

***SOM** Macro Strategies*
State Of the Markets

October 17, 2020

Alan Brazil

SOM Macro Strategies

State Of the Markets

Step 4: Identify Asymmetric Trades

Current Recommended Trades And Historical Performance Of Trades

	Number Trades	October 17, 2020		
		Initial Investment (MM)	Current Investment (MM)	Total Return
Open	5	25	28	13%
Closed	60	300	876	192%
Total	65	325	904	178%

SOM Strategy (Click On Link)	Trade	Initial Position			Current Valuation		October 17, 2020	
		Date	MM/Shares	Price	Status	Price	Invest (MM)	Total Return
<u>Dollar Depreication Cycle Has Just Started</u>	Short USD, Long Commodity EM FX (Mexico, Brazil, Russia)	5/24/20	150	100.0	10/17/20	100.5	5.8	15%
<u>Dollar Depreication Cycle Has Just Started</u>	Buy Dec 4% OTM USD Put Vs Advance Economy FX,	8/18/20	1250	0.40	10/17/20	0.15	1.9	-63%
<u>Dollar Depreication Cycle Has Just Started</u>	Buy Housing Related Equities Including "For Rent" Companies And Short S&P	8/25/20	150	100.0	10/17/20	103.5	10.3	105%
<u>Opportunities in the US Housing Market</u>	Buy Gold Miner And Short Equities	9/23/20	150	100.0	10/17/20	98.7	3.1	-39%
<u>Buy CDX Protection--Credit Is Rich</u>	Buy CDX Protection (bps)	9/17/20	500	46	10/17/20	57	7.2	44%
<u>Opportunities in the US Housing Market</u>	Buy Mortgage Finance Related Equities and Short S&P	8/25/20	150	100.0	10/4/20	107.0	15.5	210%
Dollar Depreication Cycle Has Just Started	Buy Gold Miner And Short Equities	9/2/20	150	100.0	Closed 9/16/2020	108.1	17.2	243%
Strategies For The Covid-19: Part 3: The Fall of The USD	Buy Dec 4% OTM USD Put Vs Advance Economy FX,	7/15/20	1500	0.33	Closed 8/18/2020	1.29	19.4	288%

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Step 4: Identify Asymmetric Trades

Update On Trade Performance

Short the Dollar

Well, let's just say the dollar short has even more upside after the dollar rally in the last few weeks. Many factors are at work driving the dollar rally: the reemergence of the Covid cases in Europe, Brexit uncertainty, monetary policy in China, crowded trade, etc. I believe it is still the right trade. The US is going through a U-shaped recovery. Dems will sweep the election and unleash stimulus of roughly another 10% of GDP of deficits. As I talk about in this piece, Biden's fiscal policy does not seem so extreme on the surface. However, his policy is —my view—a negative dollar story. The core of Biden's plan is to tax households with the top 1% of income, and they would pay roughly 75% of the increase in tax revenue in his plan. The top 5% will pay 85%; the top 20% will pay 92% of the tax revenue increase. The problem is that the top 20% are the only ones who save. Accordingly, Biden's plan will result in lower savings as a country, and that means less money to fund domestic investment, declining capital stocks, and more reliance on foreigners to fund our increasing deficit. Throw in the negative dollar factor of foreign net FDI into the US goes the other way, and the dollar is headed lower. Over time, GDP falls along with the dollar.

Long Housing

The long housing trade has worked thus far to the extent that I closed the housing-related trade but I have kept the long housing trade overall. Still like this trade, particularly with the tailwinds to the housing sector from a Biden win and continuing Fed support for lower rates.

Long CDX protection

This is my most recent trade recommendation. The trade is up a little but still more to come in any equity self-off. The trade makes sense both on an absolute basis and a general portfolio hedge. Long CDX protection is extraordinarily cheap downside protection in the mid-50s bps. CDX protection is also a cheaper hedge to equity sell-offs than using equity puts/VIX. Also, you can add to risk trades using this as a hedge or just take a general view of an asymmetric trade given potential risk-off events.

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State Of the Markets: Overview

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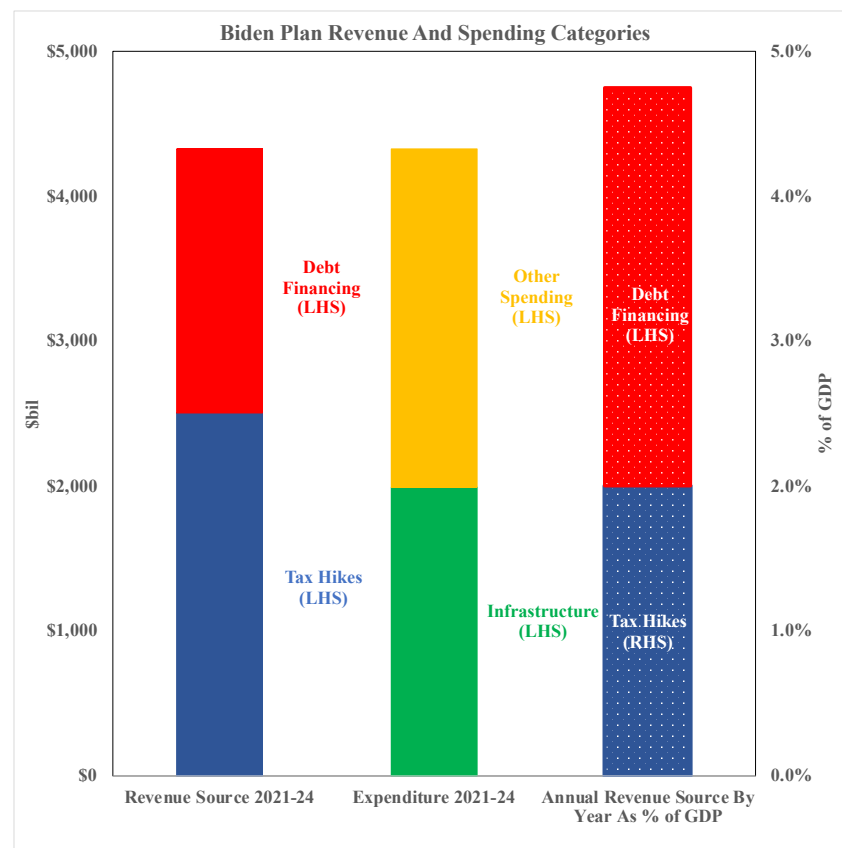
Step 1: Macro Theme

Biden's Fiscal And Tax Policy¹

Biden's Fiscal Policy: Break Down Of Spending And Tax Revenue

	2021-2024	2021-2030
Static budget deficit	-2506	-3171
Total tax revenues	1442	4099
Individual taxes	303	963
Payroll taxes	317	998
Corporate taxes	822	2139
Total government spending	3948	7270
Infrastructure	2338	2390
Transportation	872	900
"Made in America"	700	700
Clean energy	473	490
Other structures	293	300
Education	636	1906
Higher education	367	1007
K-12	160	600
Student loan debt relief	110	300
Social safety net	368	1499
Child and elderly care	257	1025
Social Security	63	329
Labor provisions	48	145
Healthcare	605	1475
Coverage expansion	688	1900
Rural health & opioid crisis	80	325
Programmatic feedback	-122	-350
Health reforms	-40	-400

