Stouff Capital

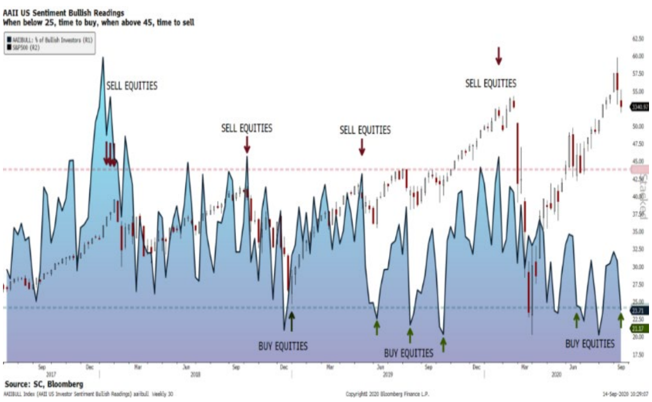
Global Equity Long-Short Quantamental Strategy

update as of September 15, 2020 | Letter 49

A GENERATIONAL FIGHT

What is observable in the markets since the start of the pandemics is also extraordinary from the point of views of different generations. While the Baby boomers and X generation are cautious on equities as can be shown in the AAIBBULL index (Chart 1 shows that the 3 week average of bullish opinions less bearish opinions is at its low while the S&P500 is near its high), their children, the Millennials, have been responsible for an explosion in the purchase of speculative upside options as shown in the chart 2. Daily volume is now explained half by their activity and the notional of options is now more than the cash equity volume. This new micro-structure trend easily explains the Nasdaq momentum in August and its reversal at the start of September.

CHART 1 & 2: BABY BOOMERS (LEFT CHART) ARE BEARISH WHILE MILLENNIALS (RIGHT CHART) ARE ULTRA-BULLISH

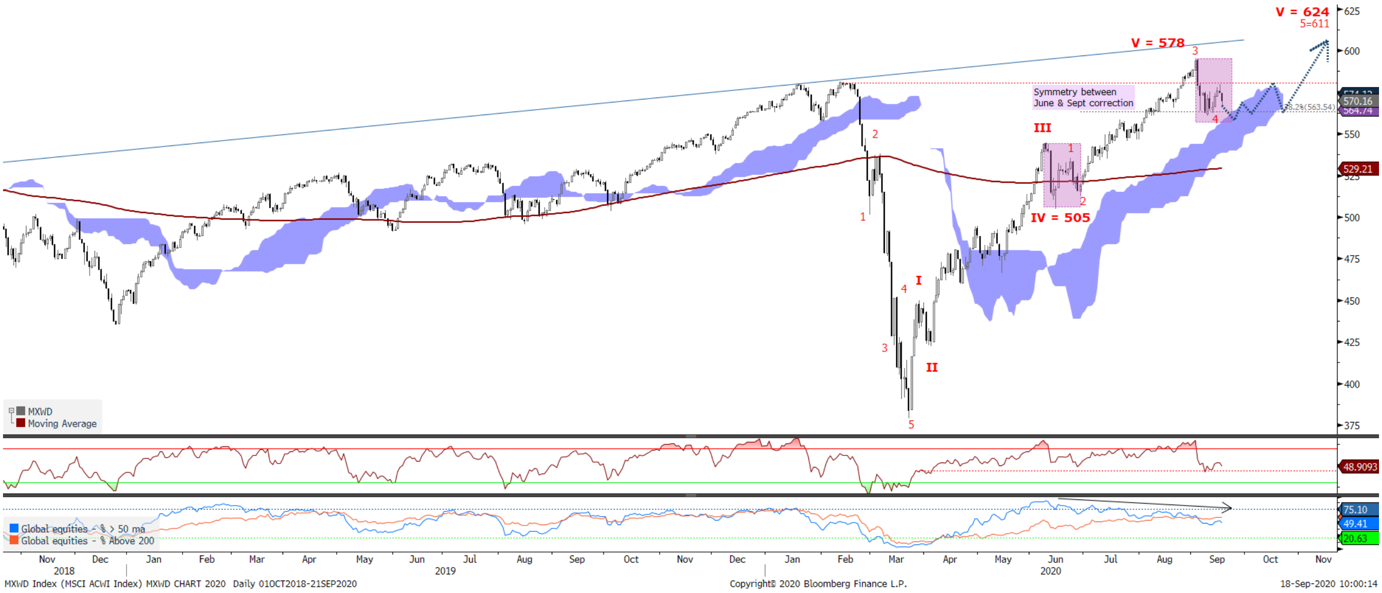


Source: Bloomberg – Stouff Capital

Indeed, global equities (MSCI World in chart 3) have reached our wave V target in August and printed a new all-time high record. But global equities have finally reversed with more than a 3% loss, enacting our CPD posture (change point detection). The technical reach of our target followed by a clear reversal means that our scenario 1 (a V rebound) has now fully played out. We expect a consolidation phase until the US election, before a resumption of the bullish trend.

