

SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

Sept 2, 2020

Alan Brazil

SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

- ***Step 1: The Dollar Depreciation Cycle Is Just Starting***
- ***Step 2: Fundamental Economic Framework (As outlined in my recent pieces below)***
 - **SOM: Strategies For Covid-19--Part 2: A U-Shaped Recovery Not A "V"**
 - **SOM: Strategies For Covid-19--Part 3: The Fall of The USD & The Rise of EM**
 - **SOM: Strategies For Covid-19--A U-Shaped Recovery Not A "V", A Focus On Savings**
- ***Step 3: Identify Potential Catalysts***
 - The Fed could ramp up QE if the US follows a U- or W-shaped recovery
 - Democrats could win the November elect and raise corporate tax rates reversing the flow of capital into the US
 - The Euro could rise driven by economic recovery and greater move towards a mutualization of risk
 - The Yen could rise as the post-Abe government backs away from QE
- ***Step 4: Find Asymmetric Trades***
 - Trade 1: Buy downside puts on the dollar vs advanced economy FX
 - Trade 2: Short the dollar vs EM commodity FX
 - Trade 3: Buy gold or gold miners

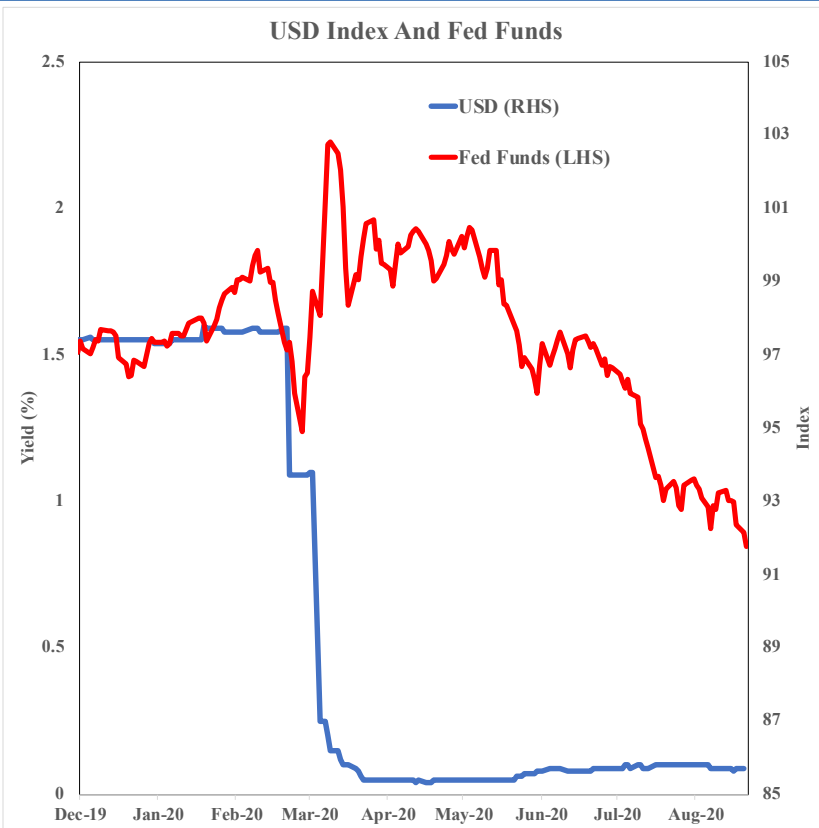
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