Infrastructure Spending Financed By Debt And Taxes Dominate



1. Moddy's Analytics, "The Macroeconomic Consequences: Trump vs. Biden", September 23, 2020

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Step 2: Fundamental Economic Framework

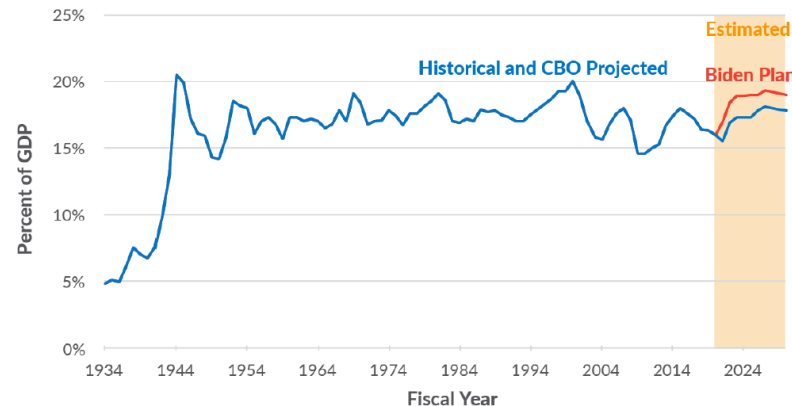
On The Surface, Biden's Fiscal Policy Does Not Appear To Be A Dramatic Shift In Taxes.¹

Changes In Tax Policy Only Pushes Revenue Back To Normal

Despite the Press, Increase In Taxes Is Not Close To Those Of WW 2

Biden's Tax Plan Would Return Federal Revenue Collections to 1998 Levels

Federal Revenue as a Percentage of GDP, 1934 to 2030



Tax Bill	Revenue Effect as a Percentage of GDP (First Fiscal Year)
Revenue Act of 1942	5.04%
Revenue Act of 1941	2.20%
Revenue and Expenditure Control Act of 1968	1.74%
Revenue Act of 1951	1.52%
<i>Biden's Tax Plan in year 2021</i>	<i>1.44%</i>
Revenue Act of 1950	1.33%
Current Tax Payment Act of 1943	1.16%
Tax Equity and Fiscal Responsibility Act of 1982	0.53%
Crude Oil Windfall Profit Tax Act of 1980	0.44%
Tax Reform Act of 1986	0.41%
Omnibus Budget Reconciliation Act of 1990	0.41%

1. Tax Foundation, "Placing Je Biden's Tax Increase in Historical Context" September 3, 2020

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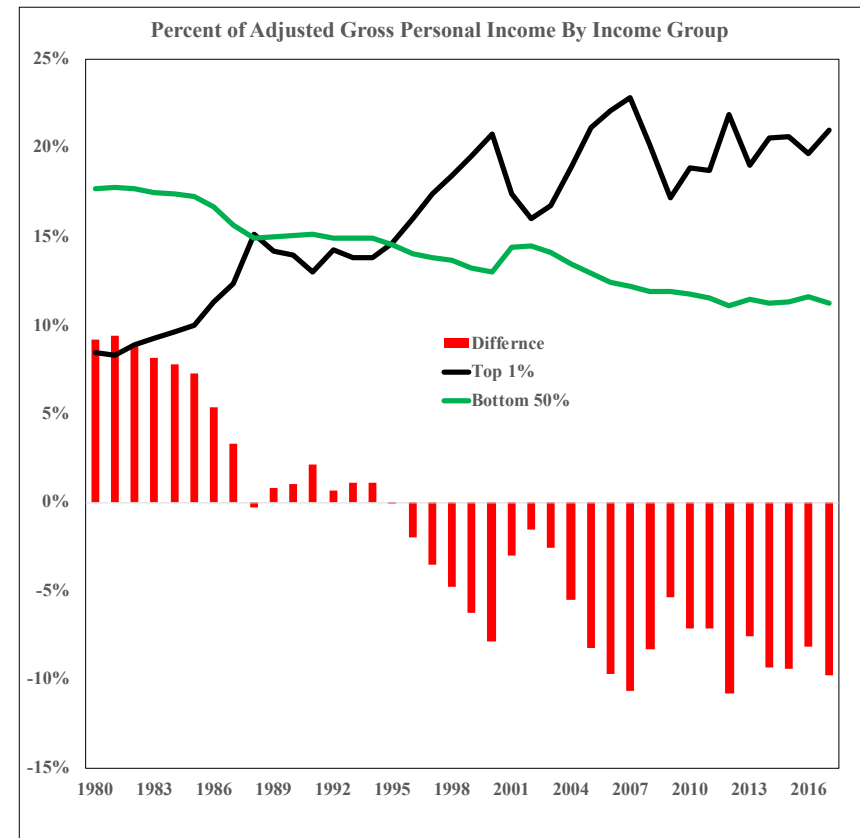
Step 2: Fundamental Economic Framework

However, It Is An Income Redistribution Policy As Almost All The Tax Revenue Comes From The 1%

The Top 1% Will Pay 74% of New Taxes¹

Goal Is To Turn Back The Clock 40 Years Not Just Trump Tax Cuts²

Income Distribution	Change		Average Tax Change	Share of Federal Income Tax	
	In After Tax Income	Share of Total Federal Tax Change		Change	New
Bottom 80'	0%	7%	4%	-3%	30%
80-99%	-4%	23%	6%	-3%	40%
Top 1%	-17%	74%	40%	6%	30%



1. Tax Policy Center, "An Analysis of Former Vice President Biden's Tax Proposals", March 5, 2020
 2. CBO, "The Distribution of Household Income, 2017", October 2020