This is our base scenario but we are now working on 3 new scenario (Chart 4): (1) a step higher to 3,690 if the US election is not delayed and brings a pro market outcome, with central banks still very accommodative and a vaccine before the end of the year, (2) a neutral election outcome with a muddle through economics but strong liquidity with a range between 3150 and 3400 or (3) a return to extreme volatility owing to fiscal cliff, nasty election or the return of the pandemic (target range 2880-3150).

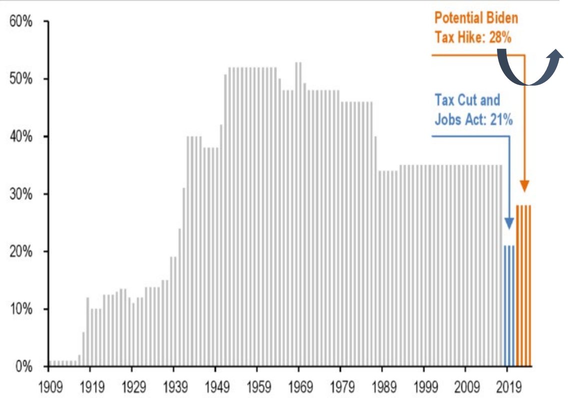
CHART 3: MSCI WORLD CHART



Source: Bloomberg – Stouff Capital

US election is the main catalyst for the coming weeks, with the following dates: Sept 19th 1st Presidential debate, Oct. 7th Vice Pres. debate, Oct 15th 2nd Pres. debate, Oct 22 3rd Pres. debate. The 2020 United States elections is scheduled for Tuesday, November 3, 2020. All 435 seats in the United States House of Representatives, 35 of the 100 seats in the United States Senate, and the office of President of the United States will be contested. In addition to the Presidency, a flip in legislative control of the Senate would be, by some measures, the biggest ideological swing in more than 200 years.

CHART 4 & 5: US TAX RATE IF BIDEN WINS (LEFT CHART) AND BIDEN VERSUS TRUMP POLICY PROPOSALS (RIGHT CHART)



	BIDEN	TRUMP
Corporate taxes	Raise corporate rate to 28%; create minimum tax rate of 15%con book income	Corp tax lowered from 35% to 21%
Personal income taxes	Restore top rate to 29.6%; raise capital gains tax to ordinary rate for those earning >$1mn; wealth tax (details unspecified)	Lowered federal rates from 10% to 39.6% brackets to 10% to 37%
Trade	Enlist US allies to challenge China on trade; advocates enforcing existing trade laws while writing new rules that protect workers, the environment and labour standards.	America First policy involving withdrawal from TPP, renegotiation of NAFTA, trade/tech/investment war against China and early-stage trade war with EU
Healthcare	Improve affordable care act (Obamacare) by adding public insurance option; Medicare to negotiate drug prices; link domestic to int'l prices	Failed attempt to repeal Obamacare in 2017
Energy	Ban new leases for drilling offshore and on federal land; partially supports Green New Deal end fossil fuel subsides; supports carbon tax; end fossil fuel subsides; 100% clean energy by 2050	Opened more federal land to drilling Reduced Iran/Venezuela output through sanctions
Tech & Comms	Supports using anti-trust legislation to investigate anti-competitive practices	No significant sector-specific policies, though DoJ, FTC & FC investigations ongoing
Finance	Support a financial transactions tax	No signature legislation
Infrastructure	$1.3trn plan; including green proposals	No signature legislation
Immigration	End family separation; protect DACA; create a pathway to citizenship; give more resources to better leadership/training within ICE; don't decriminalize crossing the border	Border wall; record contraction in legal immigration through limits
Monetary policy	No public comments	Favors lower rates and replacing Powell Two open Board seats to fill
Other	Raise minimum wage to $14/hr.	Federal minimum wage unchanged at $7.25/hr.