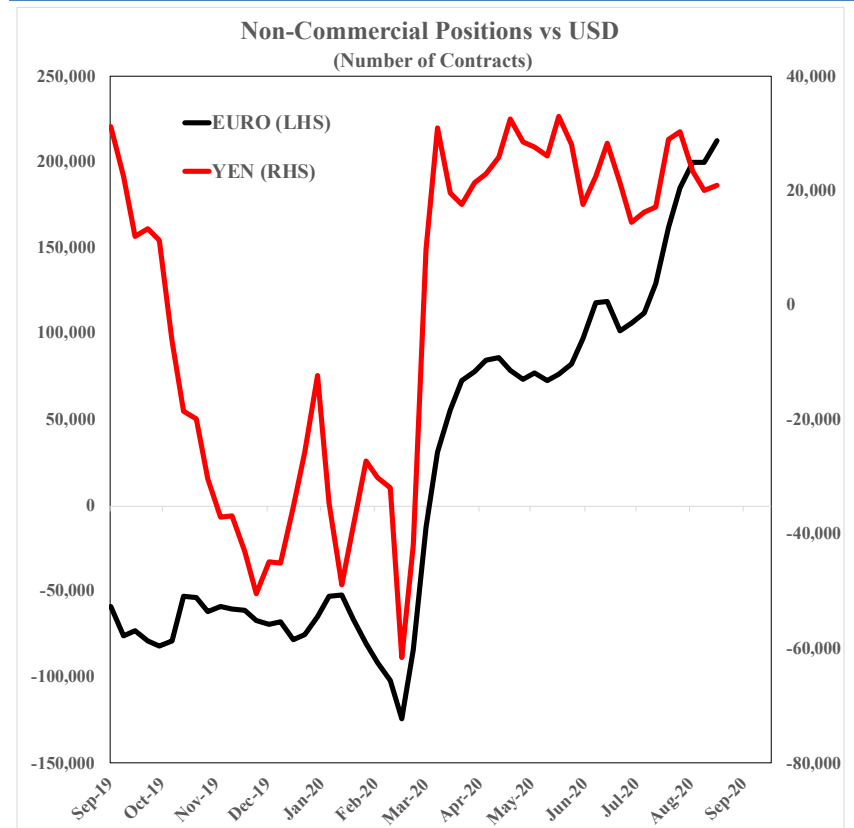
Step 1: Macro Theme

Does The Dollar Still Have Downside Given How Far It Has Depreciated?^{1,2}

The Dollar Has Depreciated Since the Start of Fed Easing



USD Short Is A Crowded Trade Which Could Limit Downside



1. Bloomberg
2. CFTC

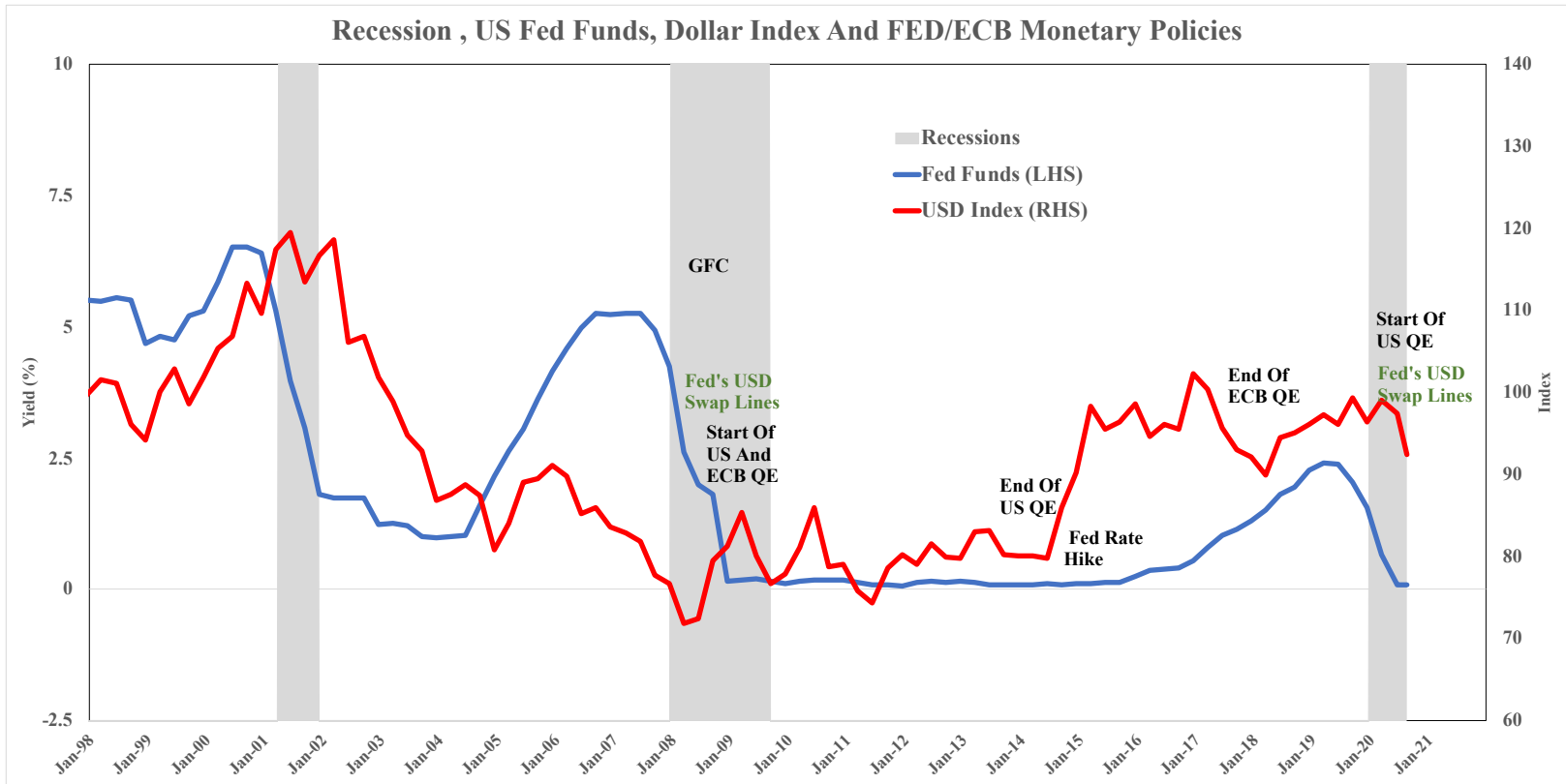
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

Step 1: Macro Theme

The Dollar Still Has Significant Downside Given Previous Depreciation Cycles And Other Factors¹

A US Economic Slowdown, Rising Deficits, And Further Fed Actions Combined With Change In Policy In ROW Could Mean Further Downside



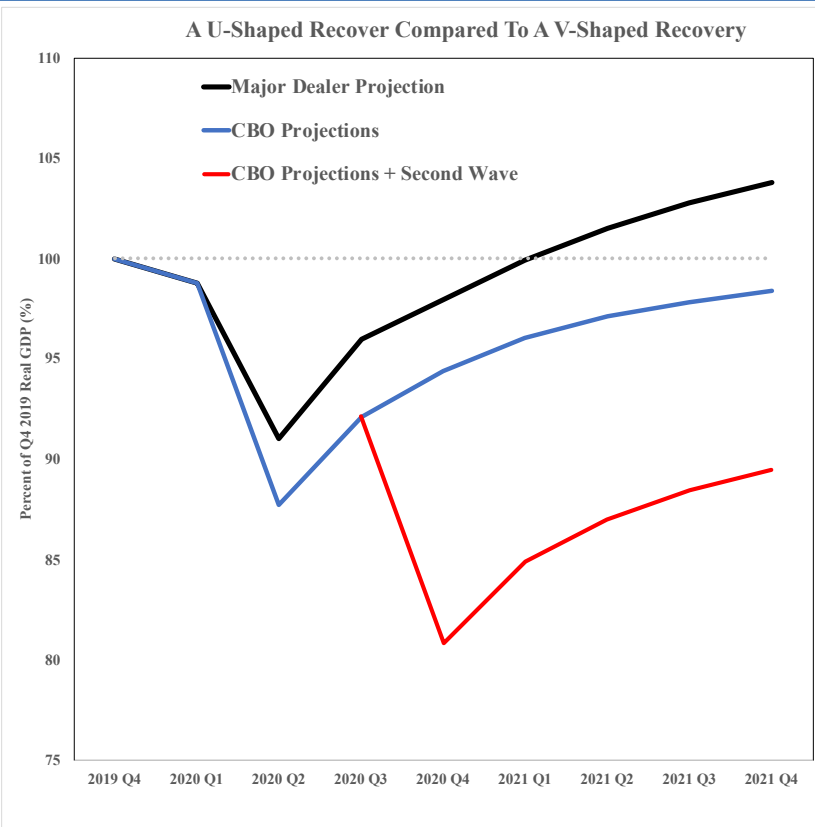
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

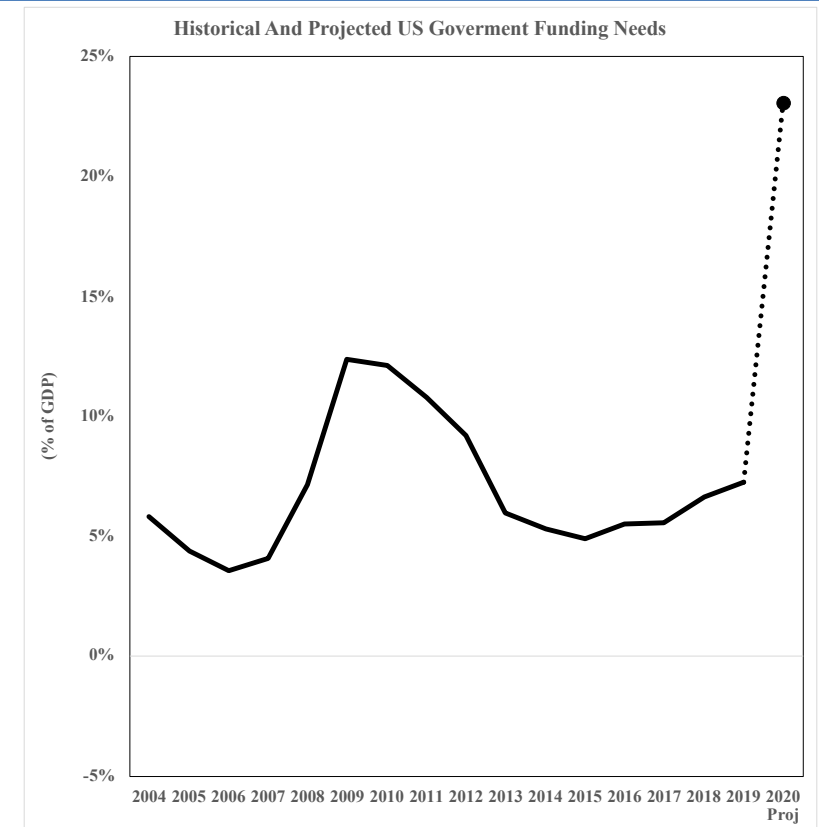
Step 3: Identify Potential Catalysts

A U-Shaped Recovery: The US Economy Is Slow To Recover And That Means More Fed QE¹