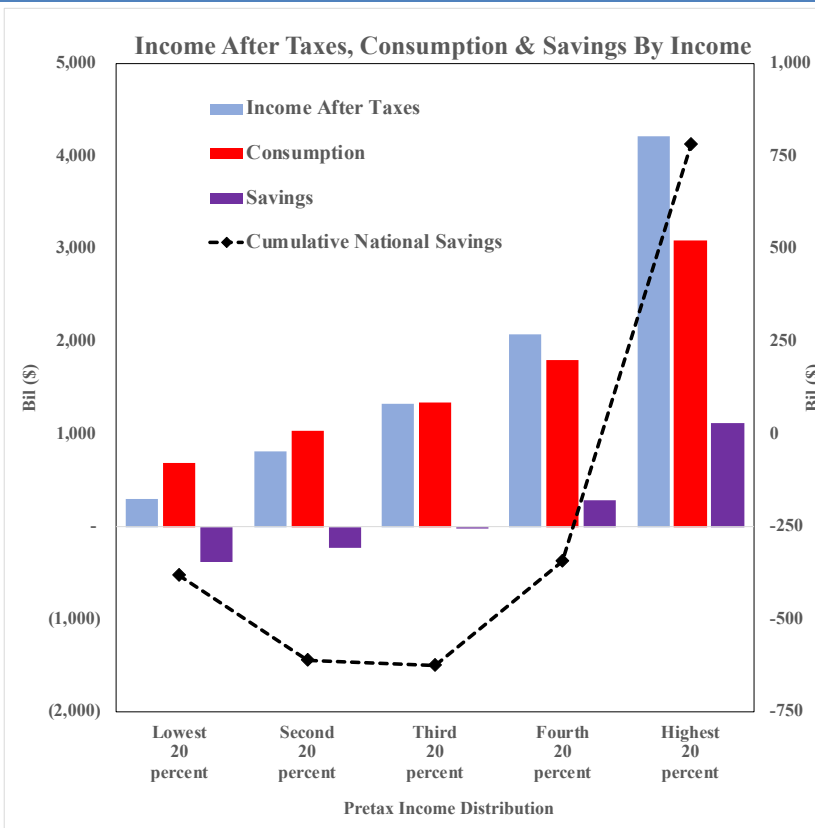
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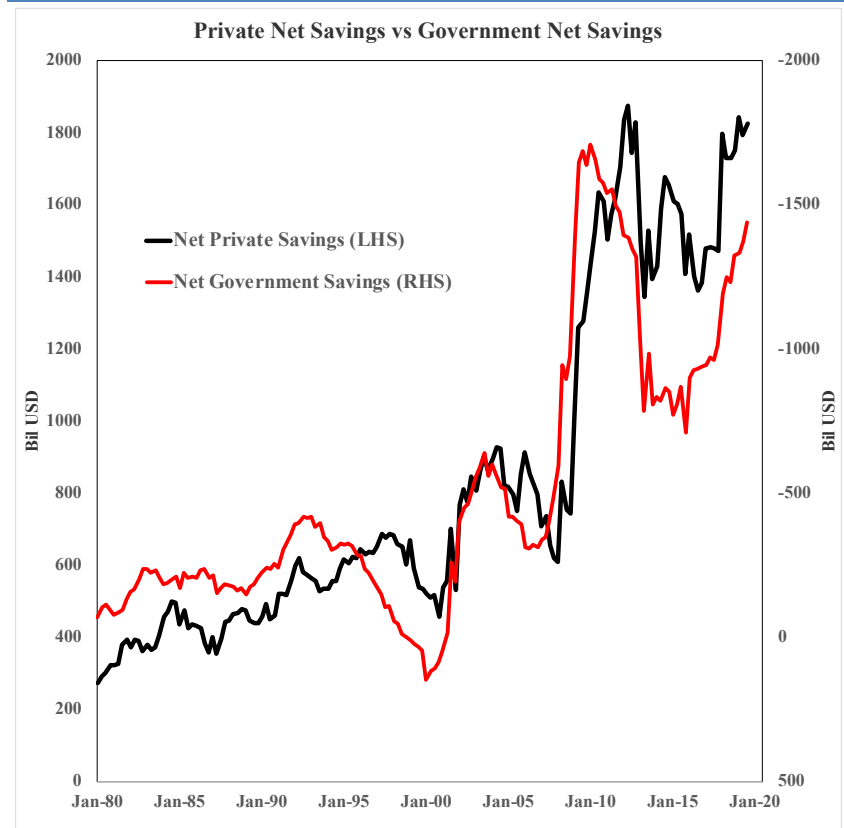
Step 3: Identify Potential Catalysts

The Problem Is National Savings Is Driven By Savings Of The Top Earners, Which Pays For The Deficits

National Savings Is Driven By The Top Earners...^{1,2}



And Savings Rises To Pay For the Deficit, But Many Not This Time^{3,4}



1. BEA
2. Author's calculations
3. BEA GDP Reports
4. Bloomberg

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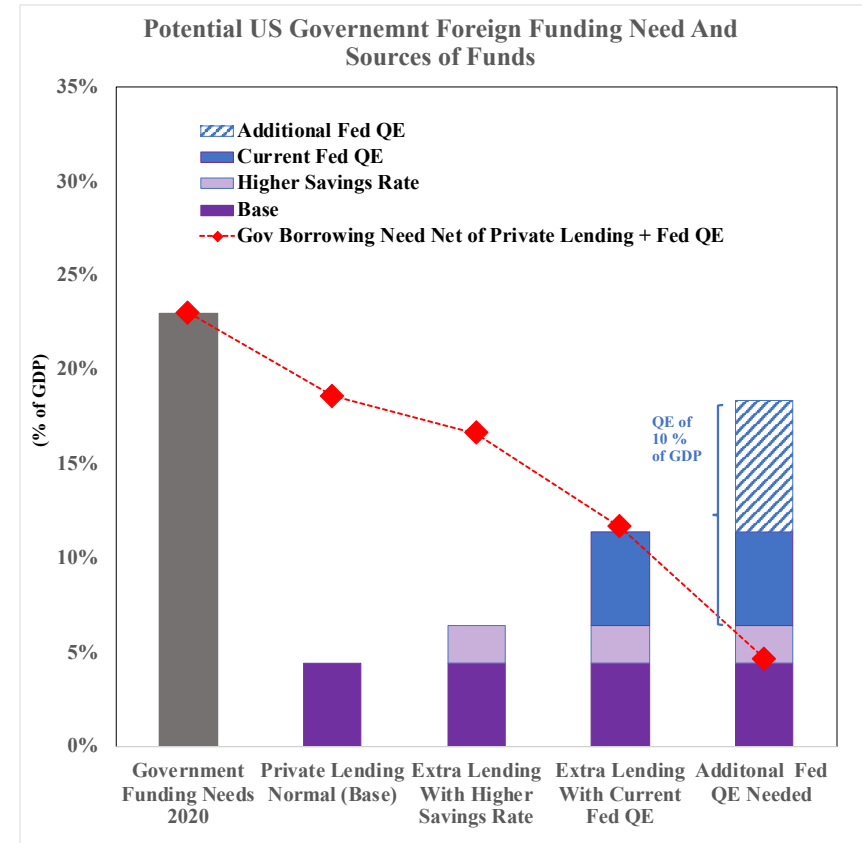
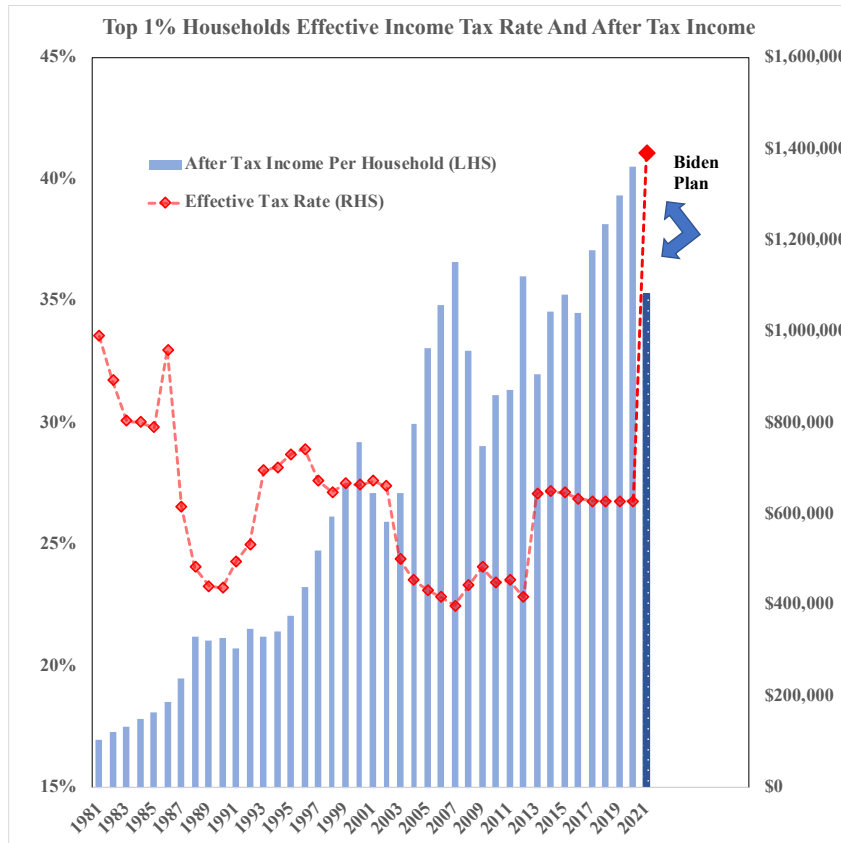
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Step 3: Identify Potential Catalysts