Source : Jpm

The market view is that a Democrat victory in November will be negative for equities. To the contrary, we argue that this outcome could be slightly positive in the context of the current economic COVID-19 crisis. Indeed, Biden’s proposed policies were introduced in a healthy economy during the Primaries and pre-COVID-19. Given the actual economic weakness, business recovery and job growth are likely to be prioritized over policies that could dampen economic growth. The degree of corporate tax reversal could be lower than discussed (<28% see chart 5).

CHART 6: SCENARIO WITH VARIOUS ELECTION OUTCOMES

USA SCENARII	Prob.	3’569		
Democrat majority + Biden – Blue Wave	**40%**	**3’150**	Outcomes	Dovish fiscal & monetary policy, No. ZIRP, $2T infrastructure bill on green/clean more stimulus vaccines, tax hike, mi. wage increase, more regulation of big Tech & Financials
			Factors	BUY: cyclicals, Value
			Sectors	BUY: cyclicals, Value, Clean Tech & Energy, ESG, Healthcare, Infrastructure, min wager winner SELL: big Techs, Defense, Energy, Financials, low margin wage, sin stock, tariff beneficiaries
Gridlock + Biden	**15%**	**3’690**	Outcomes	No further stimulus, small infrastructure bill on 5G More stimulus vaccines, tax hike, mi. wage increase, more regulation of big Tech & Financials
			Factors	BUY: secular growth SELL: Value
			Sectors	BUY: big Techs SELL: clean Energy
Status Quo Trump	**45%**	**3’900**	Outcomes	Dovish fiscal & Monetary policy, ZIRP? More stimulus vaccines
			Factors	BUY: secular growth, VIX SELL: Value
			Sectors	BUY: big Techs, energy, Financials SELL: clean energy, ESG