The US Recovery May At Best Be a U-Shaped If Not A W-Shaped



Deficit Could Still Be Substantial In 2021 As Well



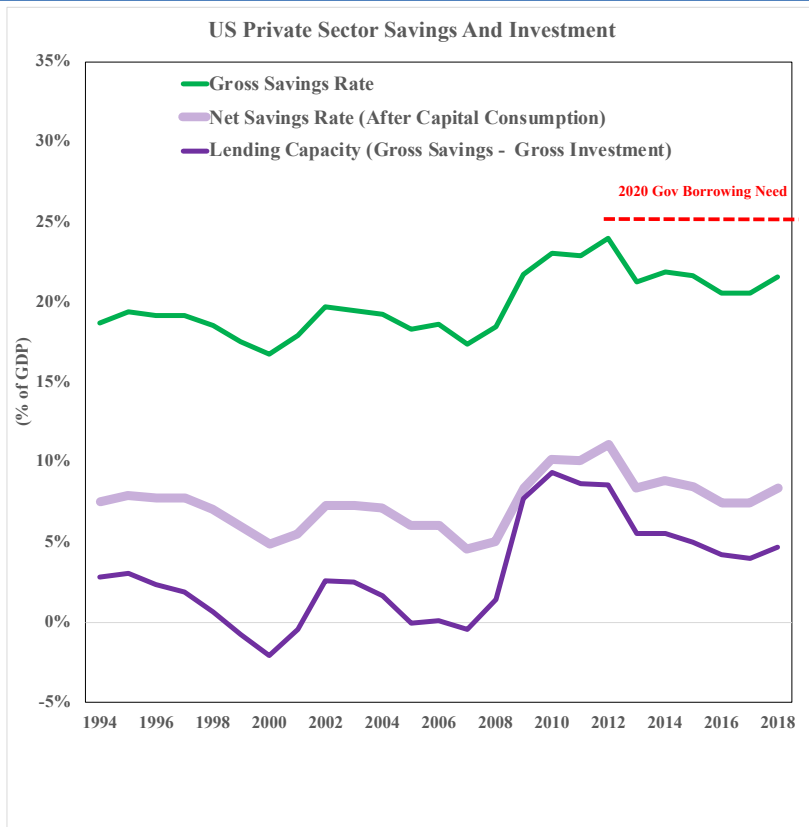
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

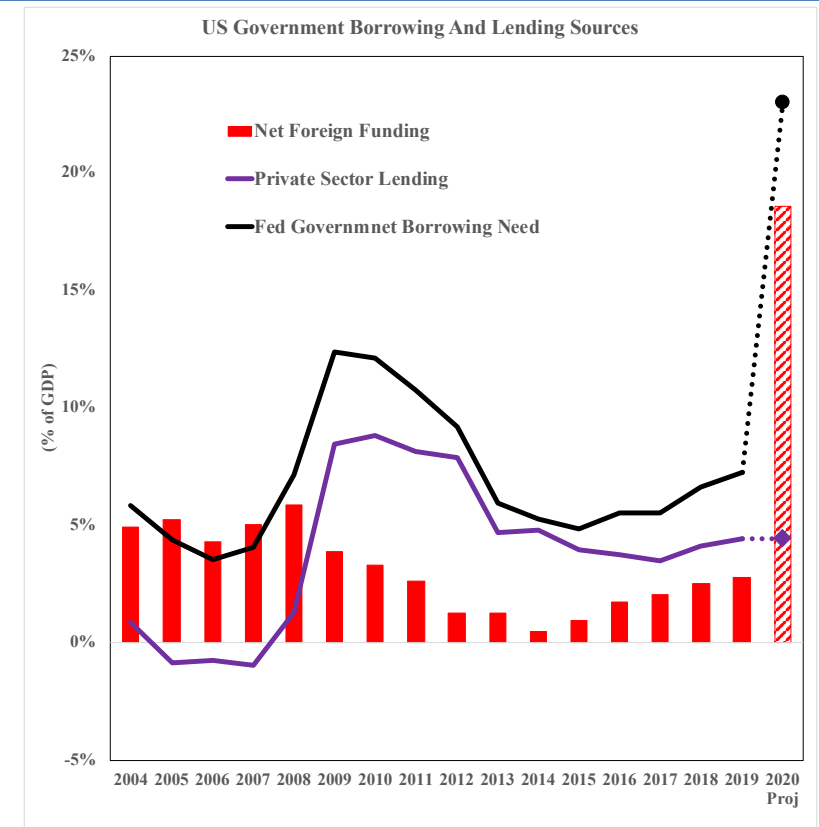
Step 3: Identify Potential Catalysts

A U-Shaped Recovery: Federal Borrowing Is Already Almost 5-times The Levels During The GFC¹