Savings Could Fall Under Biden, And That Could Force More Fed QE From Rising Deficits

Top 1% Will Face A Historically High Effective Tax Rate...^{1,2,4}

And That Could Reduce National Savings^{3,4}



1. Tax Policy Center, "An Analysis of Former Vice President Biden's Tax Proposals", March 5, 2020
2. CBO, "The Distribution of Household Income, 2017", October 2020
3. BEA
4. Author's calculations

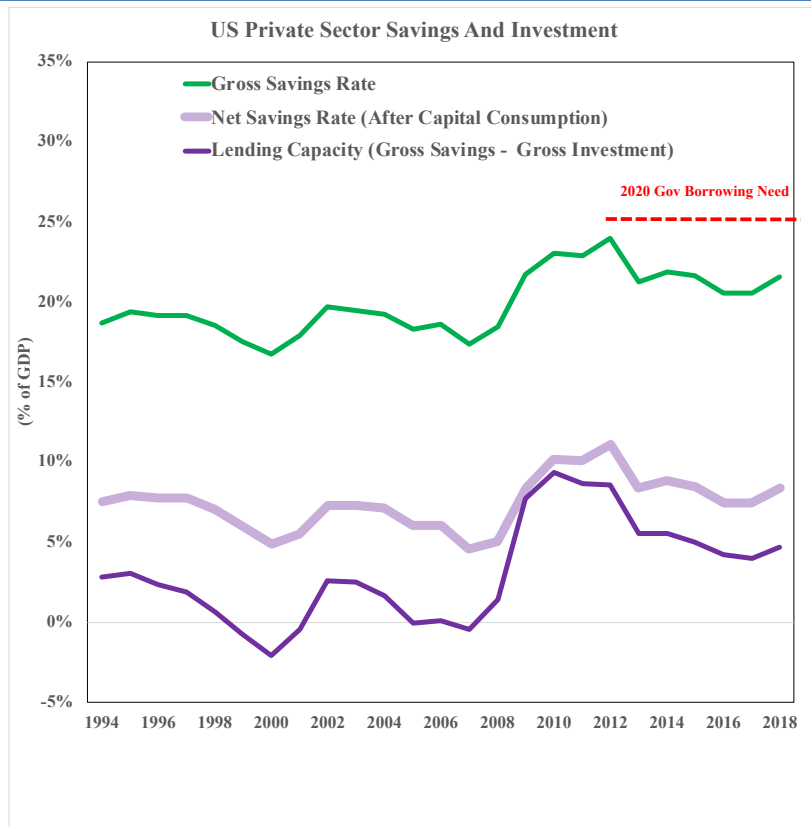
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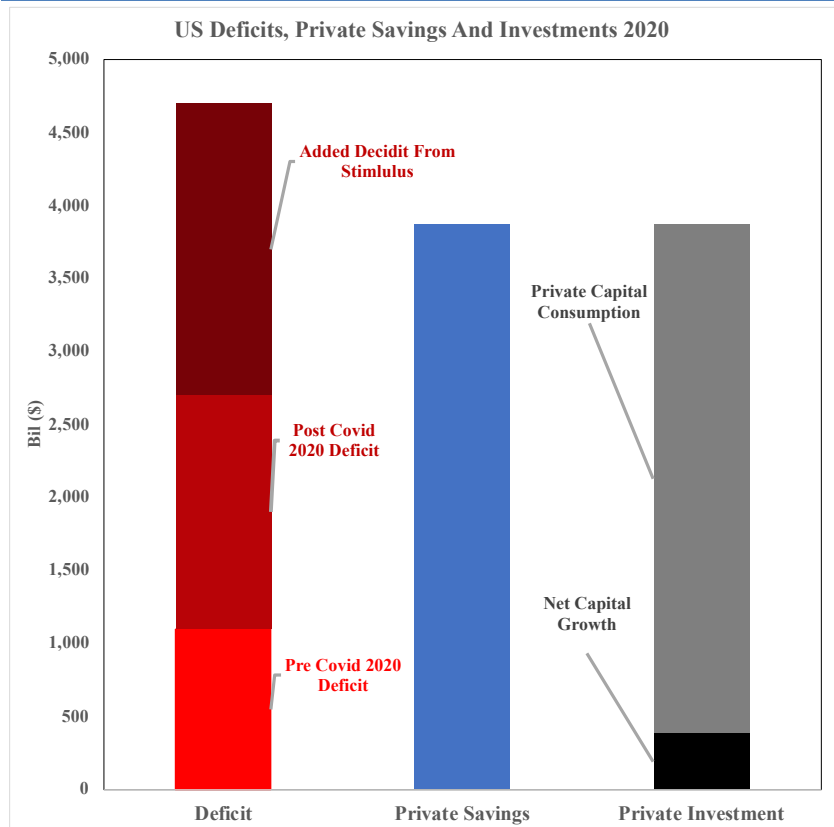
Step 3: Identify Potential Catalysts

Rising Deficit Funding With Falling Savings Could Also Reduce GDP As Net Investment Falls ^{1,2}