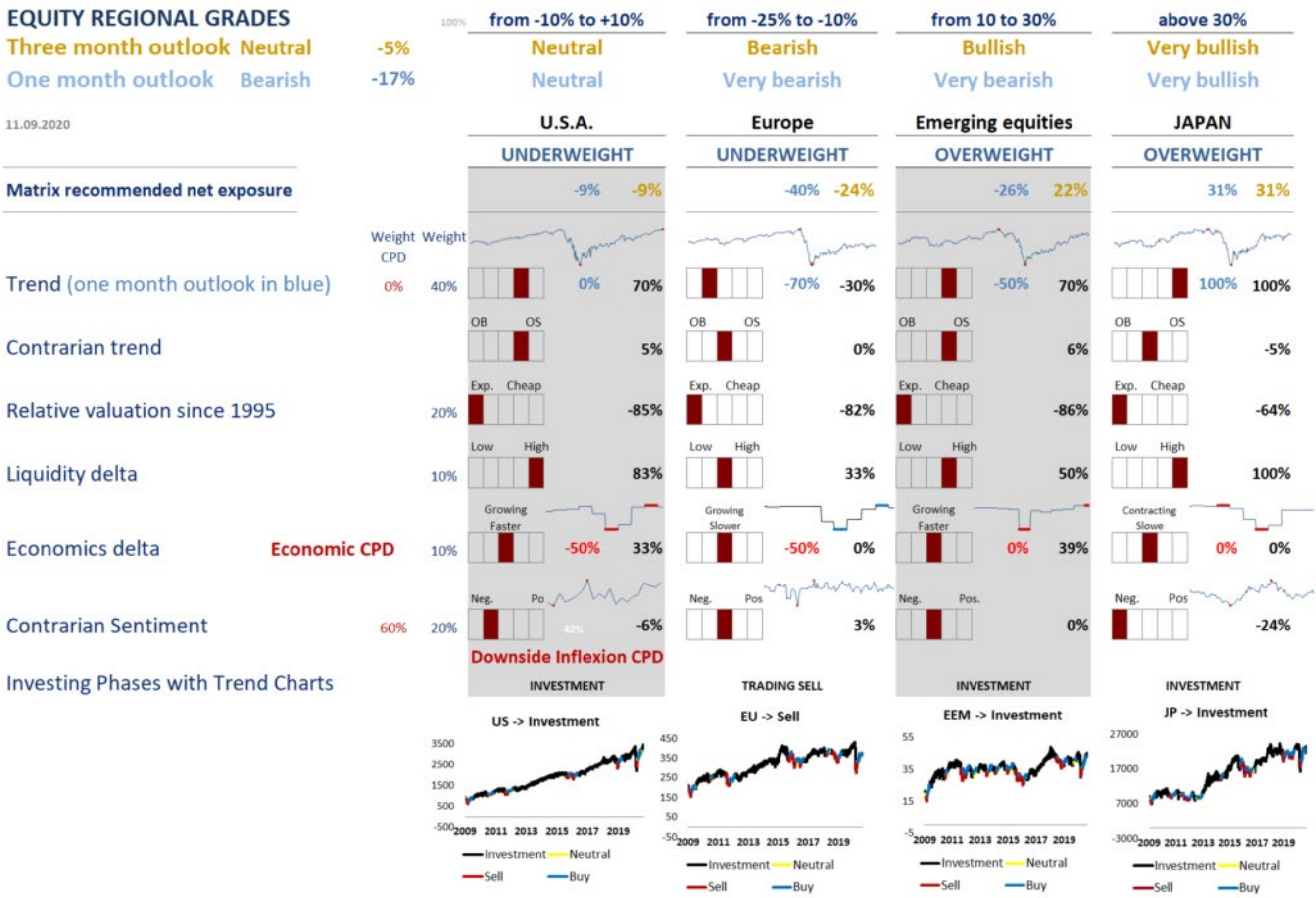
Source : Bloomberg – Stouff Capital

Other policy proposals including infrastructure spending, softening tariff rhetoric and higher wages should be net positive for S&P 500 earnings and largely offset the corporate tax headwind. Further, a more diplomatic approach to domestic / foreign policy will likely result in lower equity volatility and risk premia (VIX in the year before the trade war averaged 11%, and after the trade war started 16%). What’s more, if Democrats take the presidency and Congress, exposure to Biden's "green" agenda of which he has pledged to spend a part of his $700 billion recovery plan, would prosper. Key beneficial stocks here are surprisingly rest of the world (ROW) exporters like European automobile makers, which stand to gain from lower tariffs and electric-vehicle supportive policies. And while health-care stocks could take a hit in the lead up to that election, a relief rally is likely afterward, even in a Democratic sweep. "Overall, long-term themes that should benefit include smart mobility and energy efficiency,".

Should Republicans take the White House and Congress, energy would be a big winner, rallying in relief over the removal of the threat of stricter regulations that Democrats had been proposing. And a second-term Trump administration would likely maintain a tough line on trade, encouraging production back to the U.S. Stocks that could benefit include robotics and automation. Add the possibility of a contested election in November given the rising share of postal voting and the President’s pre-emptive allegations that this method is fraud-prone, and the backdrop has shades of late 2000. As a comparison (chart 6), during the Gore-Bush saga, US Equities dropped about 12.7% from their pre-election level, but never recovered meaningfully given that the US entered a recession in late 2000/early 2001.