Federal Borrowing Will Swamp Domestic Private Lending Capacity



Substantial Increasing The Reliance On Foreign Capital



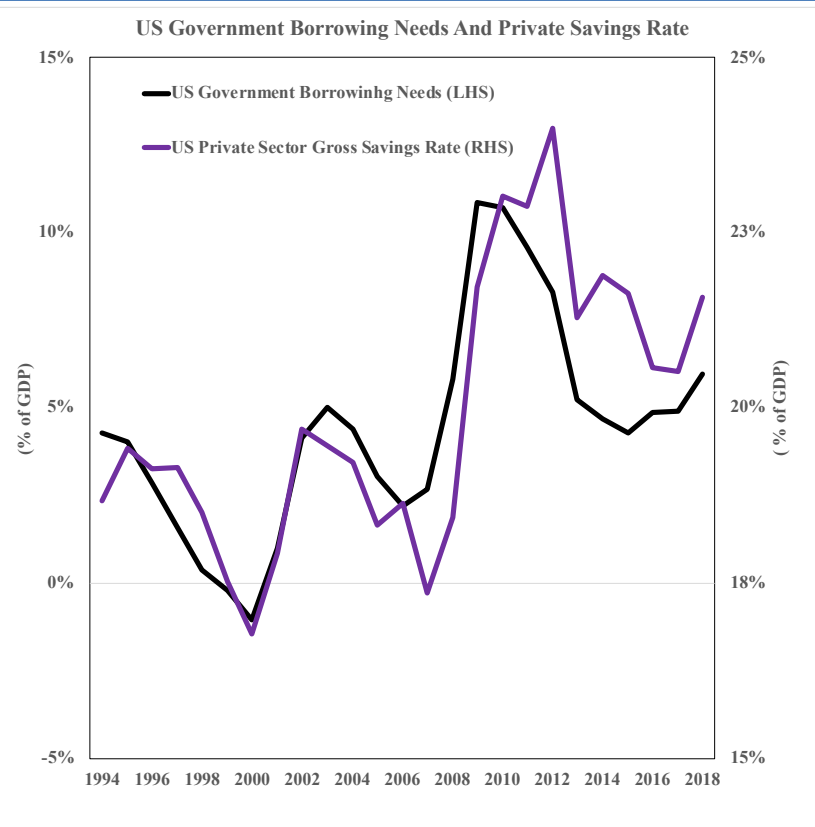
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

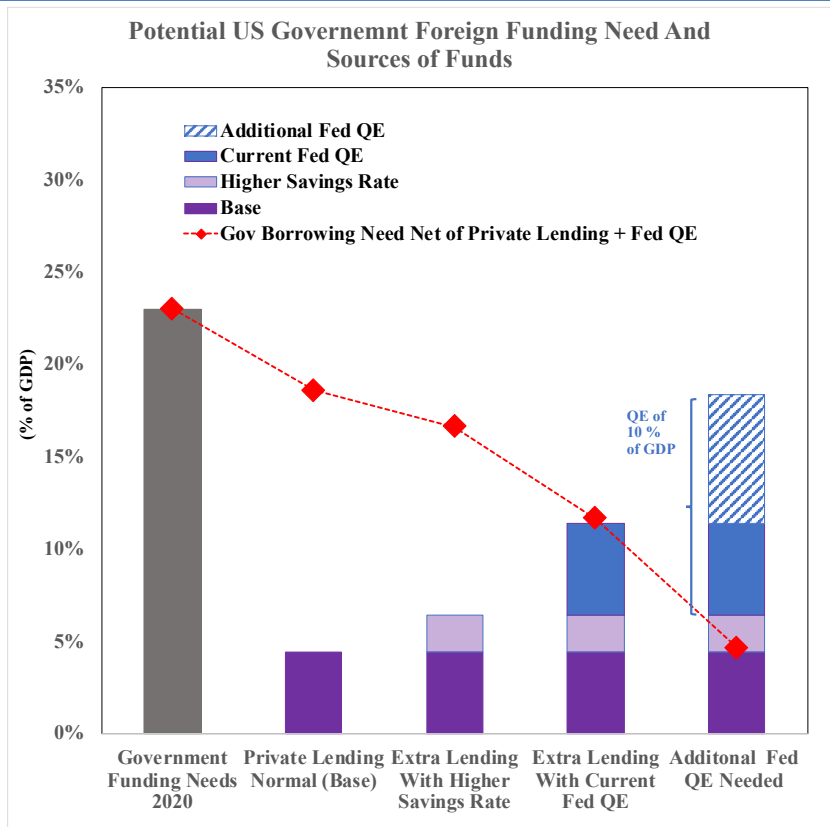
Step 3: Identify Potential Catalysts

A U-Shaped Recovery: The Fed Will Need To Expand Current QE To Plug the Government Funding Gap

Private Sector Savings Will Increase But Just Not Enough¹



The Fed Needs To Ramp Up QE Substantially^{1,2}



1. BEA GDP Reports
2. Bloomberg

SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

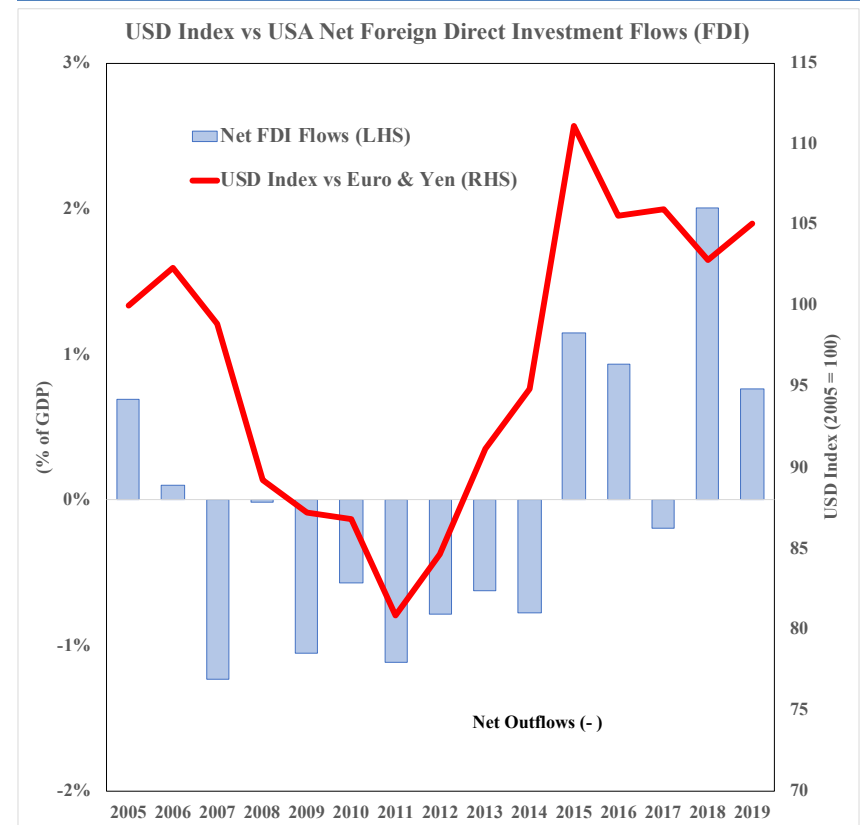
Step 3: Identify Potential Catalysts

Democrats Win: Democrats Sweep And Reverse Trump's Corporate Tax Cuts

Projected FDI Inflow Into US With Trump Corporate Tax Cuts...¹

Sector	FDI Stock As Of 2016 \$Bil (USD)		Potential Change In FDI From Tax Reform \$Bil (USD)			
	US Position In EU	EU Position in the US	US Position In EU	EU Position in US	Net Cng Into US	Net Increase
						Into US (%)
All	1,538	1,575	47	326	279	18%
Industrial	311	439	43	140	97	22%
Service	1,227	1,136	4	186	182	16%

Which Happened And Supported The USD, But Could Be Reversed?²



1. ZEW, "Analysis of US Corporate Tax Reform Proposals and their Effects for Europe and Germany", 2018
 2. OECD FDI data base