Federal Borrowing Will Swamp Domestic Private Lending Capacity



Substantial Increasing The Reliance On Foreign Capital



1. BEA
2. CBO Budget Projections

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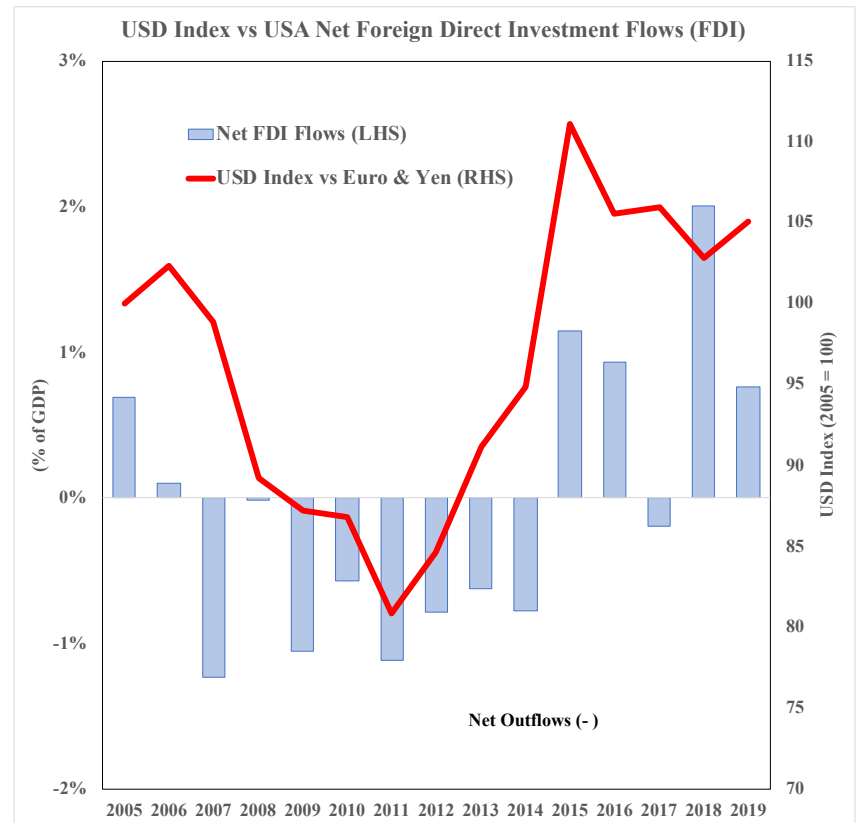
Step 3: Identify Potential Catalysts

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

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 Reversed²



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

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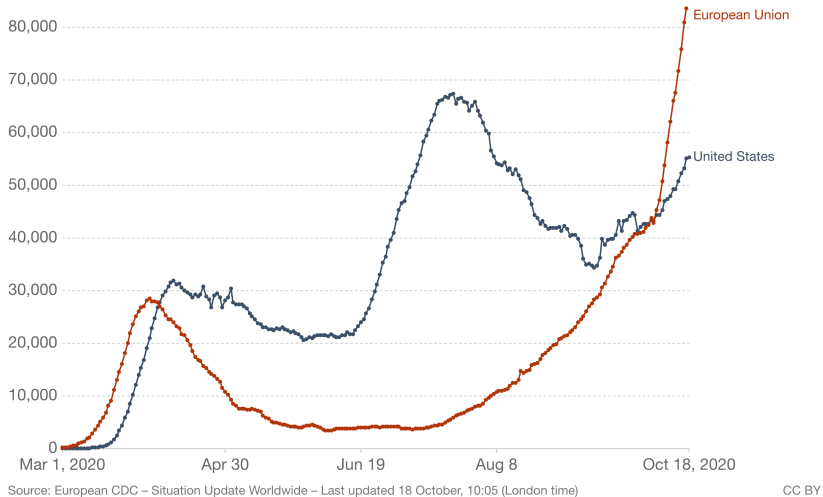
Step 3: Identify Potential Catalysts

Biden Policy Could Also Exacerbate A Slowing Economy From Another Lockdown As Covid Cases Rise

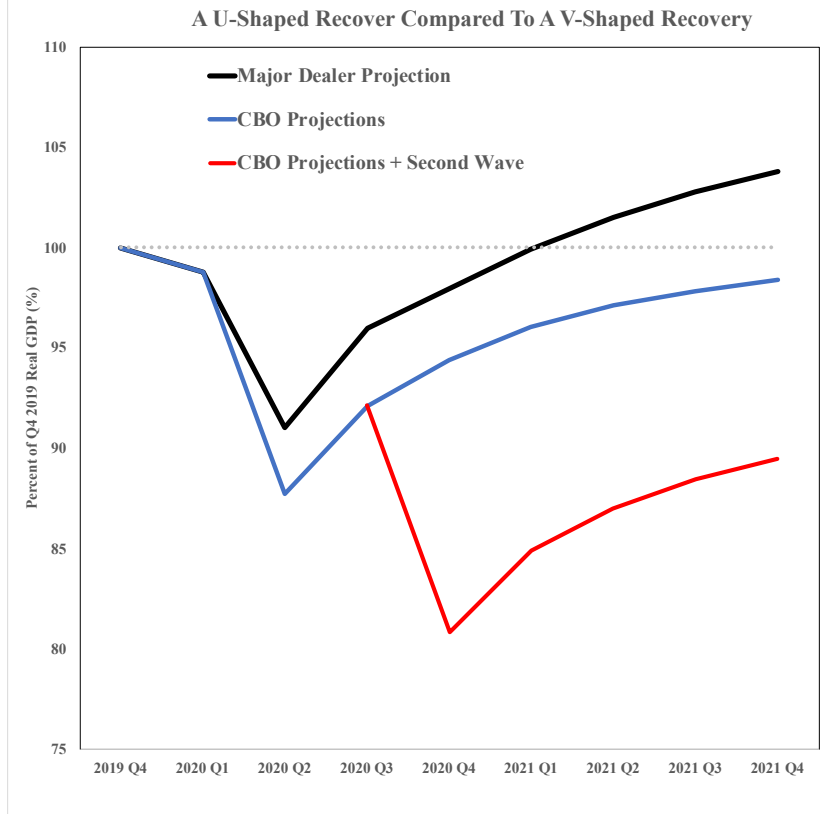
Covid Cases Are Rising In The US And Europe...¹

Daily new confirmed COVID-19 cases

Shown is the rolling 7-day average. The number of confirmed cases is lower than the number of actual cases; the main reason for that is limited testing.



That Could Lead To More Lockdowns and Slower Growth: The U²



1. Our World In Data
2. CBO Budget Projections 2020

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State Of the Markets: Current Trade Recommendations

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State Of the Markets: Opportunities In US Housing

- ***Step 1: Macro Theme: Opportunities In US Housing***
 - *Focus on housing delinquencies misses the power of the coming housing cycle*
 - Opportunity 1: Housing Starts Continue To Accelerate To Historical Highs To Make Up For Underbuilding
 - Opportunity 2: Mortgage Originations Could Surge If Ownership Rates Normalize To Higher Level
- ***Step 2: Fundamental Economic Framework***
 - The US has seen a decade of underbuilding of houses versus the growth in the US population
 - Housing prices and rental rates are rising, and vacancies are falling reflect this supply/demand imbalance
 - Tighter mortgage underwriting standards since the GFC
 - Tighter standards has potentially gone too far
 - Historical lows in homeownership
 - Pushed mortgage risk to the rental markets putting pressure on low income households
 - Reduced access to homeownership to younger adults and minorities creating a barrier to wealth creation
- ***Step 3: Identify Potential Catalysts***
 - Catalysts for more home building: increasing demand for housing and pushes prices higher
 - Demographic driven demand
 - De-urbanization driven demand
 - Low mortgage rates driven demand
 - Catalyst for growth in home ownership and mortgage originations: Dodd-Frank reform
 - Dodd-Frank has pushed banks and the GSEs to tighten mortgage underwriting reflecting the loss rates in the "Severe Adverse Scenario"
 - Dodd-Frank rules on qualified mortgages (QM) and the lack of litigation projection for underwriters has shut down non-prime mortgage originations
- ***Step 4: Find Asymmetric Trades***
 - Trade 1: Buy home builders, housing related and "For Rent" equities
 - Trade 2: Buy GSEs, mortgage insurers, and mortgage bankers/selected REITs

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State Of the Markets: Opportunities In US Housing