What our Matrix tells

EQUITY REGIONAL GRADES, GLOBAL EQUITIES MATRIX 11.09.20



Source : Bloomberg – Stouff Capital

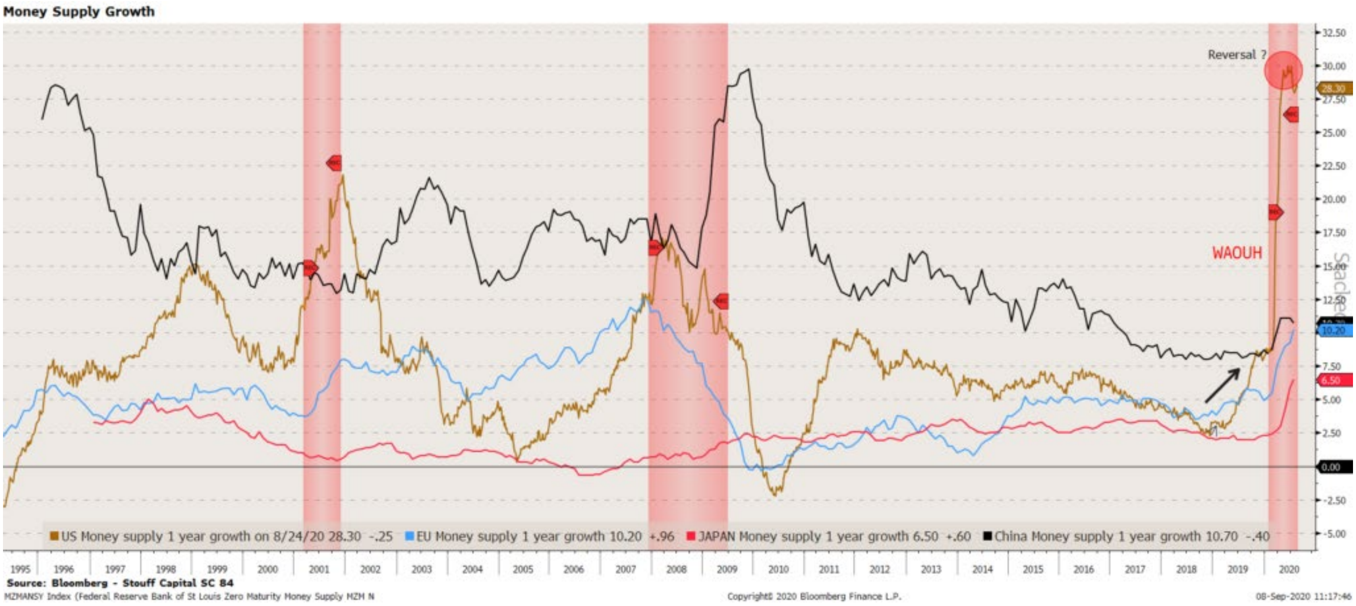
This matrix ranks from –100% to +100% the 4 regions (US, Europe, EM and Japan) with respect to 5 factors (Trend/Valuation/Liquidity/Economics/Sentiment). It suggests which region to overweight or underweight for a long only or a trader.

Our Matrix has switched in CPD in August and recommended hedging our US and European exposures, which we did through our recent trades. This CPD could at any time be cancelled (if sentiment becomes less exuberant) as indexes reached their wave 4 targets. We think equities should stay range-bound until the outcome of the US election.

Liquidity

Unsurprisingly, the Liquidity grade is very bullish in US and still supportive in the other regions. The FOMC made history, announcing a shift in its policy stance, the Fed will now target an average inflation rate and will allow prices to run a little hotter to make up for the last decade of underperformance. Powell said that while US unemployment data for August was positive, the economy's recovery from the coronavirus pandemic has a long road ahead and interest rates will remain low for a long time. "The recovery is continuing; we do think it will get harder from here. Today's jobs report was a good one," he said, adding that "to get us back to full employment, we're going to have to get the disease under control." A change in monetary policy dynamics is likely to feed through to inflation expectation...