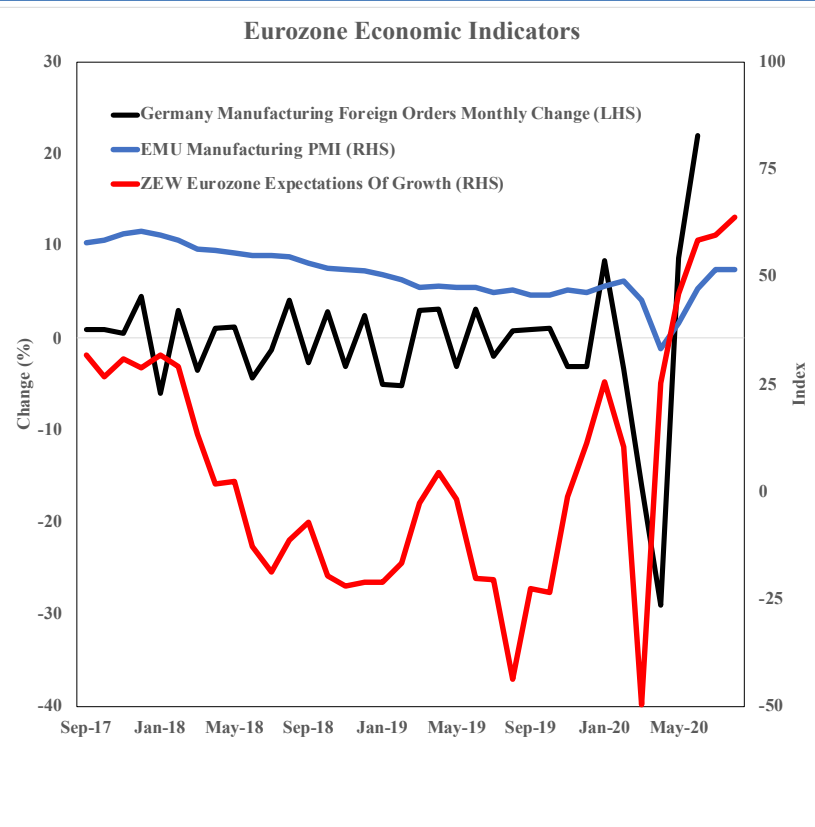
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

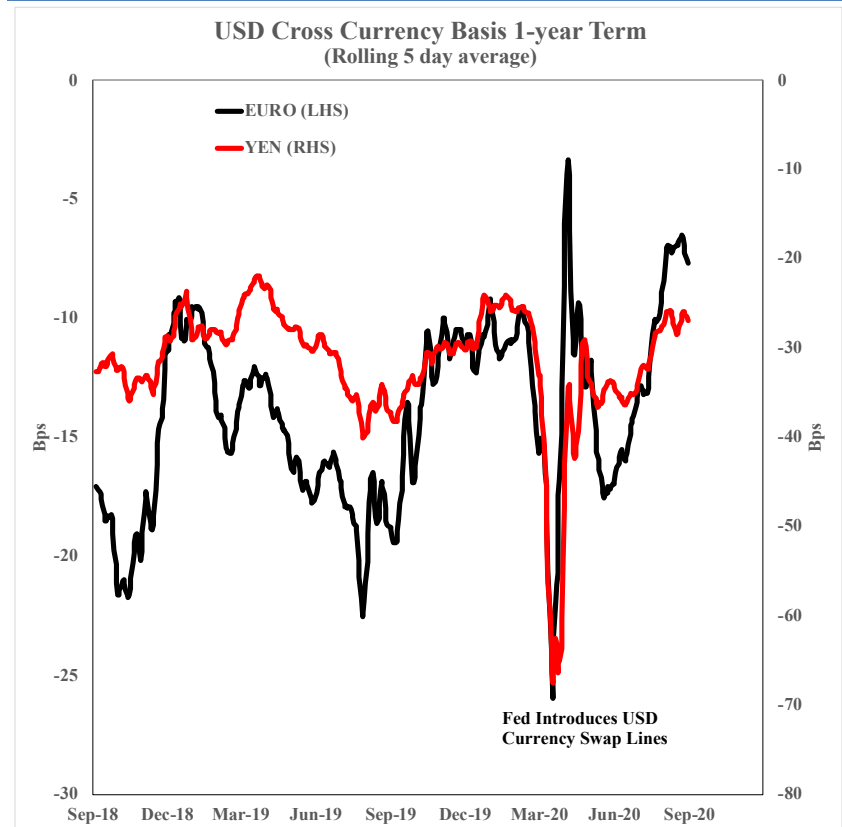
Step 3: Identify Potential Catalysts

The Rise of The Euro: EMU Growth And Greater Socialization of Risk Portends The Rise of The Euro¹

The EMU Economy Is Recovery Lead By Germany Manufacturing



Accordingly Capital Flows Into the US Could Be Slowing...



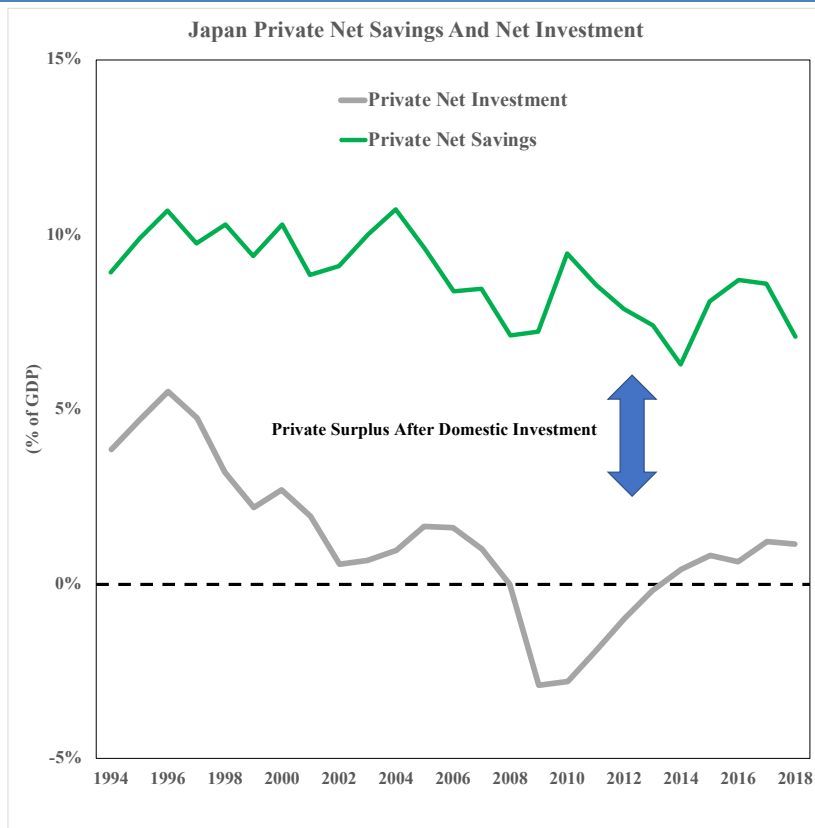
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