Step 4: Identify Asymmetric Trades

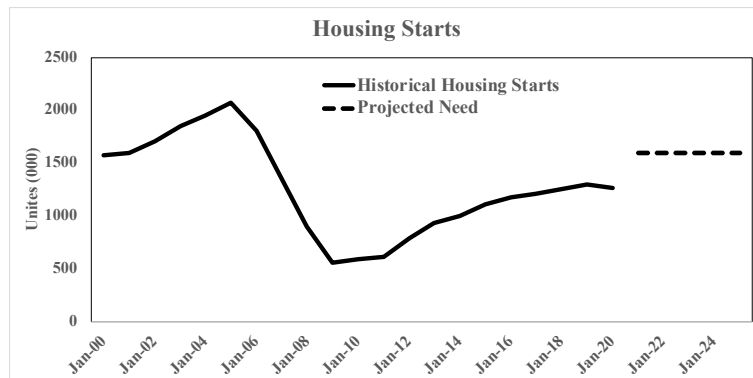
Trade 1: Buy Home Builders, Housing Related And “For-Rent” Equities

Trade Thesis

- Housing prices will continue to rise driving higher home asset values and rent rates from building and existing portfolios
- Prices and rental rates will continue to rise even in a stress economy reflecting the rising demographic driven demand and ten years of underbuilding
- Value of land banks of home builders will rise with higher housing prices, while “For Rent” companies underlying home assets will rise along with rental income

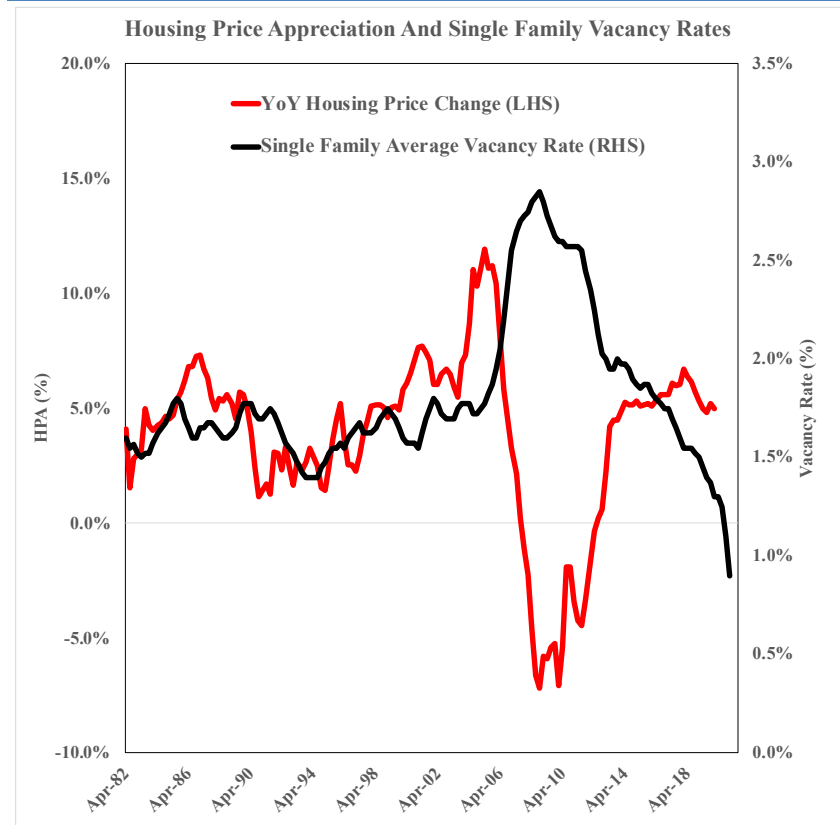
Risk is economy does not recover

Even With The Recent Spike, Starts Sill Below Needed Levels¹



1. Freddie Mac Projections
2. Federal Reserve Bank of St. Louis, Fred Data Base

Declining Vacancies Supports Rising Housing Prices And Rent Rates²



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State Of the Markets: Opportunities In US Housing

Step 4: Identify Asymmetric Trades

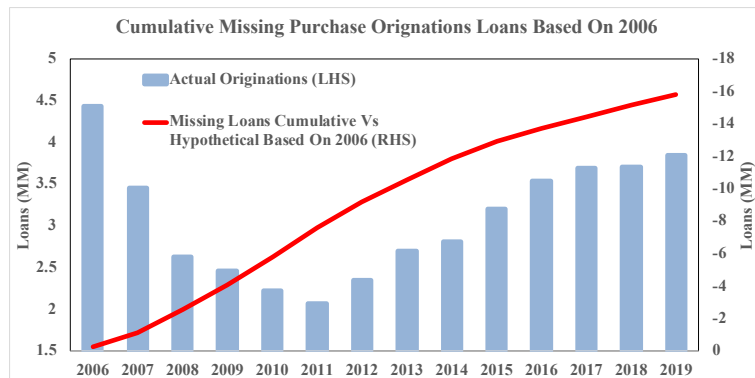
Trade 2: Buy GSEs, Mortgage Insurers, And Mortgage Bankers/Selected REITs

Trade Thesis

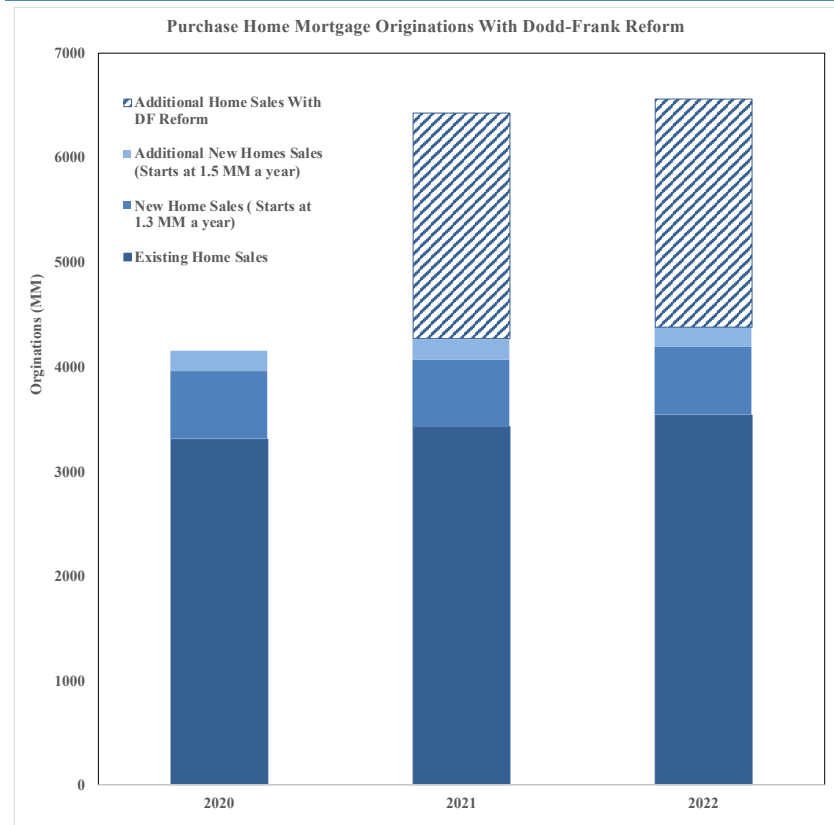
- Dodd-Frank reform unleashes another home ownership surge
- Reform could be driven by many factors
 - Support low income housing and minority access to homeownership
 - Response to the barriers for first time ownership of a sizable cohort of the US population
 - Reduce the pressure from rising housing prices on affordability from too little building
- Housing starts rise to historical levels as mortgage financing relaxes
 - Starts need to accelerate to offset the historical underbuilding
- Think the 2003-6 housing boom