CHART 7: MONEY SUPPLY GROWTH PER REGION - 08.09.20

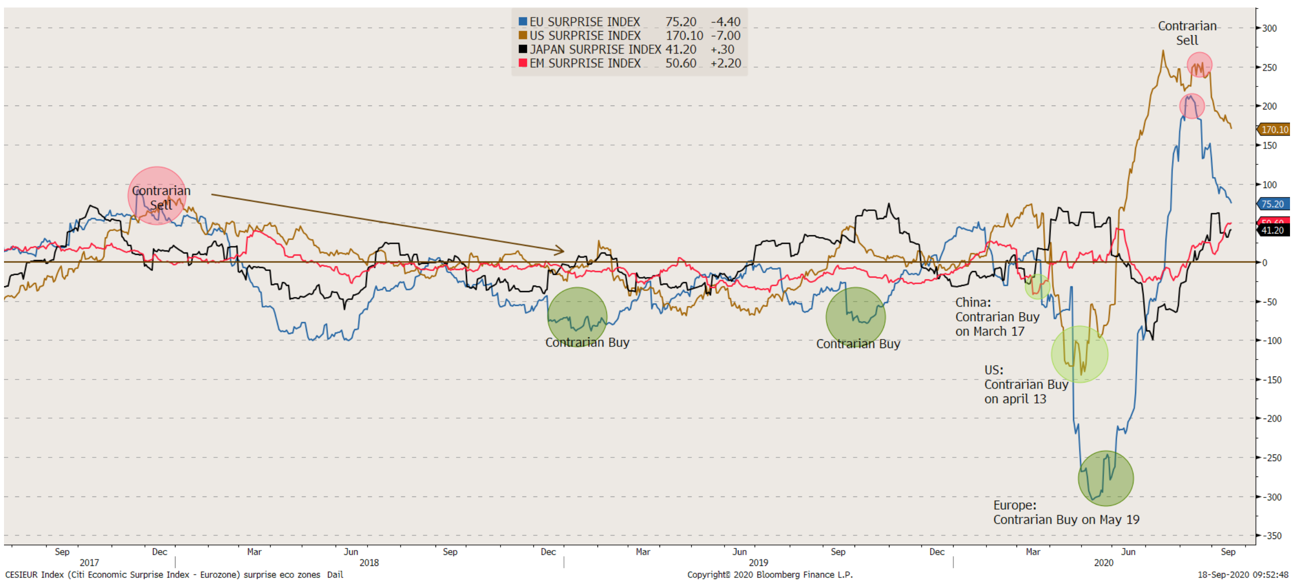


Source: Bloomberg –Stouff Capital

Economics

Our Economics grade has switched to CPD (Change point detection) as the Citigroup surprise indexes have turned south from elevated (historical high) levels. This is a negative and while the economy has not suffered the full effects of Covid-19 because fiscal policy plugged the hole in income created by job losses, without an extension of that support, the economy would need to hit the reset button to align with high rates of unemployment and all they entail. What's more, the failure of Congress to pass support for state and local governments would accelerate layoffs, which could be enough to halt improvement in the unemployment rate.

CHART 8: SURPRISE ECONOMIC INDICATORS - 18.09.20

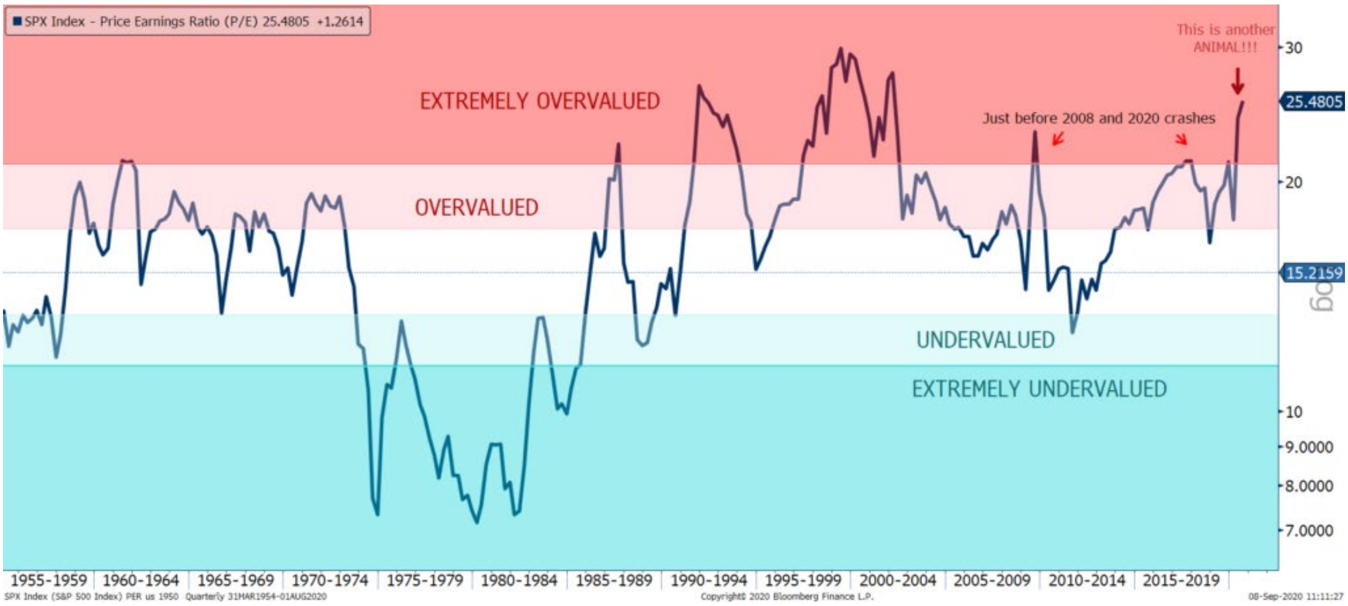


Source: Bloomberg –Stouff Capital

Valuation

Valuation is now extreme. The chart above shows that US P/E are not far from the 2000 levels. Nevertheless, compared to long term and short-term yields, equities stay cheap.