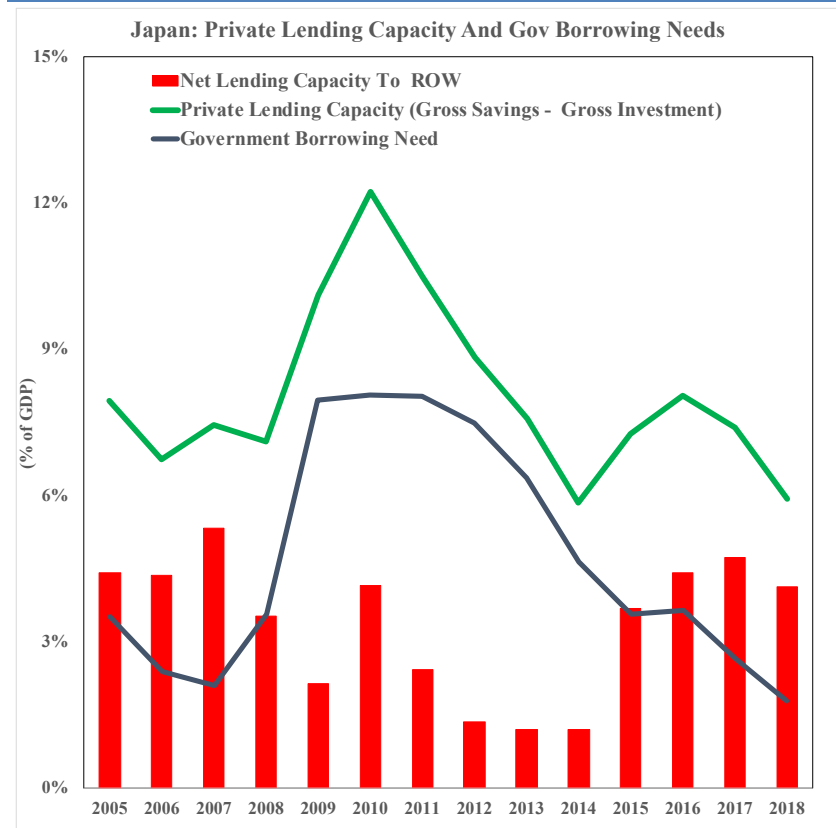
Step 3: Identify Potential Catalysts

The Rise of The Yen: New Japan PM Could Stop QE Since It Is Not Needed To Fund Gov Deficit

Japan Is A Key Source of World Capital



Japan Capacity To Invest/Lend Overseas Is Substantial



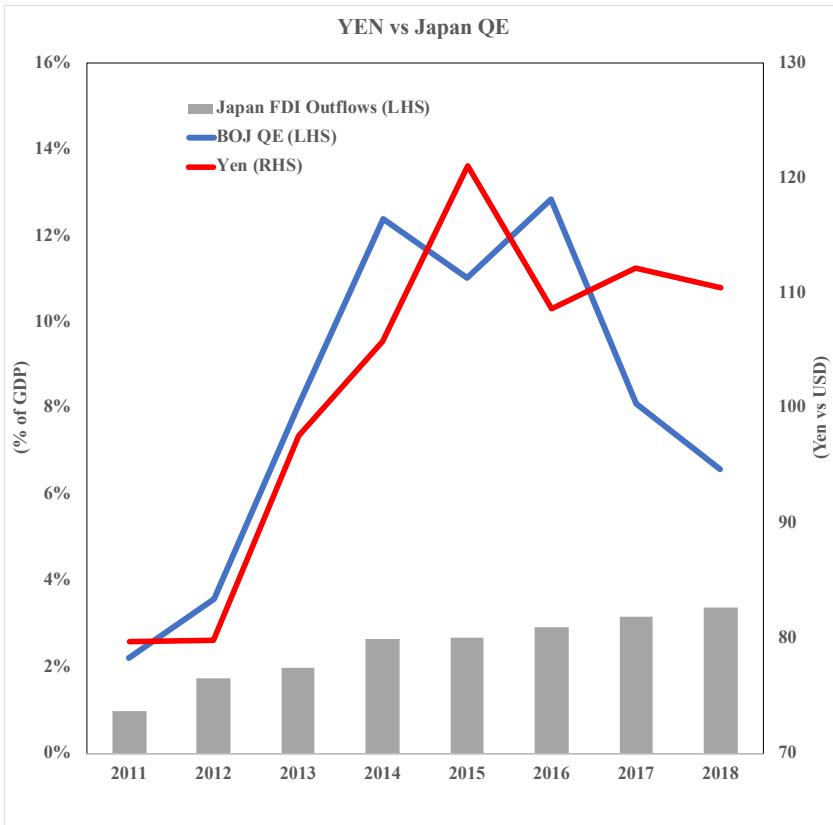
SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