Risk is nothing gets done to loosen lending standards

Mortgage Originations/Revenue During Last 10-yrs Artificially Low¹



Return To Normal Home Ownership Means A Mortgage Revenue Boom²



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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

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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

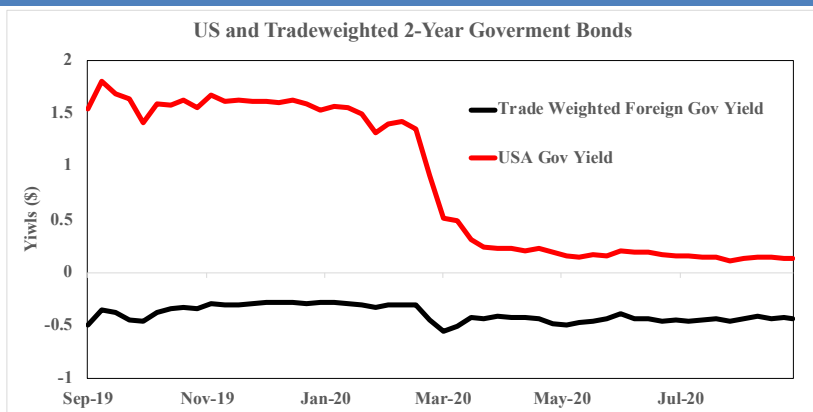
Trade Thesis

Buy December 30 delta puts

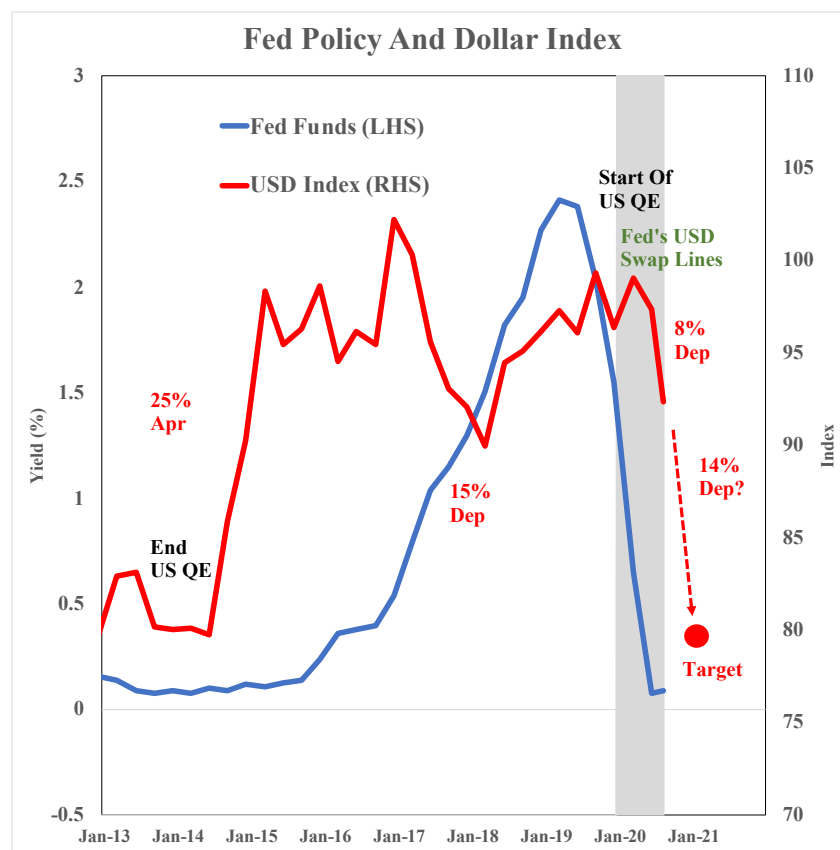
- The dollar depreciation cycle is just beginning
- US could still follow a U- if not a W-shaped recover
 - This would push the Fed to substantially increase QE
- Democrats could sweep the November elections and raise US corporate tax rates
- The rise of the Euro
- The rise of the Yen

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



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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

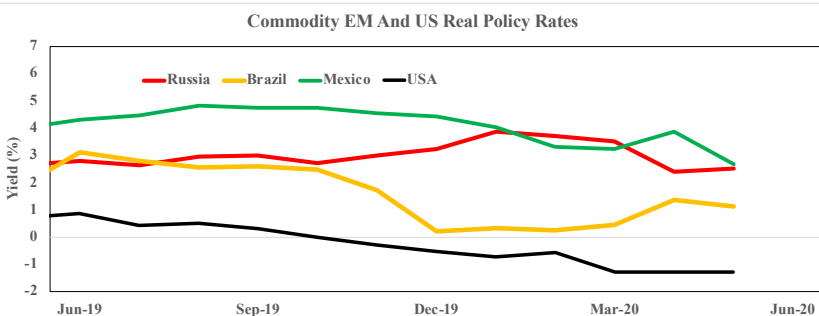
Trade Thesis

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}

YTD Performances Of Commodity FX vs USD
(Shaded Lines Are Members Of The Index)