CHART 9: S&P500 P/E SINCE 19958 - 08.09.20



Source: Bloomberg –Stouff Capital

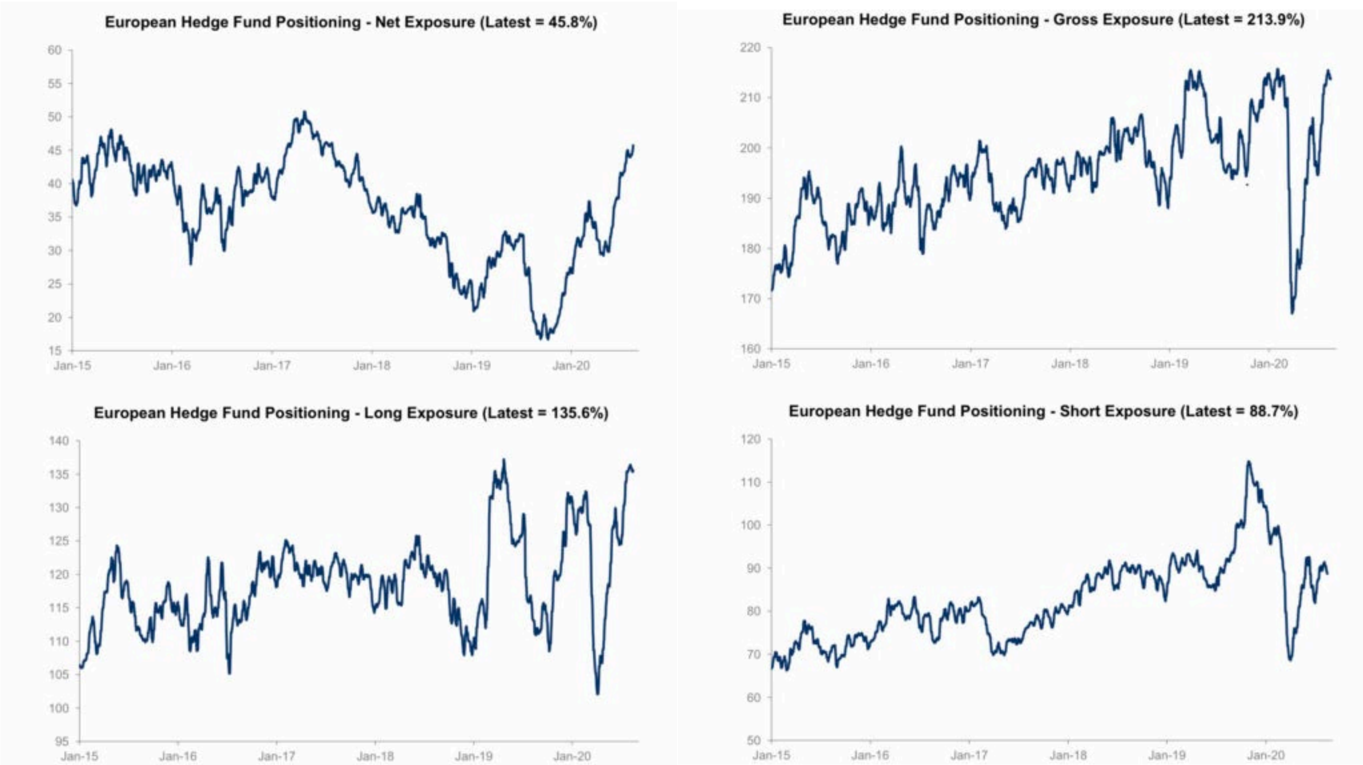
Sentiment

CHART 10: SENTIMENT INDICATORS FOR US EQUITIES - 08.09.20

Source: Bloomberg –Stouff Capital

Sentiment has been bearish since the end of July and switched our regional matrix in CPD (change point detection) conditions. In the chart above, our US SC Sentiment indicator gave short term and medium run bearish signals. Specifically, our S/D indicator went bearish in August (not as extreme as Dec 2019). But it has given many false contrarian bearish signals. It has been confirmed by the too high exposure of hedge funds (see below) as a contrarian indicator. Finally, it has worked...