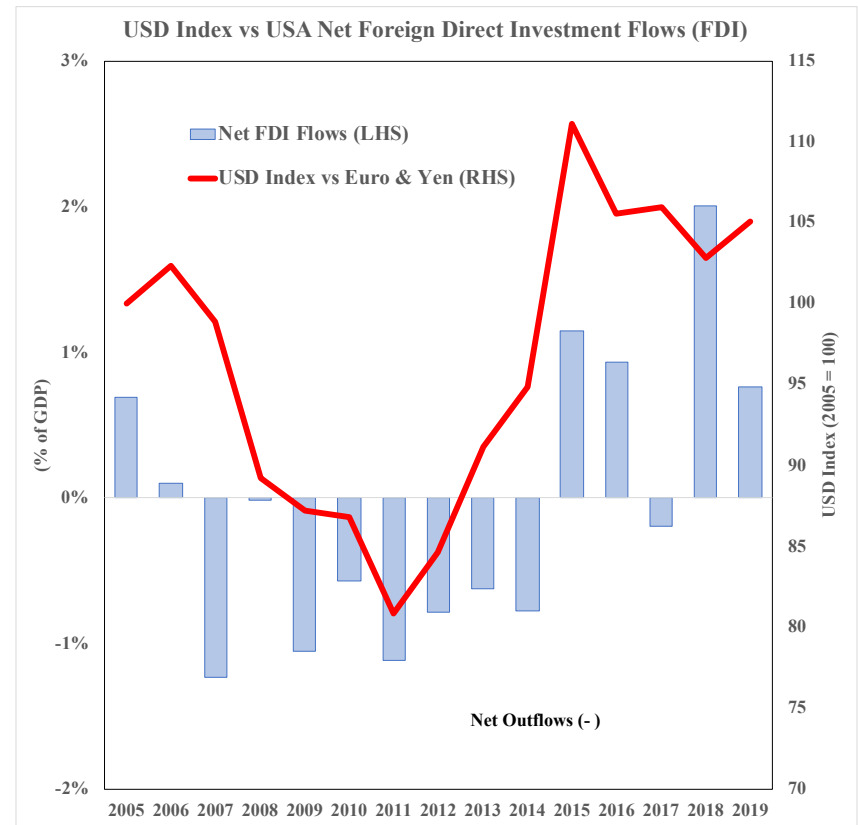
Step 3: Identify Potential Catalysts

The Rise of The Yen: Abenomics QE Drove Capital Out Of Japan And The Yen Down

Japan QE Pushed Capital Out And The Yen Down^{1,2}



Those Flows Came To The US, But What Happens After US QE?^{1,2}



1. OECD, FDI Data Base
2. Bloomberg

SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

Step 4: Identify Asymmetric Trades

Trade 1: Buy Downside Puts On The USD vs Advanced Economy FX¹

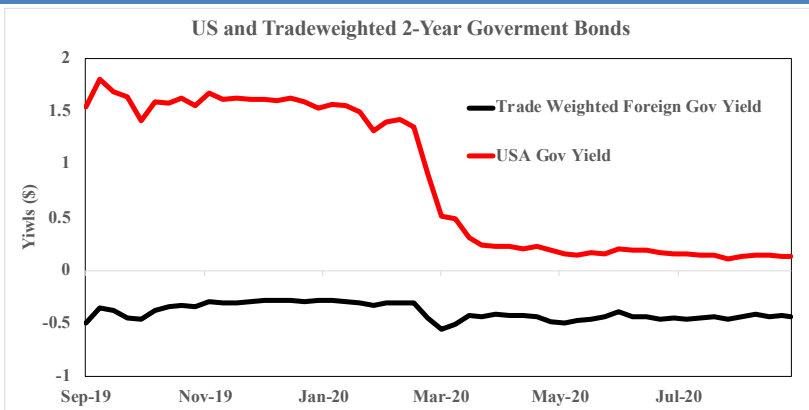
Trade Thesis

Buy December 30 delta puts

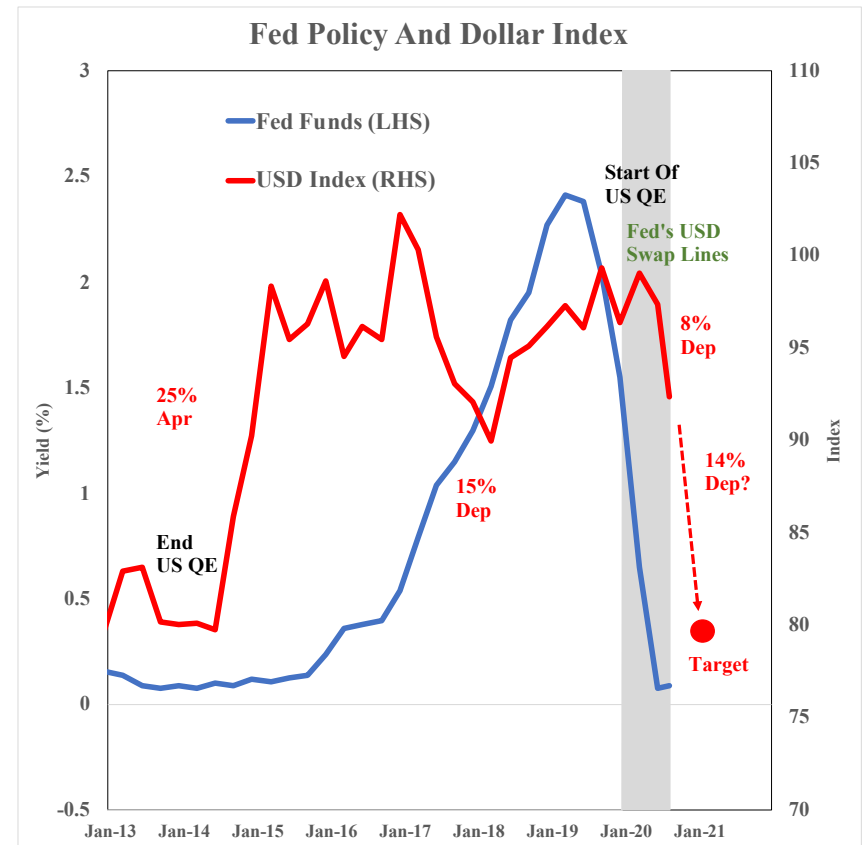
- The dollar depreciation cycle is just beginning
- US could still follow a U- if not a W-shaped recover
 - This would push the Fed to substantially increase QE
- Democrats could sweep the November elections and raise US corporate tax rates
- The rise of the Euro
- The rise of the Yen