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

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

Step 4: Identify Asymmetric Trades

Trade 3: Buy Gold Or Gold Miners Equities

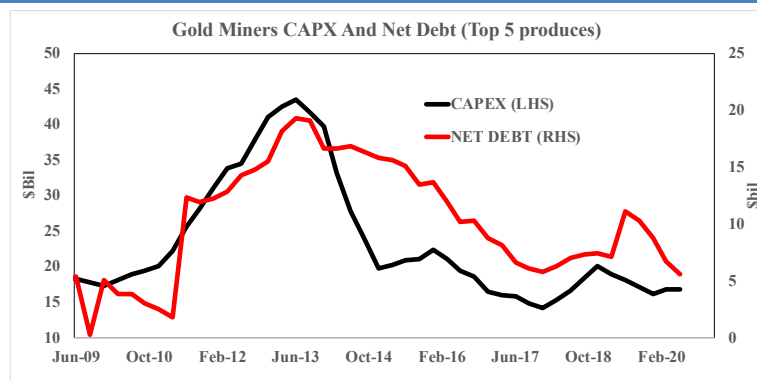
Trade Thesis

Buy an equity basket of gold miners

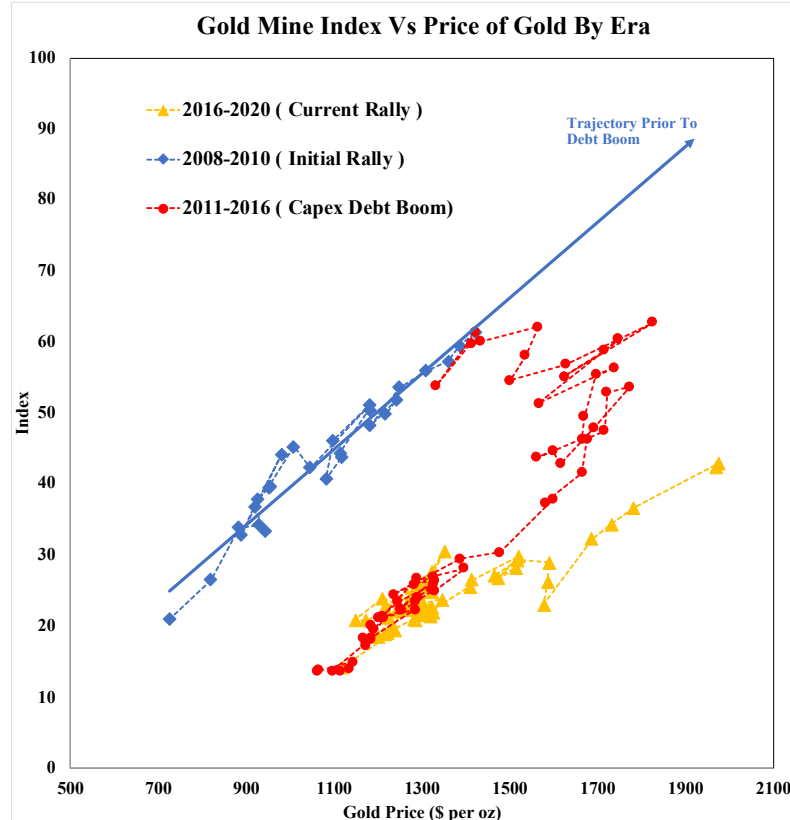
- Gold could be the best long versus other currencies while gold miners provide significant convexity to the upside vs buying gold outright
- Miners are trading at large discounts versus historical levels reflecting concerns about another debt fueled Capex wave as occurred in 2011-16
- Miners are showing 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



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



1. Bloomberg
2. Author's calculations

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State Of the Markets: Buy IG CDX Protection--Credit Is Rich

- ***Step 1: Buy IG CDX Protection—Credit is Rich***
 - Credit has tightened and followed the equity rally and returned to pre-COVID levels
- ***Step 2: Fundamental Economic Framework***
 - Credit is rich because spreads have tightened even though risks are still near their peaks
 - Leverage and implied volatility are still near March levels
 - A simple "Merton" model is a powerful tool for analyzing corporate capital structure and credit spreads
 - Merton model has captured the movement of corporate leverage through time
 - Merton models credit spreads as the value of the short position of a put option owned by equity owners
 - As with any option, the models needs two key inputs: the Strike (leverage) and Implied Volatility
 - Based on this model, CDX is rich because spreads are now at pre-COVID levels but should be near wides
 - Five year probably of default is still elevated given that leverage and implied vol are still near March levels
 - Prior to 2020, the model captured historical relationship between this probability and spreads
 - Now predicted spreads are almost 50 bp wider than actual CDX spreads (after the roll)
- ***Step 3: Identify Potential Catalysts***
 - Any risk-off event would drive spreads wider
 - Escalation of China/US economic war
 - Presidential election uncertainty
 - A second COVID wave
 - A U- or W-shaped economic recovery
- ***Step 4: Find Asymmetric Trades***
 - Trade: Buy IG CDX protection

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State Of the Markets: Buy IG CDX Protection--Credit Is Rich

Step 4: Identify Asymmetric Trades

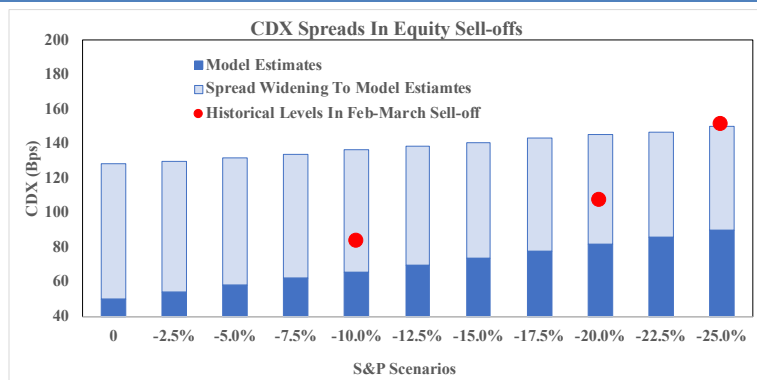
Buy CDX Protection—Cheap Downside Protection Vs Equity Puts^{1,2}

Trade Thesis

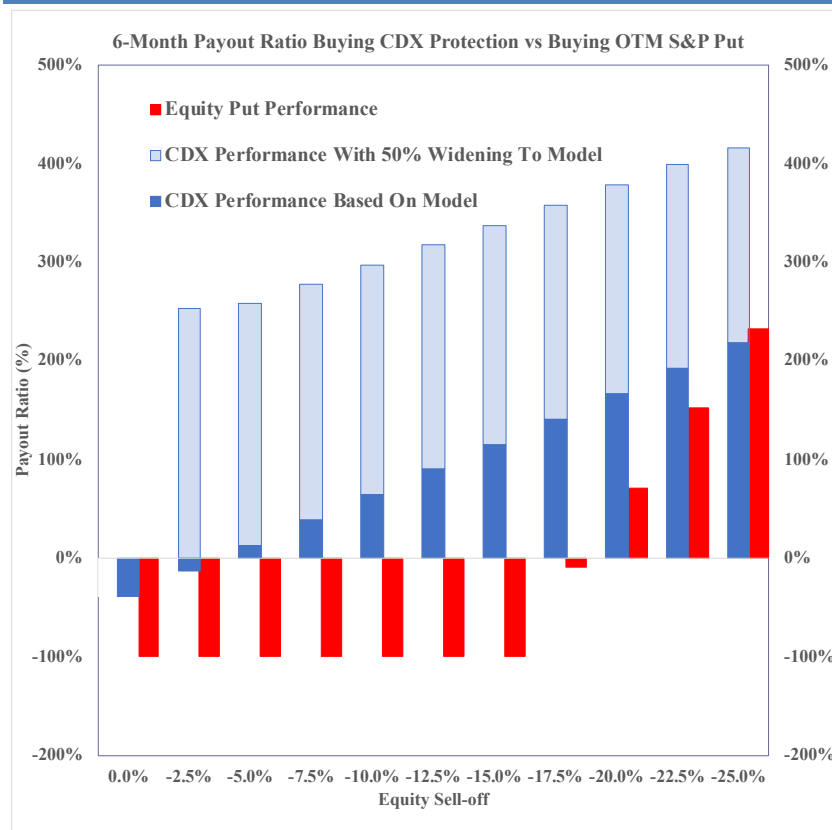
- CDX offers cheap downside protection vs equity puts
- Upside of CDX protection is even greater if spreads widen closer to model projections
- CDX protection outperforms equity puts because CDX spreads do not reflect the higher implied volatility levels of equity puts

Risks are that CDX continues to tighten

Assumed CDX Spread Movements In An Equity Sell-off



CDX Wins The Horse Race vs Equity Puts In Another Risk-off Event



1. Bloomberg
2. Author's calculations, assumes CDX tightens by 10 bp over six months

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