CHART 11: HEDGE FUND POSITIONNING - 08.09.20



Source: Bloomberg –Stouff Capital

Trading Plan

We have updated our scenarii for the end of the year as our wave 5 target has been reached. We think the extraordinary monetary conditions could send equities 10% HIGHER, if economic data rebounds more and the US election goes smoothy. It means a target of 3,690 for the S&P500, which in terms of Elliott wave means a 100% extension from the wave IV instead of the usual 61.8%. This is our new base scenario. 2 alternative scenarii would create 2 range trading: scenario (2) a muddle through economy hurt by falling economic data but financial markets still supported by excessive liquidity and (3) a negative scenario when pandemic returns and / or the US election becomes very nasty with a fiscal cliff. For scenario 2, the S&P500 should move between 3150 and 3400, while in the third scenario, the range would be between 2880-3150. With respect to scenario 3, the US fiscal cliff could become a material risk to US markets if it intersects with a contested election, so would continue supporting tactical hedges/ downside convexity on US and European Equities. Just to mention other risks, a hard Brexit is a major negative probably only for the UK economy. Then, Europe’s second virus wave is probably as manageable as the US one was this summer, given strong starting momentum and a surgical approach to mobility restrictions.

CHART 12: S&P500 CHART - 18.09.20

Source: Bloomberg –Stouff Capital

Catalysts this week: Japan LDP leadership election (Sep 14th); US IP, China IP/retail sales/FAI & ZEW (Sep 15th); FOMC, BCB & US retail sales (Sep 16th); BoE, BoJ, SARB & BI (Sep 17th); US consumer sentiment & CBR (Sep 18th).

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The Equity quantitative grades
EPS Growth Grade: The EPS Growth Grade is a proprietary formula made up of earnings revisions momentum, past earnings growth, earnings stability, and current and long-term earnings growth. A grade above 55 is considered bullish on a 3-month basis, bearish below 45 and neutral between 55 and 45.
Sales Grade: The Sales Grade is a proprietary formula made up of current and next year's sales momentum, past sales growth, sales stability, and current and long-term sales growth. A grade above 55 is considered bullish on a 3-month basis, bearish below 45, and neutral between 55 and 45.
Relative Value Grade: The Relative Value Grade is a proprietary formula made up of estimated P/E, P/B, P/S and P/CF ratios. 40% of the grade is based on historical values and 60% on current market data. A grade above 55 suggests a stock is cheap, below 45 expensive, and neutral between 55 and 45.
Quality Grade: The quality rating is a proprietary formula that focuses on the balance sheet (i.e. change in accruals, change in free cash flows and profitability). A grade above 55 suggests a stock with a good balance sheet.
Volume Flow Grade: The Volume Flow Grade is a proprietary formula that gives the accumulation/distribution based on the volume flows of a stock. A grade above 55 indicates good money flow and a grade below 45 suggests weak money flow.
Global Grade: The Global Grade is a weighted average of the Growth, Value, Berkshire, Quality and Money Flow Grades.
Relative Strength (RS) Grade: The RS grade measures the price momentum of a stock over its 1-year price performance.
Smart Sentiment Grade: Sometimes referred to as "Smart Sentiment," the Sentiment Grade ranks the sentiment of the smart money. The first digit of the figure goes to the level of bullishness, and the second digit goes to predictability. For example, a sentiment grade of 97 indicates 90% bullishness and 70% predictability.

The Regional MATRIX grades
The Regional Matrix grades range from -100% to +100%. We consider a grade above 30% to be very bullish, a grade above 10% to be bullish, and a grade between -10% and 10% to be neutral. A grade between -10% and -25% we consider bearish and a grade below -25% very bearish. This Regional Grade is a benchmark for the net exposure of the Urizen Fund.
Regional Grade: The Regional Grade (-100 to +100) is an indicator of a structural bull market or not. It is calculated by combining and applying weight to each of the other grades that make up the Regional Matrix (Trend, Contrarian Trend, Relative Valuation, Liquidity delta, Economics delta, and Contrarian Sentiment). If we believe equities to be in a structural bull market, we use 15 years of data to assess Valuation.
Trend Grade: The Trend Grade (-100% to +100%) is based on a moving averages model adjusted according to the overbought/oversold conditions of the region's main indices.
Relative Valuation Grade: The Valuation Grade (-100% to 100%) is based on the percentile rank of the regional Index stocks' P/E ratios since 1995 (current year estimated).
Economics delta Grade: The Economics delta Grade (-100% to 100%) is based on a combination of manufacturing and non-manufacturing PMIs and the Citigroup Surprise Indices. The Citigroup Economic Surprise Indices are an objective and quantitative measure of economic news and are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten the consensus.
Contrarian Sentiment Grade: The Contrarian Sentiment Grade (-100% to 100%) is based on various contrarian and non-contrarian indicators.

The SC quantamental portfolios
The SC quantamental portfolios refer to our regional single stocks portfolios which are constructed through a mixed process of algos and fundamental analysis