Risk is the US economy picks up steam and Trump wins a second term

Negative Real Policy Rates In The US



Commodity EM FX Still Have Room To Rally vs USD



SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

Step 4: Identify Asymmetric Trades

Trade 2: Go Long A Basket of Commodity EM FX Vs USD

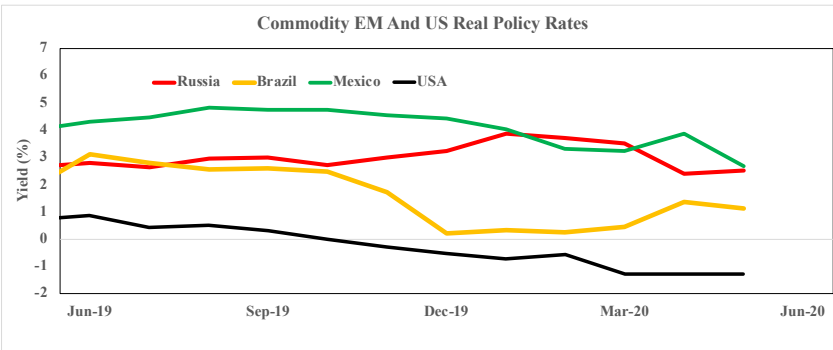
Trade Thesis

Short the USD vs an basket of commodity EM FX

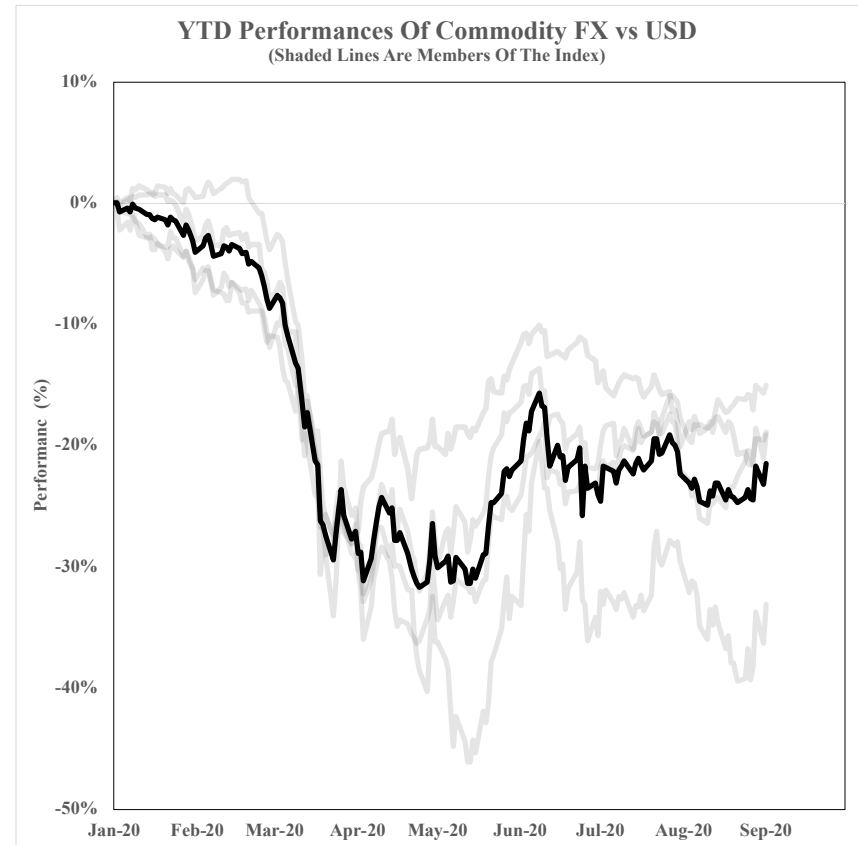
- EM commodity country FX should appreciate vs the USD
- US QE will weaken the USD vs commodity EM FX
 - QE will drive capital flows to EM
 - Weaker USD will drive up commodity prices helping commodity EM Countries
- Commodity country EMs have the capacity for fiscal stimulus that should support their economies and reduce risk
- EM countries have used even stricter containment strategies vs the US to bend the Covid curve

Risk is a general risk-off environment and a flight to the USD

Negative Real Policy Rates In The US¹



Commodity EM FX Still Have Room To Rally vs USD^{1,2}



1. Bloomberg
2. Equally weighted index of MXN, BRL, ZAR, RUB vs USD

SOM Macro Strategies

State Of the Markets: The Dollar Depreciation Cycle Is Just Starting

Step 4: Identify Asymmetric Trades

Trade 3: Buy Gold Or Gold Miners Equities

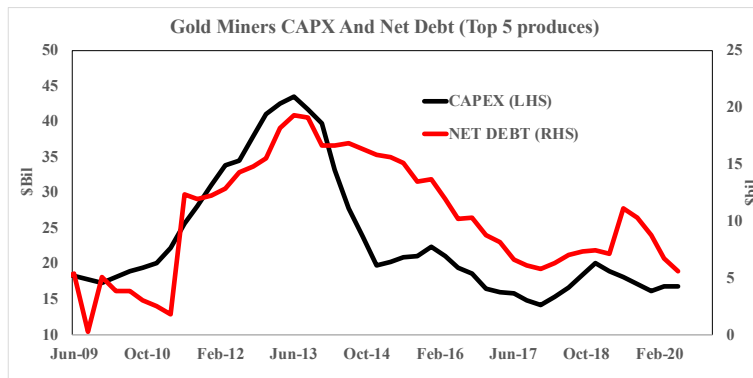
Trade Thesis

Buy an equity basket of gold miners

- Gold could be the best long versus other currencies while gold miners provide significant convexity to the upside vs buying gold outright
- Miners are trading at large discounts versus historical levels reflecting concerns about another debt fueled Capex wave as occurred in 2011-16
- Miners are showing more discipline in this cycle and continue to reduce debt and hold down Capex growth
- Miners could have asymmetric upside even at current prices as the market gets more confidence in miners behavior

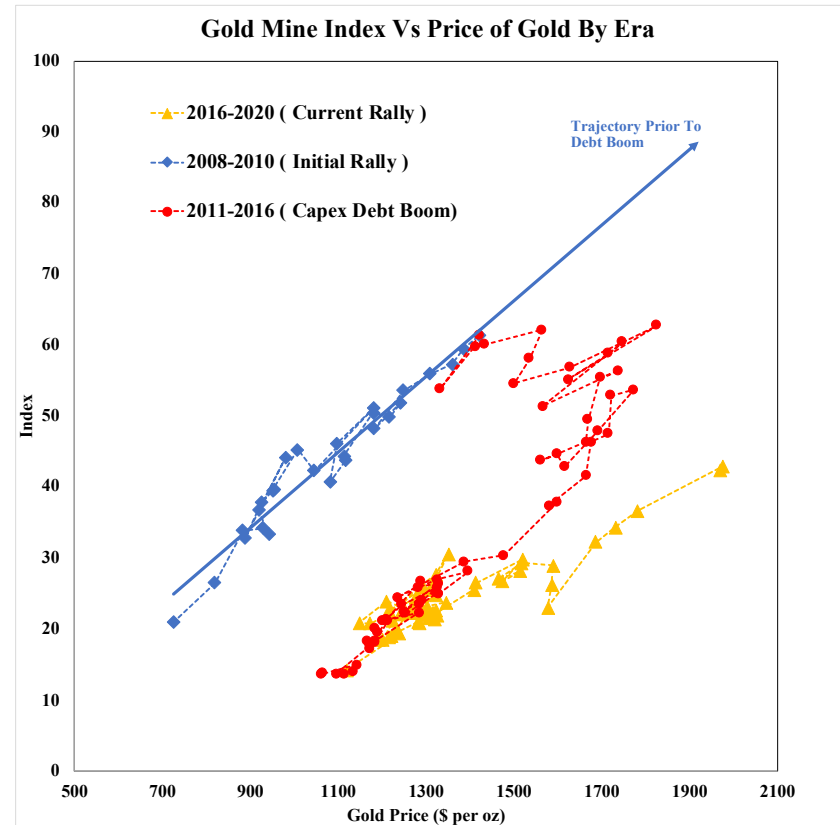
Risk is the USD strengthens and rates rise

Miners Have Changed Their Behavior Versus The Last Gold Rally¹



1. Bloomberg
2. Author's calculations

Market Still Pricing In A Large Discount To Gold Miners Vs Gold^{1,2}



SOM Macro Strategies

Disclaimer

Copyright (c) SOM Macro Strategies. 2020. All rights reserved. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. No representation or warranty, express or implied, is made as to the fairness, accuracy, completeness, or correctness of the information and opinions contained herein. The views and the other information provided are subject to change without notice. This report has been created without regard to the specific investment objectives, financial situation, or particular needs of any specific recipient and are not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not necessarily a guide to future results. Company fundamentals and earnings may be mentioned occasionally, but should not be construed as a recommendation to buy, sell, or hold the company's stock. SOM Macro Strategies accepts no liability for any damage caused by any virus transmitted by this company's emails, website, blog and Apps.