of the Canadian dollar will benefit Elixir. When the Canadian dollar falls, our existing US trading assets become more valuable. Currently, our cash deposits and securities are held equally in USD and CAD. We are a Canadian company, and our debt obligations are in CAD. Therefore, when the Canadian dollar drops, the value of our debt obligation also falls. Additionally, any revenue we earn from future software sales will be in USD. We will gain on converting USD to CAD.

On the other hand, our current Bonds issued in USD will become larger as the Canadian dollar drops. That said, our debt in USD composes only a very small portion of our balance sheet, so the effect is not that material. Just as our revenue priced in USD will see an increase in value, so, too, will our cost in USD increase for research services.

In contrast, all cash deposits, stocks, bonds, and commodities in countries under the influence of, or pegged to, the US dollar will increase in value as the price of the loonie drops. For example, if the Canadian dollar drops by 20%, your USD money market or USD cash will increase by 20%. If the return on your investment in USD increased by 5%, the return would actually be 25%.

What does a cheap loonie mean to Canadians?

Canadians with most of their assets in Canada will experience a drop in value compared to prices globally. Here is an example. Let's say your home is worth 1M CAD in Canada, while a comparable home in Hawaii is 780,000 USD today. You could sell your house in Canada, move to Hawaii, and buy that 780,000 USD home. If the loonie falls by 20%, to buy the same house in Hawaii, you would need to add 200,000 CAD in addition to the proceeds from your home sale in Canada. For those who have a reason to compare their net worth globally, the fall of the Canadian dollar would have a very negative effect.

Goods from the US or valued in a currency influenced by the US dollar (Chinese RMB or Hong Kong dollar, for example) will become more expensive. Eventually, domestically labeled goods will increase in price, too. For example, although we produce cars in Canada, parts are imported from all over the world and are priced in US dollars.